NOTES

Eliminating the Risk to Taxpayers: Privatizing Fannie Mae and Freddie Mac

“The U.S. financial system resembles a patient in intensive care. The body is trying to fight off a disease that is spreading, and as it does so, the body convulses, settles for a time and then convulses again. The illness seems to be overwhelming the self-healing tendencies of markets. The doctors in charge are resorting to ever-more invasive treatment, and are now experimenting with remedies that have never before been applied.”

I. INTRODUCTION

Economic turmoil can yield greater government regulation and oversight.2 The Securities Exchange Act of 1934 followed the Great Depression.3 The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 followed the savings and loan crisis.4 The Sarbanes-Oxley Act of 2002

2. Id (outlining history of government experimentation during financial turmoil).
followed the collapse of Enron and WorldCom.\(^5\) Congress recently passed the Emergency Economic Stabilization Act of 2008 in reaction to the mortgage meltdown and credit crunch.\(^6\) The United States financial market has suffered major setbacks in the past few years and will likely face further economic downturns going forward.\(^7\)

The federal government must therefore devise solutions to the problems developing in the current financial climate.\(^8\) Ineffective federal policies contributed to the current problems because they created moral hazards, especially in the mortgage industry, where both lenders and borrowers ignored the broader consequences of their actions.\(^9\) Another contributor to the crisis was the securitization of real estate debt by the financial industry, resulting in complex and sophisticated products.\(^10\) While some of these new financial

---


   (1) to immediately provide authority and facilities that the Secretary of the Treasury can use to restore liquidity and stability to the financial system of the United States; and (2) to ensure that such authority and such facilities are used in a manner that—(A) protects home values, college funds, retirement accounts, and life savings; (B) preserves homeownership and promotes jobs and economic growth; (C) maximizes overall returns to the taxpayers of the United States; and (D) provides public accountability for the exercise of such authority.

   Id. § 2.


8. See Steven Pearlstein, Before This Hole Gets Deeper, a Break from Digging, WASH. POST, Oct. 11, 2008, at D1 (stipulating markets require collective action to work properly).


products may serve valuable purposes, many have proven difficult to regulate and have contributed to the economic downturn.\textsuperscript{11}

This Note will discuss the uncontrollable growth of the mortgage giants, Fannie Mae and Freddie Mac, and the need to change the policies that created perverse incentives for financial institutions and investors to act in ways adverse to economic stability.\textsuperscript{12} The first part of this Note will discuss the history of the federal government’s role in financing mortgages and promoting homeownership.\textsuperscript{13} Secondly, the Note will examine the secondary mortgage market and the innovative financial securities that have emerged in the past few years and the concerns that come with these new products.\textsuperscript{14} Finally, part three of the Note will present arguments for privatizing Fannie Mae and Freddie Mac.\textsuperscript{15}

\section*{II. History}

The current economic crisis originated in the real estate market, which experienced unprecedented failures in both the residential and commercial markets.\textsuperscript{16} The root cause of these failures was a combination of easy credit, weak loan application standards, and lax governmental oversight.\textsuperscript{17} The rapid growth of opaque financial products also contributed to the real estate market failures and accelerated the downfall of the overall financial industry.\textsuperscript{18}

\subsection*{A. Development of the Mortgage Market}

Prior to 1938, local banks were the primary source of residential mortgage lending.\textsuperscript{19} The first time the federal government intervened in the private housing market was during the Great Depression to facilitate a stable mortgage market.\textsuperscript{20} To support its goal of increased home loans and homeownership, Congress enacted banking legislation to restore depositor confidence and to

\begin{flushright}
\end{flushright}
\begin{flushright}
\end{flushright}
\begin{flushright}
\textit{See infra Parts II-III (providing history and analysis regarding Fannie Mae and Freddie Mac).}
\end{flushright}
\begin{flushright}
\textit{See infra Part II.A (explaining history of mortgage market).}
\end{flushright}
\begin{flushright}
\textit{See infra Part II.B (defining real estate securitization).}
\end{flushright}
\begin{flushright}
\textit{See infra Part III (arguing for privatization of Fannie Mae and Freddie Mac).}
\end{flushright}
\begin{flushright}
\textit{See Shiller, supra note 7, at 1 (illustrating collateral effects of subprime crisis).}
\end{flushright}
\begin{flushright}
\textit{See infra notes 19-38 and accompanying text (discussing development of problems within mortgage market).}
\end{flushright}
\begin{flushright}
\textit{See infra Part II.B (explaining securitization of real estate).}
\end{flushright}
\begin{flushright}
\end{flushright}
\begin{flushright}
\textit{See id. (describing United States housing market during Great Depression). In 1933, mortgage lending and new housing production stalled and bank foreclosures on mortgages sharply increased because half of all mortgages were in default. See id. The housing market plummeted and banks issued few new loans. See id.}
\end{flushright}
encourage citizens to keep their money in banks. Following banking reform laws, Congress passed the National Housing Act of 1934, which established the Federal Housing Administration (FHA) and created a mortgage insurance system.

The creation of a uniform, federally-insured mortgage instrument decreased risk for lenders, but a national market did not develop immediately because banks were uncomfortable underwriting mortgages outside their local geographic area as they were not familiar with market characteristics. In 1938, President Franklin D. Roosevelt and Congress addressed this problem by chartering the Federal National Mortgage Association (Fannie Mae) as a federal agency to ensure a consistent mortgage credit supply throughout the country. Initially, the federal government only authorized Fannie Mae to purchase mortgage loans insured by the FHA. Specifically, Fannie Mae was to purchase FHA-insured mortgages from private lenders desiring more mortgage capital and then sell them to other lenders holding extra capital. The private lenders were then able to use the sale proceeds to finance new mortgages and the process would repeat itself, thus constantly replenishing residential mortgage funds.

---


22. National Housing Act, 12 U.S.C. § 1701 et seq. (2000) (enacting housing reforms). This legislation allowed lenders to transfer a single or multi-family mortgage to the FHA in the event of a bank foreclosure in return for ninety percent of the lent money, which was determined by the appraised property value. See 12 U.S.C. § 1709 (2000) (creating terms of mortgage insurance system); Garvin, supra note 19, at 196-97 (explaining importance of new housing legislation). The FHA also standardized mortgages by requiring compliance with certain terms, such as setting minimum property standards based on geographic location and housing structure. See Garvin, supra note 19, at 197. FHA-insured mortgages were practically identical regardless of state or bank issuance because each contained a fixed interest rate, required the same debt payments every month, and self-amortized. See id. The purpose of standardizing mortgages was to match areas of high mortgage demand with areas of high capital seeking low-risk investments. See id. Currently, the FHA is experiencing its own difficulties in the economic crash aftermath, and lawmakers have begun to inquire into the possibility of another federal bailout. See David Streitfeld & Louise Story, F.H.A. Problems Raising Concern of Policy Makers, N.Y. TIMES, Oct. 9, 2009, at A1 (anticipating further problems at federal housing agencies).

23. See Garvin, supra note 19, at 197 (examining development of national mortgage industry). Local banks were unfamiliar with market characteristics across the country and were reluctant to extend their money for long periods of time. See id.


26. See Garvin, supra note 19, at 198 (explaining mortgage transactions performed by Fannie Mae).

27. See Fannie Mae, http://www.fanniemae.com (follow “About Us” hyperlink, then follow “Our Charter” hyperlink) (last visited Dec 10, 2009) [hereinafter About Fannie Mae] (explaining history and role of
Congress created Fannie Mae to increase affordability and availability of homeownership for low and moderate income families. 28 Congress reorganized Fannie Mae in 1954 by removing federal backing for borrowings and allowing private capital in its place, thus creating a mixed ownership system. 29 By 1968 Fannie Mae had grown so large that Congress removed Fannie Mae’s debt portfolio from the federal balance sheet and converted Fannie Mae into a government-sponsored enterprise (GSE). 30 Although converting Fannie Mae into a GSE allowed private investors to own and manage Fannie Mae, the United States Department of Housing and Urban Development (HUD) retained regulatory oversight. 31 The 1968 Charter also expanded Fannie’s authority to buy non FHA-insured mortgages. 32

Two years after Fannie Mae became a private company, Congress chartered the Federal Home Loan Mortgage Corporation (Freddie Mac) as a stockholder-
owned corporation subject to HUD oversight to purchase conventional residential mortgages and to “provide liquidity, stability, and affordability to [the] housing market.”33 The stated purposes of Freddie Mac paralleled those of Fannie Mae: to provide a low-cost flow of mortgage capital, to link global capital markets to the United States mortgage market in order to make mortgage funds available for Americans, and to organize a secondary mortgage market.34

Congress debated creating a new regulator for Fannie Mae and Freddie Mac in 1992.35 While one side argued these institutions served a public purpose by lowering mortgage prices and did not need further regulation, the other rebutted that the firms had turned into money-making entities serving only stockholders’ interests.36 Congress eventually passed legislation establishing the Office of Federal Housing Enterprise Oversight (OFHEO), an independent agency within HUD, to regulate the “safety and soundness” of Fannie and Freddie, although Congress maintained control over the agency’s budget.37 OFHEO’s mandate included implementing, monitoring, and enforcing capital standards.38


34. See infra Part II.B (explaining secondary mortgage market).


36. See id. (presenting both sides of Congressional debate).


B. Secondary Mortgage Market

Congress created Fannie and Freddie to make mortgage financing available to homeowners by keeping interest rates low and by selling mortgage debt in the marketplace in the form of securities.\footnote{See infra notes 47-53 and accompanying text (explaining primary and secondary mortgage markets).} However, increased “securitization” of mortgage loans into financial products made it difficult for investors far removed from the underlying assets to accurately measure risk and value.\footnote{See infra notes 47-53 and accompanying text (explaining primary and secondary mortgage markets).} To understand the adverse effect securitization had on the financial marketplace in recent years, it is necessary to examine the primary and secondary mortgage markets, as well as the particular securities involved.\footnote{See infra notes 47-53 and accompanying text (explaining primary and secondary mortgage markets).}

The primary market process begins when an individual seeking to buy a home applies for a mortgage from a primary mortgage lender, such as a bank, mortgage company, or a thrift, such as a savings and loan institution.\footnote{See id. (setting forth GSEs’ involvement in mortgage process).} First, the lender determines whether the borrower meets its lending standards and has the ability to pay back the mortgage.\footnote{See id. (setting forth GSEs’ involvement in mortgage process).} Following loan approval and the transfer of the funds to the property seller, the lender decides whether to keep the mortgage in its portfolio or to sell the mortgage in the secondary market.\footnote{See id. (setting forth GSEs’ involvement in mortgage process).}

Congress designed Fannie Mae and Freddie Mac to serve the secondary residential mortgage market by buying mortgages that meet their underwriting standards from primary market lenders across the county.\footnote{See id. (setting forth GSEs’ involvement in mortgage process).} The primary lenders use the funds received from Fannie and Freddie to initiate more mortgages.\footnote{See id. (setting forth GSEs’ involvement in mortgage process).} Fannie and Freddie bundle together their purchased mortgages into large groups to create securities, known as mortgage-backed securities (MBS), which they guarantee and sell to investors in public markets.\footnote{See id. (explaining creation of mortgage-based securities).} Fannie and Freddie repeat the process by using the resulting proceeds to buy more

\begin{footnotes}
\footnote{See infra notes 47-53 and accompanying text (explaining primary and secondary mortgage markets).}
\footnote{See id. (describing loan approval process).}
\end{footnotes}
mortgages from primary lenders.48

A mortgage-backed security is a security that represents an interest in a pool of loans, usually consisting of residential mortgages.49 The lifecycle of a MBS through the primary and secondary mortgage markets is this: a homeowner sends his monthly payment to a lender or mortgage service that manages the payments, and then the primary lender keeps a portion as a fee for managing the borrowers’ payment and passes the remainder of the monthly payment to Fannie Mae or Freddie Mac.50 Fannie or Freddie passes the rest of the payments to investors who hold the mortgage securities.

In 1983, Freddie Mac began to issue collateralized mortgage obligations (CMOs), which create different classes of bonds backed by the same pool of mortgages.52 Each class represents a different risk level and the classes are paid in order of ascending risk when principal and interest payments are received for the underlying mortgages.53 Private investment firms became

48. See id. (recognizing cyclical process of loan creation); see also Reiss, supra note 25, at 1027-28 (summarizing secondary mortgage process); Strickland, supra note 31, at 270-72 (2004) (explaining Fannie and Freddie’s role in secondary mortgage market).
50. See id. (clarifying MBS process).
51. See id. (explaining primary mortgage market). Freddie Mac began selling MBSs in 1971. See Julia Patterson Forrester, Fannie Mae/Freddie Mac Uniform Mortgage Instruments: The Forgotten Benefit to Homeowners, 72 MO. L. REV. 1077, 1082 (2007) (detailing history of mortgage securities). MBSs are also sometimes called “pass-through securities” because Fannie or Freddie passes the mortgage payments on to investors. See id. An investor never owns the underlying security, the mortgage, but rather a piece of each pooled mortgage loan. See id. (explaining ownership interest in MBSs); Strickland, supra note 31, at 271 (describing investment in MBSs).
52. See Forrester, supra note 51, at 1082 (describing chronological history of Freddie Mac’s role in securitization). A CMO is a derivative financial instrument created by pooling individual mortgage loans together into a product Fannie and Freddie can sell in the secondary market. See JANET L. KAMINSKI LEDUC, CONNECTICUT GENERAL ASSEMBLY, OFFICE OF LEGISLATIVE RESEARCH, CREDIT DEFAULT SWAPS AND COLLATERALIZED DEBT OBLIGATIONS (Dec. 10, 2008), http://www.cga.ct.gov/2008/rpt/2008-R-0668.htm. Selling CDOs to investors is a means for companies to increase liquidity, but in many cases the investor is unaware of what assets are included in the instrument. See id.
53. See Forrester, supra note 51, at 1082 (explaining CMO process); see also Robert R. Veach, Jr.,
involved in issuing CMOs as demand for mortgage securities increased after the Federal Reserve’s successive rate cuts began in 2001.54

In 2006 and 2007, Fannie Mae and Freddie Mac lowered their standards for buying mortgages, thereby backing riskier mortgages, including subprime mortgages, to support HUD goals for increased homeownership.55 By doing this, Fannie and Freddie took on more risk because they guaranteed payments to investors in the event of borrower default.56 Even though Fannie and Freddie were supposed to target less risky loans, the agencies’ new lower


54. See Berkowitz, supra note 10, at 122-23 (examining securitization history in subprime mortgage market). Successive rate cuts led to low interest rates for home loans, which fueled demand for mortgage securities. See id. Private investment firms became involved with securitization of mortgages that did not meet Fannie or Freddie’s standards. See Passmore, supra note 49, at 3 (explaining Fannie Mae and Freddie Mac’s conforming loan standards). The investment banks revamped the traditional CMO pass-through structure after investors began to demand higher returns, and turned CMOs into products virtually impossible to assess for risk due to their lack of transparency. See Berkowitz, supra note 10, at 122-23. Wall Street customized the cash flows from underlying mortgages of the CMOs by separating them into tranches (French for slices), creating securities with varying risk levels; however, sellers and investors knew little about the underlying mortgage. See id. Sellers usually rank the securities divided into tranches by seniority of payment priority. See Steven L. Schwarz, Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown, 93 MINN. L. REV. 373, 377-78 (2008). Tranches provide a “waterfall of payment” structure to meet the differing risk needs of investors. See id. at 6. The higher priority payment classes typically receive higher credit ratings than the underlying receivables. See id. Subprime mortgages dominated mortgage pools sold by investment banks and were issued with little or no documentation indicating a borrower’s income and repayment ability. See Berkowitz, supra note 10, at 123. These loans were called “No Doc” (requiring no documentation to secure a mortgage loan) or “Alt-A” (requiring minimum documentation). See id. Wall Street gained large profits from selling these securities backed by subprime loans. See Carol D. Leonnig, How HUD Mortgage Policy Fed the Crisis: Subprime Loans Labeled “Affordable”, WASH. POST, June 10, 2008, at A1 (describing Wall Street’s role in financial crisis).

55. See Appelbaum et al., supra note 35, at A1 (describing lowering of lending standards); Alana Samuels, Understanding Two Loan Giants, L.A. TIMES, Sept. 8, 2008, at 16 (noting Fannie and Freddie lowered credit standards). In 2003, Fannie and Freddie bought $81 billion in subprime securities. See Appelbaum et al., supra, at A1. The pair’s purchase volume increased significantly the following year when they purchased $175 billion in subprime securities, representing 44 percent of the market. See id. In 2005, the firms bought $169 billion (thirty-three percent of the market). See id. In 2006, they scaled back to $90 billion (twenty percent of the market). Appelbaum et al., supra note 35, at A1. From 2004-2006, Freddie and Fannie helped expand the market for subprime lending by buying $434 billion in securities backed by subprime loans. See Leonnig, supra note 54, at A1. As Fannie and Freddie’s purchases of subprime loans increased, so did foreclosures. See id. One Senator expressed concern that HUD’s homeownership goals were not aligned with economic reality:

We need to focus on putting families in homes they can truly afford, not just on getting a sale, packaging the loan into a sophisticated financial security and walking away to the next closing . . . .

Today, people are wondering ‘Why weren’t the regulators and the industry probing these [loans] more deeply?’

Id.

purchasing standards provided liquidity for a growing, yet highly unregulated subprime market.\textsuperscript{57}

Notwithstanding the lowering of lending standards, brokers continued to market Fannie and Freddie’s mortgage securities as low-risk investments and credit rating agencies routinely issued favorable investment grade ratings.\textsuperscript{58} Consequently, investors did not understand how risky these securities were, and the subprime mortgage market ultimately depended on the ability of subprime borrowers to make their loan payments.\textsuperscript{59} This, in turn, depended on home values remaining stable.\textsuperscript{60} Thus, the market collapse was inevitable when home values declined.\textsuperscript{61}

Declining home values lowered the value of the mortgages held by Fannie and Freddie, thus decreasing the firms’ already low levels of capital.\textsuperscript{62} As more homeowners defaulted on payments, Fannie and Freddie were unable to sell securities to obtain private financing from investors and they fell into trouble because they had guaranteed payments to prior investors.\textsuperscript{63}

In 2007 and 2008, the subprime mortgage meltdown sent a shock through the securitized real estate market as many borrowers rapidly defaulted on the underlying loans of these securities.\textsuperscript{64} Confidence in the financial markets plummeted as investors in these securities lost billions of dollars.\textsuperscript{65}

\section*{C. GSE Privileges}

As GSEs serving the purported public-policy agenda of increased homeownership, both firms enjoy privileges and advantages not granted to private corporations.\textsuperscript{66} For example, Fannie Mae and Freddie Mac are exempt from paying federal and state income taxes.\textsuperscript{67} They are also exempt from Securities and Exchange Commission registration and periodic filing requirements.\textsuperscript{68} Both have been allowed to sell their debt through the Federal


\textsuperscript{58} See Fannie Mae and Freddie Mac: \textit{End of Illusions}, THE ECONOMIST, July 17, 2008 (noting favorable ratings given to GSEs).

\textsuperscript{59} See id. (recalling causes of subprime market troubles).

\textsuperscript{60} See Semuels, supra note 55, at 16 (addressing drop in home values).

\textsuperscript{61} Id. (stating troubles of Fannie and Freddie).

\textsuperscript{62} See Semuels, supra note 55, at 16 (citing poor levels of capital at GSEs).

\textsuperscript{63} See id. (discussing inability of Fannie and Freddie to secure private financing).

\textsuperscript{64} See Schwarz, supra note 54, at 378-79 (setting forth causes and effects of loan defaults).

\textsuperscript{65} See id. at 379 (quantifying investor losses).

\textsuperscript{66} See Reiss supra note 25, at 1052-68 (detailing privileges granted to Fannie Mae and Freddie Mac).

\textsuperscript{67} 12 U.S.C. § 1452(e) (2000) (exempting Fannie Mae from all federal, state and local taxes except property taxes); see also \textsc{Congressional Budget Office, Federal Subsidies and the Housing GSEs} 7 (2001), available at http://www.cbo.gov/doc.cfm?index=2841 [hereinafter \textsc{Congressional Budget Office Report}] (discussing reductions to GSEs’ operating costs resulting from benefits).

\textsuperscript{68} 15 U.S.C. § 78k(42) (2000). As GSEs, Fannie and Freddie’s securities qualify as “government securities” which are exempt from federal securities regulation. See \textsc{Congressional Budget Office Report, supra} note 67, at 13, 20 (explaining benefits of GSE legal status).
Reserve—a privilege only otherwise enjoyed by the United States Treasury. Additionally, Fannie and Freddie each had access to borrow billions from the United States Treasury at favorable rates.

These government-bestowed advantages led to other benefits as well, such as lower financing costs because investors perceived Fannie and Freddie’s securities as low-risk. The GSEs’ securities also enjoyed high credit ratings because they qualified as “agency securities.” These public-private hybrids were able to borrow at lower interest rates because investors believed the government would bail them out in the event of a crisis. This implied guarantee by the United States government, and thus the American taxpayers, allowed Fannie and Freddie to purchase more mortgages and continue to grow.

D. Federal Demand for Greater Homeownership

In addition to the advantages of GSE status, the political push for affordable housing fueled unrestrained growth of these industry giants over the past two decades. For example, the Clinton Administration put pressure on Fannie Mae to expand mortgages to low and moderate income Americans. Fannie

69. See CONGRESSIONAL BUDGET OFFICE REPORT, supra note 67, at 13 (stating right to use Federal Reserve as fiscal agent); see also Krehely, supra note 29, at 530-31 (noting Federal Reserve serves as fiscal agent of Fannie and Freddie); Strickland, supra note 31, at 277 (listing privileges of GSEs).


71. See id. at 14 (analyzing perceived risk of Fannie and Freddie’s securities).

72. See id. (discussing statutory exemptions). Credit rating agencies rated Fannie and Freddie’s securities above AAA corporate bonds and just below U.S. Treasury bonds. See id. (discussing risk and credit ratings).

73. See id. (explaining implicit government guarantee); Reiss, supra note 25, at 1056-62 (examining competitive advantages of GSEs over other financial institutions).


76. See WEISS, supra note 75 (explaining Clinton’s strategies to increase American homeownership). American homeownership steadily increased between 1960 and 1980, peaking at 65.6 percent in 1980. See id. The national homeownership rate then stagnated or declined during the Reagan and Bush Sr. Administrations, eventually settling at 64.1 percent in 1992. See id.; see also Appelbaum et al., supra note 35 (providing statistic of lagging homeownership levels); Steven A. Holmes, Fannie Mae Eases Credit to Aid Mortgage Lending, N.Y. TIMES, Sept. 30, 1999, at C2 (describing increasing pressure by Clinton Administration on Fannie Mae to expand mortgage loans). In 1994, President Clinton launched the National Homeownership Strategy, an initiative aimed at increasing the homeownership rate. See Holmes, supra, at C2. President
and Freddie complied and their profits rose significantly.77 Similarly, in 2001, President George W. Bush advocated for greater homeownership in America, giving the mortgage industry a boost and calling upon Fannie and Freddie to assist in reaching what the Bush Administration later promoted as an “ownership society.”78 Under political pressure, Fannie Mae began easing its standards for the types of loans it would purchase from banks.79 Most recently Clinton called upon then-Secretary of the Department of Housing and Urban Development, Henry Cisneros, to focus on increasing homeownership among low-income, young, and minority families. See WEISS, supra note 75. President Clinton wrote:

Homeownership is the American dream . . . . [S]ince 1980, the national homeownership rate has been declining. Reversing this trend is vital to American families, to communities, and to our economy. Homeownership strengthening families and stabilizes communities . . . . Expansion of homeownership is an integral part of the Administration’s economic plan. It spurs new investment, strengthening the economy and creating jobs. A stronger economy in turn enables more people to buy homes. For all these reasons, it is in our national interest to expand homeownership opportunities for all Americans . . . . Today, I am requesting that you lead an effort to dramatically increase homeownership in our nation over the next six years.

Id. (quoting Letter from William Jefferson Clinton, President of the United States of America, to Henry Cisneros, Secretary of the Department of Housing and Urban Development (Nov. 3, 1994)).

77. See Appelbaum et al., supra note 35 (stating homeownership push contributed to Fannie and Freddie’s profit growth).


The goal is, everybody who wants to own a home has got a shot at doing so . . . . We are here in Washington, D.C. to address problems. So I’ve set this goal for the country. We want 5.5 million more homeowners by 2010 . . . . We need more capital in the private markets for first-time, low-income buyers. And I’m proud to report that Fannie Mae has heard the call and, as I understand, it’s about $440 billion over a period of time. They’ve used their influence to create that much capital available for the type of home buyer we’re talking about here. It’s in their charter; it now needs to be implemented. Freddie Mac is interested in helping. I appreciate both of those agencies providing the underpinnings of good capital.

Id.; see also Tom Raum & Jim Drinkard, Fannie Mae, Freddie Mac Spent Millions on Lobbying, USA TODAY, July 17, 2008, available at http://www.usatoday.com/money/companies/2008-07-17-fannie-freddie-lobbying_N.htm (discussing political goal of homeownership). Immediately before and during the beginning of his second term in office, President George W. Bush called for an “ownership society” in areas such as retirement, medicine, and home ownership. See Lee Walczak et al., Selling the Ownership Society, BUS. WK., Sept. 6, 2004, at 34.

[F]or millions of our citizens, the American Dream starts with owning a home. Home ownership gives people a sense of pride and independence and confidence for the future . . . . [W]e’re creating a home—an ownership society in this country, where more Americans than ever will be able to open up their door where they live and say, welcome to my house, welcome to my piece of property.


79. See Holmes supra note 76, at C2 (discussing Fannie Mae’s decision to lower credit standards for loans it would purchase). In 1999, Fannie Mae piloted a program targeting borrowers with credit lower than Fannie Mae’s underwriting requirements—those falling in the so-called subprime mortgage market that
in February 2009, as part of its comprehensive Financial Stability Plan, the Obama Administration worked with the GSEs, Treasury Department, and HUD to implement the Making Home Affordable Program, which aims to reduce monthly mortgage payments for seven to nine million Americans, thus demonstrating continued federal efforts to increase homeownership among Americans.80

E. Congressional Attempts to Control Fannie and Freddie

As Fannie Mae and Freddie Mac grew into complex mortgage giants, many criticized Congress’ light regulatory treatment and called for greater oversight.81 Warnings came from Treasury officials and others, who testified before Congress in 2000 supporting a bill to rein in Fannie despite certainty that the bill would fail.82 Critics voiced concerns about Fannie and Freddie’s debt-to-equity ratios and the United States government’s implicit guarantee in the event of problems.83 For years, many predicted that the federal government would not allow these GSEs to fail because of their size and status, even though no statute mandated that the federal government guarantee the firms’ obligations.84

Accounting scandals exposed at the firms in 2003 reinvigorated these


81. See Krehely, supra note 29, at 539 (noting critics warned of potential GSE troubles).


83. See Fannie Mae and Freddie Mac: End of Illusions, supra note 58, at 40 (examining flaws with American housing system). Fannie and Freddie’s regulator permitted them to operate with small capital amounts. Id. The two institutions combined held $83.2 billion worth of capital to support $5.2 trillion of debt and guarantees, amounting to a sixty-five to one loan-to-value ratio. Id. Even with this high debt-to-equity ratio, Fannie and Freddie managed to receive AAA credit ratings. See id. (noting Standard & Poor’s rating agency cited “extraordinary support” by government to support high rating).

84. See Reiss, supra note 25, at 1050-51 (arguing implicit guarantee by government because GSEs “too big to fail”).
concerns. Members of Congress proposed legislation in response to the GSEs’ operational and interest rate risks exposed by the accounting scandals, yet these proposals stalled in committees. Congressional members proposed a similar bill in 2005, but this too fell short in gaining approval. Congress’s repeated failure to pass reform legislation demonstrates the political influence Fannie and Freddie held. Legislators failed to act until it was too late to control the unsustainable growth of the two mortgage giants despite critics’ repeated warnings of their dangerous size and financial practices.

F. Conservatorship of Fannie and Freddie

By 2008, subprime borrowers were defaulting on their loans en masse, and Fannie and Freddie were running out of money to cover the losses. The

85. See generally FANNIE MAE AND FREDDIE MAC: SCANDAL IN U.S. HOUSING (James R. Christie ed. 2007) (addressing Fannie and Freddie accounting scandals in depth). In 2004, OFHEO publicized a report criticizing Fannie Mae’s accounting practices. Id. at 333. OFHEO declared that Fannie Mae had not followed generally accepted accounting principles (GAAP) with respect to the amortization of financial items related to the purchase of the home mortgage and accounting of financial derivative contracts. Id. These accounting discrepancies allowed Fannie Mae to reduce earnings volatility, represent steady profitability, and give undeserved bonuses to executives. Id. Two months after OFHEO’s report became public, Fannie Mae’s accounting firm refused to sign its third-quarter accounting results. Id. One month later, the SEC forced Fannie Mae to restate its accounting results since 2001, which totaled an $11 billion reduction at the completion of the investigation. See id.; see also Press Release, United States Securities and Exchange Commission, SEC and OFHEO Announce Resolution of Investigation and Special Examination of Fannie Mae (May 23, 2006), available at www.sec.gov/news/press/2006/2006-80.htm. Fannie Mae agreed to pay $400 million in fines as part of a settlement agreement with the SEC and OFHEO. See Press Release, supra. The GSE also agreed to limit its mortgage holdings to $727 billion. Report: Fannie Mae Manipulated Accounting, ASSOCIATED PRESS, May 23, 2006, available at http://www.msnbc.msn.com/id/12923225/.


88. See Tom Raum & Jim Drinkard, Fannie Mac, Freddie Mac Spent Millions on Lobbying, USA TODAY, July 17, 2008, available at http://www.usatoday.com/money/companies/2008-07-17-fannie-freddie-lobbying_N.htm (attributing Congress’ failure to pass reforms to Fannie and Freddie’s fundraising and lobbying efforts). Over the last ten years, Fannie Mae and Freddie Mac have both ranked among the top twenty firms in amount spent on lobbying in Washington, paying a combined $170 million to cultivate and woo allies. Id. Since 1997, Fannie and Freddie executives have contributed over $16.2 million to Congressional campaigns on both sides of the political spectrum. Id. The two firms have hired many Washington insiders to promote work on behalf of their interests. Id.

89. See Appelbaum et al., supra note 35 (criticizing federal legislature for ignoring warnings).

90. See id. (describing downfall of Fannie and Freddie).
the first three fiscal quarters of 2008. At this time, Fannie and Freddie held over 10 million subprime or weak loans on their books or in MBSs they had guaranteed. To support the enterprises’ enormous obligations, HERA gives Fannie and Freddie access to the United States Treasury, essentially guaranteeing government backing of each enterprise. As of August 2009, the Treasury Department had provided Fannie and Freddie with a combined $85 billion to keep them solvent, agreeing to contribute up to $200 billion to each enterprise to keep them running. Also pursuant to HERA, HUD transferred regulatory power over Fannie Mae and Freddie Mac to a new regulator, the Federal Housing Finance Agency (FHFA), which also became the enterprises’ conservator.

In addition to HERA-authorized Treasury support of the GSEs, in November 2008 the Federal Reserve agreed to purchase $500 billion of MBSs guaranteed

98. See Randall, supra note 96, at A5 (explaining Treasury Department’s plan); Solomon et al., supra note 96 (stating government regulator’s purpose as “conserving” companies’ financial strength).

99. See Peter J. Wallison, Op-Ed., Barney Frank, Predatory Lender, WALL ST. J., Oct. 15, 2009, at A19 (citing substantial number of mortgages on balance sheets). In September 2008 the serious delinquency rate, which is the rate at which borrowers miss three or more months of loan payments, on single-family home mortgages backed or held by Fannie was 1.45 percent. See Julie Haviv, Fannie Mae Delinquencies Jump, Aug. Portfolio Flat, REUTERS, Sept. 29, 2009, available at http://www.reuters.com/article/gc03/idUSTRE58S2LS20090929. One year later, the serious delinquency rate had increased to 4.17 percent, an unprecedented level. See id.

100. See Haviv, supra note 99. (providing United States Treasury access to GSEs). The Treasury Department created several programs to support the GSEs, including the Senior Preferred Stock Purchase Agreements with Fannie and Freddie. See Fact Sheet, U.S. Treasury Department Office of Public Affairs, Treasury Senior Preferred Stock Purchase Agreement (Sept. 7, 2008), available at http://www.treas.gov/press/releases/reports/pspa_factsheet_090708%20hp1128.pdf [hereinafter Fact Sheet]; Lockhart Report, supra note 97, at 3. The Treasury Department explained the reasoning behind this plan:

   Investors have purchased securities of these [GSEs] in part because the ambiguities in their Congressional charters created a perception of government backing . . . . Because the U.S. government created these ambiguities, we have a responsibility to both avert and ultimately address the systemic risk now posed by the scale and breadth of the holdings of GSE debt and mortgage backed securities.

   See Fact Sheet, supra.

101. See Fact Sheet, supra note 100 (listing terms of Treasury and GSE contracts); see also Lockhart Report, supra note 97, at 3, Slide 1; Nick Timiraos, Freddie Turns Profit, but Issues Caution, WALL ST. J., Aug. 8, 2009, at A2. The original agreement provided that the Treasury would ensure that the GSEs maintain a positive net worth by purchasing senior preferred stock and MBSs issued by the GSEs in exchange for $100 billion to each enterprise. See Mortgage Market Note, supra note 95, at 1. In February 2009, the Treasury raised its commitment to each enterprise to $200 billion. See id.

102. See HERA, supra note 92 (introducing new regulator for GSEs). The former Director of the FHFA stated before Congress that “[t]he enhanced regulatory authorities provided by [HERA] came too late to allow FHFA to prevent excessive leveraging and to address serious safety and soundness issues at Fannie Mae and Freddie Mac.” Lockhart Report, supra note 97, at 2. As conservator, the FHFA’s responsibility is to preserve Fannie and Freddie’s assets under the conservatorship period. See id. at 2. Under the Treasury Senior Preferred Stock Purchase Agreements, the Treasury will contribute cash equal to the difference of assets and liabilities if the FHFA determines an enterprise’s liabilities have exceeded its assets. See Fact Sheet, supra note 100.
by Fannie Mae, Freddie Mac, and Ginnie Mae, as well as $100 billion of debt issued by the GSEs. 103 Four months later, the Federal Reserve increased these commitments to $1.25 trillion of MBS purchases and $200 billion of debt purchases by the end of the year. 104 Although these purchases have helped keep interest rates lower on mortgages guaranteed by Fannie and Freddie, the federal government’s purchases have created market distortions. 105 The end date of these market distortions is uncertain for now, as federal support of the GSEs will likely continue while the enterprises remain under conservatorship. 106 The Obama Administration has put off the difficult task of issuing a proposal to address the future of Fannie Mae and Freddie Mac until March 2010, when it will consider the future structure of the entities and the federal government’s involvement. 107

III. ANALYSIS

For years, the federal government ignored the warning signs that the government would be liable if Fannie and Freddie suffered severe financial losses. 108 Many predicted that the federal government would not allow Fannie Mae and Freddie Mac to fail because of their size and political ties. 109 Unfortunately, this prediction became a reality, which forced the government to act after it was too late to control the enterprises’ growth. 110 The federal government’s intervention in September 2008 in taking control over Fannie and Freddie shows that now, more than ever, the government needs to act further to


105. See Deborah Solomon & Jon Hilsenrath, No Easy Exit for Government as Housing Market’s Savior, WALL ST. J., Sept. 15, 2009, at A1 (detailing federal government’s 2008 and 2009 housing market interventions). The central bank is making purchases regardless of price, which prevents the market from finding its own equilibrium. Id.

106. See id. (speculating on future of enterprises and federal support).

107. See id. (stating expected date of White House proposal for future of Fannie and Freddie). One journalist gave the following analogy to explain the difficulties facing the current administration regarding Fannie and Freddie: “Dr. Frankenstein’s monster was hardly easy to reform. The Obama administration will find the same with hybrid creatures Fannie Mae and Freddie Mac.” Peter Eavis, Taming the Two-Headed Monster, WALL ST. J., Aug. 17, 2009, at C6.

108. See Appelbaum et al., supra note 35 (arguing legislators ignored potential GSE problems).

109. See supra note 82 and accompanying text (explaining criticisms of Fannie Mae and Freddie Mac). Until 2008, the federal government denied responsibility to back the GSEs in the event of extreme financial problems. See WALLISON ET AL., supra note 74, at 2-3. The Fannie and Freddie charters explicitly state that the federal government does not guarantee their securities, however recent government action has shown otherwise. See id. (stating Fannie and Freddie charters disclaim federal guarantees).

110. See id. (stating passage of statute with new regulator too late).
protect taxpayers from future inevitable harms caused by risks the housing GSEs created.111

As GSEs, Fannie and Freddie are guilty of “privatizing profits but socializing risk.”112 Unfortunately, the focus of Fannie Mae and Freddie Mac devolved from their original purpose—providing a consistent mortgage supply for American citizens—to creating large profits for shareholders and high salaries for directors.113 Many studies conclude that Fannie and Freddie have failed to lead the private residential mortgage market to create affordable housing.114 Recent Congressional action, including the creation of FHFA as a new regulator, is only a temporary solution to a much bigger problem.115 Before the economic crash, politicians made various proposals to address the issues posed by the housing GSEs, but more regulation is not enough to fix the enormous problems the GSEs have created.116 The current dire financial condition of the two firms demonstrates the ineffectiveness of their quasi-governmental legal status.117

There are three general ownership structures for Fannie and Freddie’s future:

---


112. Wallison et al., supra note 74, at 5 (identifying key issue with GSEs). Fannie and Freddie’s implicit government backing allowed them to attract funds at lower costs and earn profits while placing the risk of serious losses on taxpayers. See id. (explaining Fannie and Freddie’s advantages over private companies).

113. See Reiss, supra note 25, at 1078 (supporting privatization of GSEs once economically viable); see also Wallison et al., supra note 74, at 10 (listing expansion of activities performed by Fannie and Freddie). Wallison describes the “mission creep” of Fannie and Freddie into other financial activities. See Wallison et al., supra note 74, at 10. Some of these additional activities include expanding home equity loan purchases, expanding residential real estate sales, replacing mortgage lenders with automated underwriting systems, lending to apartment housing developers, and entering the arena of consumer lending. See id.

114. See Wallison et al., supra note 74, at 20 (arguing Fannie and Freddie failed to provide affordable housing). Considering that over the past twenty years the homeownership rate has only moved up 3.4 percentage points, to 67.3 percent, it is time to implement reasonable affordable housing policies and reduce government involvement. Eavis, supra note 107, at C6. The former Director of the FHFA stated: “Going forward, affordable housing goals should be in line with and responsive to actual market conditions and should promote sustainable mortgage options for low- and moderate-income families and neighborhoods.” Lockhart Report, supra note 97, at 6.


116. See Wallison et al., supra note 74, at 1 (proposing regulation will not solve housing GSE problems).

117. See Reiss, supra note 25, at 1076-78 (citing several proposals to reform Fannie and Freddie). Suggestions to solve Fannie and Freddie’s problems include limiting their mortgage portfolio size, removing the unique GSE privileges, freezing the conforming loan value to limit mortgage size, and requiring credit agencies to discount the implicit government guarantee. See id.
government agencies, GSEs, or private firms. Despite its political disfavor, the privatization of Fannie Mae and Freddie Mac is the best hope for protecting taxpayers and the economy from further financial difficulties. Critics of Fannie and Freddie have made proposals specifying how the government should go about de-regulating the housing GSEs, and there is even government precedent to follow in privatizing a GSE.

A. Eliminate GSE Privileges

The special privileges granted to Fannie and Freddie as government-sponsored enterprises allowed the firms to grow to unsustainable size. Congress and the Obama administration should correct the overgrowth and create a truly competitive mortgage market by eliminating these special privileges once the entities are no longer under conservatorship. First, Congress should eliminate federally-created tax exemptions and require Fannie Mae and Freddie Mac to pay state and local income taxes. This way, the firms will not enjoy cost savings that private firms do not. Second, Fannie and Freddie should no longer be exempt from registering and filing financial statements with the SEC. Exemption from the federal securities laws indicated that these securities were safer than securities issued by public

---

118. See Lockhart Report, supra note 97, at 17-19 (proposing three alternatives for Fannie and Freddie’s future). Nationalizing the entities would put the government, and ultimately taxpayers, in a worse position than the current state because permanent government insurance programs contain even greater risk and moral hazard. Id. at 17. Keeping Fannie and Freddie as GSEs does not eliminate the conflict between private profits and public benefits. Id. at 17-18. Ultimately, the third option of turning Fannie and Freddie into private firms is the best option because it generates competition and less risk to taxpayers. Id. at 18.

119. See Reiss, supra note 25, at 1076-81 (supporting privatization of Fannie and Freddie); cf. supra note 88 (highlighting Fannie and Freddie’s lobbying efforts and myriad political connections). See generally WALLISON ET AL., supra note 74 (advocating privatization of Fannie and Freddie).

120. See generally WALLISON ET AL., supra note 74 (suggesting legislative text for privatizing housing GSEs); Bert Ely, How to Privatize Fannie Mae and Freddie Mac, 40th Annual Bank Structure Conference, sponsored by the Federal Reserve Bank of Chicago, May 7, 2004, available at http://www.chicagofed.org/news_and_conferences/conferences_and_events/files/2004_bank_structure_how_to_privatize_fannie_mae.pdf (introducing plan to privatize Fannie and Freddie). In the 1990s, Congress privatized Sallie Mae, a GSE that issued higher education loans to students and parents. See Reiss, supra note 25, at 1079 (offering precedent for GSE privatization). Congress and the company created a non-GSE holding company to facilitate the process, which eventually disposed itself of Sallie Mae’s obligations. Id. Sallie Mae became a private company once the holding company completed its obligations. Id. The process and its result were considered a success for both the government and the company. Id.

121. See supra Part II.C (discussing how unique privileges led to extreme growth). The GSE model “created private, for-profit corporations with special privileges that protected them from market discipline and led them to manage political risk more aggressively than economic and financial risks . . . result[ing] in large, systemically important institutions with excessive leverage . . . .” Lockhart Report, supra note 97, at 13.

122. See Kulp, supra note 74 (calling for elimination of implicit government guarantee of GSEs).

123. See Reiss, supra note 25, at 1057-58 (describing tax exemptions for GSEs).

124. See supra note 67 and accompanying text (citing statutes exempting Fannie and Freddie from certain taxes).

125. See supra note 68 and accompanying text (citing exemptions from SEC reporting requirements).
companies, which was not the case. Additionally, Fannie and Freddie saved money because they did not have to pay registration and filing fees. The GSEs also had the opportunity to withhold important financial information that public companies have to disclose in their SEC filings.

Furthermore, Congress should sever Fannie and Freddie’s ties to the United States Treasury because this puts taxpayers on the hook for their financial liabilities. The government should not afford these quasi-governmental agencies a United States Treasury line of credit in the future because that distorts the underlying value of their stock. Eliminating this support system would force the enterprises to be more financially responsible.

B. Eradicate Political Ties to GSEs

Fannie and Freddie are two of the most politically-connected entities in Washington. These connections hindered meaningful regulation of the firms, and prevented the passage of legislation aimed at curtailing their growth and excessive debt-to-equity ratios. The housing GSEs influenced politicians to maintain a lackluster regulatory regime that benefited the executives and shareholders.

To address this, Congress should protect taxpayers and break their ties to Fannie Mae and Freddie Mac by imposing restrictions to limit lobbying efforts by these firms. To eliminate conflicts of interest, Congressional members should also impose a rule upon themselves and their staff members that Fannie

126. See Congressional Budget Office Report, supra note 67, at 14 (indicating GSE securities may not actually be safe).
127. See id. at 15 (estimating costs GSEs save from not filing with SEC and not paying income taxes).
128. See Reiss, supra note 25, at 1056-57 (arguing Fannie and Freddie may withhold information because of registration exemptions). But see Alison Bisbey Colter, Freddie Sees Dividends and Buybacks, WALL ST. J., Oct. 5, 2005, at B3 (discussing voluntary disclosure by Fannie and Freddie due to political pressure).
129. See supra note 70 and accompanying text (noting $2.25 billion credit line Fannie and Freddie held with Treasury). The passage of HERA allows Fannie and Freddie to have unlimited access to the Treasury until the end of 2009. See supra note 100 and accompanying text (explaining HERA provisions).
130. See supra note 73 and accompanying text (explaining cost advantages of GSEs); see also supra note 109 (stating explicit denial of federal government financial backing). Even though for years the federal government explicitly denied responsibility for guaranteeing securities backed by the firms, the implicit guarantee affected the stock value. Supra, note 109.
131. See supra note 118 (indicating private model less risky to government because entities must self-support).
132. See supra note 88 and accompanying text (citing statistics related to Fannie and Freddie’s lobbying efforts).
133. See supra Part II.E (discussing numerous failed bill proposals addressing financial problems of Fannie and Freddie).
134. See supra note 88 (explaining political ties in Washington).
135. See id. (examining extent of Fannie and Freddie’s power and influence). The FHFA disaffirmed all lobbying contracts and political contributions by the GSEs once the government put them into conservatorship, and these practices should remain once Fannie and Freddie are no longer under government control. See Lockhart Report, supra note 97, at 8.
and Freddie cannot hire them for a certain number of years. \(^{136}\) Now that Fannie and Freddie have achieved their fundamental purposes, Congress and the Obama administration should wean them off their unlimited access to federal money, restrict them from using their powerful lobbying forces, and force them to compete competitively with private institutions.\(^{137}\)

### IV. Conclusion

More than seven decades have passed since the federal government created Fannie Mae to assist in the development of a consistent and uniform residential mortgage market. \(^{138}\) Originally chartered as a government agency with limited purchasing power, Fannie facilitated an increase in American homeownership within reasonable means. \(^{139}\) Congress then chartered Freddie Mac in 1970, hoping that competition between the two entities would ensure lower housing costs for homebuyers. \(^{140}\) Unfortunately, Fannie Mae and Freddie Mac grew from small government agencies with controllable balance sheets into enormous government-sponsored enterprises. \(^{141}\) These enterprises’ privileges gave shareholders and executives large profits and dividends, while leaving American taxpayers to clean up the mess their irresponsibility created. \(^{142}\)

The current economic crisis began with problems stemming from the mortgage market. \(^{143}\) Fannie and Freddie’s lower mortgage-purchasing standards coupled with an implied government backing of these purchases led to unsustainable debt-to-equity ratios and an inevitable federal government intervention. \(^{144}\) The government takeover of Fannie and Freddie was an extreme act, demonstrating the government’s explicit backing of Fannie and Freddie and the need to seriously question the future of these quasi-government entities. \(^{145}\) Although recent Congressional action has forced Fannie and Freddie to refocus on the homeownership needs the crisis generated, the federal government should devise a long-term solution to wean the two entities off government support. \(^{146}\)

In the long run, the solution that will best protect taxpayers from paying for

---

136. See Raum & Drinkard, supra note 88 (suggesting existence of revolving door between Capitol Hill and housing GSEs).
137. See Reiss, supra note 25, at 1080 (advocating privatization of Fannie and Freddie); see also WALLISON ET AL., supra note 74, at 1 (calling for structural changes to GSEs through privatization).
138. See supra text accompanying note 24 (stating Fannie Mae chartered in 1938).
139. See supra note 25 and accompanying text (noting Fannie’s original purchase limitations).
140. See supra note 33 and accompanying text (explaining Freddie Mac’s origination and purpose).
141. See supra note 89 and accompanying text (highlighting criticism of rapid growth of mortgage companies).
142. See supra Part I.A (setting forth chronological history and development of housing GSEs).
143. See supra note 16 and accompanying text (discussing onset of economic problems).
144. See supra notes 83 and 96 and accompanying text (noting causes of government takeover of Fannie and Freddie).
145. See supra note 98 and accompanying text (discussing reasons for conservatorship).
146. See Hagerty & Ng, supra note 96 (noting shift in focus since conservatorship).
a federal bailout is to remove the quasi-governmental status from Fannie Mae and Freddie Mac and convert the two entities into private corporations. Converting the GSEs into private corporations will eliminate their special advantages and force them to maintain adequate levels of capital to support costs. Fannie and Freddie may have been necessary to the development of the mortgage securitization process back in the 1970s. The financial industry, however, now widely uses this financing process and excessive securitization has spiraled out of control with the creation of many opaque products, which contributed to the current financial sector woes. Any consequences to privatization, such as slightly higher interest rates in the residential mortgage market, would be modest in comparison to the enormous costs to American taxpayers by keeping Fannie Mae and Freddie Mac under the protective wings of the federal government.

Elyse Boyle

---


148. See WALLISON ET AL., supra note 74, at 3 (discussing debt-to-equity ratios).

149. See supra note 51 and accompanying text (describing Fannie and Freddie’s roles in secondary mortgage market).

150. See supra Part II.B (explaining secondary mortgage market and risks).

151. See White, supra note 147, at 15 (arguing modest consequences of privatization); see also Solomon & Hilsenrath, supra note 105 (noting how federal government’s purchases affect mortgage interest rates).