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## **THE FAILURE OF FANNIE MAE AND FREDDIE MAC AND THE FUTURE OF GOVERNMENT SUPPORT FOR THE HOUSING FINANCE SYSTEM**

*Thomas H. Stanton\**

In devising the government's response to the Great Depression, President Franklin Roosevelt turned not only to bankers, economists and lawyers, but also to scholars and practitioners in the field of public administration such as Charles Merriam and Louis Brownlow.<sup>1</sup> This article seeks to build on that tradition. While other disciplines concern themselves with devising appropriate policies, public administration focuses more on trying to ensure that those policies are effectively implemented.

Lessons from public administration, and especially the art of organizational design, provide insight about the failure of Fannie Mae and Freddie Mac and also suggest more stable means for government to support today's troubled housing finance system.

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<sup>1</sup> See, e.g., PERI E. ARNOLD, MAKING THE MANAGERIAL PRESIDENCY: COMPREHENSIVE REORGANIZATION PLANNING, 1905-1996, at 81-117 (1998).

Part I of this Article outlines how the two companies failed as a result of high leverage, poor business decisions, and weak regulatory supervision. Part II describes inherent vulnerabilities of the government-sponsored enterprise (GSE) as an organizational form. Specifically, GSE officers and directors have a legal obligation to serve shareholders and this can conflict with pressure from other stakeholders to serve the public purposes for which the GSE is chartered. Often this tension is manageable but at key times it is not. The GSE uses its government backing to gain so much power as to dominate virtually any system of financial accountability that government might try to establish. Part III evaluates the GSE as an organizational form. While the GSE may possess greater capacity and flexibility than a wholly owned government corporation or other government agency, it is subject to only limited accountability and displays significant vulnerabilities as it evolves over its organizational life-cycle.

Part IV recommends that the two GSEs be placed into receivership and converted into wholly owned government corporations. The article concludes that the two government corporations should either be terminated after five years or, if policymakers believe that there is yet further value to be gained from them at that time, that they be organized into a single government corporation and reauthorized on a five-year cycle to periodically determine whether their public benefits still outweigh their public costs. Caution is merited here because of the systemic implications of concentrating so much financial risk into a single specialized financial institution, whether in the public or private sector.

#### I. WHY FANNIE MAE AND FREDDIE MAC FAILED

On September 7, 2008, Fannie Mae and Freddie Mac voluntarily went into conservatorship.<sup>2</sup> As they recognize their

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<sup>2</sup> See, e.g., 12 U.S.C. § 4617 (2008) (prescribing the terms of conservatorship of Fannie Mae and Freddie Mac through the Federal Housing Enterprise Safety and Soundness Act of 1992); James B. Lockhart, Dir., Fed.

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losses it becomes clear that taxpayer costs from the government backing of the two companies will be substantial.<sup>3</sup>

The two companies are government-sponsored enterprises, privately owned companies that, before their failure, benefitted from the perception that the government would back their debt obligations and mortgage-backed securities (MBSs).<sup>4</sup> There are

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Hous. Fin. Agency, Statement of FHFA Director James B. Lockhart (Sept. 7, 2008), [http://money.cnn.com/2008/09/07/news/economy/lockhart\\_statement/index.htm](http://money.cnn.com/2008/09/07/news/economy/lockhart_statement/index.htm) (“In order to restore balance between safety and soundness and mission, FHFA has placed Fannie Mae and Freddie Mac into conservatorship.”); Henry M. Paulson, Jr., Sec’y, Treasury Department, Statement on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers (Sept. 7, 2008), <http://www.ustreas.gov/press/releases/hp1129.htm> (“I support the Director’s decision as necessary and appropriate and had advised him that conservatorship was the only form in which I would commit taxpayer dollars to the GSEs.”). The law prescribes that the regulator should use conservatorship to restore the companies to financial health. *See, e.g.*, FED. HOUS. FIN. AGENCY, FACT SHEET: QUESTIONS AND ANSWERS ON CONSERVATORSHIP 2 (2008) (“A conservatorship is the legal process in which a person or entity is appointed to establish control and oversight over a Company to put it in a sound and solvent condition. In a conservatorship, the powers of the Company’s directors, officers, and shareholders are transferred to the designated Conservator.”).

<sup>3</sup> *See* Dawn Kopecki, *Fannie, Freddie Won’t Repay All Aid*, *Lockhart Says*, BLOOMBERG, July 30, 2009, <http://www.bloomberg.com/apps/news?pid=20601103&sid=aEwoLtQMhQ5Y> (“Fannie Mae and Freddie Mac, the largest U.S. mortgage-finance companies, won’t be able to repay all of the \$84.9 billion in federal aid they have received since being seized by the government last year, their regulator said.”).

<sup>4</sup> More formally, a government-sponsored enterprise is a government chartered, privately owned and privately controlled institution that, while lacking an express government guarantee, benefits from the perception that the government stands behind its financial obligations. *See* Ronald C. Moe & Thomas H. Stanton, *Government Sponsored Enterprises as Federal Instrumentalities: Reconciling Private Management with Public Accountability*, 49 PUB. ADMIN. REV. 321, 321–22 (1989); *accord* 2 U.S.C. § 622(8) (2009) (definition Congress enacted in amendments to the Congressional Budget Act of 1974). The Treasury purchase of stock in Fannie Mae and Freddie Mac on September 7, 2008, and its commitment to infuse up to \$200 billion into the companies as needed, made the government’s backing explicit rather than implicit, as it had been before the

five GSEs: Fannie Mae, Freddie Mac, the Federal Home Loan Bank System, the Farm Credit System and a small GSE known as Farmer Mac.<sup>5</sup> Fannie Mae, Freddie Mac, and Farmer Mac are investor-owned. The Farm Credit System and Federal Home Loan Bank System are cooperatives, owned by their member-borrowers.<sup>6</sup> A sixth GSE, Sallie Mae, which funds student loans, gave up its government sponsorship and became a completely private investor-owned company.<sup>7</sup>

The housing bubble was an unprecedented increase in housing prices averaging over 100 percent from 2000–2006 in urban areas, followed by a substantial drop in prices.<sup>8</sup> The failure of Fannie Mae and Freddie Mac cannot be attributed solely to the housing credit bubble and collapse. Rather, it appears that the collapse of the housing credit bubble was a precipitating event with consequences that could have been avoided by more prudent practices by the two GSEs and their management, and that revealed shortcomings in the GSE as an institutional form.

Fannie Mae and Freddie Mac committed serious misjudgments that helped to bring about their insolvency. The most serious misjudgments involved the companies' resistance to accepting more effective supervision and capital standards.<sup>9</sup> For

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companies went into government hands.

<sup>5</sup> THOMAS H. STANTON, *GOVERNMENT-SPONSORED ENTERPRISES: MERCANTILIST COMPANIES IN THE MODERN WORLD 1* (2002) [hereinafter STANTON, *MERCANTILIST COMPANIES*].

<sup>6</sup> Thomas H. Stanton, *Government-Sponsored Enterprises: Reality Catches up to Public Administration Theory*, 69 *PUB. ADMIN. REV.* 632, 632 (2009) [hereinafter Stanton, *Public Administration Theory*].

<sup>7</sup> Thomas H. Stanton, *Reducing Government Involvement in a Market: Lessons from the Privatization of Sallie Mae*, 28 *PUB. BUDGETING. & FIN.* 101–23 (2008) [hereinafter Stanton, *Reducing Government Involvement*].

<sup>8</sup> See, e.g., MARK ZANDI, *FINANCIAL SHOCK: A 360° LOOK AT THE SUBPRIME MORTGAGE IMPLOSION, AND HOW TO AVOID THE NEXT FINANCIAL CRISIS* (2009).

<sup>9</sup> Among the bills that the GSEs helped to defeat in the years 2000–2007 were Fed. Hous. Enterprise Regulatory Reform Act, S. 1100, 110th Cong. (2007) (enacted); Fed. Hous. Fin. Reform Act, H.R. 1427, 110th Cong. (2007) (enacted); Fed. Hous. Fin. Reform Act, 109th Cong. (2005)

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years, starting with their successful efforts to weaken the legislation that established their regulator, the Office of Federal Housing Enterprise Oversight (OFHEO),<sup>10</sup> the two companies managed to fend off capital standards that would have reduced their excessive leverage and provided a cushion to absorb potential losses.<sup>11</sup> In 2007 Freddie Mac concluded a stock buyback program that further weakened the company's ability to withstand a financial shock.<sup>12</sup> As late as March 2008, Freddie

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(enacted); Fed. Hous. Enterprise Regulatory Reform Act, S. 190, 109th Cong. (2005); Fed. Hous. Enterprise Oversight Modernization Act, S. 1656, 108th Cong. (2003); Leave No Securities Behind Act, H.R. 2022, 108th Cong. (2003); Secondary Mortgage Market Enterprises Regulatory Improvement Act, H.R. 2575, 108th Cong. (2003); Hous. Fin. Regulatory Restructuring Act, H.R. 2803, 107th Cong. (2002); Secondary Mortgage Market Enterprises Regulatory Improvement Act, H.R. 1409, 107th Cong. (2001); Hous. Fin. Regulatory Improvement Act, H.R. 3703, 106th Cong. (2000).

<sup>10</sup> Many reports document the successful efforts of Fannie Mae and Freddie Mac at weakening the legislation creating OFHEO and prescribing their capital standards. *See, e.g.*, Kenneth H. Bacon, *Privileged Position: Fannie Mae Expected to Escape Attempt at Tighter Regulation*, WALL ST. J., June 19, 1992, at A1; Stephen Labaton, *Power of the Mortgage Twins: Fannie and Freddie Guard Autonomy*, N.Y. TIMES, Nov. 12 1991, at D1; Carol Matlack, *Getting Their Way*, NAT'L L.J., Oct. 27, 1990, at 2584-88; Jill Zuckman, *Bills to Increase GSE Oversight Move Ahead in House, Senate*, CQ WEEKLY, Aug. 3, 1991, <http://www.cq.com/display.do?dockey=/cqonline/prod/data/docs/html/weeklyreport/102/wr404032.html@allnewsarchive&metapub=CQ-WEEKLYREPORT&searchIndex=5&seqNum=6>.

<sup>11</sup> *See, e.g.*, Ben S. Bernanke, Chairman, Bd. of Governors of Fed. Reserve Sys., Address at the UC Berkley/UCLA Symposium: The Future of Mortgage Finance in the U.S. (Oct. 31, 2008) ("For example, the GSEs were reluctant earlier this year to raise capital and to expand their operations, even though this would have helped financial and macroeconomic stability at a time of much-reduced mortgage availability. The GSEs' disinclination to support the mortgage market was motivated by the fact that raising additional capital would have diluted the values of the holding of the existing private shareholders.").

<sup>12</sup> FREDDIE MAC, 2007 ANN. REP. at 25 ("On March 23, 2007, we announced that our board of directors had authorized us to repurchase up to \$1 billion of outstanding shares of common stock. The repurchase program was completed in August 2007.").

Mac defied calls to increase its capital cushion.<sup>13</sup> As late as summer 2008, Fannie Mae continued to resist legislation that would give a federal regulator the discretion to set higher capital standards.<sup>14</sup> As a result the two companies were far too weak financially to cope with any significant financial stress that might occur.

The companies fought for high leverage because it benefited their shareholders and managers, at least until the companies failed.<sup>15</sup> Freddie Mac reported returns on equity of over 20 percent in most years since becoming an investor-owned company in 1989, reaching highs of 47.2 percent in 2002 and 39.0 percent in 2000.<sup>16</sup> Fannie Mae reported earnings of almost as much, reaching a high of 39.8 percent in 2001.<sup>17</sup> The two companies fought higher capital requirements because more capital would have diluted those returns to shareholders.<sup>18</sup>

Fannie Mae and Freddie Mac compounded the problem of their self-inflicted structural vulnerabilities with a series of misjudgments that involved taking on excessive risk just at the point that housing prices were peaking.<sup>19</sup> According to press reports, the chief executives of both Fannie Mae and Freddie Mac disregarded warnings from their risk officers and greatly increased their purchases of risky loans to catch up with the

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<sup>13</sup> David S. Hilzenrath, *Chief Says Freddie Won't Raise Capital: Mortgage Financer Cites Responsibility to Shareholders, Won't Increase Loan Capacity*, WASH. POST, Mar. 13, 2008, at D04.

<sup>14</sup> Steven Sloan, *Fannie CEO Details Issues with GSE Bill*, AM. BANKER, June 5, 2008, [http://www.americanbanker.com/issues/173\\_109/-354497-1.html](http://www.americanbanker.com/issues/173_109/-354497-1.html).

<sup>15</sup> Bernanke, *supra* note 11.

<sup>16</sup> FED. HOUS. AGENCY, REPORT TO CONGRESS 110, 127 (2008) (Freddie Mac).

<sup>17</sup> *Id.* at 127.

<sup>18</sup> *See supra* notes 9–11.

<sup>19</sup> *See* James B. Lockhart, Dir., Fed. Hous. Fin. Agency, FHFA'S First Anniversary and Challenges Ahead (July 30, 2009) (transcript available in the National Press Club) ("Fannie Mae and Freddie Mac did not create the housing price bubble, but their procyclical actions further inflated the bubble, despite our regulatory efforts to curtail their growth.").

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market.<sup>20</sup> The following excerpts from their annual reports indicate that the two GSEs took on substantial risk from purchasing subprime mortgages (i.e., those with borrowers who failed to meet traditional standards of creditworthiness), “Alt-A” mortgages (i.e., “Alternative-A” mortgages which lacked verification of crucial data about creditworthiness such as the borrower’s income), “interest-only” mortgages (those that permitted borrowers to continue to accrue mortgage principal without paying it down in a timely fashion), and adjustable rate mortgages (ARMs) (those that allowed mortgage interest rates and borrowers’ required monthly payments to increase over time according to a stated index even though the borrower might have qualified only to make monthly payments on the mortgage at a lower interest rate).<sup>21</sup> Freddie Mac reported in its 2007 Annual Report that:

[t]he proportion of higher risk mortgage loans that were originated in the market during the last four years increased significantly. We have increased our securitization volume of non-traditional mortgage products, such as interest-only loans and loans originated with less documentation in the last two years in response to the prevalence of these products within the origination market. Total non-traditional mortgage products, including those designated as Alt-A and interest-only loans, made up approximately 30% and 24% of our single-family mortgage purchase volume in the years

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<sup>20</sup> See., e.g., Charles Duhigg, *The Reckoning: Pressured to Take More Risk, Fannie Reached Tipping Point*, N.Y. TIMES, Oct. 5, 2008, <http://www.nytimes.com/2008/10/05/business/05fannie.html>; Charles Duhigg, *At Freddie Mac, Chief Discarded Warning Signs*, N.Y. TIMES, Aug. 5, 2008, <http://www.nytimes.com/2008/08/05/business/05freddie.html>; David S. Hilzenrath, *Fannie’s Perilous Pursuit of Subprime Loans: As It Tried to Increase Its Business, Company Gave Risks Short Shrift, Documents Show*, WASH. POST, Aug. 19, 2008, at D01.

<sup>21</sup> Among the most financially risky ARMs were those with initial low rates (so-called “teaser rates”) that reset to much higher rates after two or three years.



ended December 31, 2007 and 2006, respectively.<sup>22</sup>

Fannie Mae's 2007 Annual Report states:

[w]e are experiencing high serious delinquency rates and credit losses across our conventional single-family mortgage credit book of business, especially for loans to borrowers with low credit scores and loans with high loan-to-value ("LTV") ratios. In addition, in 2007 we experienced particularly rapid increases in serious delinquency rates and credit losses in some higher risk loan categories, such as Alt-A loans, adjustable-rate loans, interest-only loans, negative amortization loans, loans made for the purchase of condominiums and loans with second liens. Many of these higher risk loans were originated in 2006 and the first half of 2007.<sup>23</sup>

Fannie Mae reported that purchases of interest-only and negative amortizing ARMs amounted to 7% of its business volume in 2007 and 12% in both 2006 and 2005.<sup>24</sup> Moreover, Alt-A mortgage loans "represented approximately 16% of . . . single-family business volume in 2007, compared with approximately 22% and 16% in 2006 and 2005, respectively."<sup>25</sup> Both companies also invested in highly rated private-label, mortgage-related securities, backed by Alt-A or subprime mortgage loans, amounting to total holdings by the two companies of over \$200 billion in 2007.<sup>26</sup>

In short, the mix of private incentives and government backing created a dynamic leading not only to the hubris that brought about the meltdown of internal controls at both Fannie Mae and Freddie Mac a few years ago,<sup>27</sup> but also to their

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<sup>22</sup> FREDDIE MAC, 2007 ANN. REP., at 13.

<sup>23</sup> FANNIE MAE, 2007 ANN. REP., at 24.

<sup>24</sup> *Id.* at 128.

<sup>25</sup> *Id.* at 129.

<sup>26</sup> FANNIE MAE, 2007 ANN. REP. 93 (2008); FREDDIE MAC, 2007 ANN. REP. 94 (2008).

<sup>27</sup> Thomas H. Stanton, *The Life Cycle of the Government-Sponsored Enterprise: Lessons for Design and Accountability*, 67 PUB. ADMIN. REV. 837, 840 [hereinafter Stanton, *Lessons for Design and Accountability*] (2007).

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insolvency in 2008.

That said, Fannie Mae and Freddie Mac did not cause the housing bubble or the proliferation of subprime and other mortgages that borrowers could not afford to repay. In analyzing the dynamics of Fannie Mae and Freddie Mac, I discovered a phenomenon that can be called Stanton's Law: *risk will migrate to the place where government is least equipped to deal with it.*<sup>28</sup> Thus, the capital markets arbitrated across regulatory requirements and sent literally trillions of dollars of mortgages to Fannie Mae and Freddie Mac,<sup>29</sup> where capital requirements were low and federal supervision was weak.<sup>30</sup>

However, the capital markets also found other places where government could not manage the risk,<sup>31</sup> including structured investment vehicles of commercial banks, private securitization conduits, and collateralized debt obligations that were virtually unregulated except by the vagaries of the rating agencies and exuberance of the market during the housing bubble.<sup>32</sup> Huge

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<sup>28</sup> I first presented this dynamic in 1989 testimony before the Senate Banking Committee, where I pointed out that increases in stringency of capital requirements and government supervision for thrift institutions after the savings and loan debacle would drive many billions of dollars of mortgages from the portfolios of savings and loan associations to Fannie Mae and Freddie Mac because their capital standards and government oversight were much weaker. *The Safety and Soundness of Government Sponsored Enterprises: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 101st Cong. 41, 52 (1989) (statement of Thomas H. Stanton, Attorney at Law).

<sup>29</sup> See, e.g., Report to Congress 2008, *supra* note 16, at 111 tbl.4 (Fannie Mae), 128 tbl.11 (Freddie Mac) for the annual growth of Fannie Mae and Freddie Mac.

<sup>30</sup> See *supra* notes 9–11.

<sup>31</sup> See, e.g., Ben S. Bernanke, Chairman, Bd. of Governors of Fed. Reserve Sys., Address at the Federal Reserve Bank of Chicago Conference on Bank Structure and Competition: Lessons of the Financial Crisis for Banking Supervision (May 7, 2009).

<sup>32</sup> See, e.g., Markus Brunnermeier et al., *The Fundamental Principles of Financial Regulation*, Geneva Reports on the World Economy 11, Preliminary Conference Draft, Centre for Economic Policy Research (CEPR), Jan. 2009, app. A “The Boundary Problem in Financial Regulation,” at 63–69.

volumes of subprime, Alt-A, interest-only and other “toxic mortgages” went to these parts of the market.<sup>33</sup> As the bubble reached its limits and began to deflate, the GSEs tried to catch up and regain the market share that they had lost to the new competition. Former Freddie Mac CEO Richard Syron explained the pressures on the GSEs:

The subprime market was developed largely by private label participants, as were most non-traditional mortgage products. Freddie Mac entered the non-traditional slice of the market because, as the private lending sector shifted toward those types of loans, Freddie needed to participate in order to carry out its public mission of promoting affordability, liquidity and stability in housing finance. In addition, if it had not done so, it could not have remained competitive or even relevant in the residential mortgage market we were designed to serve.<sup>34</sup>

## II. LESSONS FROM THE FAILURE OF FANNIE MAE AND FREDDIE MAC

Many other kinds of financial institutions have failed in the current debacle, including commercial banks, thrift institutions, mortgage companies, and insurance companies. Among all of these, the GSE has specific shortcomings that call the value of this institutional form into doubt.

In making their mistakes, Fannie Mae and Freddie Mac revealed the inherent vulnerabilities of the GSE as an organizational model. First, the GSE lives or dies according to its charter and other laws that determine the conditions under which it operates.<sup>35</sup> That means that GSEs must balance their

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<sup>33</sup> *Id.*

<sup>34</sup> *The Role of Fannie Mae and Freddie Mac in the Financial Crisis: Hearing Before the H. Comm. on Oversight & Government Reform*, 110th Cong. 17–22 (2008) [hereinafter Syron Statement] (statement of Richard F. Syron, Former CEO of Freddie Mac), available at <http://oversight.house.gov/story.asp?ID=2252>.

<sup>35</sup> See, e.g., FANNIE MAE, 2007 ANN. REP., at 29–31 (“As a federally chartered corporation, we are subject to the limitations imposed by the

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profit goals against public purposes and those interests of stakeholders which can influence their charters.

Second, the GSE combines private ownership with government backing in a way that creates a political force that can dominate virtually any safety-and-soundness framework. GSEs select chief officers, in good part, based on their ability to manage political risk,<sup>36</sup> rather than on their ability to manage two of the largest financial institutions in the world. This article will consider these issues in turn.

*A. GSEs Are Inherently Difficult if Not Impossible to Manage*

The GSE business model, involving private ownership and public purposes, is difficult, if not impossible, to manage. Fannie Mae and Freddie Mac were more vulnerable than commercial banks or other federal instrumentalities to the contradictions between the requirement to serve private shareholders and the need to serve public purposes that other stakeholders, including members of Congress, guarded and

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Charter Act, extensive regulation, supervision and examination by OFHEO and HUD, and regulation by other federal agencies, including the Department of the Treasury and the SEC. We are also subject to many laws and regulations that affect our business, including those regarding taxation and privacy. In addition, the policy, approach or regulatory philosophy of these agencies can materially affect our business.”).

<sup>36</sup> For example, in the mid-1990s the Congressional Budget Office reported on some of Fannie Mae’s activities:

In keeping with its fiduciary responsibility to shareholders and its own financial interests, the management of the housing GSEs has devoted a significant (but undisclosed) portion of the enterprises’ resources to countering—or hedging—that political risk . . . . Fannie Mae, in particular, makes no secret of its attempts to influence federal policy toward the GSEs as a means of controlling political risk . . . . Significantly, too, Fannie Mae explicitly includes the contribution to preserving its ‘franchise’ when evaluating the performance of executive staff.

CONG. BUDGET OFFICE, ASSESSING THE PUBLIC COSTS AND BENEFITS OF FANNIE MAE AND FREDDIE MAC 36–37 (1996) (internal citations omitted).

enforced.<sup>37</sup>

It has long been recognized that GSEs are a special type of federal instrumentality.<sup>38</sup> Other federal instrumentalities include most commercial banks and thrift institutions and other for-profit and nonprofit institutions chartered to serve public purposes.<sup>39</sup> In contrast to those other instrumentalities, the officers and directors of Fannie Mae and Freddie Mac seem to have had a much more difficult time balancing their fiduciary responsibilities to shareholders against the public purposes of their charter acts.<sup>40</sup> Pressure from stakeholders to carry out public purposes,<sup>41</sup> too, has conflicted with the GSEs' responsibility to maintain themselves as sources of long-term

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<sup>37</sup> Richard Syron, Freddie Mac's former CEO, pointed to this issue:

Freddie Mac is a shareholder-owned corporation, chartered for the public purpose of supporting America's mortgage finance markets, and operating under government mandates. We had obligations to Congress and to the public to promote our chartered purposes of increasing affordability, liquidity and stability in housing finance, which included some very specific low-income housing goals.

Syron Statement, *supra* note 34.

<sup>38</sup> STANTON, *MERCANTILIST COMPANIES*, *supra* note 5, at 13–32 ch.2.

<sup>39</sup> See, e.g., THOMAS H. STANTON, *A STATE OF RISK: WILL GOVERNMENT-SPONSORED ENTERPRISES BE THE NEXT FINANCIAL CRISIS?* App. A, at 205–07 (1991) [hereinafter STANTON, *A STATE OF RISK*]; Thomas H. Stanton, *Federal Supervision of Safety and Soundness of Government-Sponsored Enterprises*, 5 *ADMIN. L.J.* 395 (1991) [hereinafter Stanton, *Federal Supervision*].

<sup>40</sup> Richard Syron, Freddie Mac's former CEO, faced this problem:

Freddie Mac chief executive Richard F. Syron . . . said yesterday that conflicting demands on the government-chartered mortgage giant have made his job “almost impossible.”

On the eve of Freddie Mac's quarterly earnings report, Syron said that the McLean company has been whipsawed by the dual tasks of creating profit for private investors and serving the public by boosting the housing market. “What this organization is all about is balancing among the different missions,” Syron said in an interview. “It makes the job almost impossible.”

Jeffrey H. Birnbaum & David S. Hilzenrath, *Freddie CEO Feels Strain of Firm's Twin Missions*, *WASH. POST*, Aug. 6, 2008, at D01.

<sup>41</sup> See, e.g., Syron Statement, *supra* note 34.

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strength to the housing market.<sup>42</sup>

Perhaps most eloquent on this issue was Daniel Mudd, the former CEO of Fannie Mae, who testified in December 2008:

I would advocate moving the GSEs out of No Man's Land. Events have shown how difficult it is to balance financial, capital, market, housing, shareholder, bondholder, homeowner, private, and public interests in a crisis of these proportions. We should examine whether the economy and the markets are better served by fully private or fully public GSEs.<sup>43</sup>

There were several reasons why Fannie Mae and Freddie Mac were susceptible to being whipsawed between their fiduciary obligations to shareholders and their public purposes. One source of mischief was the fact that the two companies were chartered by an act of Congress rather than by an independent federal administrative agency. Members of Congress could constantly pressure Fannie Mae and Freddie Mac to undertake unwise lending policies. The two GSEs complied as a way to buy loyalty from the relevant congressional committees that otherwise might accede to requests from the Treasury or others to impose higher capital requirements or other restrictions that were unwelcome to shareholders. For example, Mr. Mudd testified that he felt pressure to increase Fannie Mae's market activity even as other

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<sup>42</sup> [W]e have to confront the future of the secondary mortgage market, which will, I believe, shape the other decisions. That has to be the first principle as we . . . evaluate the options for Fannie Mae's and Freddie Mac's future. A second principle is that the Enterprises or any successors should have a well-defined and internally consistent mission based on their fundamental role in the mortgage market. Their mission activities should not require excessive risk taking as it did in the past.

Lockhart, *supra* note 19.

<sup>43</sup> *The Role of Fannie Mae and Freddie Mac in the Financial Crisis: Hearing Before H. Comm. on Oversight and Government Reform*, 110th Cong. 25–26 (2008) (written statement of Daniel H. Mudd, Former Interim CEO of Fannie Mae), available at <http://oversight.house.gov/story.asp?ID=2252>.

institutions were stepping back because of declining market conditions.<sup>44</sup> Stakeholder pressure to serve public purposes was substantial; by contrast, far fewer stakeholders pushed to ensure effective supervision of safety and soundness.<sup>45</sup>

In addition, the GSEs selected a political strategy of achieving short-term goals at the potential cost of longer term achievements. Their refusal to accept bank-type capital requirements and a bank-type supervisory framework for accountability has already been mentioned.<sup>46</sup> The GSEs marshaled so much political power that they simply dominated their environment and dampened feedback signals that might have helped company officials to make better decisions.<sup>47</sup> In return, however, the GSEs had to buy off stakeholders with large volumes of mortgage purchases that they, or at least their risk officers, knew were unwise.<sup>48</sup>

In their governance shortcomings, the two GSEs compounded the more general problem that the current debacle has revealed. Former Federal Reserve Chairman, Alan Greenspan, put it best:

I made a mistake in presuming that the self interest of organizations, specifically banks and others, was such

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<sup>44</sup> *Id.*

<sup>45</sup> JONATHAN G.S. KOPPELL, *THE POLITICS OF QUASI-GOVERNMENT: HYBRID ORGANIZATIONS AND THE DYNAMICS OF BUREAUCRATIC CONTROL* 107, Cambridge University Press (2003).

<sup>46</sup> See sources cited *supra* notes 9–17.

<sup>47</sup> This problem is analyzed with respect to the two GSEs' failed internal controls in Stanton, *Lessons for Design and Accountability*, *supra* note 27.

<sup>48</sup> See sources cited *supra* note 20. Confidential company documents released by the House Committee on Oversight and Government Reform on December 9, 2008 detail some of the pressures on the companies and the mistakes made by the GSEs during 2005 through 2007. In particular, these documents indicate that the GSEs sought yield and market share despite added risk from nontraditional mortgage products and warnings from risk officers. Fannie Mae Office of Corporate Strategy, Memorandum to Daniel Mudd . . . from Gary Friend, Subject: CONFIDENTIAL Cambridge Summary, July 7, 2006, available at <http://oversight.house.gov/documents/20081209131806.pdf> (“Single Family’s strategy is to say ‘yes’ to our customers by increasing purchases of sub-prime and Alt-A loans . . .”).

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that they were best capable of protecting their own shareholders and the equity in the firms.<sup>49</sup>

There are significant governance implications of this admission, coming as it does from a firm believer in the efficiency of market forces.<sup>50</sup> Not only GSEs, but other financial firms also sought ways to increase their leverage and reduce the quality of their government supervision.<sup>51</sup> There was a difference, though. As they served the perceived interests of their shareholders, banks and other investors were filled with the irrational exuberance of the market bubble. In addition, the GSEs faced (and failed to manage) stakeholder pressure to engage in activities that they probably knew (as their risk officers did), could inflict serious harm on the companies.<sup>52</sup>

*B. GSEs Gain Virtually Unstoppable Political Power*

The GSE combines private ownership with government backing in a way that creates a political force that can dominate virtually any safety-and-soundness framework. The statutory framework of GSEs also creates special financial vulnerability because of incentives that GSEs have to appoint CEOs and senior management that are politically adept and who may not necessarily be experienced at managing a major financial

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<sup>49</sup> Kevin G. Hall, *Greenspan Takes Some Blame for Financial Meltdown*, MCLATCHY NEWSPAPERS, Oct. 23, 2008, available at [http://www.mcclatchydc.com/staff/kevin\\_hall/v-print/story/54712.html](http://www.mcclatchydc.com/staff/kevin_hall/v-print/story/54712.html).

<sup>50</sup> Alan Greenspan, Chairman, Fed. Res. Bd., Speech to the Federal Reserve Bank of Chicago's Forty-first Annual Conference on Bank Structure: Risk Transfer and Financial Stability (May 5, 2005) ("Except where market discipline is undermined by moral hazard, for example, because of federal guarantees of private debt, private regulation generally has proved far better at constraining excessive risk-taking than has government regulation.").

<sup>51</sup> See, e.g., Stephen Labaton, *The Reckoning: Agency's '04 Rule Let Banks Pile Up New Debt*, N.Y. TIMES, Oct. 3, 2008 (reporting an SEC rule change which allowed investment banks to increase leverage significantly, enacted at behest of the regulated firms).

<sup>52</sup> See sources cited *supra* note 20.



institution.<sup>53</sup>

A GSE lives or dies according to the terms of its enabling legislation.<sup>54</sup> Especially GSEs such as Fannie Mae and Freddie Mac that are directly chartered by Congress have tended (albeit not invariably) to select CEOs because of their ability to manage political risk rather than the risks that derive from their financial activities.<sup>55</sup> This was seen in the newest GSE, Farmer Mac, which returned to Congress several times since its original authorization in 1987 requesting adjustments to its charter powers so that it could offer increasingly profitable financial services. Farmer Mac has never been a strong success in public policy terms<sup>56</sup> and has invested heavily in assets that have nothing to do with meeting public needs.<sup>57</sup>

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<sup>53</sup> KOPPELL, *supra* note 45, at 101 (“ . . . Fannie Mae and Freddie Mac rosters boast numerous alumni of the executive and legislative branches . . . Furthermore, there is an impressive history of GSE executives crossing back into government service, giving the company advantages in terms of access, and sympathy, at the highest levels.”).

<sup>54</sup> STANTON, MERCANTILIST COMPANIES, *supra* note 5, at 70–75 (“From mercantilist times, companies with special charter privileges have understood that their ultimate success or failure hinges even more on politics than on the efficient provision of services.”).

<sup>55</sup> KOPPELL, *supra* note 45, at 99 (“[S]ince every aspect of their operations can be affected by congressional action, Fannie Mae and Freddie Mac have powerful incentives to devote significant attention to Congress and politics in general. Thus one can conclude that GSEs *will* possess resources and motive to expend these resources for political advantage.”) (emphasis in original).

<sup>56</sup> U.S. GEN. ACCT. OFFICE, REP. TO THE CHAIRMAN, SUBCOMMITTEE ON CAPITAL MARKETS, SEC. AND GOV'T-SPONSORED ENTERPRISES, COMMITTEE ON BANKING AND FIN. SERVICES, HOUSE OF REPRESENTATIVES, FARMER MAC: REVISED CHARTER ENHANCES SECONDARY MARKET ACTIVITY, BUT GROWTH DEPENDS ON VARIOUS FACTORS, GAO/GGD-99-85 (May 1999).

<sup>57</sup> Among other investments having nothing to do with its public purpose, in September 2008 Farmer Mac held in its investment portfolio \$50.0 million of Fannie Mae floating rate preferred stock and \$60.0 million of Lehman Brothers senior debt securities. After taking losses on these investments the GSE was recapitalized on September 30, 2008 by issuing new stock to institutions of the Farm Credit System, another GSE, and thereby averted

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Fannie Mae and Freddie Mac made a practice of mastering political risk, both by providing blandishments to favored members of the political establishment and other stakeholders, and by aggressively containing threats to what the companies considered their franchise value.<sup>58</sup> The GSEs are active participants in the process of influencing policymakers, especially those who are in positions to affect their charter legislation.<sup>59</sup> On April 19, 2006, Freddie Mac paid a record fine to the Federal Election Commission to settle charges that the company violated federal law by using company resources to hold some \$1.7 million in fundraisers, many involving the then-Chairman of the House Financial Services Committee.<sup>60</sup> That Committee is responsible for the legislation that created both Fannie Mae and Freddie Mac and periodically considered legislation to address shortcomings in their supervision.<sup>61</sup>

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insolvency. *See* Farmer Mac, Quarterly Report (Form 10-Q), at 44 (Nov. 10, 2008).

<sup>58</sup> This has been a long-standing policy. In 1991 Representative Jim Leach (R-IA) stated:

[I]t is not surprising that Fannie and Freddie are beginning to exhibit that arrogant characteristic of a duopoly, controlling 90% of the market. Such market dominance allows for heavy-handed approaches to competitors, to financial intermediaries, and to consumers. Competitors such as community based savings and loan associations and commercial banks are also users of GSE services. They are understandably apprehensive about expressing reservations about their practices in fear of retaliation. Likewise, would-be competitors such as securities firms run well known market risks if they object or attempt to compete with Fannie and Freddie. The two GSEs distribute billions of dollars of business on Wall Street and have a reputation of not cottoning to challengers of the status quo.

H.COMM. ON BANKING, FINANCE AND URBAN AFFAIRS, H.R. Rep. No. 102-206, at 122 (1991) (Dissenting Views of Representative Jim Leach from Report to accompany H.R. 2900 on the Government-Sponsored Housing Enterprises Financial Safety and Soundness Act of 1991).

<sup>59</sup> KOPPELL, *supra* note 45, at 99.

<sup>60</sup> *See, e.g.,* Stanton, *Lessons for Design and Accountability*, *supra* note 27.

<sup>61</sup> *Id.* Almost all of the legislation cited *supra* in note 9, falls within the jurisdiction of the House Financial Services Committee.

Professor Jonathan Koppell notes that “the characteristics that distinguish government-sponsored enterprises from traditional government agencies and private companies endow Fannie Mae and Freddie Mac with unique political resources.”<sup>62</sup> The potential inability of government to supervise safety and soundness of the GSEs has long been recognized. The Treasury pointed this out in a 1991 study of GSEs:

The problem of avoiding capture appears to be particularly acute in the case of regulation of GSEs. The principal GSEs are few in number; they have highly qualified staffs; they have strong support for their programs from special interest groups; and they have significant resources with which to influence political outcomes. A weak financial regulator would find GSE political power overwhelming and even the most powerful and respected government agencies would find regulating such entities a challenge.<sup>63</sup>

The Treasury knew whereof it spoke. There are at least two cases on record where the Treasury Department, which had no safety-and-soundness regulatory authority over Fannie Mae and Freddie Mac, reportedly came under pressure and agreed to make its reported views more congenial to the two companies.<sup>64</sup>

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<sup>62</sup> KOPPELL, *supra* note 45, at 97.

<sup>63</sup> TREASURY DEPARTMENT, 1991 REPORT OF THE SECRETARY OF THE TREASURY ON GOVERNMENT-SPONSORED ENTERPRISES 8 (1991).

<sup>64</sup> On the weakening of a 1996 Treasury report on desirability and feasibility of removing government sponsorship from Fannie Mae and Freddie Mac, see, for example, Jackie Calmes, *Federal Mortgage Firm Is Facing New Assault to Privileged Status: But Fannie Has Clout to Counter the Agencies That Seek to Privatize It*, WALL ST. J., May 14, 1986, at 1; Chairman Richard Baker, comments, U.S. House of Representatives, Committee on Banking and Financial Services, Subcommittee on Capital Markets, Securities, and Government-Sponsored Enterprises, *Oversight of the Federal National Mortgage Association [Fannie Mae] and the Federal Home Loan Mortgage Corporation [Freddie Mac]*, 104th Congress, 2nd session 136-41 (July 24, 1996). For discussion of possible pressure in 1991 on Treasury to state that HUD would be an appropriate regulator of Fannie Mae and Freddie Mac, see Thomas H. Stanton, *Increasing the Accountability of Government-Sponsored Enterprises: Next Steps*, 51 PUB. ADMIN. REV. 572

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Thanks to the lobbying power of Fannie Mae and Freddie Mac, OFHEO was, at its creation, an institution that lacked the capacity to do its job.<sup>65</sup> OFHEO was limited by the appropriations process and had a budget that was much smaller, in comparison to its responsibilities, than the budgets of federal bank regulators.<sup>66</sup>

Whenever OFHEO tried to do its job well, as in the 2004 Special Examination Report on Fannie Mae, it experienced political pressure.<sup>67</sup> Fannie Mae lobbyists generated a congressional request for the Inspector General (IG) of the Department of Housing and Urban Development (HUD) to investigate OFHEO's conduct of the special examination.<sup>68</sup> Between October 2002 and June 2004, there were three other congressional requests for IG investigations of OFHEO.<sup>69</sup> Fannie Mae lobbyists also tried to use the appropriations process to force a change in the leadership of OFHEO. They convinced the relevant Senate Appropriations Subcommittee to try to withhold \$10 million from OFHEO's appropriation until a new OFHEO director was appointed.<sup>70</sup>

The enactment of a stronger supervisory framework in 2008 meant that the new regulator, the Federal Housing Finance Agency (FHFA), was no longer subject to the appropriations process.<sup>71</sup> However, the political strength of the GSEs was reflected in the fact that the new legislation, improving as it did

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(1991), and articles cited therein.

<sup>65</sup> STANTON, *MERCANTILIST COMPANIES*, *supra* note 5, at 42.

<sup>66</sup> *See, e.g.*, Stanton, *Lessons for Design and Accountability*, *supra* note 27.

<sup>67</sup> OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT, REPORT OF THE SPECIAL EXAMINATION OF FANNIE MAE 273-77 (May 2006), *available at* <http://www.fhfa.gov/webfiles/747/FNMSPECIALEXAM.pdf>.

<sup>68</sup> *Id.* at 273.

<sup>69</sup> *Id.*

<sup>70</sup> *Id.* at 284.

<sup>71</sup> Section 1106 of the Housing and Economic Recovery Act of 2008 (HERA), Pub. L. 110-289, amended the 1992 Federal Housing Enterprises Safety and Soundness Act to remove the new regulator from the appropriations process.

on the old law, continued to deny the regulator the mandate, discretion, or authority to regulate safety and soundness that federal bank regulators have long possessed.<sup>72</sup>

The new Housing and Economic Recovery Act of 2008 (“HERA”) became law less than two months before Fannie Mae and Freddie Mac failed.<sup>73</sup> Ultimately the two GSEs were not well-served by their tradition of selecting politically capable CEOs who could fend off the kind of supervision that a more capable regulator might have been able to provide.<sup>74</sup>

Because of their government backing and low capital requirements in their charters, Fannie Mae and Freddie Mac gained immense market power.<sup>75</sup> They doubled in size every five years or so<sup>76</sup> until their failure in 2008, when the two companies had funded over \$5 trillion of mortgages—over 40 percent of the mortgage market.<sup>77</sup>

Their market power gave them political power. Whenever someone would urge regulatory reform, such as higher capital standards to reduce the GSEs’ dangerous leverage, huge numbers of constituents could be expected to flood Capitol Hill.<sup>78</sup> In turn, that political power further entrenched the GSEs’

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<sup>72</sup> To give but one example, the new law required the new regulator to conduct an estimated 25–30 rulemakings, often with short deadlines, to implement key provisions of the act. The bank regulators have discretion in many of the areas where HERA sought to impose inflexibility upon the FHFA through required rulemakings.

<sup>73</sup> President Bush signed HERA into law on July 30, 2008; Fannie Mae and Freddie Mac went into conservatorship on September 7, 2008.

<sup>74</sup> See, e.g., Stanton, *Lessons for Design and Accountability*, *supra* note 27, at 844 (“What does effective accountability mean? First, feedback is essential for effective operations . . . . Many examples exist, in both the private and public sectors, of how too much autonomy can lead to subsequent failure.”).

<sup>75</sup> STANTON, *MERCANTILIST COMPANIES*, *supra* note 5, at 70–75.

<sup>76</sup> See, e.g., figures presented in STANTON, *supra* note 5, at 4.

<sup>77</sup> See, e.g., Nelson D. Schwartz, *A History of Public Aid During Crises*, N.Y. TIMES, Sept. 7, 2008, at A27.

<sup>78</sup> Observers have long noted this pattern. David A. Vise, *The Money Machine: How Fannie Mae Wields Power*, WASH. POST, Jan. 16, 1995, at A14 (“Builders, real estate brokers and bankers across the country rely so

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market power.

The failure of Fannie Mae and Freddie Mac shows the shortcomings of the GSE as an organizational model. However sound the accountability structure may be when the organization begins, the incentive to satisfy private owners will lead a GSE to try to weaken safety and soundness oversight and reduce capital standards. Both Fannie Mae and Freddie Mac arguably had more effective accountability structures when they were chartered as GSEs than when they were supervised by OFHEO. Between 1968 and 1992, when OFHEO was established, both companies had successfully removed government controls that they considered unacceptable.<sup>79</sup>

In short, the drive to satisfy shareholders is intense and can easily overwhelm considerations for the financial system, the housing system, and American taxpayers.

### III. EVALUATING THE GSE AS AN ORGANIZATIONAL FORM

#### *A. Four Criteria Help to Evaluate Organizations That Carry Out Public Purposes: Capacity, Flexibility, Accountability, and Life-Cycle*

Four criteria are helpful in evaluating the quality of government agencies and instrumentalities that carry out public purposes:<sup>80</sup>

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heavily on Fannie Mae for mortgage funds that they live in fear of offending the firm and routinely defend it in Washington.”).

<sup>79</sup> For example, when Freddie Mac was chartered as a GSE in 1970 its board of directors consisted of three federal officials rather than a shareholder-controlled board; when Fannie Mae was chartered in 1968 its charter contained provisions permitting the HUD Secretary to fix the capitalization of the GSE at 6.6 percent, significantly higher than the 2.5 percent permitted by the 1992 Act.

<sup>80</sup> See, e.g., Thomas H. Stanton, *Moving Toward More Capable Government: A Guide to Organizational Design*, in MEETING THE CHALLENGE OF 9/11: BLUEPRINTS FOR MORE EFFECTIVE GOVERNMENT 25 (2006) [hereinafter Stanton, *Moving Toward More Capable Government*]; Thomas H. Stanton, *The Administration of Medicare*, 60 WASH. & LEE L. REV. 1373 (2003) [hereinafter Stanton, *Administration of Medicare*].

*Capacity*: What is the capacity of the organization, in terms of people, administrative budget, systems, and organization, to carry out its public purposes?

*Flexibility*: What flexibility does the organization have, under the law and in practice, to carry out its public purposes?

*Accountability*: How well is the organization held accountable for (1) carrying out its public purposes, and (2) its stewardship of public resources?

*Life Cycle*: As the organization matures, what strengths and shortcomings manifest themselves?

For different organizations, different measures will become more critical than others in understanding strengths and weaknesses. As a general rule, to the extent that weaknesses appear, government agencies may have difficulty with the measures of capacity and flexibility, while privately owned instrumentalities may have difficulty with accountability.<sup>81</sup> Numerous organizations of all types have difficulty with life-cycle, and the ability to remain active, focused, and useful over many years.<sup>82</sup>

Government-sponsored enterprises are privately owned institutions free from the budgetary and other constraints imposed on government agencies.<sup>83</sup> As such, they tend to develop significant capacity and flexibility compared to government agencies that serve the same economic sector.<sup>84</sup> A comparison of mortgage operations of Fannie Mae and Freddie Mac, on the one hand, and the Federal Housing Administration

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<sup>81</sup> Stanton, *Moving Toward More Capable Government*, *supra* note 80, at 25; Stanton, *Administration of Medicare*, *supra* note 80.

<sup>82</sup> Stanton, *Moving Toward More Capable Government*, *supra* note 80, at 25; Stanton, *Administration of Medicare*, *supra* note 80.

<sup>83</sup> Thomas H. Stanton & Ronald C. Moe, *Government Corporations and Government Sponsored Enterprises*, in *TOOLS OF GOVERNMENT: A GUIDE TO THE NEW GOVERNANCE* 85 (Lester M. Salamon ed., 2002) [hereinafter Stanton & Moe] (“Indeed, GSEs can, and usually do, become virtually autonomous from the government that charters them.”).

<sup>84</sup> Stanton, *Reducing Government Involvement*, *supra* note 7.

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(FHA), on the other, displays this pattern. While Fannie Mae and Freddie Mac were able to dedicate substantial resources to building their automated underwriting and other mortgage-related systems, the federal budget process has constrained FHA from making similar needed investments even though they are essential to the future success of the agency.<sup>85</sup>

On the other hand, the issue of accountability is salient for GSEs, and for Fannie Mae and Freddie Mac in particular. As private companies operating with substantial government subsidies, GSEs often grow to dominate their markets.<sup>86</sup> Market power leads to political power,<sup>87</sup> which in turn leads to favorable changes to the GSE's charter that help expand its market power and reduce the effectiveness of any accountability framework government may seek to apply to the GSEs.

Finally, the issue of life cycle is also important for the GSEs. The rapid growth of GSEs combined with their ability to dominate their government regulator and other accountability measures and avoid being required to adopt prudent capital standards can lead to flawed business decisions.<sup>88</sup> The current crisis in the mortgage market highlights problems of GSE accountability and life cycle with special force.

*B. GSE Vulnerabilities Will Not Disappear Merely by  
Changing Regulation or Governance*

Proposals to craft special rules such as regulating the GSEs as public utilities<sup>89</sup> or limiting them to cooperative ownership<sup>90</sup>

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<sup>85</sup> Steve Preston, Secretary, HUD, Prepared Remarks at the National Press Club (Nov. 19, 2008), *available at* <http://www.hud.gov/news/speeches/2008-11-19.cfm>.

<sup>86</sup> STANTON, *MERCANTILIST COMPANIES*, *supra* note 5, at 3 (“Thanks to their special government benefits, GSEs have grown rapidly to dominate many market segments, especially in housing (Fannie Mae, Freddie Mac, and the Federal Home Loan Banks) and student loans (Sallie Mae).”).

<sup>87</sup> *See supra* note 78.

<sup>88</sup> *See, e.g.*, Stanton, *Lessons for Design and Accountability*, *supra* note 27.

<sup>89</sup> *See, e.g.*, Steven Sloan & Emily Flitter, *Paulson's Third Way: GSEs*



will not overcome the vulnerabilities of the GSE as an institutional form that is based on political dominance. Such proposals to create a different accountability framework or governance structure for Fannie Mae and Freddie Mac do not change the assessment of the GSE's organizational form. Most importantly, the issue of political dominance of the GSEs over their regulators, and GSE influence over their congressional authorizing committees, would not go away even if these changes were actually implemented.

Some have suggested that Fannie Mae and Freddie Mac can be regulated as public utilities. This suggestion has several defects. First, utility regulation is designed to address the problem that public utilities benefit from scale economies that may give them characteristics of monopolies;<sup>91</sup> price regulation by a public utility commission seeks to prevent a public utility from imposing monopoly pricing on its customers.<sup>92</sup>

In other words, rather than limiting the size of a public utility, government accepts a utility's dominant market position and seeks to limit the high prices that could result. But taxpayers are at risk if the GSEs grow to hold a dominant position in the mortgage market.<sup>93</sup> The need to control monopoly pricing is not

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*Taking Utility Role*, AM. BANKER, Jan. 8, 2009. The public utility model is described in R. S. Seiler, Jr., *Fannie Mae and Freddie Mac as Investor-Owned Utilities*, 11 J. PUB. BUDGETING, ACCT. & FIN. MGMT. 117 (1999).

<sup>90</sup> At the time of this writing, such proposals are circulating informally among federal agencies and stakeholder groups.

<sup>91</sup> Seiler, *supra* note 89, at 121, 124 (“[T]he utility industries have generally exhibited economies of scale . . . . The superior technology and monopoly franchise of a traditional utility gives the firm considerable market power.”).

<sup>92</sup> *Id.* at 124 (“[W]hen only one firm is allowed to serve a market, the company has an incentive to set prices above marginal cost, restrict output, and engage in price discrimination, in order to earn monopoly profits. To limit these incentives, governments traditionally imposed limits on the rates of return that utilities could earn and required that their rate structures be fair and equitable.”).

<sup>93</sup> Stanton, *supra* note 27, at 840 (“As the GSEs have grown Treasury Secretary John Snow, Comptroller General David M. Walker, Congressional Budget Office Director Douglas Holtz-Eakin, and Federal Reserve Chairmen

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as much a concern for today's taxpayers as is the need to limit the size of GSEs and their accompanying financial risks. The public utility model, with its focus on price regulation, is not relevant to that problem. Indeed, a regulator with authority to supervise pricing could potentially decide to permit a GSE to charge high prices as a way to build a strong capital cushion.<sup>94</sup>

Secondly, regulated companies too often capture their regulators.<sup>95</sup> As political scientist Marver Bernstein noted, regulatory commissions are frequently dominated by the interests that they are supposed to regulate.<sup>96</sup> Thus, under any new regulatory scheme, the GSEs would simply shift the application of their political power from domination of their past regulators to the new public utility regulator.

Third, the creation of a separate utility-type regulator for the GSEs would not combine GSE supervision with the responsibilities of a regulator that supervises banks and thrifts as

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Alan Greenspan and Ben Bernanke have warned about the possibility of financial failure at a GSE spreading to the many holders of GSE obligations such as commercial banks and foreign central banks. This is what is known as systemic risk, which is the possibility that a failure at one institution causes market turmoil that spreads to other institutions in the financial system, with potentially serious effects for the performance of the U.S. economy.”).

<sup>94</sup> This is similar to the position of Gary Gorton, *Slapped in the Face by the Invisible Hand: Banking and the Panic of 2007* 5 (Federal Reserve Bank of Atlanta Conference Paper, 2009), available at <http://www.frbatlanta.org/news/CONFEREN/09fmc/gorton.pdf> (creating a stable banking structure “will require that a valuable charter be recreated for firms that are deemed ‘banks’”).

<sup>95</sup> See, e.g., Willem H. Buiter, *Lessons from the North Atlantic Financial Crisis* 36–38 (May 28, 2008), available at <http://www.newyorkfed.org/research/conference/2008/rmm/buiter.pdf> (paper prepared for presentation at the conference “The Role of Money Markets” jointly organized by Columbia Business School and the Federal Reserve Bank of New York on May 29–30, 2008).

<sup>96</sup> MARVER BERNSTEIN, *REGULATING BUSINESS BY INDEPENDENT COMMISSION* 92 (1955) (“During old age the working agreement that a commission reaches with the regulated interests becomes so fixed that the regulatory agency has no creative force left to mobilize against the regulated groups.”).

well as GSEs. Rather, it would encourage the preferential capital and supervisory requirements that lie at the core of GSE financial vulnerability.<sup>97</sup>

In short, application of a public utility model to Fannie Mae and Freddie Mac would perpetuate many of the vulnerabilities and large-scale risks of the GSE model that lie at the root of their failure in 2008.

Another idea being discussed informally, though not yet published in a formal treatment, is to change the governance structure of Fannie Mae and Freddie Mac so that they would be owned and controlled by companies that do business with them—a cooperative structure. The cooperative governance structure also fails to add quality to the GSE model. This was seen among the GSEs in the financial failure of the Farm Credit System in the mid-1980s and the troubled financial condition of the Federal Home Loan Banks today.<sup>98</sup> While the investor-owned GSE seeks to increase risk to serve its investor owners, the cooperative GSE has an incentive to serve the cooperative owners who use its services.<sup>99</sup> That incentive led the Farm

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<sup>97</sup> See, e.g., Thomas H. Stanton, Government Sponsored Enterprises (GSEs): Why is Effective Government Supervision Hard to Achieve?, Address to the 37th Annual Conference on Bank Structure and Competition, Federal Reserve Bank of Chicago (May 10, 2001) (“ . . . (1) the government subsidy allows GSEs to expand and increase their risk-taking without facing the market discipline that constrains other companies; (2) the GSEs have both incentive and ability to influence or dominate the political process; and (3) the unusual legal structure of GSEs involves complexities that policymakers may not fully understand. This paper contends that all of these factors make government supervision difficult, if not impossible.”).

<sup>98</sup> Steven Sloan, *Insurance Fund for FHLBs is on the Table: Idea Could Help Instill Confidence, Provide Backstop*, AM. BANKER, June 3, 2009, at 1 (“As the Federal Home Loan banks continue to struggle with charges on their mortgage holdings, the Federal Housing Finance Agency is considering the creation of an insurance fund that could absorb losses at a troubled Home Loan bank.”).

<sup>99</sup> See, e.g., Stanton, *Moving Toward More Capable Government*, *supra* note 80, at 75 (“For the cooperative, governance by a board of directors means attention to the needs of the owners that use the cooperative’s services. Thus, a cooperative such as the Farm Credit System in the past showed a tendency to underprice its services . . .”).

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Credit System to provide credit to its cooperative borrowers below the GSE's own cost of funds.<sup>100</sup> Such an approach was not sustainable and led to the system declaring insolvency in the mid-1980s. The experience of the cooperative GSEs shows that turning Fannie Mae and Freddie Mac into cooperatives would not reduce their incentives or capacity to dominate the GSE regulator and avoid prudential requirements such as bank-type capital standards.

IV. WHAT TO DO WITH THE GSEs NOW THAT THEY ARE IN GOVERNMENT HANDS

As instruments of government policy,<sup>101</sup> the future of Fannie Mae and Freddie Mac should depend on the amount and kind of support that the markets actually need. More substantial government support is needed in the next few years, as the effects of the collapsing housing credit bubble make themselves felt in a weakened mortgage market, rather than in five years or so, when the housing markets have returned to greater strength and stability.

*A. The Government Should Place Fannie Mae and Freddie Mac into Receivership*

The government placed Fannie Mae and Freddie Mac into conservatorship rather than receivership. Unlike receivership, the voluntary acceptance of conservatorship by Fannie Mae or Freddie Mac was not subject to litigation,<sup>102</sup> which could have

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<sup>100</sup> Stanton, *Lessons for Design and Accountability*, *supra* note 27, at 421–23.

<sup>101</sup> Political scientist Lester Salamon considers the GSEs to be what he calls “tools of government.” A GSE, although not a government agency or other part of the formal government, is a tool of government that helps to carry out public purposes. *See* Stanton & Moe, *supra* note 83.

<sup>102</sup> Section 1369(b)(4) (“Appointment of Conservators”) of the 1992 Act provides that “[a]ppointment of a conservator pursuant to consent of the enterprise under subsection (a)(2) shall not be subject to judicial review under this subsection.” Codified at 12 U.S.C. § 4619(b)(2)(2008).

further troubled the financial markets at a difficult time.

Placing a failed financial institution directly into conservatorship violates the customary practice of the federal bank and thrift regulators who first place an institution into receivership, then separate the assets into a “good-bank/bad-bank” structure and send the good bank, cleaned out of troubled assets, into conservatorship or bridge-bank status.<sup>103</sup> Placing an institution into receivership removes the shareholders of the defunct institution. Thus, when IndyMac, a large thrift institution with over \$32 billion in assets, failed,<sup>104</sup> it was placed into receivership.<sup>105</sup> The receiver then transferred the deposits and most of the assets to a newly chartered thrift, IndyMac Federal Bank,<sup>106</sup> with the FDIC as conservator.<sup>107</sup>

It is now time to place Fannie Mae and Freddie Mac into receivership. As past losses materialize and are recognized by the two GSEs, it is clear that both institutions have lost much more than their entire net worth.<sup>108</sup> Placing both companies into

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<sup>103</sup> Appointment of a receiver for an insolvent bank or thrift institution with federally insured deposits is required under conditions specified in 12 U.S.C. § 1831o(h)(3)(C) (2008). Authority to establish a bridge bank is found in 12 U.S.C. § 1821(m)(2008).

<sup>104</sup> Press Release, Fed. Deposit Ins. Corp., FDIC Establishes IndyMac Fed. Bank, FSB as Successor to IndyMac Bank, F.S.B., Pasadena, Cal. (July 11, 2008), *available at* <http://www.fdic.gov/news/news/press/2008/pr08056.html>.

<sup>105</sup> *See, e.g.*, Chief Financial Officer’s (CFO) Report to the Board, Executive Summary Third Quarter 2008, Fed. Deposit Ins. Corp., *available at* [http://www.fdic.gov/about/strategic/corporate/cfo\\_report\\_3rdqtr\\_08/exec\\_summary.html](http://www.fdic.gov/about/strategic/corporate/cfo_report_3rdqtr_08/exec_summary.html) (“During the third quarter of 2008, the FDIC was named receiver for . . . IndyMac Bank of Pasadena, California.”).

<sup>106</sup> Sheila C. Bair, Chairman, Fed. Deposit Ins. Corp., A Review of Foreclosure Mitigation Efforts Before the Fin. Servs. Comm. U.S. House of Representatives (Sep. 17, 2008), *available at* <http://www.fdic.gov/news/news/speeches/archives/2008/chairman/spsep1708.html> (“As the Committee knows, the former IndyMac Bank, F.S.B., Pasadena, California, was closed July 11. The FDIC is conservator for a new institution, IndyMac Federal Bank, F.S.B. (IndyMac Federal), to which the accounts and assets of the former IndyMac Bank, F.S.B. were transferred.”).

<sup>107</sup> *Id.*

<sup>108</sup> *Fannie Mae Seeks \$10.7B in US Aid After 2Q Loss*, N.Y. TIMES,

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receivership will help to remove an inherent conflict in the government's position. Technically, conservatorship means that the government is working to restore the companies to financial health;<sup>109</sup> the government has preserved the shareholders in the two companies and allowed their stock to trade freely. This is inconsistent with key aspects of the government's need to use the two companies to support the mortgage market, now that the value of the holdings of private shareholders in the companies is zero.<sup>110</sup> Until shareholders are removed from the equation, officers and directors of the two companies will be conflicted as to their fiduciary responsibilities. Do they price mortgage purchases low to support the market or do they price higher to replenish the companies' shareholder value?<sup>111</sup> The two companies and their managers appear to be caught in the strong contradiction between their obligations to serve their remaining shareholders and the needs of the housing market.<sup>112</sup>

If the government placed both companies into receivership,

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Aug. 7, 2009, <http://dealbook.blogs.nytimes.com/2009/08/07/fannie-mae-seeks-107-billion-in-aid-after-loss/?scp=1&sq=fannie&st=cse> ("Fannie Mae's new request for \$10.7 billion from the Treasury Department will bring the total for Fannie and Freddie to nearly \$96 billion.").

<sup>109</sup> "The FHFA, as Conservator, may take all actions necessary and appropriate to (1) put the Company in a sound and solvent condition and (2) carry on the Company's business and preserve and conserve the assets and property of the Company." FEDERAL HOUSING FINANCE AGENCY, FACT SHEET: QUESTIONS AND ANSWERS ON CONSERVATORSHIP 2 (2008), <http://www.fhfa.gov/webfiles/35/FHFACONSERVQA.pdf>.

<sup>110</sup> Kopecki, *supra* note 3.

<sup>111</sup> The two companies themselves complain of the conflict in their roles in conservatorship. *See* Fannie Mae, Quarterly Report (Form 10-Q), at 7 (Sept. 30, 2008); Freddie Mac, Quarterly Report (Form 10-Q), at 5 (Sept. 30, 2008).

<sup>112</sup> Zachary A. Goldfarb, *Government-Picked Leader Resigns as Losses Pile Up*, WASH. POST, Mar. 3, 2009, at D01 ("The government-appointed chief executive of Freddie Mac announced yesterday that he is stepping down . . . . David M. Moffett's resignation comes amid growing losses at the McLean mortgage-finance company and unresolved questions about whether it should follow the path of a private firm trying to make its way back to profitability or that of a government agency whose overriding goal is carrying out public policy.").

then it could use Fannie Mae and Freddie Mac as agents of reform for the mortgage market.<sup>113</sup>

*B. Fannie Mae and Freddie Mac Should Not Again  
Become GSEs*

To best support the mortgage market, Fannie Mae and Freddie Mac should not again become privately owned organizations that operate with federal backing.

For many reasons, it is important to now end the GSE status of Fannie Mae and Freddie Mac. First, the GSEs have now squandered a policy tool that government had used for decades: the perception of an implicit rather than explicit federal guarantee of their debt obligations.<sup>114</sup> That means that government would need to provide some form of express guarantee if the GSEs were to be restored; providing an express government guarantee to only two companies, or even a few companies, would raise fundamental issues of fairness. Second, as was seen in the savings and loan debacle<sup>115</sup> and now with the GSEs,<sup>116</sup> the government has great difficulty managing the risks when it insures the liabilities of a specialized financial institution. If policymakers want to support the mortgage

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<sup>113</sup> For examples of government corporations successfully helping to address the consequences of earlier crises, see MARK K. CASSELL & SUSAN M. HOFFMAN, IBM CENTER FOR THE BUSINESS OF GOVERNMENT, MANAGING A \$700 BILLION BAILOUT: LESSONS FROM THE HOME OWNERS' LOAN CORPORATION (2009), [http://www.businessofgovernment.org/pdfs/Cassell\\_Report.pdf](http://www.businessofgovernment.org/pdfs/Cassell_Report.pdf).

<sup>114</sup> Stanton, *Public Administration Theory*, *supra* note 6, at 636 (“ . . . the Treasury’s infusion of capital starting on September 7, 2008, creates the perception of an explicit federal guarantee for the GSEs.”).

<sup>115</sup> See, e.g., R. DAN BRUMBAUGH, JR., THRIFTS UNDER SIEGE at 179 (1988) (“Now, economic volatility and widespread information distribution are facts of life, and exogenous and endogenous economic volatility for thrifts and banks are rendering deposit insurance, with its implicit taxpayer burden, and balance-sheet regulation increasingly untenable.”).

<sup>116</sup> See, e.g., STANTON, A STATE OF RISK, *supra* note 39, at 8–12 (comparing the institutional characteristics of savings and loan associations (S&Ls) with GSEs).

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market, they should authorize government guarantees of mortgages, or at most, mortgage-backed securities.

Third, the government should not provide special charters to a limited number of specialized institutions. As the GSEs have shown, it is virtually impossible to protect the regulator of a few private institutions from being dominated.<sup>117</sup> This is especially true if the regulated institutions operate under a law such as HERA,<sup>118</sup> which provides for different rules, especially for capital, but also for other aspects of safety and soundness, than those applicable to other institutions in the same lines of business.<sup>119</sup> Fourth, proposals to craft special rules such as trying to regulate the GSEs as public utilities or by limiting them to cooperative ownership will not overcome the vulnerabilities of the GSE as an institutional form that is based on political dominance. Consider each of these issues in turn.

*1. The End of the Implicit Government  
Guarantee of GSE Obligations*

In earlier years, government was careful to preserve the option that it would decline to bail out holders of GSE obligations and GSE-guaranteed mortgage-backed securities.<sup>120</sup>

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<sup>117</sup> See, e.g., U.S. GEN. ACCOUNTING OFFICE, GOVERNMENT-SPONSORED ENTERPRISES: A FRAMEWORK FOR LIMITING GOVERNMENT'S EXPOSURE TO RISKS, GAO/GGD-91-90, May 1991, at 45 ("We also believe a regulator that oversees a single regulated entity may have difficulty remaining at arm's length from that entity.").

<sup>118</sup> Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, (2008).

<sup>119</sup> For example, a federal financial regulator needs discretion to set and adjust capital standards according to events as they occur. Compare the rulemaking requirements of HERA, section 1111(d)(3), with the much more flexible authority of the federal bank regulators at 12 U.S.C. § 3907(a)(2)(2008) ("Each appropriate Federal banking agency shall have the authority to establish such minimum level of capital for a banking institution as the appropriate Federal banking agency, in its discretion, deems to be necessary or appropriate in light of the particular circumstances of the banking institution.").

<sup>120</sup> Thus, the Fannie Mae Charter Act contains a requirement that:



Government officials regularly used careful language indicating that the government's involvement merely created the perception of an implicit guarantee rather than an actual guarantee.<sup>121</sup> These niceties began to erode with the financial rescue of the failed Farm Credit System in the mid-1980s and the government's rush to support obligations of the Financing Corporation (FICO) in 1996.<sup>122</sup> With the government support of holders of Fannie Mae and Freddie Mac debt obligations and mortgage-backed-securities as part of the government's rescue of Fannie Mae and Freddie Mac on September 7, 2008, the perception of implicit government backing of GSEs has become an anachronism.<sup>123</sup> One consequence of the destruction of the implicit guarantee is that in the future, government will be required to provide either an express guarantee, backed by the full-faith and credit of the United States, or none at all. Another consequence is that, unlike the former implicit federal guarantee, explicit government guarantees are included in the federal budget. Thus, the Office

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The corporation shall insert appropriate language in all of its obligations issued under this subsection clearly indicating that such obligations, together with the interest thereon, are not guaranteed by the United States and do not constitute a debt or obligation of the United States or any agency or instrumentality thereof other than the corporation.

12 U.S.C. § 1719(b) (2008). The corresponding Freddie Mac Charter provision is found at 12 U.S.C. § 1455(h)(2) (2008).

<sup>121</sup> See, e.g., U.S. GEN. ACCOUNTING OFFICE, HOUSING ENTERPRISES: POTENTIAL IMPACTS OF SEVERING GOVERNMENT SPONSORSHIP, GGD-96-120, May 1996, at 25 ("The most important benefit that the enterprises receive from their government-sponsored status, however, is an implicit one stemming from investors' perception that the federal government would not allow the enterprises to default on their obligations.").

<sup>122</sup> On the former, see, STANTON, A STATE OF RISK, *supra* note 39, at 124. On the latter see, e.g., Associated Press, *House Panel Backs Rescue of S & L Fund*, N.Y. TIMES, July 26, 1996, <http://www.nytimes.com/1996/07/26/business/house-panel-backs-rescue-of-s-l-fund.html?scp=55&sq=%22financing+corporation%22&st=nyt&pagewanted=print>. The Financing Corporation is authorized by 12 U.S.C. § 1441 (2008).

<sup>123</sup> Stanton, *Public Administration Theory*, *supra* note 6, at 636 (" . . . the Treasury's infusion of capital starting on September 7, 2008, creates the perception of an explicit federal guarantee for the GSEs.").

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of Management and Budget (OMB) (which administers budgeting for credit programs for the Executive Branch),<sup>124</sup> is likely to score borrowing by Fannie Mae and Freddie Mac (or their successor organizations performing similar functions) as a part of credit reform, comparable to the budget treatment of financial guarantees issued by Ginnie Mae (a wholly owned government corporation located in the Department of Housing and Urban Development that guarantees mortgage-backed securities insured or guaranteed by FHA or other government agencies).<sup>125</sup> The days of the GSE as a source of an off-budget government subsidy for housing finance are coming to an end.

*2. The Risks of Insuring Liabilities of Specialized Financial Institutions*

As periodic failures of federal guarantee programs have shown,<sup>126</sup> the government can, and sometimes does, lose the capacity to supervise use of its financial guarantee. Losses occur when a federal program incurs defaults on loans that an agency guarantees, or on direct loans that an agency provides.<sup>127</sup> For

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<sup>124</sup> OFFICE OF MGMT. AND BUDGET, EXEC. OFFICE OF THE PRESIDENT, CIRCULAR NO. A-129, POLICIES FOR FEDERAL CREDIT PROGRAMS AND NON-TAX RECEIVABLES (2000).

<sup>125</sup> Ginnie Mae, the Government National Mortgage Association, was chartered in 1968 as a wholly owned government corporation at the time that Fannie Mae was chartered as a GSE. Both organizations are successors to the original Federal National Mortgage Association that until 1968 was a wholly owned government corporation. 12 U.S.C. § 1717 (2008).

<sup>126</sup> See generally, LEONARD DOWNIE, JR., MORTGAGE ON AMERICA 143 (Praeger Publishers 1974) (discussing the failure of HUD single-family and multifamily programs in the early 1970s).

<sup>127</sup> Credit budgeting requires a calculation of the so-called credit subsidy, i.e., the budgetary outlays that will be required to fund new loans or loan guarantees that the government provides each fiscal year. Credit reform recognizes that a loan's true cost is . . . the net value of its cash flows over the life of the loan. This value is the loan's "subsidy cost", [sic] which is the net present value of a loan's expected cash inflows and outflows over the life of the loan. For example, if the estimated present value of a direct loan's cash

example, the FHA's single-family mortgage insurance program<sup>128</sup> currently would seem to be especially at risk of incurring high rates of defaults on mortgages that the FHA insures.<sup>129</sup>

However, a guarantee of assets rather than liabilities has several advantages for the government and taxpayers. First, asset guarantees are subject to oversight through the federal budget and the application of credit budgeting.<sup>130</sup> This allows the Office of Management and Budget to monitor the risks involved in extending the guarantee and to provide regular feedback to the agency and program through the annual process of re-estimating the budgetary costs.<sup>131</sup>

Such supervision and discipline is lacking for federal

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outflows equals \$100 and the present value of its inflows equals \$90, its subsidy cost is \$10 and its subsidy rate is 10 percent. If an agency proposed to make \$2,000 of these loans, it would seek an appropriation of 10 percent of the desired face value, or \$200. Budgeting for loan programs with this present value-based accounting system represented a significant departure for the otherwise cash-based Federal budget.

THOMAS H. STANTON, *Loans and Loan Guarantees*, in *TOOLS OF GOVERNMENT*, *supra* note 83, at 384.

<sup>128</sup> The FHA program is explained on the HUD website. HUD, Federal Housing Administration, <http://www.hud.gov/offices/hsg/fhahistory.cfm> (last visited Aug. 10, 2009) ("The Federal Housing Administration, generally known as 'FHA', [sic] provides mortgage insurance on loans made by FHA-approved lenders throughout the United States and its territories. FHA insures mortgages on single family and multifamily homes including manufactured homes and hospitals. It is the largest insurer of mortgages in the world, insuring over 34 million properties since its inception in 1934.").

<sup>129</sup> See, e.g., Preston, *supra* note 85; Barry Meier, *As FHA's Role Grows, So Does the Risk of Fraud*, N.Y. TIMES, Dec. 10, 2008.

<sup>130</sup> See *supra* note 124 and accompanying text.

<sup>131</sup> The Office of Management and Budget annually estimates the risk of each federal credit program and the amount of subsidy that would need to be provided to offset the risk of loans and loan guarantees originated during the year. For data on credit programs for the most recent Fiscal Year, see Federal Credit Supplement: Budget of the U.S. Government Fiscal Year 2010, available at [http://www.whitehouse.gov/omb/budget/fy2010/assets/cr\\_supp.pdf](http://www.whitehouse.gov/omb/budget/fy2010/assets/cr_supp.pdf) (last visited Nov. 1, 2009).

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programs that guarantee liabilities rather than financial assets.<sup>132</sup> Thus, the Federal Deposit Insurance Corporation (“FDIC”) has been able to guarantee hundreds of billions of dollars of debt in response to the financial crisis, including obligations of troubled institutions such as Citigroup and Bank of America, without being accountable through the federal budget.<sup>133</sup> Similarly, guarantees of corporate pension plan liabilities by the Pension Benefit Guaranty Corporation (“PBGC”) are not subject to budget constraints.<sup>134</sup>

Second, it is less difficult to monitor the risks inherent in a guarantee of assets than in a guarantee of liabilities. For a guarantee of assets, the government must monitor the quality of origination, servicing, and collections, and the credit quality of the assets themselves.<sup>135</sup> By contrast, monitoring a guarantee of liabilities of a financial institution involves trying to assess the quality of the institution’s management, its capitalization, its accounting practices, and many other potential sources of risk besides the quality of its assets.

Third, as was seen most clearly in the savings and loan

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<sup>132</sup> F. Stevens Redburn, *How Should the Government Measure Spending? The Uses of Accrual Accounting*, 53 PUB. ADMIN. REV. 228 (1993).

<sup>133</sup> OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, ANALYTICAL PERSPECTIVES: BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2009 69 (2008). The “Credit and Insurance” chapter is instructive when one compares budget treatment of credit programs, including direct loans and federal guarantees of financial assets, with guarantees of liabilities such as the FDIC guarantee of obligations of insolvent financial institutions.

<sup>134</sup> Estimated losses on guarantees by the PBGC were estimated at \$47 billion. Again, the *Analytical Perspectives* “Credit and Insurance” chapter is instructive when one compares budget treatment of credit programs, including direct loans and federal guarantees of financial assets, with guarantees of liabilities by the PBGC. *See id.* The law states that liabilities of the PBGC are not backed by the United States. 29 U.S.C. § 1302(g)(2) (2008) (“The United States is not liable for any obligation or liability incurred by the corporation.”). As with the backing of GSE obligations that the GSEs disavow in their loan documentation, no one believes this. *See supra* note 120.

<sup>135</sup> Stanton, *Public Administration Theory*, *supra* note 6.

debacle, a federal guarantee of an institution's liabilities creates adverse incentives. When the government guarantees obligations of a financial firm through deposit insurance, for example, insured depositors lose incentive to monitor the safety and soundness of the institution to which they are lending money when they make a deposit. Unless the government supervises them closely, owners of such a financial institution, can in turn, take much greater risks than if investors were more vigilant in their obligations. This can greatly compound the government's risk exposure, compared to the actual volume of liabilities that government believes it is guaranteeing.<sup>136</sup> By contrast, when government guarantees financial assets or even pools of financial assets, it can provide for risk sharing that, at least in principle, can reduce the government's potential losses.

For all of these reasons, if government can avoid guaranteeing the liabilities of a private institution, it should do so. In the case of providing support for the residential mortgage market, this conclusion is bolstered by the fact that federal mortgage insurance, or perhaps a federal guarantee of pools of mortgages, with appropriate risk-sharing with the loan originator, can provide needed support for the mortgage market without incurring the risks involved in trying to guarantee the liabilities of a GSE.<sup>137</sup> It also seems prudent that the future structure of housing finance must take account of the difficulty that both public and private sector managers can have in trying to manage a large volume of assets and mortgage-backed securities.

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<sup>136</sup> For example, that was the case with the savings and loan debacle. *See, e.g.*, BRUMBAUGH, *supra* note 115; STANTON, A STATE OF RISK, *supra* note 39, at 8–12.

<sup>137</sup> *See, e.g.*, Stanton, *Public Administration Theory*, *supra* note 6, at 636 (“The benefit of this option is that it cleanly removes shareholders and current management from the equation and allows the government to pump federally backed funds into the mortgage market on a prudent basis.”).

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*3. Special Charters and the Problem  
of Regulatory Capture*

Regulatory capture is a major problem for federal regulators in many parts of the economy.<sup>138</sup> The problem is especially acute for a regulator of only a few institutions. Such a regulator can be expected to assume a parochial point of view compared to a regulator with responsibility for supervising a plethora of institutions with varying interests and perspectives.<sup>139</sup>

The problem becomes especially acute for institutions such as GSEs that fall into a hybrid category between other organizational types.<sup>140</sup> Take, for example, the issue of appropriate capital standards: should GSE capital standards be set according to bank-type standards or according to the standards that state regulators apply to private mortgage-backed securities conduits? Economist Willem Buiter argues that what he calls “cognitive regulatory capture” can bring financial

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<sup>138</sup> See BERNSTEIN, *supra* note 96, at 295 (“By insulating themselves from popular political forces, the commissions have subjected themselves to undue influence from the regulated groups and tend to become protective spokesmen for the industries which they regulate.”); see also Buiter, *supra* note 95, at 36–41 (showing the power of what he calls “cognitive regulatory capture”).

<sup>139</sup> The GAO has made similar observations and earlier recommended that all of the GSEs be supervised by a single high-level regulator:

Because of its important responsibility to supervise the safety and soundness of all the enterprises, the members of the independent regulator’s board need to have sufficient status, respect in government and business, and financial expertise. GAO proposes a three-member board composed of a full-time chairperson who acts as the chief executive officer of the regulatory staff, the Secretary of the Treasury, and the Chairman of the Federal Reserve System.

CHARLES BOWSHER, GOVERNMENT SPONSORED ENTERPRISES: A FRAMEWORK FOR LIMITING GOVERNMENT’S EXPOSURE TO RISKS GAO/GGD-91-90, May 1991, at 8. This recommendation failed to be adopted, in part because it could have placed congressional jurisdiction over the regulator into a broad-based committee such as the House Ways and Means Committee rather than in the hands of the GSE authorizing committees.

<sup>140</sup> STANTON, *supra* note 5, at 1.

regulators into the cognitive mindset of the institutions that they regulate.<sup>141</sup> Cognitive capture is not a product of corruption, but rather a process by which the regulator or relevant congressional actors internalize “as if by osmosis, the objectives, interests, and perception of reality of the vested interests they are meant to regulate and supervise . . . .”<sup>142</sup> The dynamic of Buiter’s cognitive regulatory capture means that over time, a regulator can grow to favor the institutions that it regulates. Thus, a regulator with responsibility for supervising only the housing GSEs under a statute with a unique statement of capital requirements compared to other financial institutions, can gain motivation to move towards lower capital standards.<sup>143</sup> This opens the door to regulatory arbitrage and the likelihood that the GSEs once again would resume their excessive growth, based on their regulatory advantages rather than on whether it makes sense to concentrate so much risk in a few specialized financial institutions.

The inability of the Congress to set bank-type capital standards for Fannie Mae and Freddie Mac or to create for them a supervisory framework that was at least as strong as the supervisory framework for banks,<sup>144</sup> stands as a warning of the political dynamics that are at play here. As specialized institutions,<sup>145</sup> GSEs tend to be the province of parochial

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<sup>141</sup> Buiter, *supra* note 95, at 37.

<sup>142</sup> *Id.*

<sup>143</sup> See *supra* note 71 and accompanying text. In contrast to HERA, which maintains a distinct statutory framework for the GSEs, there are now consolidated statutory requirements for the bank and thrift regulators. The Federal Deposit Insurance Corporation Act, as amended, in 12 U.S.C. § 1813(q) (2008) defines “Appropriate Federal Banking Agency” to include the Office of Thrift Supervision (the thrift regulator) as well as the bank regulators and, in 12 U.S.C § 1818 (2008), grants common supervisory authority and imposes common responsibility upon each “appropriate federal banking agency” to apply remedies to deal with troubled institutions that are under their supervision.

<sup>144</sup> See Stanton, *Public Administration Theory*, *supra* note 6, at 634–35.

<sup>145</sup> See, e.g., STANTON, *MERCANTILIST COMPANIES*, *supra* note 5, at 8 (“Like thrifts, government-sponsored enterprises are specialized lenders. In return for their statutory benefits they are limited by law to serving

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committees or subcommittees of the Congress that are attuned to the benefits of GSEs for the stakeholders whom they serve, and are relatively insensitive to the need to protect ordinary taxpayers from having to pay for an expensive rescue.<sup>146</sup>

The prospect of differential capital and other supervisory requirements that permit regulatory arbitrage means that GSEs again can evolve to become not only “too big to fail,” but also too big to succeed.<sup>147</sup> The failure of internal controls at both GSEs was revealed at Freddie Mac in 2003 and at Fannie Mae in 2004,<sup>148</sup> when they were much smaller than they were when they failed completely several years later. More recently, Fannie Mae and Freddie Mac have shown, at great cost to the residential mortgage market and larger financial system, that the GSEs and their politically oriented managers lack the ability to manage such large institutions.

One should not ignore the fact that many other kinds of financial institutions, including banks, thrifts, and investment banks and their holding companies also failed in the recent debacle. The point here is that the GSE can be replaced by a wholly owned government corporation to provide comparable

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prescribed kinds of borrowers or dealing in specified kinds of loans.”).

<sup>146</sup> Thus, when considering whether to create the first safety-and-soundness regulator for Fannie Mae and Freddie Mac (which became OFHEO in 1992), members of the House Banking Committee joked about whether the legislation was necessary. Asked one Representative, “I’m just not sure exactly what we’re doing . . . . I still want to know what basic problem we’re attempting to fix.” Answered another, “Palpitations in the Treasury Department, cause unknown.” Jill Zuckman, *Bills To Increase GSE Oversight Move Ahead in House, Senate*, CONG. Q., Aug. 3, 1991, at 21–39.

<sup>147</sup> See, e.g., GARY H. STERN & RON J. FELDMAN, *TOO BIG TO FAIL: THE HAZARDS OF BANK BAILOUTS* 26 (Brookings Institution Press 2004) (defining institutions that are too big to fail as so large, complex, or intertwined with the rest of the financial system that policymakers support the institution’s uninsured creditors—despite having no legal obligation to do so—for fear that the institution’s failure could cause an unacceptable amount of damage to other institutions and the larger financial system. Economic costs accrue “when weak market discipline associated with too big to fail induces banks to make suboptimal decisions.”).

<sup>148</sup> Stanton, *supra* note 27, at 840–42.



support to the mortgage market without incurring the political and financial risks inherent in the GSE's hybrid organizational form.

*C. The Government Should Turn Fannie Mae and Freddie Mac into Wholly Owned Government Corporations*

The government should promptly end Fannie Mae and Freddie Mac as investor-owned companies with perceived federal backing and turn them into wholly owned government corporations.<sup>149</sup> At some specified time—say five years from now, when the mortgage market stabilizes once again—policymakers can decide the extent to which government support for the secondary mortgage market would be useful or affordable.

The wholly owned government corporation is a special type of government agency that is intended to operate in a businesslike way.<sup>150</sup> Government corporations are supposed to be financially self-sustaining, or at least potentially self-sustaining. They keep their books similar to a private firm and submit business-type budgets rather than government budgets each year. The idea of a government corporation is that it should seek to fund itself from its operations. If Congress decides to add noneconomic programs to a government corporation charter, then it should appropriate money to enable the government corporation to carry out these activities.

In the current environment, when many people express concerns about the large size of government, it is helpful to remember that GSEs combine the involvement of government with the incentives of private owners to create a much larger, and economically more distorting, presence in the mortgage

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<sup>149</sup> Government Corporation Control Act, 31 U.S.C.A. § 9101 (2008) (defining the contours of the term “wholly owned government corporation”).

<sup>150</sup> See, e.g., Stanton & Moe, *supra* note 83, at 81; Office of Management and Budget, Memorandum on Government Corporations, M-96-05, at 3 (Dec. 8, 1995); U.S. Government Accountability Office, Government Corporations: Profiles of Existing Government Corporations, GGD-96-14, at 5 (1995).

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market than occurs if a government corporation were quietly serving its mission without the drive to constant expansion that systematically occurs with any GSE.<sup>151</sup>

Transformed into government corporations, Fannie Mae and Freddie Mac could carry out significant activities during the next five years. They could:

1. Lower the cost of mortgages to help consumers refinance out of adjustable rate and other kinds of mortgages that are proving difficult for many homeowners to repay.
2. Serve as vehicles to deliver improved federal support for homeowners who are forced into foreclosure by losing their jobs.
3. Provide essential consumer protections for borrowers, such as Alex Pollock's one-page mortgage disclosure form.<sup>152</sup>
4. Devise and impose requirements that primary lenders and other participants in the mortgage process have appropriate financial strength and capability, accountability, and that they engage in appropriate risk-sharing before they are allowed to do business with the two companies. Implementation of some of these requirements may need to be deferred until the housing and mortgage markets regain some semblance of stability.
5. Adapt their Automated Underwriting Systems, and perhaps other systems and capabilities, for use by other federal agencies, starting with the FHA, and perhaps Ginnie Mae and the direct loan program for homeowners (part of the disaster loan program) of the Small Business

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<sup>151</sup> See, e.g., Stanton & Moe, *supra* note 83, at 82; see also STANTON, *MERCANTILIST COMPANIES*, *supra* note 5, at 4–6, (showing statistics of how all of the GSEs, whether investor-owned or cooperatives, virtually doubled in size every five years).

<sup>152</sup> ALEX POLLOCK, *THE BASIC FACTS ABOUT YOUR MORTGAGE LOAN* (American Enterprise Institute 2007), available at [http://www.aei.org/docLib/20070913\\_20070515\\_PollockPrototype.pdf](http://www.aei.org/docLib/20070913_20070515_PollockPrototype.pdf).

Administration.<sup>153</sup>

In short, the government could turn the collapse of Fannie Mae and Freddie Mac into an opportunity to fashion important rules of conduct for those types of participants in the housing market that have served American consumers and taxpayers so poorly. The government also could use the GSEs to help shore up the FHA by providing technical and IT systems support. Once they become wholly owned government corporations without the need to serve a mix of public and private objectives, Fannie Mae and Freddie Mac could play major roles in supporting the housing market.

Congress would be well advised to place a sunset provision of perhaps five years into each government corporation charter. A sunset date, which formally would terminate the corporation charter and require an end to its operations, provides an opportunity for policymakers to determine whether the enabling legislation should be reauthorized and, if so, in what form. As the sunset approaches, and the mortgage debacle is hopefully behind us, policymakers can decide whether further support for the mortgage market is required, and which organizational form is most suitable.

If they decided to wind up two government corporations at the end of five years, policymakers would address both the capacity and the life-cycle disadvantages that can otherwise accompany the creation of wholly owned government corporations. Having a five year sunset period would allow the wholly owned government corporations to provide support for the mortgage market at a critical time.<sup>154</sup> The experience of the Resolution Trust Corporation (“RTC”) indicates how a temporary government corporation can develop the capacity to

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<sup>153</sup> Thomas H. Stanton, *Strengthening Government’s Ability to Deal With the Financial Crisis* IBM CENTER FOR THE BUSINESS OF GOVERNMENT (2009) [hereinafter Stanton, *Strengthening Government’s Ability*], at 13, available at <http://www.businessofgovernment.org/pdfs/StantonFinancial.pdf>. (discussing FHA’s need for enhanced capacity).

<sup>154</sup> As GSEs, Fannie Mae and Freddie Mac in 2009 fund almost three quarters of new residential mortgage originations. See, e.g., Lockhart, *supra* note 19, at 10.

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deal with complex financial issues. It does this by attracting high-quality talent that might not contemplate a longer term career in government.<sup>155</sup> The RTC was impressive in the way that it evolved constant improvements in its approach to its mission.<sup>156</sup>

Even though the Congress could allow one or both of the government corporations to sunset at the end of their charter terms, this is not a foregone conclusion. The continuation of a government corporation could appeal to some policymakers, for example because of the ability to use revenues from mortgage operations to support affordable housing.<sup>157</sup>

In 1996, the General Accounting Office undertook a study to examine the consequences for the housing market if Fannie Mae and Freddie Mac ceased to operate as firms with any government backing at all. The GAO concluded that the effects would be limited:

Privatization would likely change the behavior of market participants and increase average interest rates on fixed-rate, single-family mortgages within an average range of about 15 to 35 basis points. However, privatization would not mean the end of the secondary mortgage market, a return to regional disparities in mortgage interest rates that were not based on differences in risk, or a lack of mortgage credit in the economy during parts of the business cycle. It would probably mean that mortgage rates would increase in areas with higher risks, for houses with higher loan-to-value ratios, and in

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<sup>155</sup> *Accord* Stanton, *supra* note 6, at 636 (“Life cycle is also an issue. After some years the government corporations could ‘ossify,’ i.e., begin to display some of the kinds of bureaucratic infirmities that FHA (for example) has manifested in recent years.”).

<sup>156</sup> *See, e.g.*, Thomas H. Stanton, *Lessons Learned: Obtaining Value From Federal Asset Sales*, 23 PUB. BUDGETING & FIN. 22 (2003).

<sup>157</sup> Section 1131 of HERA, Pub. L. 110-289, established a Housing Trust Fund that Fannie Mae and Freddie Mac would fund with contributions. It would be possible to build such an affordable housing program into a government corporation that serves the mortgage market. *See supra* note 6, at 636.

periods of high mortgage demand.<sup>158</sup>

Just as one must question whether a GSE or other private institution is properly manageable once it funds, say, a trillion dollars of mortgages,<sup>159</sup> one must also question whether managers of wholly owned government corporations will be up to the task. As a matter of protecting taxpayers from excessive financial risk it would be prudent to limit the size of both public and private institutions that provide financial support to the mortgage market. One clear lesson of the current debacle is that it is risky to maintain immense financial institutions of any kind over the long term.<sup>160</sup>

One possible way would be to use a government corporation to provide government support for limited purposes, such as a 30-year fixed-rate mortgage for selected borrowers such as first-time homebuyers. Alternatively, concern about size and risk could lead policymakers to sunset the government corporations after the mortgage market is back on its feet. In either event, the model of the wholly owned government corporation would

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<sup>158</sup> U.S. General Accounting Office, *Housing Enterprises: Potential Impacts of Severing Government Sponsorship*, GGD-96-120, May 1996, at 70. A “basis point” is one-one-hundredth of a percentage point.

<sup>159</sup> Economist Joseph Stiglitz makes this point about banks:

[T]he problem of too-big-to-fail institutions remains. There are but two solutions: breaking up the institutions or regulating them heavily. For reasons that I will make clear, we need to do both.

The only justification for allowing these huge institutions to continue is that there are significant economies of scope or scale that otherwise would be lost. I have seen no evidence to that effect . . . we have little to lose, and much to gain, by breaking up these behemoths, which are not just too big to fail but also too big to save and too big to manage.

*Too Big to Fail or Too Big to Save? Examining the Systematic Threats of Large Financial Institutions: Hearing Before the Joint Economic Committee*, 111th Cong. 25–26 (2009) (statement of Joseph Stiglitz, 2001 Nobel Prize Recipient & Professor, Columbia University), available at <http://jec.senate.gov/index.cfm?FuseAction=Hearings.HearingsCalendar> (follow “April 21st—Too Big to Fail or Too Big to Save?” hyperlink; then follow “Joseph Stiglitz” hyperlink).

<sup>160</sup> *See id.*

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remain available when needed to provide government support for the mortgage market in the event of any future crisis.

CONCLUSION: USE THE FORMER GSEs EXTENSIVELY AT FIRST AND THEN FOR MORE LIMITED SUPPORT OF THE MORTGAGE MARKET

The government-sponsored enterprise has outlived its usefulness as an instrument of government policy. While other financial institutions have also shown vulnerability, the GSE appears to be especially prone to dominating and ultimately evading any reasonable accountability structure. GSEs are simply too powerful for their own good. Fannie Mae and Freddie Mac, now demonstrably insolvent, should be placed into receivership and turned into wholly owned government corporations that could sunset after perhaps five years. As such they could support the mortgage market, not only through their access to government funding, but also by imposing rules for consumer and investor protection, capital requirements on mortgage market participants, and other protective measures that policymakers could apply to the rest of the housing finance system. Also, they could help to shore up potentially vulnerable government agencies such as the FHA that are playing increasingly important roles in the mortgage market. After that, when circumstances have improved, policymakers can decide whether the needs of the housing market should be served by a government corporation, and how to shape that government corporation to address those needs. Especially for the next few years, but also potentially for the longer term, the wholly owned government corporation is an organizational form that offers great promise as a source of support for the mortgage market.