

Brooklyn Law School

From the Selected Works of David J Reiss

2010

Fannie Mae and Freddie Mac: Creatures of Regulatory Privilege

David J Reiss, *Brooklyn Law School*



Available at: https://works.bepress.com/david_reiss/38/



**Brooklyn Law School Legal Studies
Research Papers
Accepted Paper Series**

Research Paper No. 181 January 2010

**Fannie Mae and Freddie Mac:
Creatures of Regulatory Privilege**

David Reiss

This paper can be downloaded without charge from the
Social Science Research Network Electronic Paper Collection:
<http://ssrn.com/abstract=1547317>

David Reiss

**Fannie Mae and Freddie Mac:
Creatures of Regulatory Privilege¹**

As part of its response to the ongoing credit crisis, the federal government placed Fannie Mae and Freddie Mac, the government-chartered, privately owned mortgage finance companies, in conservatorship. These two massive companies are profit-driven, but as government-sponsored enterprises (“GSEs”) they also have a government-mandated mission to provide liquidity and stability to the United States mortgage market and to achieve certain affordable housing goals. How the two companies should exit their conservatorship is of key importance to the future of federal housing finance policy. Indeed, this question is of pressing importance as the Obama Administration has signaled that it would rely heavily on Fannie and Freddie as part of the short term response to the foreclosure epidemic that has swept across America in the last couple of years. Once the acute crisis is dealt with, however, the Administration will need to put American housing finance policy on the right track for the long-term health of the system. This will require a framework for analyzing the needs of that system, a framework which this chapter provides.

Fannie and Freddie are extraordinarily large companies: together, they own or guarantee more than forty percent of all the residential mortgages in the United States. This amounts to over 5.4 trillion dollars in mortgages. By statute, Fannie and Freddie’s operations are limited to the “conforming” portion of the mortgage market, which is made up of mortgages that do not exceed an annually adjusted threshold (\$417,000 in 2009 and significantly higher in high-cost areas). The two companies effectively have no competition in the conforming sector of the mortgage market because of advantages granted to them by the federal government in their charters. The most significant of these advantages has been the federal government’s implied guarantee of Fannie and Freddie’s debt obligations. The implied guarantee allowed Fannie and Freddie to borrow funds

¹ This chapter is based in large part on *Fannie Mae and Freddie Mac and the Future of Federal Housing Finance Policy: A Study of Regulatory Privilege*, 61 ALA. L. REV. xxx(forthcoming 2010).

more cheaply than its fully-private competitors and thereby offer the most attractive pricing in the conforming market. As the two companies have grown and grown, numerous commentators and government officials called for their reform. Fannie and Freddie's powerful lobbying forces, however, have kept these reformers mostly at bay until they entered conservatorship.

As a result, Fannie and Freddie continued to grow at a rapid rate through the early 2000s, until they were each hit by accounting scandals. In response to those scandals, Congress and the two companies' regulators began to take various steps to limit their growth. But once they stabilized in 2007, the current credit crisis commenced and their market share began to increase once again as other lenders could not raise capital to lend to borrowers. At first, many commentators believed that Fannie and Freddie would ride the crisis relatively unscathed, but it turned out that they had much more exposure to the problems in the toxic subprime and Alt-A portions of the mortgage market than they had let on in their public disclosures.

Because of their poor underwriting, the two companies started posting quarterly losses in 2007 that ran into the billions of dollars, with larger losses on the horizon. As a result, they were having trouble complying with the capital requirements set by their regulator. Their problems began to spiral out of the control along with those of the rest of the financial sector until then-Secretary of the Treasury Henry M. Paulson, Jr. asked that Congress give the Treasury the authority to take over the two companies if they were not able to meet their financial obligations. Congress, with remarkable alacrity, passed the Housing and Economic Recovery Act of 2008 (the "Act") in the summer of 2008. Soon thereafter Paulson decided that the two companies were flirting with insolvency and placed them in conservatorship, pursuant to the Act.

While the American taxpayer will likely be required to fund a bailout of the two companies that will be measured in the hundreds of billions of dollars, the current state of affairs presents an opportunity to reform the two companies and the manner in which the mortgage market is structured. Though the need for reform is evident, few scholars have considered the issue systematically. Scholars have, however, built up a significant base

of knowledge about what works well and what does not work well with public/private hybrids like Fannie and Freddie.

Contemporary theories of regulation persuasively argue that special interests work to bend the tools of government to benefit themselves. This chapter, relying on regulatory theory, provides a framework with which to conceptualize the possibilities for reform by viewing Fannie and Freddie as creatures of regulatory privilege. A critical insight of regulatory theory is that regulatory privilege should be presumed to be inconsistent with a competitive market, unless proven otherwise. The federal government's special treatment of Fannie and Freddie is an extraordinary regulatory privilege in terms of its absolute value, its impact on its competitors and its cost to the federal government. As such, regulatory theory offers a fruitful resource for academics and policymakers considering reform of Fannie and Freddie's privileged status because it clarifies how Fannie and Freddie have relied upon their hybrid public/private structure to obtain and protect economic rents at the expense of homeowners as well as Fannie and Freddie's competitors.

Once analyzed in the context of regulatory theory, Fannie and Freddie's future seems clear. They should be privatized so that they can compete on an even playing field with other financial institutions and their public functions should be assumed by government actors. While this is a radical solution and one that would have been considered politically naïve until the current credit crisis, it is now a serious option that should garner additional attention once its rationale is set forth.

In an earlier study, I provided a comprehensive analysis of the regulatory privilege that Fannie and Freddie enjoy.² This chapter builds on that work to situate that privilege within a broader understanding of regulatory theory and to explain the rare hybrid public/private nature of the privilege that Fannie and Freddie enjoy. In doing so, this chapter argues that the existing regulation of the two companies should be brought in line with our current understanding of how government should be deploying its power in the private sector.

² Reiss. (2008).

This chapter proceeds as follows. Part I will describe Fannie and Freddie's role in the secondary market for residential mortgages. After describing what happened to the two companies in the credit crisis that commenced in 2007, it will outline the key provisions of the Housing and Economic Recovery Act of 2008, which authorized the federal government to place the Fannie and Freddie in conservatorship.

Part II then shifts to construct a theoretical framework with which to evaluate Fannie and Freddie. Part II.A presents Fannie and Freddie's assessment of their own roles in the secondary residential mortgage market. Part II.B reviews how other scholars have conceptualized the role of Fannie and Freddie in the housing finance market. Part II.C then evaluates the operation of Fannie and Freddie in the context of six policy goals that derive from contemporary regulatory theory: (i) maintaining competition; (ii) efficiently allocating society's goods and services; (iii) promoting innovation; (iv) preventing inappropriate wealth transfers; (v) preserving consumer choice; and (vi) preventing an overly-concentrated economy. It finds that Fannie and Freddie come up short under nearly all of those goals.

Based on the conclusion of Part II that Fannie and Freddie no longer have a net positive impact, Part III argues that the two companies should be privatized. It also argues that the benefits that Fannie and Freddie produce in the residential mortgage market should be maintained through alternative means, including financial regulation, consumer protection legislation and increased subsidies for affordable housing.

I. Fannie and Freddie and the Credit Crisis

This Part begins by explaining what Fannie and Freddie do in the mortgage markets. It then describes how they fared in the credit crisis that commenced in 2007. This brief history opens with the early phase of the credit crisis in which the two companies were perceived as potential white knights, mounting a defense of the distressed secondary mortgage market. It then details their own troubles that led to the enactment of the Housing and Recovery Act of 2008. It concludes with the government placing them in conservatorship as the financial condition of the two companies rapidly disintegrated.

A. Fannie and Freddie's Business

Fannie and Freddie have two primary lines of business. First, they provide credit guarantees so that groups of residential mortgages can be packaged as residential mortgage-backed securities (RMBS). Second, Fannie and Freddie purchase residential mortgages and related securities with borrowed funds. Because of the federal government's implied guarantee of their debt securities, 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.

Fannie and Freddie's charters restrict the mortgages they may buy. 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 and may not buy mortgages with principal amounts greater than an amount set each year. Loans that Fannie and Freddie can buy are known as "conforming" loans. Loans that exceed the loan amount limit in a given year are known as "jumbo" loans. Most of the remainder of the RMBS market belongs to "private label" firms which securitize (i) jumbo mortgages and (ii) subprime mortgages that Fannie and Freddie cannot or choose not to guarantee or purchase for their own portfolio.

Because Fannie and Freddie have so dominated the conforming sector of the mortgage market, they have standardized that sector by promulgating buying guidelines that lenders must follow if they want to sell their mortgages to either of the two companies. Such standardization has led to increases in the liquidity and attractiveness of mortgages as investments to a broad array of investors.

The government guarantee of Fannie and Freddie's debt obligations is a regulatory privilege that arose from Congress' efforts to create a national secondary residential mortgage market in the 1960s and 1970s. It is the characteristic that allows them to borrow more cheaply than other financial institutions. It is the characteristic that allows them to completely dominate the prime conforming mortgage market. And it is the characteristic that poses the greatest threat to the federal government and the American

taxpayer. One must therefore properly account for it in order to understand Fannie and Freddie.

Unlike true monopolists, Fannie and Freddie's market power is limited by the nature of their competitive advantage: in an otherwise efficient market, the maximum amount that they can retain as economic rent is the spread between the interest rates they must pay and those that their competitors must pay. Nonetheless, Fannie and Freddie share a key characteristic in common with government-granted monopolies: a legally-created and overwhelming competitive advantage in a particular market, which translates into higher prices for consumers than would exist if Fannie and Freddie did not retain a portion of their economic rent for themselves.

Because of their government guarantee, Fannie and Freddie were thought to be well situated when the current credit crisis commenced. As other lenders began to fail and the secondary market for subprime mortgages dried up in 2007, a Citigroup report suggested that Fannie and Freddie could easily ride out the turmoil in the mortgage markets.³ Even more, some commentators were arguing that Fannie and Freddie would be able to bail out other mortgage market players by buying additional mortgages. At the same time, however, some were raising the alarm that Fannie and Freddie could face some of the same problems that other mortgage lenders had been facing. But this view was overtaken in 2007 by the more dominant one which saw Fannie and Freddie as saviors of the mortgage markets.

This was a happy development for Fannie and Freddie because it meant that the terms of the debate regarding their appropriate role in the mortgage markets went from one in which the Executive Branch was beating the drums to limit their growth to one in which politicians and mortgage executives were calling for their role to be significantly expanded. Fannie and Freddie quickly tried to capitalize on this change in their political fortunes, advocating for an increased role in the crisis. At the earliest stage of the credit crisis, the Bush Administration continued to oppose an expansion of Fannie and Freddie's roles. As the crisis progressed, the regulator of the two companies began to

³ Hagerty. (2007, July 28).

signal that they were considering some expansions in Fannie and Freddie's role. The Federal Reserve, which had also been calling for limitations on Fannie and Freddie before the credit crisis struck, also began to publicly consider a greater role for the two firms.

B. The Crisis Deepens

As Fannie and Freddie's political star began to appear ascendant, troubling accounts of possible losses started to appear: their underwriting models had been too optimistic and had not accounted for the possibility of severe reductions in housing prices across the nation. These fears were confirmed soon thereafter, as Fannie and Freddie began to report very large losses. These losses meant that Fannie and Freddie did not have the capital to expand their role in the mortgage markets and that their political star began its fall once again. The large losses led both companies to seek infusions of fresh capital. By this point, the federal government was now concerned both with Fannie and Freddie's viability as well as with the health of the overall market. Nonetheless, the federal government was running out of policy responses to the credit crisis and Fannie and Freddie were seen as some of the few remaining possible agents that could execute federal policy.

By the beginning of 2008, the Bush Administration and Congress were seriously considering various initiatives to create more funding for mortgages, a number of which were implemented. As part of the Economic Stimulus Act of 2008, enacted in February 2008, Fannie and Freddie were temporarily allowed to buy or guarantee mortgages with principal amounts as high as \$729,750 in order to restore liquidity to at least a portion of the jumbo sector. Fannie and Freddie's safety and soundness regulator, the Office of Federal Housing Enterprise Oversight ("OFHEO"), also lifted Fannie and Freddie's portfolio accounts caps and repeatedly lowered capital requirements in order to help respond to the housing slump and expand the supply of credit for mortgages.

These steps seemed to have had the intended effect of increasing the supply of credit available for mortgages. Some commentators, however, were still warning that Fannie and Freddie continued to be heavily exposed to losses resulting from the housing

slump that they were supposed to be alleviating. The market also began to worry about Fannie and Freddie's solvency, as the yields on their debt widened by 30 basis points to trade at a historically high 40 basis points above LIBOR in mid-March. By May, more and more parties were concerned about the solvency of the two companies and Congress and the Bush Administration were seriously negotiating an overhaul of Fannie and Freddie's safety and soundness regulator, OFHEO, to increase its ability to oversee and regulate the two companies.

By mid-July, the market's serious concerns about Fannie and Freddie's viability were reflected in their stock prices, which were at their lowest levels in more than 16 years. The federal government, on the heels of the Bear Stearns bailout, took decisive action to prevent another acute crisis in the financial markets. The Treasury Department announced that it was seeking broad authority from Congress to support Fannie and Freddie through acquisition of its debt and equity securities. At the same time, the Federal Reserve announced that it was authorizing emergency lending to the two companies on the same terms that it has historically lent to its regulated banks and, since the Bear Stearns bailout, to primary dealers. The Bush Administration kept up the pressure to move the bailout plan forward, even in the face of Republican hostility in Congress based on opposition to a taxpayer bailout of the two entities. The bailout plan was enacted as part of the Housing and Economic Recovery Act of 2008. While this gave confidence that debt-holders would be bailed out in the case of insolvency, shareholders could not feel the same way, particularly since Fannie and Freddie's massive portfolios were still in trouble. It also did not offer much hope to those who had hoped that Fannie and Freddie would continue to support the housing market.

C. Congress Responds: The Housing and Economic Recovery Act of 2008

The Housing and Economic Recovery Act of 2008 (the "Act") was one of the major legislative responses to the credit crisis that had begun in 2007. Among other things, the Act revamped the regulatory oversight for Fannie and Freddie and provided the Treasury with the authority to bail out Fannie and/or Freddie if they faced insolvency. 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. OFHEO had limited power over Fannie and Freddie to establish capital standards; conduct financial examinations; determine capital levels; and appoint conservators.

Two provisions of the Act are most relevant here: (1) one that strengthens Fannie and Freddie's financial safety and soundness regulation and (2) one that temporarily increases government support for the two companies.

1. Improved Financial Safety and Soundness Regulation

The Act replaces OFHEO with a new independent Federal Housing Finance Agency (the "Agency"). The Agency has general regulatory authority over the two companies and the Federal Home Loan Banks. The Agency's role mirrors that of OFHEO, but grants it significantly more power to regulate financial safety and soundness issues. The Agency is intended to be a top notch financial regulator along the lines of Federal Deposit Insurance Corporation.

The Agency is run by a Director appointed by the President, with the advice and consent of the Senate. The Director's mandate is to ensure that both entities operate with sufficient capital and internal controls, with a mind towards the public interest, such that Fannie and Freddie accomplish their purpose of providing liquidity to the mortgage markets. The Director is assisted in his duties by the Federal Housing Finance Oversight Board, which advises the Director about strategies and policies. In addition to the Director, the Board includes the Secretary of the Treasury, the Secretary of Housing and Urban Development and the Chairman of the Securities and Exchange Commission.

The Act addresses the possible actions to be taken by the Agency should Fannie and/or Freddie become undercapitalized, significantly undercapitalized or critically undercapitalized. An undercapitalized entity falls under greater monitoring and restriction of activities. A significantly undercapitalized entity may have its board replaced and/or executive officers fired. This is also grounds to withhold executive bonuses. A critically undercapitalized entity may have the Agency named as conservator or receiver.

2. Temporary Government Support

The Act temporarily authorizes the Secretary of the Treasury to make unlimited equity and debt investments in Fannie and Freddie securities. This appears to be the first time that the Treasury has been authorized to invest in the equity of privately held companies. This will only be done by mutual agreement between the relevant GSE and the Secretary of the Treasury. In order to purchase obligations, an emergency determination must be made by the Secretary of the Treasury. This determination must address whether such actions are necessary to provide stability to the financial markets, prevent disruptions in the availability of mortgage finance and protect the taxpayer.

The Director must consult with, and consider the views of, the Chairman of the Board of Governors of the Federal Reserve System, with respect to the risks posed by the regulated entities to the financial system, prior to issuing any proposed or final regulations, orders and guidelines with respect to the exercise of the additional authority provided in the Act regarding prudential management and operations standards; safe and sound operations of; and capital requirements and portfolio standards applicable to, Fannie and Freddie.

In addition to the two provisions discussed above, the Act has two more that are of some importance to this discussion. These two provisions relate to how the two firms seek to expand their market share and how they engage in political horse-trading to achieve their ends, which topics relate to the argument in favor of privatization set forth in Part III below. The first provision provides funding for affordable housing through an assessment on Fannie and Freddie. The second provision increases the conforming loan limits. This increase expanded the companies' market and increases the availability of mortgage credit during the crisis.

The Act requires that Fannie and Freddie “set aside an amount equal to 4.2 basis points for each dollar of unpaid principal balance of its total new business purchases.”⁴ When the Act was passed, it was generally agreed that this provision would raise upwards of \$500 million each year for affordable housing initiatives.

⁴ 12 U.S.C. §1337.

The Act also raises the conforming loan limits in some areas. Such limits shall be increased in areas for which 115 percent of the median house price exceeds the conforming loan limits, to the lesser of 150 percent of such loan limit or the amount that is equal to 115 percent of the median house price in such area.

D. Fannie and Freddie Enter Conservatorship

Within days of the passage of the Housing and Economic Recovery Act of 2008, Fannie and Freddie faced demands to raise more capital, pressures that they would not be able to meet. Within a few weeks, the markets were expecting the federal government to bail out the two companies. And within a couple of months, Paulson announced that he was placing the two companies in conservatorship because they were not able to raise the capital they needed to continue operating. Throughout the credit crisis, their reported losses have continued to increase.

One important consequence of conservatorship is its impact on the implied guarantee. Some commentators argue that the implied guarantee is now an explicit one. The government and the market have not yet embraced this view. How the two companies exit their conservatorships will help shape the nature of the government guarantee as well.

As the credit crisis unfolds, there is much speculation as to what form Fannie and Freddie should take upon exiting conservatorship once the credit crisis has passed. Part II proposes a theoretical framework to help determine the answer to that question.

II. Evaluating Fannie and Freddie

There is very little controversy over the overwhelming benefits that Fannie and Freddie brought to the national mortgage market during the 1970s. Indeed, they, along with Ginnie Mae, effectively created it. But at least since the early 1990s, there has been much disagreement with Fannie and Freddie's claims that they continue to provide overwhelming benefits to America's homeowners. There has also been an exploration of the costs that the two companies impose on the American government and on the mortgage markets. This Part begins by reviewing how Fannie and Freddie claim to

benefit the residential housing finance market and how “independent scholars”⁵ evaluate their success at reaching these goals. It then draws on theories of regulation and monopoly to propose a more comprehensive mode of evaluation which untangles their hybrid public/private structure to demonstrate how that structure gives them extraordinary benefits that undercut competition in the mortgage markets as well as their statutorily mandated public missions.

A. Fannie and Freddie’s Self-Assessment

Fannie and Freddie set forth four standards by which they believe they should be judged: (a) they lower overall interest rates for homeowners; (b) they offer systemic stability and liquidity to the market; (c) they increase the supply of affordable housing; and (d) they have increased consumer protection in the residential market. I will review evidence for each of these claims in turn. I find that independent research challenges some of these claimed benefits. Moreover, these four standards are *ad hoc* and fail to account for many other impacts that the two companies have on the housing market.

(a) *Lower Overall Interest Rates for Homeowners.* Fannie and Freddie claim that they lower interest rates for homeowners. There is nearly universal agreement that this is true. While Fannie and Freddie describe these lower rates as significant, independent scholars describe them as modest.

Various studies have measured the benefit to conforming borrowers as being between 24 and 43 basis points. Assuming an increased 34 point spread (halfway between the two figures) on a \$200,000 mortgage, a borrower would pay an additional \$57 dollars a month in interest. This figure, while significant for the average American homeowner, is not an extraordinary benefit, particularly for those who can itemize their

⁵ Fannie and Freddie have funded directly or indirectly most of the research that pertains to them. That research typically supports Fannie and Freddie’s own agendas. In addition, many of the scholars writing about Fannie and Freddie have worked or do work for one of the two companies. Again, much of their research is supportive of the two companies. I use the terms “independent scholars” and “independent research” to distinguish scholarly work produced by those without a connection to the two firms as well as research by Fannie- or Freddie-affiliated researchers that does not appear to have a pro-Fannie and Freddie bias.

home mortgage interest deduction to further reduce the after-tax bite of such interest payments.

Moreover, Michael Fromkin identifies a hidden cost that the Fannie and Freddie financing model imposes: in many ways the federal government is borrowing at a higher cost than it needs to if it wants to subsidize residential mortgages.⁶ Instead of borrowing through a GSE, the federal government could act directly at a lower cost to assist favored constituencies like homeowners. For instance, the federal government could directly provide or guarantee certain kinds of mortgages at a cheaper cost than Fannie and Freddie, much like it directly provides student loans at a cheaper cost than private educational lenders. This hidden cost has come into sharper relief during the current credit crisis, where Fannie and Freddie's borrowing costs remained for quite some time stubbornly high, even after they entered conservatorship. Thus, the Fannie and Freddie model may not be the most cost-effective means by which the government can achieve the goal of lower interest rates for homeowners.

(b) *Systemic Stability and Liquidity.* Congress gave Fannie and Freddie the task of providing liquidity and stability to the secondary mortgage markets. In 2003, OFHEO issued a report titled "Systemic Risk: Fannie Mae, Freddie Mac and The Role of OFHEO" that evaluated their role in the broad financial markets. The report argued that the systemic implications of Fannie or Freddie's financial difficulties would depend on the circumstances: "Any systemic disruption would likely be minimal as OFHEO took prompt corrective action and other market participants filled the short-term market void. Alternatively, in the unlikely circumstance that an enterprise experienced severe financial difficulties, they could cause disruptions to the housing market and financial system."⁷

While the secondary mortgage markets generally function well and without liquidity crises, the credit crunch of 2007-09 has provided a rare opportunity to evaluate the impact of Fannie and Freddie on liquidity. At early stages in the crisis, Fannie and Freddie promoted themselves as white knights and lobbied for access to a broader swath

⁶ Fromkin, at 618.

⁷ OFHEO. (2003).

of the mortgage market in order to stabilize them. But as the credit crisis developed, it became clear that Fannie and Freddie were subject to the same forces that had led to the insolvency and massive write-downs of private mortgage lenders, until the government stepped in quite forcefully to bolster the government-supported mortgage market.

In early 2008, the federal government authorized Fannie and Freddie to purchase loans with significantly higher principal amounts in high-cost areas like New York and California, again in order to provide additional liquidity. But at around the same time, Fannie and Freddie revealed that they faced billions of dollars in losses caused by their poor underwriting. Fannie Mae issued additional shares to raise billions of dollars of capital to ensure that they complied with the OFHEO capitalization requirements and Freddie Mac planned to do the same. But, as noted above, Fannie and Freddie ultimately required a bailout in order to prevent a crisis that would have spread far beyond the American residential mortgage market to infect the entire global credit market, if left unchecked. The net effect is that Fannie and Freddie did provide some temporary liquidity and stability but their long term impact was very harmful to the broad financial system and will likely cost the American taxpayer many tens of billions of dollars to resolve the harm they ultimately caused.

(c) *Affordable Housing Goals.* The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 established three affordable housing goals for Fannie and Freddie, those for (1) low- and moderate-income housing; (2) special affordable housing; and (3) central cities, rural areas, and other underserved areas housing. Pursuant to this statute, HUD is responsible for monitoring, adjusting and enforcing these housing goals. These goals represent what should be the percentage of housing units financed by Fannie and Freddie each year.

Fannie and Freddie typically meet these goals, although they sometimes may use financing shenanigans (such as buying a portfolio of loans solely to meet affordable housing goals) to do so. Independent research, however, has challenged whether these goals actually increase the net amount of affordable housing. A number of studies have indicated that Fannie and Freddie actually cannibalize the Federal Housing Administration (FHA) loan market by lending to borrowers who would have otherwise

received FHA mortgages. The U.S. General Accounting Office has also questioned whether Fannie and Freddie, notwithstanding their particular affordable housing mandate, do any more than any other lenders to promote affordable housing.

(d) *Consumer Protection.* Fannie and Freddie argue that they have helped to standardize the conforming mortgage to the benefit of consumers. Many, including this author, have praised this standardization as a positive, something that on the whole reduces bad options for consumers. This generally positive development is not without some costs to consumers, however, as it reduces the financing choices available to them. For instance, Fannie and Freddie have effectively banished prepayment penalties from the prime conforming mortgage market, which sounds like a good thing for consumers. But some consumers might have preferred to take a loan with a prepayment penalty if it meant that the loan would have had a lower interest rate.

Moreover, recent news about Freddie's role in the subprime and Alt-A markets undercut Fannie and Freddie's consumer protection argument to some extent. Apparently, the two firms had a much greater exposure to the disastrous Alt-A (also known as the "liar loan") subsector than they had previously let on. In Congressional testimony in late 2008, Fannie's former chief credit officer reported that the two companies "now guarantee or hold 10.5 million nonprime loans worth \$1.6 trillion -- one in three of all subprime loans, and nearly two in three of all so-called Alt-A loans, often called 'liar loans.'"⁸ As these two sectors were rife with predatory lending practices, Fannie and Freddie may be seen as complicit with these practices even though they did not engage in them directly.

B. Existing Theories of the Government-Sponsored Enterprise

Alice Rivlin, as then-director of the Office of Management and Budget, has stated that "GSEs were created because wholly private financial institutions were believed to be incapable of providing an adequate supply of loanable funds at all times and to all regions

⁸ Browning.

of the nation for specified types of borrowers.”⁹ This is certainly the primary reason that Congress employs GSEs, even if, as Thomas Stanton notes, “market imperfections are much more difficult to find today” than they were when Fannie and Freddie were created.¹⁰

Michael Froomkin has suggested four additional reasons behind Congress’ decision to create federal government corporations like Fannie and Freddie: (a) they are believed to be more efficient at achieving market-related goals; (b) they are believed to be more insulated from politics than a division of a large federal agency; (c) they are believed to be effective at delivering targeted subsidies; and (d) they are a useful subterfuge for Congress because their borrowing is typically not counted as part of the federal deficit.¹¹ As seen in this chapter, there is good reason to doubt that the first three reasons are as compelling as Congress would have liked. There is also good reason to believe that Congress was spot on regarding the fourth. Rivlin and Froomkin outline the major reasons that Congress creates GSEs, but they do not offer a comprehensive theory of the GSE. Existing efforts to do that are reviewed below.

Finance and economics scholars have proposed a variety of cost/benefit frameworks with which to evaluate Fannie and Freddie, although this is no mean task. These frameworks have often relied upon various *ad hoc* metrics, such as whether Fannie and Freddie actually lower interest rates for homeowners or how much of the Fannie/Freddie subsidy is passed on to homebuyers. There is general agreement that the two companies do lower interest rates to some extent and that they do so by passing on a portion of the subsidy that derives from the government’s guarantee of their obligations on to homeowners.

Fannie and Freddie, of course, argue that they still provide an array of benefits, while others vigorously dispute this claim. Fannie and Freddie know that this debate is fundamentally one about their right to exist as GSEs. Their critics, on the other hand,

⁹ OMB.

¹⁰ Stanton, at 10.

¹¹ Froomkin, 557-559.

have become increasingly strident in their criticism of the Fannie and Freddie business model as these companies have grown way beyond the expectations of anyone who had studied them in the 1970s and 1980s.

While this body of literature has provided many insights into Fannie and Freddie, it does not provide an overarching theoretical framework that would help determine their value. Such a framework should describe the ecology of Fannie and Freddie as well as the incentives and structural limitations that drive the development of the two companies. It should also provide guidance as to how they should be treated going forward.

C. Fannie and Freddie Evaluated through the Lens of Regulatory Theory

Given Fannie and Freddie's monstrous size and market power, there are no comparable public-private hybrid entities. As products of regulation, however, they fit well within existing theories of regulation. This section evaluates their value as agents of public policy through the lens of regulatory theory.

Two oft-stated objectives of government economic policy are to maintain and encourage competition between firms in order to increase "the material welfare of society"¹² as well as to maximize consumer welfare "through lower prices, better quality and greater choice."¹³ Cass Sunstein has rightfully noted that many regulatory regimes therefore reflect "a belief that regulatory enactments might simultaneously promote economic productivity and help the disadvantaged."¹⁴ But Sunstein has also noted, along with many others, that one of the main criticisms of regulation is that it is "only purportedly in the public interest" and that it "turns out on inspection to be interest-group transfers designed to protect well-organized private groups . . . at the expense of the rest of the citizenry."¹⁵

¹² *See, e.g.*, Brodley.

¹³ *See, e.g.*, United States Department of Justice Antitrust Division website, <http://www.usdoj.gov/atr/overview.html>.

¹⁴ Sunstein, at 3.

¹⁵ Sunstein, at 32.

Indeed, modern theories of regulation stem from the insight that firms attempt to use regulation as a device “to establish or to enhance monopoly power.”¹⁶ Assessing the role of regulation in a particular market is necessary to understand whether that market is functioning competitively and equitably. Fannie and Freddie, although born of regulation themselves, claim to act competitively. Theories of regulation thus provide a useful framework with which to understand the market in which Fannie and Freddie operate, one that allows us to evaluate whether the companies increase “the material welfare of society” and maximize consumer welfare. This Part will analyze Fannie and Freddie as creatures of regulatory privilege within the context of regulatory theory.

The core of Fannie and Freddie’s regulatory privilege is the government’s guarantee of their obligations, which was initially granted to create a national secondary residential mortgage market. This implied guarantee drives any competition from the conforming mortgage market because the two companies can borrow money so much more cheaply than their competitors. This lower cost of funds means that they can out-compete fully-private financial institutions in the conforming market, thereby keeping the conforming sector to themselves.

The government guarantee is a variant 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 by Queen Elizabeth I to the English East India Company in 1600 in order to increase English trade with Asian nations. 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. 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.

¹⁶ Crew & Rowley, at 6-7. (1989).

Unlike true monopolists, Fannie and Freddie are limited by the nature of their competitive advantage: in an otherwise efficient market, the maximum amount that they can retain as economic rent is the spread between the interest rates they must pay and those that their competitors must pay. Notwithstanding this cap on profits, Fannie and Freddie share an important characteristic with government-granted monopolies: a legally-created and overwhelming competitive funding advantage in a particular market that derives from their special charters. This advantage translates into higher prices for consumers than would exist if Fannie and Freddie did not retain a portion of their economic rent for shareholders and management.

Regulatory theory identifies six goals that are relevant to a study of Fannie and Freddie, including (i) maintaining competition; (ii) efficiently allocating society's goods and services; (iii) promoting innovation; (iv) preventing inappropriate wealth transfers; (v) preserving consumer choice; and (vi) preventing an overly-concentrated economy. The first three goals related to economic efficiency concerns. The second three goals address additional public policy objectives. As shall be seen below, Fannie and Freddie do little to effectuate these goals. Indeed, in some cases they act contrary to them.

(i) *Maintaining Competition.* Maintaining competition is one of the most important goals of economic regulation. But applying this goal to Fannie and Freddie's activities is a bit difficult as there was no real national mortgage market when they were created. Indeed, they were formed in order create a new product: a fungible mortgage product. So, to begin with, there was barely any competition with which Fannie and Freddie could interfere. And now, because of their funding advantage, they have no competitors in the prime conforming market. This state of affairs presents two questions regarding competition in the modern residential mortgage market: should there be more competition in the conforming mortgage market; and should Fannie and Freddie be allowed to expand the markets in which they compete while maintaining their funding advantage?

As to the first question, it is non-controversial to answer that competition is considered healthy in almost all markets, except for those that are better suited to natural monopolies like the utilities market. While Fannie and Freddie maintain that they

compete with each other, independent commentators describe their behavior more as that of duopolists than competitors. As to the second question, it again is non-controversial to state that introducing subsidized firms like Fannie and Freddie into a generally efficient non-subsidized mortgage market like the jumbo market would distort pricing in that market.

And Fannie and Freddie are entering that jumbo market: the rapidly increasing size of the conforming loan limit, a product of furious lobbying by the two firms, allows Fannie and Freddie to claim more of the overall mortgage market for themselves as opposed to their jumbo-originating competitors. As Fannie and Freddie both operate without competition in the conforming market and expand their markets through political action, they seem to operate contrary to the goal of maintaining competition.

Moreover, if one believes that Fannie and Freddie were primarily created to develop the national mortgage market, then it follows that their government-granted privilege should be revoked after they have completed that task. That is, Fannie and Freddie's regulatory privilege should be treated more like the privilege granted to patents, which only allows for a temporary monopoly for the express purpose of encouraging innovation, rather than a natural monopoly like that of a utility company that is typically regulated in perpetuity because they have no potential competition.

(ii) *Efficiently Allocating Society's Goods and Services*. In a productively efficient system, each unit of a product is produced at the lowest possible cost. If a producer in a competitive market fails to produce its product at the lowest possible cost, it would likely fail. This result would not typically apply to a monopolist because it does not face competition in its market. Monopolists thus typically lack "sufficient incentive to hold production costs at low levels."¹⁷

The competitive advantage provided by Fannie and Freddie's regulatory privilege is limited, as discussed above, by the fact that they would face competition if the price (interest rate and fees) in the conforming market was equal to or higher than the price in the jumbo market. But so long as they keep the price lower than the price in the jumbo

¹⁷ Breyer, at 16.

market, they are able to extract some economic rent. Thus, they are not efficiently allocating society's goods and services.

Regulatory privilege imposes certain additional social costs. Its beneficiaries incur costs to retain and expand it, often through campaign contributions, lobbying and bribery. Such firms are also more likely to dissipate their rents through expenditures like advertising in order to protect their privileged status. Fannie and Freddie are thus best understood as rent-seekers who expend resources to obtain favorable regulation in order to obtain rents.

(iii) *Promoting Innovation.* Recipients of regulatory privilege may have less impetus to innovate because of their competitive advantage. Fannie and Freddie claim, however, that they continue to innovate as the secondary market matures. Indeed, they have executed a number of innovations that allow them to profit from aspects of the mortgage market that had traditionally fallen outside of the scope of their activities. These include, for instance, the development of automated underwriting systems and underwriting guidance systems for third parties. It is no coincidence that these innovations allow the two companies to enter new markets, thereby pushing against the limitations on their expansion into new markets contained in their charters. The Mortgage Banking Association argues that in the area of underwriting technology, Fannie and Freddie have actually squelched the innovations of others, much as Microsoft has squelched its competitors by tying new products to its operating software.

Private label competitors have innovated at a far greater rate than Fannie and Freddie, introducing a dizzying array of products for consumers to choose from and securities for investors to choose from although much of that innovation now seems foolish, greedy and wrongheaded. At a minimum, there is no evidence that Fannie and Freddie innovate more than they would if they faced a marketplace filled with many competitors. That being said, as the subprime crisis unfolds, the once vaunted innovation of private-label lenders has taken on a decidedly morbid pall. Kathleen Engel and Patricia McCoy argue quite convincingly how the business model of these private-label

lenders led directly to much of the abusive lending of the last ten years.¹⁸ One might argue that this goal of regulatory theory should weigh in favor of Fannie and Freddie if they themselves did not invest so heavily in subprime and Alt A mortgages originated by the very same private label lenders that engaged in such dangerous innovations.

(iv) *Preventing Inappropriate Wealth Transfers.* Monopolists are willing to forgo sales for increased profits. Similarly, Fannie and Freddie forgo offering the lowest possible price for mortgages; they do this by retaining a portion of their subsidy, instead of passing it on the borrowers as they would in a perfectly competitive market. This is reflected in the outsized profits that Fannie and Freddie have historically enjoyed as compared to other financial institutions. It may also be reflected in the generous pay packages that management awards itself before turning over the remainder of the economic rent to shareholders. Furthermore, just as monopoly pricing dissuades some buyers who would have purchased a good at a competitive price from doing so at the monopoly price, which is allocatively inefficient, Fannie and Freddie's retention of a portion of their subsidy keeps some potential borrowers from borrowing.

(v) *Preserving Consumer Choice.* Government regulates businesses that operate in markets that are not fully competitive, in part, to achieve fairness for consumers. Because of their competitive advantage in the conforming loan market, consumers effectively only have the choice of Fannie or Freddie. As noted above, Fannie and Freddie argue convincingly that they have helped to standardize the prime, conforming mortgage to the benefit of consumers.

There is no question that private label firms would enter the conforming market if they were able to borrow funds at rates comparable to those that Freddie and Fannie can borrow at. The pros and cons of those private-label firms have been well documented in the jumbo and subprime markets: they expand consumer choice but often at the expense of the consumer protection inherent in a simple and standardized market place. More competitors would, of course, mean more consumer choice of lenders. It would also likely mean more choice of mortgage products. But in the context of mortgage lending,

¹⁸ Engel & McCoy.

more consumer choice is a two-edged sword, as the implosion of the subprime market attests.

Fannie and Freddie also argue that they implement the government's policy of increasing homeownership; indeed, Fannie's slogan is "Our Business is the American Dream." They claim that they have thereby helped the nation achieve a great increase in the rate of homeownership. This claim is undercut in a variety of ways. First, the credit crunch has made some question whether homeownership is a good in and of itself for all households. Second, some scholars argue that America over-invests in housing and that Fannie and Freddie are part of that problem. Third, it is unclear whether they actually help to fund affordable housing for low- and moderate-income homeowners, who should presumably be the main beneficiaries of such a government initiative. Fourth, the amount that the typical homeowner saves because of Fannie and Freddie is relatively modest.

(vi) *Preventing an Overly-Concentrated Economy.* Regulation may be employed to reduce over-concentrations of market power. Fannie and Freddie argue, however, that their vast size provides stability to the mortgage market; independent scholars disagree. Recent events further disfavor the Fannie/Freddie perspective. Each of Fannie and Freddie present an over-concentration of risk that is perhaps unsurpassed by any other private firm operating anywhere in the world. Because the two companies have the identical, undiversified business model, that risk is only magnified. Thus, any substantial operational risk or mistaken hedging strategy at either of those firms, poses a systemic risk to the international economy, a risk that has already become a reality.

* * *

Fannie and Freddie do not do well when these six regulatory goals are taken together. As to the three economic efficiency goals, the conforming market is not as competitive or efficient as it would be if there were more competitors. There is also no evidence that the market is more innovative than it would be if there were more competitors. Thus, merely on economic efficiency grounds, Fannie and Freddie's regulatory privilege does not serve the public interest. Nor do Fannie and Freddie do

particularly well with the other public policy goals. The two companies engage in rent-seeking; limit consumer choice; and keep other firms from competing with them.

The two areas where Fannie and Freddie seem to offer some clear and significant benefits are (i) providing short term liquidity and stability to the mortgage market during an acute crisis and (ii) promoting consumer protection, at least in the prime, conforming sector. This second point is underscored by the events leading up to the credit crisis which have demonstrated that too much consumer choice in the mortgage arena can lead to horrible results. If the benefits offered by Fannie and Freddie could be undertaken through alternate means, one might conclude that Fannie and Freddie are not particularly beneficial agents of public policy.

In sum, regulatory theory helps to untangle Fannie and Freddie's intended market function from their intended public mission and to explain how the two purposes do not work well individually or taken together. Because Fannie and Freddie are creatures of federal regulatory privilege, and not independent firms that are operating in a relatively unregulated market, the federal government has broad latitude in setting new goals for these two firms and modifying the regulatory privileges awarded to them.

III. Fannie and Freddie's GSE Status Should Be Terminated

Identifying the weaknesses of Fannie and Freddie as agents of public policy is very different from identifying what should be done with them. The two companies have two of the most powerful lobbying machines in Washington. Moreover, the nature of Fannie and Freddie's privileges makes it unlikely that they will be revisited by Congress with any regularity. Because Fannie and Freddie are poor agents of public policy and are political powerhouses with unmatched influence, the two companies should be fully privatized.

A. Fannie and Freddie Are Political Powerhouses

Jonathan Koppell has thoroughly documented how Fannie and Freddie have been able to exercise unparalleled influence in Washington.¹⁹ Mirroring the hybrid analysis in

¹⁹ Koppell, at 97-121.

this chapter, he concludes that it is the combining of elements of public instrumentalities and private companies that is what gives them the “best of both worlds” – in terms of the political influence the two companies can marshal. Thus, any policy proposals relating to the two companies must be evaluated in the context of the political environment in which they operate.

Given that Fannie and Freddie have outsized influence in Washington, one must be cautious in recommending half-measures in reaction to their limitations as agents of public policy. Unfortunately, most of the reforms floated in the last few years would seem to fall within this category. They include

- limiting the size of their mortgage portfolios;
- limiting their debt issuance;
- stripping the two companies of some of their unique privileges to signal to the market that the implied guarantee has been weakened;
- freezing the conforming loan value to limit the size of mortgages they can buy, thereby limiting their overall size;
- requiring them to obtain ratings from rating agencies for their debt issuances that discount the implied guarantee;
- imposing user fees; and
- strengthening their subordinated debt programs.

If any of these half-measures were adopted, however, Fannie and Freddie’s lobbying juggernaut would be sure to undercut them as soon as Congress’ focus moved on to another pressing issue.

B. The Government Guarantee Is a Reckless Budgeting Device

Michael Fromkin, among others, has identified the encouragement of federal budget shenanigans as a hard to quantify “cost” of the Fannie and Freddie hybrid business model.²⁰ This is because the federal government’s contingent liability for its guarantee of Fannie and Freddie’s obligations is off-budget, allowing Congress to avoid having that liability trigger debt ceiling limits. If off-budget accounting is a bad sign when found in corporations such as Enron, it is at least as bad for the federal government. For, while the federal government was ultimately able to investigate Enron, who will

²⁰ Fromkin, at 618.

watch the watchers? Indeed, if the federal government had to quantify and account for this contingent liability in its budget, it would most certainly reduce Congress' ability to increase net spending.

Fannie and Freddie thus pose four serious budgetary problems. First, the cost of the government's guarantee is hidden because it is historically treated as off-budget. Second, the cost of the guarantee is particularly difficult to quantify. Third, the cost of the guarantee is not capped by the federal government, given that the federal government has not imposed any meaningful limits on Fannie and Freddie's growth. Finally, Fannie and Freddie's charters and the costs they might pose to the federal government are infrequently revisited by Congress. Indeed, Congress only takes a serious look at them every ten years or so.

Cheryl Block, in her work on the federal tax budget, proposes a set of principles that should guide the budget legislative process. These principles are built on those relied upon by the General Accounting Office and are 1) budget formation as a democratic exercise; 2) enforceability; 3) accountability; 4) transparency; and 5) openness and durability.²¹ These five principles help to clarify the manner in which the contingent liability of the government's guarantee should be treated in the federal budget process.

The government's guarantee of Fannie and Freddie's obligations, when viewed as an item in the legislative budgetary process, fails to abide by any of these principles. Because the government guarantee of Fannie and Freddie's obligations was effectively created decades ago, it is generally not part of the annual debate surrounding the budget. Because the size of the guarantee is uncapped and contingent, it fails the enforceability and accountability principles: it operates outside of the budget, its cost is hard to estimate and the trigger for the federal government's obligation to make good on it is in itself an unexpected event. Similarly, the guarantee, because of its contingent nature, is quite confusing to those outside of the budget process. Finally, it fails to meet the openness and durability principles because it is not typically part of the annual budget deliberations.

²¹ Block, at 900-904.

In sum, the budgetary implications of the government's guarantee provide an additional public policy argument against Fannie and Freddie's hybrid structure, one that even on its own weighs heavily against them as agents of public policy.

C. Fannie and Freddie Should Be Privatized

There are four broad positions regarding the appropriate role of Fannie and Freddie in the housing finance market. First, Fannie and Freddie are generally doing the job that they were designed to do, although their powers and that of their regulators should be tweaked. Second, Fannie and Freddie are generally doing their job, but they are retaining too much of the value of the government guarantee for the benefit of shareholders and management at the expense of their affordable housing goals. Third, Fannie and Freddie should be nationalized because the federal government has taken on most of the risk associated with them already. And finally, Fannie and Freddie pose a systemic risk to the financial system, unfairly benefit from their regulatory privilege and do not create net benefits for the American people.

This chapter has taken the fourth position. In particular, it argues that the government guarantee should be terminated and the two companies should be privatized. Until they entered conservatorship, this position has been considered a political nonstarter, particularly because Fannie and Freddie have many allies in the Republican and Democratic parties. Due to recent events, it is now one of the options on the table for a post-conservatorship Fannie and Freddie.

One taking the first view—that Fannie and Freddie are generally doing the job that they were designed to do—might argue that “[t]he penetration of competitive markets by laws and regulations is a highly durable and robust intrusion in the U.S. economy . . . [which] is arguable as tightly regulated as the more socialistic economics of Western Europe.”²² Thus, there is no need to extricate the federal government from its relationship with Fannie and Freddie because the government has similar relationships with many other private companies. Proponents of this view typically recommend the limited reforms outlined in Part III.A above.

²² Crew & Rowley. (1988).

Affordable housing providers and advocates often take the second position: Fannie and Freddie are pretty much doing their job of making housing more affordable to Americans, but they are retaining too much of the value of the government guarantee for the benefit of the shareholders and management, at the expense of their affordable housing goals. Given the shared agenda of Fannie and Freddie on the one hand and affordable housing providers and advocates on the other, this position should not come as a surprise to a student of regulation. Thus, these parties favor proposals that redirect some of the excess profits of Fannie and Freddie from their shareholders and management to affordable housing programs.

And, indeed, in a plan subsequently suspended by federal conservatorship, Congress had implemented an affordable housing fund in which the two firms would deposit upwards of \$500 million of their income each year. These monies were to be invested in affordable housing projects throughout the country. Affordable housing advocates saw this as a painless way to dramatically increase the supply of affordable housing. The ongoing bailout of the two companies demonstrates that the initiative was not painless, just pain deferred.

Fannie and Freddie supported this proposal in exchange for expanding their market. This expansion was implemented by increasing the conforming loan limit in high-cost parts of the country, which allowed the two companies to expand into the bottom part of the jumbo market. It is of note, of course, that Fannie and Freddie's support for such an extraordinarily costly initiative as the affordable housing fund came at a low point of their public prestige and was widely seen as a political compromise that brought together a broad set of special interests whose goals are aligned with those of Fannie and Freddie. These interests included affordable housing advocates, local governments and the construction industry.

The dynamics of this position are complex. Housing advocates are concerned with the sustained lack of attention that federal and state governments have paid to affordable housing policy and see any dedicated housing dollars as a long overdue priority. Implicit in this view is that the risk of a Fannie and/or Freddie bailout to the typical American taxpayer is worth the benefit of the affordable housing dollars that the

affordable housing fund could direct to low- and moderate-income families. The real debate, from this perspective, is how much of the golden egg of the economic rents resulting from the implied subsidy (as revealed by Fannie and Freddie's profits that consistently and greatly exceed their industry average) can be redirected to these affordable housing objectives without killing the Fannie and Freddie geese.

The third position, nationalization, had only begun to be taken seriously as the Fannie and Freddie bailouts become more and more likely. Indeed, then-Secretary Paulson has raised the idea, one which would seem to be anathema to a fiscal conservative like himself. Paulson proposed merging the two companies with the Federal Housing Administration, a government agency, which already insures certain mortgages. He did note, however, that such a plan would place much of the underwriting in the hands of the government, which is unlikely to do that task well (not the private sector has done so either in recent years!).

As noted above, this chapter advocates for the fourth view: Fannie and Freddie pose a systemic risk to the financial system, unfairly benefit from their regulatory privilege and no longer create meaningful net benefits for the American people. In speaking of regulatory reform, Sunstein notes that a good first step "would be to adopt a presumption in favor of flexible, market-oriented, incentive-based, and decentralized regulatory strategies. Such strategies should be focused on ends . . . rather than on the means of achieving those ends."²³ Fannie and Freddie are holdovers from an earlier philosophy of government action, one that has seen its day come and go. Indeed, if one were to create from scratch a new system of federally-supported residential mortgage finance, it is quite clear that the model would not be Fannie and Freddie, which are relatively inflexible and centralized solutions to the complex and fluid problems posed by the housing finance market. And while there is an argument to be made that Fannie and Freddie are market-oriented and incentive-based, it is a stronger argument to say that they are beneficiaries of regulatory privilege with incentives that have benefited their management disproportionately.

²³ Sunstein.

Privatization is needed to remedy this state of affairs. Notwithstanding Fannie and Freddie's potency in Washington, this is not merely some fanciful policy proposal. Theories of regulation and rent-seeking identify erosions of government-granted monopolies over time as part of their natural lifecycle. And, as the credit crisis continues to worsen, more and more previously unthinkable solutions are being taken quite seriously.

Four concrete plans have been proposed to fundamentally change Fannie and Freddie's structure, each involving different degrees of government involvement. First, convert them into cooperatives owned by lenders. Second, break the companies up into a number of smaller companies (or charter a number of similar competitors). Third, leave them intact, but regulate them like public utilities. Fourth, convert them into generic financial holding companies.

The first proposal, converting Fannie and Freddie into cooperatives, has precedent. There are two other privately-owned GSEs that are cooperative lenders: the Federal Home Loan Bank System (FHLB System) and the Farm Credit System. Some commentators have called for the FHLB System to take over Fannie and Freddie. This proposal has some initial attraction as it might attenuate the short term profit-maximizing culture that characterizes publicly-traded corporations like Fannie and Freddie. But history does not give comfort that such a GSE structure is superior to that of Fannie and Freddie's. Indeed, Congress had to bail out the Farm Credit System in 1987. And there are rumblings that the FHLB System may face problems similar to those of Fannie and Freddie.

The second proposal, chartering additional housing finance competitors, has some initial attraction. Indeed, one might consider the federal deposit insurance system to be a model of this: numerous recipients of regulatory privilege (access to federally guarantee insurance) who must compete amongst themselves. If the Fannie/Freddie duopoly could be diluted with enough similar competitors, the amount of economic rent that Fannie and Freddie retain from their government guarantee subsidy should reduce significantly. In addition, one might think that a more competitive market would spread risk among more firms.

Upon further reflection, however, this proposal also reveals significant flaws. The benefit of GSE competition is less compelling now that we have experienced a bubble where so many financial institutions demonstrated herd-like behavior in their business models. And, as with the first proposal, the American taxpayer is still left with the contingent liability of the government guarantee.

The third proposal, regulating them like utilities, appears to be favored by Paulson and taken seriously by the likes of former Federal Housing Finance Agency Director Lockhart. One worries however, how the common regulatory problem of capture would be avoided here where the two companies to be regulated are so clearly skilled in the art of politics.

The fourth proposal, converting them into generic financial services holding companies along the lines of institutions like Citigroup, J.P. Morgan and Bank of America, has the attraction of simplicity. It also terminates the contingent liability of the government guarantee and allows the conforming mortgage market to function like other sectors of the overall mortgage market. There is also a precedent for this approach: Sallie Mae was successfully converted from a GSE to a private company. This approach would also send the message that the American mortgage markets have grown up and are now to be integrated with the rest of the financial sector.

This proposal has its own limitations which must be addressed if it were to be implemented. First, because Fannie and Freddie can offer at least a short term stabilizing role in the residential mortgage markets, the federal government would need to implement other policies to take on that role. Possible policy responses to market disruptions could include providing targeted federal mortgage guarantees; authorizing the Treasury to make mortgage-backed securities purchases; and allowing mortgage lenders to access the Federal Reserve's discount window. Policies like these can ensure that the residential mortgage market function during a panic.

Second, homeowners will pay slightly higher interest for conforming mortgages if the two companies were privatized. If Congress determines that this increase were too much, particularly given the current condition of the economy, it could reduce the burden by modifying the deduction for mortgage interest or by providing a tax credit relating to

mortgage interest. While such a strategy will decrease federal revenues it will be offset by the liability that Fannie and Freddie impose on the federal government, a liability that is already on its way to costing taxpayers hundreds of billions of dollars as part of the current bailout.

Third, if the federal government wanted to increase funding for affordable housing as contemplated in the Act, it would need to do so through direct expenditures. Again, this direct cost would be offset by terminating the contingent liability of the government guarantee.

Finally, Fannie and Freddie have imposed pro-consumer terms on the prime conforming mortgage market. These must be maintained and built upon through new consumer protection regulation in order to avoid the nasty and brutish environment of the subprime mortgage market. And, indeed, it is hard to imagine that privatization would be politically feasible if such protections were not built into the privatization proposal.

Notwithstanding these limitations, the full-privatization proposal has the most going for it. It avoids the problem of the government guarantee that remains with the other three proposals. It leaves to the private sector what the private sector is supposed to do best: evaluate risk. And it leaves to the government what it is supposed to do best: protect against systemic risk, protect consumers; and provide affordable housing to those who could not otherwise afford it.

IV. Conclusion

The main problem with GSEs is well-documented: they take on a life of their own and can survive well after they have achieved the purposes for which they are created. Alice Rivlin, in her then-capacity as the director of the Office of Management and Budget, stated that “GSEs should only be created with a clearly articulated ‘exit strategy’ and an express sunset date in their charter.”²⁴ Unfortunately, this is almost never the case.

²⁴ OMB.

The typical result of poor GSE design is that the GSE ends up driving much of the legislative and regulatory agenda regarding their own fates. Stanton and Moe argue that this can lead to “increasing dominance over the governmental process” by GSEs; the inability “of the government to supervise GSE safety and soundness and the government’s resulting financial exposure;” as well as government inability “to induce GSEs to serve public purposes that conflict with the interests of shareholders.”²⁵

Fannie and Freddie reflect what is worst in GSE design. After fulfilling their purpose of creating a national mortgage market, they have taken on monstrously large lives of their own. In the midst of their bailout, Congress should take the opportunity to convert them to fully private status. Congress should also enact appropriate financial regulation, consumer protection legislation and affordable housing programs. And Congress should remember the lessons of Fannie and Freddie when it considers using the GSE as a tool of government in the future. It should reflect on the appropriate design for such a hybrid tool, a design informed by a theoretical understanding of the GSE based on regulatory theory and sound federal budget policies.

Bibliography

- American Institute of Architects. (2008, August 4). *Washington update: Housing relief bill signed into law* [Press release]. Retrieved from http://www.aia.org/nwsltr_print.cfm?pagename=angle_nwsltr_20080804.
- An, X. & Bostic, R. W. (2006). *GSE activity, FHA feedback, and implications for the efficacy of the affordable housing goals* (U.S.C. Lusk Center for Real Estate Working Paper 2006-1005). Los Angeles, CA: University of Southern California.
- Andrews, E. L. (2005, July 15). Loose reins on galloping loans; efforts to regulate risky mortgage innovations are so far ignored. *The New York Times*, p. C1.
- Areeda, P. E. & Hovenkamp, H. (2000). *Antitrust law: An analysis of antitrust principles and their application* (2nd ed.). New York, NY: Aspen Publishers.
- Authers, J. (2007, August 7). The short view. *Financial Times* (London ed.), p. 15.
- Block, C. (2001-2002). Pathologies at the intersection of the budget and tax legislative process. *Boston College Law Review*, 43, 864-934.
- Block, C. (2003-2004). Congress and accounting scandals: Is the pot calling the kettle black? *Nebraska Law Review*, 82, 365-459.
- Breyer, S. G. (1982). *Regulation and its reform*. Cambridge, MA: Harvard University Press.
- Brodley, J. F. (1987). The economic goals of antitrust: Efficiency, consumer welfare and technological progress. *New York University Law Review*, 62, 1020-1053.
- Browning, L. (2008, December 10). Ex-officer faults mortgage giants for 'orgy' of nonprime loans. *The New York Times*, p. B3.

²⁵ Stanton & Moe.

- Bruce, R. C. (2007, December 17). Fannie Mae, Freddie could get relief on surplus capital mandate, Lockhart says. *BNA's Banking Report*, 89, 1028.
- Bruskin, E., Sanders, A.B. & Sykes, D. (2000). The nonagency mortgage market: background and overview. In Fabozzi, F. J., Ramsey, C. & Marz, M. (Eds.), *The handbook of nonagency mortgage-backed securities* (2nd ed.), Hoboken, NJ: Wiley.
- Burnett, K. & Fosburg, L. B. (2001). *Study of multifamily underwriting and the GSEs' role in the multifamily market: Final report*. Washington, DC: U.S. Department of Housing and Urban Development.
- Carleton, D. W. & Waldman, M. (2002). The strategic use of tying to preserve and create market power in evolving industries. *RAND Journal of Economics*, 33, 194-220.
- Carlton, D. W. & Picker, R. C. (2007). *Antitrust and regulation* (NBER Working Paper 12902). Cambridge, MA: National Bureau of Economic Research. Retrieved from <http://ssrn.com/abstract=937020>.
- Carnell, R. S. (2005). Handling the failure of a government-sponsored enterprise. *Washington Law Review*, 80, 565-642.
- Carrozzo, P. M. (2005). Marketing the American mortgage: the Emergency Home Finance Act of 1970, standardization and the secondary market revolution. *Real Property, Probate & Trust Journal*, 39, 765-806.
- CBO. (1996). *Assessing the public costs and benefits of Fannie Mae and Freddie Mac*. Washington, DC: Congressional Budget Office.
- Cochran III, J. & England, C. (2001). *Neither fish nor fowl: an overview of the big-three government-sponsored enterprises in the U.S. housing finance markets* (Mercatus Center Working Papers in Regulatory Studies.). Arlington, VA: Mercatus Center. Retrieved from http://mercatus.org/sites/default/files/publication/MC_RSP_RP-FishNorFowl_011115.pdf.
- Congressional Budget Act of 1974, P.L. 93-344, 88 Stat. 297 (1974).
- Cowden, R. (2007, November 26). Government-sponsored enterprises downbeat earnings report could affect GSE's role in resolving subprime troubles. *BNA's Banking Report*, 89, 864.
- Cowling, K. & Mueller, D. C. (1980). The social costs of monopoly power. In Buchanan, J. M., Tollison, R. D., & Tullock, G. (Eds.) *Towards a theory of rent-seeking society*. College Station, TX: Texas A&M University Press.
- Crew, M. A. & Rowley, C. K. (1988). Dispelling the disinterest in deregulation. In Rowley, C. K., Tollison, R. D., Tullock, G. (Eds.) *The political economy of rent-seeking*. Boston, MA: Kluwer Academic Publishers.
- Crew, M. A. & Rowley, C. K. (1989). Feasibility of deregulation: a public choice analysis. In Crew, M. A. (Ed.), *Deregulation and diversification of utilities*. Boston, MA: Kluwer Academic Publishers.
- Crittendon, M. R. (2008, April 16). Some progress cited at Fannie and Freddie. *The Wall Street Journal*, p. A2.
- Currie, A. (2008, March 14). Buck up, Fannie and Freddie. *The Wall Street Journal*, p. C12.
- Cyran, R. (2007, August 9). False hopes for mortgage lenders. *The Wall Street Journal*, p. C10.
- Dash, E. (2007, August 11). Fannie Mae's offer to help ease credit squeeze is rejected, as critics complain of opportunism. *The New York Times*, p. C1.
- Democratic Policy Committee. (2008, July 25). H.R. 3221, the Housing and Economic Recovery Act of 2008: Summary and background. Retrieved from http://dpc.senate.gov/dpcdoc.cfm?doc_name=lb-110-2-123.
- Dogan, S. L. & Lamley, M. A. (2008). *Antitrust law and regulatory gaming* (James M. Olin Program in Law and Economics, Working Paper 367). Stanford, CA: Stanford Law School. Retrieved at <http://ssrn.com/abstract=1287221>.
- Duhigg, C. (2009, March 3). U.S. likely to keep the reins on 2 fallen mortgage giants. *The New York Times*, p. A1.
- Eavis, P. (2008, February 29). How to value Fannie, Freddie. *The Wall Street Journal*, p. C2.
- Economic Stimulus Act of 2008, Pub. L. No. 110-185, 122 Stat. 613 (2008).
- Engel, K. C. & McCoy, P. A. (2007). Turning a blind eye: wall street finance of predatory lending. *Fordham Law Review*, 75, 2039-2104.

- Fannie Mae. (n.d.). *Fannie Mae's business FAQ*. Retrieved January 21, 2010, from <http://www.fanniemae.com/faq/faq2.jhtml?p=FAQ>.
- Farm Credit Administration. (n.d.). *FCS information*. Retrieved January 21, 2010, from <http://www.fca.gov/info/index.html>.
- Farm Credit System. (n.d.). *About the Farm Credit System*. Retrieved January 21, 2010, from <http://www.farmcredit.com/map/FCSsystem.html>.
- Federal Home Loan Banks. (n.d.). *Frequently asked questions*. Retrieved January 21, 2010, from http://www.fhlbanks.com/overview_faqs.htm.
- Federal Home Loan Mortgage Corporation Act, 12 U.S.C. §1454 (2006).
- Federal Housing Enterprises Financial Safety and Soundness Act of 1992, 12 U.S.C. §§ 4501-4641 (2006).
- Federal National Mortgage Association Act (Fannie Mae Charter Act), 12 U.S.C. §§ 1716-1717 (2006).
- Federal National Mortgage Association. (2008, November 12). *Form 8-K*. Retrieved from <http://www.sec.gov> archives.
- Ferullo, M. (2008, July 28). Housing report says GSE holdings of private securities pose substantial risk. *BNA's Banking Report*, 91, 142.
- Ferullo, M. (2008, August 11). Fannie, Freddie report unexpected losses, offer grim outlook for housing market. *BNA's Banking Report*, 91, 216.
- FHFA (2008, November 7). *Conforming loan limit for U.S. to remain \$417,000 in 2009; different limits in some areas*, [Press release]. Retrieved from <http://www.fhfa.gov/GetFile.aspx?FileID=135>.
- FHFA. (2009). *Enterprise share of residential mortgage debt outstanding: 1990-2009 Q3*. Retrieved January 21, 2010, from <http://www.fhfa.gov/Default.aspx?Page=70>.
- Flannery, M. J. (2007). Supervising bank safety and soundness: some open issues. *Economic Review (Federal Reserve Bank of Atlanta)*, 92, 83-100.
- Forrester, J. P. (2007). Fannie Mae/Freddie Mac uniform mortgage instruments: the forgotten benefit to homeowners. *Missouri Law Review*, 72, 1077-1110.
- Freddie Mac. (n.d.). *Glossary of finance and economic terms, A-F*. Retrieved January 21, 2010, from http://www.freddiemac.com/smm/a_f.htm.
- Freddie Mac. (n.d.). *Our business*. Retrieved January 21, 2010, from http://www.freddiemac.com/corporate/company_profile/our_business/.
- Froomkin, M. (1995). Reinventing the government corporation. *University of Illinois Law Review*, 1995, 543-634.
- Gan, J. & Riddiough, J. (2008). Monopoly and information advantage in the residential mortgage market. *Review of Financial Studies*, 21, 2678-2702.
- Goldfarg, Z. A. & Cho, D. (2009, August 6). U.S. considers remaking mortgage giants. *The Washington Post*, p. A1.
- Gongloff, M. (2008, May 6). Counting on a Fan, Fred safety net. *The Wall Street Journal*, p. C1.
- Goodman, J. L. & Passmore, W. S. (1992). *Market power and the pricing of mortgage securitization* (Federal Reserve Board's Finance and Economics Discussion Series 187). Washington, DC: Federal Reserve Board.
- Grant, J. & Guha, K. (2007, November 26). Tough stance on Freddie, Fannie is vindicated. *Financial Times* (USA ed.), p. 6.
- Grant, J. (2007, August 11). Fannie Mae offer to ease subprime pain rebuffed by regulator. *Financial Times* (USA ed.), p. 3.
- 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*. Oxford, UK: Elsevier Science Ltd.
- Guerrera, F., Mackenzie, M. & Scholtes, S. (2008, February 28). Fannie-Freddie caps lifted amid deepening gloom. *Financial Times* (USA ed.), p. 1.
- Guerrera, F., Scholtes, S., Sender, H., Politi, J., & Guha, K. (2008, July 15). Bail-out fails to calm nerves. *Financial Times* (USA ed.), p. 1.
- Guha, K. (2008, July 14). Fannie and Freddie handed roadmap. *Financial Times* (USA ed.), p. 2.
- Guha, K., Scholtes, S. & Politi, J. (2008, June 4). Saviours of the suburbs: are US's twin home loan titans at risk? *Financial Times* (USA ed.), p. 1.

- Gup, B. E. (2004). Are Fannie Mae and Freddie Mac too big to fail? In Gup, B.E. (Ed.) *Too big to fail: Policies and practices in government bailouts*. Westport, CT: Praeger Publishers.
- Hagerty, J. R. (2004, March 29). Fannie, Freddie face a tough plan—Senate Republicans offer strong bill to strengthen mortgage firms' oversight. *The Wall Street Journal*, p. A2.
- Hagerty, J. R. (2007, February 24). Mortgage-bond pioneer dislikes what he sees. *The Wall Street Journal*, p. B1.
- Hagerty, J. R. (2007, July 28). Fannie, Freddie are said to suffer in subprime. *The Wall Street Journal*, p. A3.
- Hagerty, J. R. (2007, August 8). Big fans for Fannie, Freddie. *The Wall Street Journal*, p. C1.
- Hagerty, J. R. (2007, November 13). Mortgage crisis extends its reach—Fannie, Freddie regain dominance as investors shrink from housing. *The Wall Street Journal*, p. A1.
- Hagerty, J. R. (2007, November 19). Fannie, Freddie feel default heat. *The Wall Street Journal*, p. A14.
- Hagerty, J. R. (2007, November 21). Mortgage giant fuels worries with steep loss. *The Wall Street Journal*, p. A1.
- Hagerty, J. R. (2007, December 5). Fannie Mae hurries to raise \$7 billion. *The Wall Street Journal*, p. A3.
- Hagerty, J. R. (2007, December 12). Freddie seeks to put loss into context. *The Wall Street Journal*, p. B4.
- Hagerty, J. R. (2008, January 25). More risk for Fannie, Freddie? *The Wall Street Journal*, p. A8.
- Hagerty, J. R. (2008, March 11). Pressure on Fannie and Freddie. *The Wall Street Journal*, p. A3.
- Hagerty, J. R. (2008, May 17). Fannie, Freddie called weak in capital base. *The Wall Street Journal*, p. A3.
- Hagerty, J. R. (2008, May 23). Fannie, Freddie report progress in cutting some mortgage rates. *The Wall Street Journal*, p. A5.
- Hagerty, J. R. (2008, July 8). Mortgage giants take beating on fears over loan defaults. *The Wall Street Journal*, p. A1.
- Hagerty, J. R. (2008, July 10). US mulls future of Fannie, Freddie. *The Wall Street Journal*, p. A1.
- Hagerty, J. R. (2008, July 11). Mortgage giants face pressure over capital. *The Wall Street Journal*, p. A1.
- Hagerty, J. R. (2008, August 12). S&P cuts some ratings on Fannie and Freddie. *The Wall Street Journal*, p. C5.
- Hagerty, J. R. (2008, October 30). Mortgage plan isn't cutting rates—borrowing costs for Fannie Mae, Freddie Mac are rising amid debt buyer's jitters. *The Wall Street Journal*, p. A3.
- Hagerty, J. R. (2008, December 10). Fannie, Freddie knew of risks. *The Wall Street Journal*, p. A2.
- Hagerty, J. R. (2009, January 8). Paulson: Redo Fannie, Freddie. *The Wall Street Journal*, p. A11.
- Hagerty, J. R. (2009, January 21). Home-Loan Banks struggle to maintain capital. *The Wall Street Journal*, p. A6.
- Hagerty, J. R. & Edwards, A. (2008, February 28). Fannie Mae lowers housing outlook as it logs \$3.56 billion loss. *The Wall Street Journal*, p. A2.
- Hagerty, J. R., Langley, M., & Pulliam, S. (2008, July 18). Mortgage giant Freddie Mac considers major stock sale—issue of up to \$10 billion would aim to stave off rescue plan. *The Wall Street Journal*, p. A1.
- Hagerty, J. R. & Paletta, D. (2009, February 27). Red ink clouds role of Fannie, Freddie. *The Wall Street Journal*, p. A2.
- Hagerty, J. R. & Saha-Bubna, A. (2008, February 29). Credit crunch: Freddie posts big loss but has enough capital. *The Wall Street Journal*, p. C2.
- Hagerty, J. R. & Saha-Bubna, A. (2008, August 19). Fannie Mae, Freddie Mac are pounded—two stocks plunge on growing fears of a U.S. bailout. *The Wall Street Journal*, p. A3.
- Hagerty, J. R., Simon R., & Paletta, D. (2008, September 8). U.S. seizes mortgage giants—government ousts CEOs of Fannie, Freddie; promises up to \$200 billion in capital. *The Wall Street Journal*, p. A1.
- Halderman, E. (2010, January 25). Featured perspectives: The principles of the secondary mortgage market. Retrieved from http://www.freddiemac.com/news/featured_perspectives/20100125_haldeman.html.
- Hermalin, B. E. & Jaffee, D. M. (1996). The privatization of Fannie Mae and Freddie Mac: Implications for mortgage industry structure. In *Studies on privatizing Fannie Mae and Freddie Mac*. Washington, DC: U.S. Department of Housing and Urban Development.

- Herszenhorn, D. M. (2008, June 25). Approval is near for bill to help U.S. homeowners. *The New York Times*, p. A1.
- Hilsenrath, J. & Reddy, S. (2008, December 2). Fed signals more action as slump drags on—recession began a year ago, making it longest since early '80s, panel says; Bernanke considers rate cuts, bond purchases. *The Wall Street Journal*, p. A1.
- Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, 122 Stat. 2654 (2008).
- Housing Goals, 24 C.F.R. §§ 81.11-81.22 (2004).
- Hylton, K. N. (2003). *Antitrust law: Economic theory and common law evolution*. Cambridge, UK: Cambridge University Press.
- Ishamel, S. (2007, September 20). CIT to sell subprime book to Freddie Mac. *Financial Times* (London ed.), p. 17.
- Ishmael, S. (2007, September 28). Freddie Mac chief warns of recession. *Financial Times* (London ed.), p. 27.
- Jackson, P. (2005). *Fundamental tax reform: Options for the mortgage interest deduction* (CRS Report for Congress RL33025). Washington, DC: Congressional Research Service.
- Jaffe, D. M. (2006). *Controlling the interest rate risk of Fannie Mae and Freddie Mac* (NFI Policy Brief 2006-PB-04). Indianapolis, IN: Networks Financial Institute. Retrieved from <http://ssrn.com/abstract=923568>.
- Jenkins Jr., H. (2008, July 30). How to shake off the mortgage mess. *The Wall Street Journal*, p. A13.
- Jeske K. & Krueger, D. (2005). *Housing and the macroeconomy: The role of implicit guarantees for government-sponsored enterprises* (Working paper 2005-15). Atlanta, GA: Federal Reserve Bank of Atlanta.
- Joint Center for Housing Studies of Harvard University. (2009). *Meeting multifamily finance needs during and after the credit crisis: A policy brief*. Cambridge, MA: Joint Center for Housing Studies.
- Kahn, A. (1988). *The economics of regulation*. Cambridge, MA: MIT Press.
- Komesar, N. K. (1994). *Imperfect alternatives: Choosing institutions in law, economics and public policy*. Chicago, IL: The University of Chicago Press.
- Kopecki, D. (2005, August 17). Study faults federal home-lending subsidies as aiding wealthy. *The Wall Street Journal*, p. A4.
- Kopecki, D. (2009, May 11). *Options for Fannie, Freddie may include 'wind-down.'* Bloomberg. Retrieved from <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aYaMsoGGUf6l>.
- Koppell, J. G. (2003). *The politics of quasi-government*. Cambridge, UK: Cambridge University Press.
- Krugman, P. (2008, June 23). Home not-so-sweet home. *The New York Times*, p. A21.
- Kupiec, P. & Nickerson, D. (2004). Assessing systemic risk exposure from banks and GSEs under alternative approaches to capital regulation. *Journal of Real Estate Finance & Economics*, 28, 123-145.
- Labaree, B.W. (1981). *The Boston Tea Party*. Boston, MA: Northeastern University Press.
- Lawson, P. (1993). *The East India Company: A history*. New York, NY: Addison Wesley Longman.
- Lea, M.J. (2006). *Privatizing a government sponsored enterprise: Lessons from the Sallie Mae experience* (NFI Policy Brief 2006-PB-09). Indianapolis, IN: Networks Financial Institute. Retrieved from <http://ssrn.com/abstract=923461>.
- Lee, J. & Dash, E. (2004, October 6). Long insulated, Fannie Mae feels political heat. *The New York Times*, p. C1.
- Lockhart, J.B. (2009, June 30). Speech before the National Press Club, FHFA's first anniversary and challenges ahead. Retrieved from <http://www.fhfa.gov/webfiles/14715/FHFA1stAnnSpeechandPPT73009.pdf>.
- 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. *Virginia Law Review*, 74, 472-518.
- Mackenzie M. & Chung, J. (2008, May 7). Regulator boost for Fannie Mae. *Financial Times* (USA ed.), p. 15.
- McClure, K. (2001). The twin mandates given to the GSEs: Which works best, helping low income homebuyers or helping underserved areas? *Cityscape*, 5(3), 107-143.

- McKinnon, J. D. & Wilke, J. R. (2004, October 15). HUD says Freddie double-counted some transactions. *The Wall Street Journal*, p. A2.
- Mitchell, C. (2008, August 20). Domestic banking: a new regulator of government sponsored enterprises. *New York Law Journal*, p. 3.
- Mozilo, A. R. (2007, December 5). Calling Fannie and Freddie. *The Wall Street Journal*, p. A24.
- NAHB. (2010, January 27). *New and existing single family home prices, U.S.* Retrieved from <http://www.nahb.org/>.
- Natarajan, P. (2008, April 15). GSEs could affect US credit rating. *The Wall Street Journal*, p. C2.
- National Association of Home Builders. (2009, June 4). *Bolstering the GSEs key to future of nation's housing system* [Press release]. Retrieved from http://www.nahb.org/news_details.aspx?newsID=9303.
- National Association of Realtors. (n.d.). *Government sponsored enterprises presidential advisory group: NAR principles for ensuring a robust financing environment for homeownership*. Retrieved January 21, 2010 from http://www.realtor.org/government_affairs/gapublic/gse_principles.
- National Housing Trust Fund. (n.d.). *NHTF background*. Retrieved January 21, 2010, from <https://www.2398.ssldomain.com/nlihc/template/page.cfm?id=40>.
- Norris, F. (2007, March 2). Can lenders suddenly tighten reins? *The New York Times*, p. C1.
- Nothaft, F., Pearce, J. E., & Stevanovic, S. (2002). Debt spreads between GSEs and other corporations. *Journal of Real Estate Finance & Economics*, 25, 151-172.
- Nott, L. & Miles, B. (2006). *GSE regulatory reform: Frequently asked questions* (CRS Congressional Reports RS21724). Washington, DC: Congressional Reporting Service.
- OFHEO. (2003). *Systemic risk: Fannie Mae, Freddie Mac and the role of OFHEO*. Washington, DC: Office of Federal Housing Enterprise Oversight.
- OFHEO. (2008, March 6). *Temporary conforming loan limit released for high-cost areas* [Press release]. Retrieved from <http://www.fhfa.gov/webfiles/2263/3608TempCLLreleased.pdf>.
- OMB. (1995). *Memorandum on government corporations* (M-96-05). Retrieved from www.whitehouse.gov/omb/assets/omb/memoranda/m96-05.pdf.
- Paletta, D. (2006, August 2). Freddie Mac will voluntarily cap yearly mortgage-portfolio growth. *The Wall Street Journal*, p. A2.
- Paletta, D. (2007, September 10). Schumer to seek mortgage funding boost. *The Wall Street Journal*, p. A3.
- Paletta, D. (2007, September 22). Limits of Fannie, Freddie could be lifted. *The Wall Street Journal*, p. A4.
- Paletta, D. (2007, October 4). Democrats propose mortgage aid. *The Wall Street Journal*, p. A5.
- Paletta, D. (2007, October 24). OFHEO is pressured over mortgages. *The Wall Street Journal*, p. B10.
- Paletta, D. (2007, November 9). Idea of jumbo-loan guarantee is floated. *The Wall Street Journal*, p. A2.
- Paletta, D. (2008, January 17). Grip on Freddie, Fannie may ease. *The Wall Street Journal*, p. A3.
- Paletta, D. (2008, March 18). Plans would boost funds for mortgages. *The Wall Street Journal*, p. A6.
- Paletta, D. (2008, March 20). US boosts its role in mortgages. *The Wall Street Journal*, p. A3.
- Paletta, D. (2008, May 20). Senate strikes housing rescue deal. *The Wall Street Journal*, p. A1.
- Paletta, D. & Hagerty, J. R. (2008, March 20). U.S. puts faith in Fannie, Freddie—firms, once hemmed in, are freed for bigger role in aiding mortgage market. *The Wall Street Journal*, p. A3.
- Passmore S. W., Sparks, R. and Ingpen, J. (2002). GSEs, mortgage rates, and the long-run effects of mortgage securitization, *Journal of Real Estate Finance & Economics*, 25, 215-242.
- Pearce, J. E. & Miller III, J. C. (2006). *Revisiting the net benefits of Freddie Mac and Fannie Mae*. McLean, VA: Freddie Mac.
- Peltzman, S. (1998). The economic theory of regulation after a decade of deregulation. In Peltzman, S. (Ed.) *Political participation and government regulation*. Chicago, IL: University of Chicago Press.
- Peritz, R. J. R. (2000). *Competition policy in America*. New York, NY: Oxford University Press.
- Phillips, M. M & Paletta, D. (2008, March 22). Paulson takes lead amid crisis. *The Wall Street Journal*, p. A4.
- Posner, R. A. (1986). *Economic analysis of law* (3d ed.). Boston, MA: Little, Brown.
- Reilly, D. & Eavis, P. (2008, May 7). Will \$6 billion do for Fannie? *The Wall Street Journal*, p. C26.
- Reiss, D. (2006). Subprime standardization: How rating agencies allow predatory lending to flourish in the secondary mortgage market. *Florida State University Law Review*, 33, 985-1066.

- Reiss, D. (2008). The federal government's implied guarantee of Fannie Mae and Freddie Mac's obligations: Uncle Sam will pick up the tab. *Georgia Law Review*, 42, 1019-1083.
- Reiss, D. (2008, September 15). After Fannie and Freddie. *The National Law Journal*, p. 23.
- Roll, R. (2003). Benefits to homeowners from mortgage portfolios retained by Fannie Mae and Freddie Mac. *Journal of Financial Services Research*, 23, 29-42.
- Saha-Bubna, A. & Natarajan, P. (2008, August 9). Fannie cuts support for mortgage market. *The Wall Street Journal*, p. B6.
- Sanders, A. B. (2002). Government sponsored agencies: Do the benefits outweigh the costs. *Journal of Real Estate Finance & Economics*, 25, 121-128.
- Schick, A. & LoStracco, F. (2000). *The federal budget: Politics, policy, process*. Washington, DC: The Brookings Institution Press.
- Scholtes, S. (2008, March 13). Freddie Mac decides against raising capital. *Financial Times* (London ed.), p. 42.
- Scholtes, S. (2008, March 18). Shock widening in spreads of Fannie and Freddie debt. *Financial Times* (London ed.), p. 25.
- Scholtes, S. (2008, April 3). Data shows Fannie and Freddie taking the wheel in home loans. *Financial Times* (London ed.), p. 19.
- Seidman, H. (1983). Public enterprise in the United States. *Annals of Public & Cooperative Economics*, 54, 3-18.
- Seidman, H., Stanton, T.H., Woodward, G.T. (1989, Autumn). Budgetary consequences of using a government sponsored enterprise to provide financial assistance to the Federal Savings and Loan Insurance Corporation. *Public Budgeting and Finance*, 9, 76-91.
- Seiler, R. (1999). Fannie Mae and Freddie Mac as investor-owned utilities. *Journal of Public Budgeting, Accounting & Financial Management*, 11, 117-154.
- Shenn, J. & Kopecki, D. (2009, October 21). Fannie, Freddie focus on Obama's mortgage program, CEOs say. *Bloomberg*. Retrieved from <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aFIx8bxb3FPg>.
- Sherman, R. (1989). *The regulation of monopoly*. New York, NY: Cambridge University Press.
- Shireman, R. (2004, June 14). What school loan scandal? *The New York Times*, p. A19.
- Simon, R. (2008, December 4). Homeowners' refinancing jumps by record pace. *The Wall Street Journal*, p. C1.
- Simon, R. & Hagerty, J. R. (2007, March 1). Mortgage defaults start to spread: New data shows that nontraditional loans are beginning to haunt borrowers with midlevel credit; prime still fine. *The Wall Street Journal*, p. D1.
- Sloan, S. (2008). Who will own Fannie, Freddie next—FHLBs? *American Banker*, 173(231), p. 4.
- Sloan, S. (2009). One year later, GSEs' future even less certain. *American Banker*, 174(304), 1.
- Solomon, D. (2007, August 22). How FHA could help homeowners. *The Wall Street Journal*, p. A4.
- Solomon, D. (2007, September 12). Paulson confident on economy. *The Wall Street Journal*, at A3.
- Solomon, D. (2008, July 18). Rescue plan is latest in a series of risks taken on by taxpayers. *The Wall Street Journal*, p. A10.
- Stanton, T. H. (1991). *A state of risk: Will government-sponsored enterprises be the next financial crisis?* New York, NY: HarperBusiness.
- Stanton, T. H. (2002a). *Government-sponsored enterprises: Mercantilist companies in the modern world*. Washington, DC: AEI Press.
- Stanton, T. H. (2002b). *Presentation to the Section on Administrative Law, AALS Annual Meeting: The administrative conference of the United States: A resource to help policymakers deal with the legal framework of third party government*. New Orleans, LA: Association of American Law Schools.
- Stanton, T. H. (2007). The life cycle of the government-sponsored enterprise: lessons for design and accountability. *Public Administration Review*, 67, 837-845.
- Stanton, T. H. & Moe, R. (2002). Government corporations and government-sponsored enterprises. In Salaman, L.M. (Ed.), *The tools of government: A guide to the new governance* (80-116). New York, NY: Oxford University Press.

- Stolberg, S. G. & Andrews, E. L. (2009, February 19). \$275 billion plan seeks to address crisis in housing. *The New York Times*, p. A1.
- Summers, L. (2008, July 28). Unfinished business at Freddie and Fannie. *The Washington Post*, p. A17.
- Sunstein, C. (1990). *After the rights revolution: Reconceiving the regulatory state*. Cambridge, MA: Harvard University Press.
- Surowiecki, J. (2008, March 10). Home economics. *The New Yorker*. Retrieved from http://www.newyorker.com/talk/financial/2008/03/10/080310ta_talk_surowiecki.
- Taylor, L.L. (1998). Does the United States still overinvest in housing? *Economic & Financial Policy Review (Federal Reserve Bank of Dallas)*, *Second Quarter*, 10-18.
- Timiraos, N. (2008, September 12). Homeownership push is rethought—both candidates weigh the best path to American dream. *The Wall Street Journal*, p. A4.
- Timiraos, N. (2009, September 2). Industry seeks Fannie, Freddie overhaul. *The Wall Street Journal*, p. A4.
- Timiraos, N. & Holzer, J. (2009, October 20). More housing aid is on the way. *The Wall Street Journal*, p. A5.
- Timiraos, N. & Simon, R. (2008, December 2). Smaller mortgage lenders see opportunity in turmoil. *The Wall Street Journal*, p. C1.
- Tullock, G. (1967). The welfare costs of tariffs, monopolies, and theft. *Western Economics Journal*, *5*, 224-232.
- Tullock, G. (1988). Rents and rent-seeking. In Rowley, C.K., Tollison, R.D., & Tullock, G. (Eds.) *The political economy of rent-seeking*. Boston, MA: Kluwer Academic Publishers.
- U.S. Constitution article 1, § 8.
- U.S. Department of Justice. (n.d.). *About the division: Antitrust division*. Retrieved January 21, 2010 from <http://www.justice.gov/atr/about/mission.htm>.
- U.S. Department of the Treasury. (1990). *Report of the Secretary of the Treasury on government-sponsored enterprises*. Washington, DC: U.S. Department of the Treasury.
- U.S. House Budget Committee Task Force on Housing and Infrastructure. (2000). *Housing enterprises: The role of Fannie Mae and Freddie Mac in the U.S. housing system*, statement of Thomas J. McCool, Director, Financial Institutions and Market Issues, U.S. GAO, 106th Congress. Washington, DC: U.S. Government Printing Office.
- U.S. House Committee on Financial Services. (2007). *Possible responses to rising mortgage foreclosures*, statement of Daniel H. Mudd, President and Chief Operating Officer, Fannie Mae, 110th Congress. Washington, DC: U.S. Government Printing Office.
- U.S. House Committee on Oversight and Government Reform. (2008). *The role of Fannie Mae and Freddie Mac in the financial crisis*, statement of Thomas H. Stanton, 110th Congress. Retrieved from http://oversight.house.gov/index.php?option=com_content&task=view&id=4712&Itemid=2.
- U.S. Senate Committee on Banking, Housing and Urban Affairs. (2004). *Proposals for improving the regulation of the housing government sponsored enterprises*, statement of Alan Greenspan, Chairman, Federal Reserve, 108th Congress. Washington, DC: U.S. Government Printing Office.
- U.S. Senate Committee on Banking, Housing and Urban Affairs. (2004). *Proposals for improving the regulation of the housing government sponsored enterprises*, statement of Franklin D. Raines, Chief Executive Officer, Fannie Mae, 108th Congress. Washington, DC: U.S. Government Printing Office.
- U.S. Senate Committee on Banking, Housing and Urban Affairs. *Reform of the government sponsored enterprises*, statement of Alan Greenspan, Chairman, Federal Reserve System, 109th Congress. Retrieved from <http://banking.senate.gov>.
- U.S. Senate Committee on Banking, Housing and Urban Affairs. (2009). *The future of the mortgage market and the housing enterprises*, statement by Edward J. DeMarco, Acting Director, FHFA, 111th Congress. Retrieved from <http://banking.senate.gov>.
- Van Order, R. (2000a). A microeconomic analysis of Fannie Mae and Freddie Mac. *Regulation*, *23*, 27-33.
- Van Order, R. (2000b). The U.S. mortgage market: a model of dueling charters. *Journal of Housing Research*, *11*, 233-256.
- Van Order, R. (2001). Some notes on the effects of Fannie Mae and Freddie Mac on mortgage markets. *Journal of Real Estate Finance & Economics*, *23*, 365-374.

- Wallace, M. (n.d.). President signs federal housing bill. Retrieved January 21, 2010 from <http://www.nlc.org>.
- Wallison, P. J. (2004). Applying the Microsoft decision to Fannie Mae and Freddie Mac. In Geddes, R.R. (Ed.) *Competing with the government: Anti-corruption behavior and public enterprises* (59-84). Stanford, CA: Hoover Institution Press.
- Wallison, P. J. (2008). Fannie and Freddie by twilight. *AEI: Financial Services Outlook*, pp. 1-7. Retrieved from <http://www.aei.org/outlook/28517>.
- Wallison, P. J. & Calomiris, C. W. (2008). The last trillion-dollar commitment: The destruction of Fannie Mae and Freddie Mac. *AEI: Financial Services Outlook*, 1-10. Retrieved from http://www.aei.org/docLib/20080930_Binder1.pdf.
- Wallison, P. J. & Ely, B. (2000). *Nationalizing mortgage risk: The growth of Fannie Mae and Freddie Mac*. Washington, DC: AEI Press.
- Wallison, P. J., Stanton, T. H., & Ely, B. (2004). *Privatizing Fannie Mae, Freddie Mac, and the Federal Home Loan Bank*. Washington, DC: AEI Press.
- Weisman, S. R. (2008, July 16). Plan to rescue mortgage giants faces resistance. *The New York Times*, p. A1.
- Weiss, E. (2006). *Limiting Fannie Mae and Freddie Mac's portfolio size* (CRS Congressional Reports RS22307). Washington, DC: Congressional Research Service.
- White, L. J. (2005, December). On truly privatizing Fannie Mae and Freddie Mac: Why it's important and how to do it. *Housing Finance International, 2005*, 13-19. Retrieved January 21, 2010 from <http://www.housingfinance.org/publications/hfi-archives>.
- White, L. J. & Frame, W. S. (2005). Fussing and fuming over Fannie and Freddie: How much smoke, how much fire? *The Journal of Economic Perspective, 19*, 159-184.
- Williams, R. A., McConnell, E., & Nesiba, R. (2001). The effects of the GSEs, CRA, and institutional characteristics on home mortgage lending to underserved markets. *Cityscape, 5*(3), 9-106.
- Williamson, E. (2008, July 18). Trouble may diminish Fannie and Freddie's lobbying clout. *The Wall Street Journal*, p. A10.
- Williamson E. & Mullins, B. (2008, July 31). Democratic ally mobilizes in housing crunch. *The Wall Street Journal*, p. A1.
- Willis, L.E. (2006). Decisionmaking and the limits of disclosure: the problem of predatory lending. *Maryland Law Review, 65*, 707-840.
- Woodward, S.E. (2005). *Rechartering Freddie Mac and Fannie Mae: The policy issues* (working paper). Menlo Park, CA: Sand Hill Econometrics. On file with author.