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# The Proposed Regulatory Changes to Fannie Mae and Freddie Mac: An Analysis

## I. INTRODUCTION

No one would want to be responsible for curtailing the vitality of the multi-trillion dollar mortgage market,<sup>1</sup> the trillions in consumer spending it helps to support,<sup>2</sup> or the beneficial effects to the U.S. economy that spring from that spending.<sup>3</sup> These are the concerns that Congress must face as it considers overhauling the regulatory scheme that governs mortgage giants Fannie Mae and Freddie Mac.<sup>4</sup>

The Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) are chartered by Congress to facilitate the flow of capital to residential mortgages, thereby supporting home ownership in America.<sup>5</sup> Though federally chartered, these two firms are owned

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1. See *The Industry*, at <http://www.fanniemae.com/aboutfm/industry/index.jhtml> (last visited Feb. 7, 2004).

2. See *Home Equity 'Wealth Effect' Fuels Consumer Spending*, at [http://www.freddie.com/news/finance/commentary/sp-comm\\_082203.html](http://www.freddie.com/news/finance/commentary/sp-comm_082203.html) (last visited Feb. 7, 2004).

3. See *id.*; James C. Cooper & Kathleen Madigan, *Consumers Will Keep Carrying The Ball*, BUS. WK., Sept. 22, 2003, at 25-26; James C. Cooper & Kathleen Madigan, *Housing: Still Solid, but Creaking a Little*, BUS. WK., Oct. 13, 2003, at 29-30; James C. Cooper & Kathleen Madigan, *The Virtuous Cycle Is Finally Kicking In*, BUS. WK., Nov. 3, 2003, at 25-26.

4. See John D. McKinnon, *Bill Takes Aim at Freddie, Fannie*, WALL ST. J., June 24, 2003, at A2.

5. See *Our Mission*, at <http://www.freddie.com/corporate/whoweare/mission/index.html> (last visited Feb. 7, 2004); *The Industry*, *supra* note 1. Fannie Mae and Freddie Mac are lightly regulated by the Office of Federal Housing Enterprise Oversight within the Department of Housing and Urban Development. See Bradley K. Krehely, *Government Sponsored Enterprises: A Discussion of the Federal Subsidy of Fannie Mae and Freddie Mac*, 6 N.C. BANKING INST. 519, 539 (2002). The firms are able to offer new products with little approval required. *Id.* Fannie Mae and Freddie Mac are exempt from SEC regulation. See 12 U.S.C. § 1719(d), (e) (2000). State and local governments are barred from imposing income taxes, but not property taxes, on Fannie Mae and Freddie Mac. See 12 U.S.C. § 1452(e) (2000); 12 U.S.C. § 1723a(c)(1), (2) (2000). Fannie Mae and Freddie Mac are able to borrow funds from the U.S. Treasury at favorable rates. See 12 U.S.C. 1719(b), (c) (2000). The firms also have the advantage of selling their debt through the Federal Reserve; the United States Treasury is the only other institution allowed to do this. See 149

by private stockholders, leading to their designation as government sponsored entities (GSEs).<sup>6</sup> Fannie Mae and Freddie Mac purchase mortgages from banks, securitize them, and use the proceeds to purchase more mortgages.<sup>7</sup> The banks use the cash from the sale of the mortgages to issue more mortgages.<sup>8</sup> The process thus provides a liquid market for mortgages and greater capital for the issuance of more mortgages.<sup>9</sup> This makes mortgages easier and cheaper to obtain for homebuyers.<sup>10</sup>

Fannie Mae and Freddie Mac have become goliaths<sup>11</sup> in this secondary mortgage market.<sup>12</sup> Fannie Mae and Freddie Mac have combined their government subsidies<sup>13</sup> with arguably good business practices to become the preeminent companies in their industry.<sup>14</sup> The two companies are responsible for approximately

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CONG. REC. E1767 (daily ed. Sept. 11, 2003) (statement of Rep. Paul). A 2001 Congressional Budget Office study calculated that these benefits translated into an imputed federal subsidy of \$13.6 billion annually. See 149 CONG. REC. E972 (daily ed. May 15, 2003) (statement of Rep Stark).

6. See LISSA L. BROOME & JERRY MARKHAM, REGULATION OF BANK FINANCIAL SERVICE ACTIVITIES 324-25 (2001)

7. See *Our Mission*, *supra* note 5; *The Industry*, *supra* note 1.

8. See BROOME & MARKHAM, *supra* note 6, at 325-27.

9. *Id.*

10. *Id.*

11. See *infra* notes 13-17 and accompanying text.

12. A secondary market is one where goods, services, or securities previously issued, bought, or sold are made available for further buying or selling. See BLACK'S LAW DICTIONARY 984 (7th ed. 1999). When investors trade securities on an exchange, they are trading on a secondary market, as the securities were previously issued and bought in the primary market via an initial public offering. *Id.* The primary mortgage market is the initial issuance of mortgages to homeowners by banks. See Krehely, *supra* note 5, at 523; *An Investor's Guide to Pass-Through and Collateralized Mortgage Securities*, at [http://www.investinginbonds.com/info/igmba/an\\_investors\\_guide\\_to\\_mortgage\\_securities.pdf](http://www.investinginbonds.com/info/igmba/an_investors_guide_to_mortgage_securities.pdf) (last visited Feb. 7, 2004).

13. See *supra* note 5.

14. See *supra* note 5. Fannie Mae is the country's second largest corporation based on assets. *Understanding Fannie Mae*, at <http://www.fanniemae.com/aboutfm/understanding/index.jhtml> (last visited Feb. 7, 2004). Fannie Mae is also one of the country's largest issuers of debt behind the U.S. Treasury. *For the Media – Corporate Fact Sheet*, at <http://www.fanniemae.com/media/formedia/factsheet.jhtml> (last visited Feb. 7, 2004). Fannie Mae and Freddie Mac are responsible for \$871 billion and \$602 billion in liabilities respectively. FANNIE MAE, 2002 Annual Report 89 (2003) [hereinafter Fannie Mae Annual Report], at <http://www.fanniemae.com/ir/pdf/annualreport/2002/2002annualreport.pdf> (last visited Feb. 7, 2004); FREDDIE MAC, 2001 Annual Report 59 (2002) [hereinafter Freddie Mac Annual Report], at [http://www.freddiemac.com/include/hitbox/track\\_and\\_redirect.html?file=/investors/pdffiles/annual2001.pdf](http://www.freddiemac.com/include/hitbox/track_and_redirect.html?file=/investors/pdffiles/annual2001.pdf) (last visited Feb. 7, 2004). Freddie's 2002 financials are currently being restated because of the accounting problems which have rocked the

\$2.65 trillion<sup>15</sup> of the \$4.1 trillion mortgage-backed securities outstanding.<sup>16</sup> These institutions have drawn much criticism over the years from those who think greater oversight is needed due to the sheer scope of these institutions and the light regulatory treatment allowed them by Congress.<sup>17</sup> Accounting problems at Freddie Mac in the spring of 2003 renewed these criticisms<sup>18</sup> and led to legislation pending in Congress that proposes to increase oversight of Fannie Mae and Freddie Mac.<sup>19</sup>

Part II of this note provides an overview of Fannie Mae, Freddie Mac, and the secondary mortgage market.<sup>20</sup> Part III discusses the recent accounting problems at Fannie Mae and Freddie Mac.<sup>21</sup> Part IV analyzes some of the risks associated with these GSEs and explores the more recent criticisms of Fannie Mae and Freddie Mac.<sup>22</sup> Parts V and VI then examine both the specific legislation pending in Congress and other proposed changes.<sup>23</sup> Finally, Part VI argues that although additional oversight is needed, it should be developed and implemented carefully.<sup>24</sup>

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company. See *infra* notes 56-65 and accompanying text. Fannie Mae generated \$4.6 billion in net income in 2002, making it one of the world's most productive companies with 4,700 employees. *Understanding Fannie Mae, supra*. Freddie Mac generated \$4.1 billion in net income in 2001. Freddie Mac Annual Report at 58. Fannie Mae currently owns, or holds in trust, one out of every five mortgages in the United States. See *Frequently Asked Questions – Mortgage Industry Primer*, at <http://www.fanniemae.com/faq/industry.jhtml> (last visited Feb. 7, 2004).

15. See Paula Dwyer, *Breaking Up Is Good to Do*, BUS. WK., Oct. 13, 2003, at 115.

16. See *An Investor's Guide to Pass-Through and Collateralized Mortgage Securities, supra* note 12, at 3.

17. See generally Krehely, *supra* note 5 (discussing the suggested reforms of Fannie Mae and Freddie Mac at that time).

18. *Freddie's Market Bomb*, WALL ST. J., June 10, 2003, at A18.

19. See John D. McKinnon, *Bill to Overhaul Mortgage Agency Regulation Gains*, WALL ST. J., Sept. 11, 2003, at A2; John D. McKinnon, *House Drafts Fannie-Freddie Bill*, WALL ST. J., Oct. 3, 2003, at A2; *infra* notes 96-97 and accompanying text.

20. See *infra* notes 25 - 55 and accompanying text.

21. See *infra* notes 56 - 65 and accompanying text.

22. See *infra* notes 66 - 95 and accompanying text.

23. See *infra* notes 96 - 139 and accompanying text.

24. See *infra* notes 140 - 164 and accompanying text.

## II. BRIEF OVERVIEW OF FANNIE MAE AND FREDDIE MAC

In 1938, the Federal government created Fannie Mae and authorized it to purchase Federal Housing Authority-insured mortgages.<sup>25</sup> In 1968, Fannie Mae became a private company and its charter was expanded to buy mortgages outside the traditional government limits.<sup>26</sup> At this time, Ginnie Mae split from Fannie Mae and became a separate entity with responsibility for special assistance and housing support programs.<sup>27</sup> Fannie Mae's charter directs it to "channel [its] efforts into increasing the availability and affordability of homeownership for low-, moderate-, and middle-income Americans."<sup>28</sup> Freddie Mac was created in 1970 and charged with purchasing conventional residential mortgage loans.<sup>29</sup> Both entities are shareholder owned, but operate under federal charters that limit the scope of their activities, while also providing special benefits.<sup>30</sup> Both companies point to the strength and size of America's secondary mortgage market, compared to other countries, as evidence that they are meeting their mandate of making home ownership more accessible and affordable for Americans.<sup>31</sup>

Fannie Mae and Freddie Mac operate in what is known as the secondary mortgage market.<sup>32</sup> Fannie Mae and Freddie Mac are limited by their respective charters to the purchase of residential mortgages.<sup>33</sup> The two entities purchase mortgages from banks and then create a pool of mortgages.<sup>34</sup> These pools of

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25. *Understanding Fannie Mae*, *supra* note 14.

26. *Id.*

27. See Alan Kronovet, *An Overview of Commercial Mortgage Backed Securitization: The Devil is in the Details*, 1 N.C. BANKING INST. 288, 291-92 (1997).

28. *Understanding Fannie Mae*, *supra* note 14.

29. See, e.g., Kronovet, *supra* note 27, at 292.

30. See *supra* note 5.

31. See *Understanding Fannie Mae*, *supra* note 14; *Our Role Within the Secondary Market*, at <http://www.freddiemac.com/corporate/whoware/mission/secmkt.html> (last visited Feb. 7, 2004).

32. See *supra* note 12; *Frequently Asked Questions – Mortgage Industry Primer*, *supra* note 14; *Our Role Within the Secondary Market*, *supra* note 31.

33. See *Understanding Fannie Mae*, *supra* note 14; *The Secondary Market for Mortgage Loans*, *supra* note 31.

34. See Kronovet, *supra* note 27, at 291-95. The mortgages in a given pool typically have the same or similar maturities, type (fixed or adjustable-rate), and

mortgages are then converted into securities<sup>35</sup> and sold to investors.<sup>36</sup> Rather than owning an individual mortgage, each security holder owns a percentage of each mortgage in the pool.<sup>37</sup> The security holder receives regular returns that are funded by the mortgage payments made by each borrower toward his or her mortgage.<sup>38</sup> The security holder is able to invest in mortgages with less risk, since the loss suffered as the result of any single default is distributed to all of the security holders.<sup>39</sup> Furthermore, Fannie Mae and Freddie Mac typically guarantee the mortgages in the pool, essentially assuming the risk of default.<sup>40</sup> The only risk to the securities investors then is that Fannie Mae or Freddie Mac will default.<sup>41</sup> Fannie Mae and Freddie Mac provide a kind of insurance; they pay out dollars to the pool when an individual mortgagor defaults.<sup>42</sup> As a result of this “insurance,” Fannie Mae and Freddie Mac are able to sell the securities for more than they could without this guarantee.<sup>43</sup>

Fannie Mae and Freddie Mac use the proceeds from the sale of securities and the issuance of debt to buy more mortgages from banks, thereby beginning the aforementioned process again.<sup>44</sup> Fannie Mae and Freddie Mac borrow from the Federal Treasury and investors to acquire the money used to buy mortgages and to provide short-term financing.<sup>45</sup> Fannie Mae’s and Freddie Mac’s earnings are derived primarily from selling the securities for a higher price than what they paid for the underlying pool of

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interest rates. See *Effects of Repealing Fannie Mae’s and Freddie Mac’s SEC Exemptions – A CBO Paper*, THE CONGRESSIONAL BUDGET OFFICE, Box 1 (May 2003), at [ftp://ftp.cbo.gov/41xx/doc4199/05-06-03-GSEs.pdf](http://ftp.cbo.gov/41xx/doc4199/05-06-03-GSEs.pdf) (last visited Feb. 7, 2004). Investors can estimate the cash flow by treating the pool as a single mortgage. *Id.*

35. The securities are commonly referred to as “mortgage-backed securities.” See *The Industry*, *supra* note 1; *An Investor’s Guide to Pass-Through and Collateralized Mortgage Securities*, *supra* note 12.

36. See Kronovet, *supra* note 27, at 291-95.

37. See *id.*

38. See *id.*

39. See *id.*

40. See *id.*

41. See Kronovet, *supra* note 27, at 291-95.

42. *Id.*

43. *Id.*

44. *Id.*

45. See *supra* note 5.

mortgages.<sup>46</sup> The secondary market provides banks, and other mortgage issuers, with a liquid market where they can sell an otherwise illiquid asset for cash.<sup>47</sup> The cash is used to issue more mortgages.<sup>48</sup> The banks are also able to move assets with long term maturities — those subject to adverse movements in interest rates — off their balance sheets and replace them with cash.<sup>49</sup> This process has the aggregate effect of moving more capital to the mortgage markets.<sup>50</sup> This makes mortgages cheaper, via lower rates and fees, and easier for homeowners to obtain.<sup>51</sup>

Fannie Mae and Freddie Mac derive certain benefits because of their public-policy oriented mission and special quasi-governmental status.<sup>52</sup> Additionally, other companies with the size and scope of Fannie Mae or Freddie Mac could be at risk of violating antitrust regulations. Fannie Mae's and Freddie Mac's size and scope, however, would seem to be subject only to curtailment by Congress.<sup>53</sup>

Although their obligations are not guaranteed by the full faith and credit of the United States government, their size and status as GSEs lead many investors to believe that the Federal government would not allow these entities to fail.<sup>54</sup> This presumed Federal guarantee allows Fannie Mae and Freddie Mac to sell their securities for even more than they would without such a presumed guarantee.<sup>55</sup>

### III. ACCOUNTING PROBLEMS AT FREDDIE MAC

In the spring of 2003, Freddie Mac announced that, due to recommendations from a new auditor, it would be restating

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46. See Kronovet, *supra* note 27, at 291-95.

47. See *id.* at 289; *The Industry*, *supra* note 1.

48. See Kronovet, *supra* note 27, at 291-95.

49. *Id.*

50. *Id.*

51. *Id.*

52. See *supra* note 5.

53. See Krehely, *supra* note 5, at 535-38.

54. See *id.* at 535-38; Holman W. Jenkins Jr., *Freddie's Problem and Ours*, WALL ST. J., June 18, 2003, at A17 (arguing that Fannie Mae and Freddie Mac are "too big to fail").

55. See Krehely, *supra* note 5, at 535-38; Jenkins, *supra* note 54.

earnings for the previous three years to reflect higher derivatives earnings.<sup>56</sup> Three months later, Freddie Mac terminated three of its executives because the accounting changes had become “accounting irregularities.”<sup>57</sup> This announcement caused Freddie Mac’s stock to lose sixteen percent of its value in one day, with the stock market “falling broadly” and bond markets “aboil.”<sup>58</sup> This situation led to some concern that Freddie Mac was attempting to either manipulate earnings or disguise problems with its credit risks.<sup>59</sup> This raised the concern that Fannie Mae or Freddie Mac could boost their earnings by under-reporting hedging gains or costs while exposing themselves to greater interest rate movement risks. This was one of the primary concerns with Freddie Mac’s accounting problems.<sup>60</sup>

Another troubling issue with Freddie Mac’s accounting announcement was that it took nearly three months after Freddie Mac’s initial announcement for the Office of Federal Housing Enterprise Oversight (OFHEO) to begin requesting more

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56. See *Mortgage Firm to Delay Release of Earnings for First Quarter*, WALL ST. J., Mar. 26, 2003, at B9.

57. See *Freddie’s Market Bomb*, WALL ST. J., June 10, 2003, at A18. Due to their heavily leveraged nature, Fannie Mae and Freddie Mac must use extensive hedging with derivatives to protect themselves from interest rate swings. *Id.* Hedging involves purchasing or selling derivatives whose value depends on a secondary source such as an underlying bond, currency, or commodity that will change in value in such a way as to offset changes in value to the holder’s assets or liabilities. See BROOME & MARKHAM, *supra* note 6, at 813, 821-25; BLACK’S LAW DICTIONARY 454, 726 (7th ed. 1999). The derivative thus helps to offset the potentially devastating effects of interest rates or market values moving in a direction or to a degree unanticipated by the holder. See BROOME & MARKHAM, *supra* note 6, at 821-25. Freddie Mac held a pool of derivatives that gained in value and the firm improperly took advantage of an accounting technique that allowed it to spread the gains out over time rather than realizing them immediately. See Patrick Barta & John McKinnon, *Freddie Restatement May Be Big*, WALL ST. J., June 19, 2003, at C1. This had the effect of reducing the firm’s present earnings but allowed the firm to make its earnings appear more consistent. *Id.* Thus, Freddie Mac’s investment strategy looks more sound (gains from derivatives used for hedging are typically indicative that markets are moving in a direction opposite that anticipated by the holder), and Freddie Mac will have future gains which could offset future potential losses. *Id.* This improper accounting resulted in Freddie Mac understating present earnings by as much as \$4.5 billion. See Patrick Barta & John McKinnon, *Freddie May Have Understated Profits By Up To \$4.5 Billion*, WALL ST. J., June 26, 2003, at C1.

58. *Freddie’s Market Bomb*, *supra* note 57.

59. *Id.*

60. *Id.*



information from the firm.<sup>61</sup> Given that the OFHEO's sole job is to oversee Fannie Mae and Freddie Mac, some found it troubling that Freddie Mac announced a significant accounting restatement and the OFHEO did not act more quickly and decisively.<sup>62</sup>

From the outset of Freddie Mac's accounting problems, Fannie Mae claimed that the accounting problems were confined to Freddie Mac and not indicative of any problems at Fannie Mae.<sup>63</sup> Fannie Mae consistently claimed that its finances and accounting practices were proper.<sup>64</sup> Notwithstanding these declarations, Fannie Mae announced on October 29, 2003, that it had made "computational errors" on its third quarter financial statements.<sup>65</sup>

#### IV. RENEWED CRITICISMS AND CALLS FOR REFORMS OF FANNIE MAE AND FREDDIE MAC

As a result of the accounting problems initially at Freddie Mac and then at Fannie Mae, the ongoing calls for reform of these firms were made with renewed vigor.<sup>66</sup> For many years Fannie Mae's and Freddie Mac's size and complexity had led many to call for reform.<sup>67</sup> Freddie Mac's accounting problems made those calls

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61. *Id.*

62. See John McKinnon & Michael Schroeder, *Regulator Gets Into Hot Water*, WALL ST. J., June 11, 2003, at C9.

63. See Jonathan Weil, *Volatility at Fannie, Freddie? The Two Are Firm in Denial*, WALL ST. J., June 20, 2003, at C1.

64. *Id.*

65. See Patrick Barta & John D. McKinnon, *Fannie Mae Made \$1.1 Billion Error In Its Accounting*, WALL ST. J., Oct. 30, 2003, at A1. In response to this news, the interest rates on Fannie Mae's debt securities diverged from interest rates on comparable Treasury securities. *Id.* Fannie Mae's stock was "pummeled" but recovered and closed that day down 2.4% to \$73.10. *Id.* The OFHEO released a statement the same day "saying that Fannie Mae's error underscored the need for a closer examination of the company's overall accounting practices the OFHEO is 'about to begin.'" *Id.* Fannie Mae's stock was trading at \$77.70 as of Feb. 4, 2004 (based on stock quotes from [www.quicken.com](http://www.quicken.com)).

66. See, e.g., McKinnon, *supra* note 62; Holman W. Jenkins Jr., *Business World: Freddie's Problem and Ours*, WALL ST. J., June 18, 2003, at A17.

67. See generally Krehely, *supra* note 5 (discussing opponents of Fannie Mae and Freddie Mac, mainly public policy groups, who argue that the firms receive an imputed federal subsidy; have moved into new, unwarranted lines of business; control too much of the secondary mortgage market; allocate their "subsidy" to shareholders rather than homeowners; and other criticisms).

more relevant and the reform proposals more drastic.<sup>68</sup> Legislation has been introduced in Congress<sup>69</sup> that proposes to reform the regulatory structure of the two firms while eliminating some of the benefits<sup>70</sup> they currently receive.<sup>71</sup>

The most common criticism of Fannie Mae and Freddie Mac has been that the oversight by the OFHEO is too weak and that the Department of Housing and Urban Development is not the ideal umbrella department for this agency.<sup>72</sup> OFHEO has 140 full-time staff members and a budget of \$30 million with which to oversee these two trillion-dollar entities.<sup>73</sup> Congress is currently considering whether to move the agency to the Treasury Department and increase its regulatory oversight powers.<sup>74</sup>

The sheer size, scope, and complexity of Fannie Mae and Freddie Mac create the potential for “systemic risk.”<sup>75</sup> Given the large amount of the secondary mortgage market that they control, a failure, or even perceived risk of failure, of either firm would cause shockwaves through the economy that could push the country into recession or worse.<sup>76</sup> The fact that many see an implied government guarantee protecting these institutions also raises the possibility that the market is not adequately measuring and controlling the risk associated with the two firms.<sup>77</sup> Even if the two firms are not in danger of failing, their size means that market

68. See Dwyer, *supra* note 15; John McKinnon, *Snow to Testify for New Oversight of Freddie Mac*, WALL ST. J., July 14, 2003, at A2.

69. See *infra* note 96.

70. See *supra* note 5.

71. John D. McKinnon, *Bill to Overhaul Mortgage Agency Gains*, WALL ST. J., Sept. 11, 2003, at A2. In the past, Freddie Mac and Fannie Mae have been able to stymie serious reform considerations in Congress with their extremely effective lobbying efforts. See Jenkins, *supra* note 54; Mike McNamee & Paula Dwyer, *Fannie and Freddie Dodge a Bullet for Now*, BUS. WK., Oct. 27, 2003, at 55. Indeed, the firms' were able to work with Democrats in Congress to prevent a bill requiring stricter regulation from moving out of committee in the fall of 2003. See *id.*

72. See Dwyer, *supra* note 15, at 115-16.

73. See McKinnon & Schroeder, *supra* note 62.

74. See *infra* note 98.

75. See Dwyer, *supra* note 15, at 115-16; *The Trouble With Freddie*, WALL ST. J., June 13, 2003, at A6.

76. See Dwyer, *supra* note 15, at 115-16.

77. See Krehely, *supra* note 5, at 530-33; *Federal Subsidies and the Housing GSEs*, THE CONGRESSIONAL BUDGET OFFICE (May 2001), at <ftp://ftp.cbo.gov/28xx/doc2841/GSEs.pdf> (last visited Feb. 7, 2004).

distortions can occur whenever one firm conducts a major transaction; the size of the transaction may overwhelm the liquidity and flexibility of the markets.<sup>78</sup>

There is some evidence that minimum capital standards at these two entities are less than what they would be at financial institutions of comparable size.<sup>79</sup> Federal Reserve Chairman Alan Greenspan has urged an increase in a key capital standard for the two companies.<sup>80</sup> This reflects the concern that these institutions have too little capital to support the massive amount of debt and liabilities underlying their equally substantial assets.<sup>81</sup> This is the equivalent of the firms being over-leveraged. Fannie Mae and Freddie Mac argue that they are more than adequately capitalized.<sup>82</sup> They further argue that they have become extremely adept at managing risk so that small amounts of capital can be used to support larger transactions.<sup>83</sup> Critics counter that Fannie Mae and Freddie Mac may be adept at handling risk but that is no

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78. See Dwyer, *supra* note 15, at 115-16.

79. See Dwyer, *supra* note 15, at 115; see also *infra* note 81 (comparing the capital-to-asset ratios of the two firms with banking institutions).

80. See Dwyer, *supra* note 15, at 115.

81. *Id.* Fannie Mae has \$16 billion in capital which is used to support \$887 billion in assets, giving the firm a capital-to-asset, or leverage, ratio of 1.8%. See Fannie Mae Annual Report, *supra* note 14, at 89. Freddie Mac has \$15 billion in capital which is used to support \$617 billion in assets, giving the firm a capital-to-asset ratio of 2.4%. See Freddie Mac Annual Report, *supra* note 14, at 59. Banking institutions are typically required to have capital-to-asset ratios, with certain adjustments, of 5% to be considered "well-capitalized." See BROOME & MARKHAM, *supra* note 6, at 515-18; see also Amy Borrus & Paula Dwyer, *A New Chaperone For Fannie and Freddie?*, BUS. WK., Sept. 8, 2003, at 42. Banking institutions with capital-to-asset ratios like Fannie Mae's and Freddie Mac's would be considered "critically undercapitalized" and "significantly undercapitalized" respectively. See BROOME & MARKHAM, *supra* note 6, at 518. Bank of America has a capital-to-asset ratio of 7.2%. See BANK OF AMERICA, 2002 Annual Report 27 (2003) at <http://ccbn16.mobular.net/ccbn/7/169/175/> (last visited Feb. 7, 2004). BB&T, a regional bank headquartered in North Carolina, has a capital-to-asset ratio of 9.2%. See BB&T, 2002 Annual Report 28 (2003), at <http://www.bbandt.com/uploads/qreports/ar42002.pdf> last (visited Feb. 7, 2004). Capital-to-asset ratios are a simplistic means of measuring Fannie Mae's and Freddie's Mac's financial stability. Banks' assets are typically discounted, increasing the capital-to-asset ratio, based on the risk associated with the particular asset. See BROOME & MARKHAM, *supra* note 6, at 516. The MBSs that make up such a large part of Fannie Mae's and Freddie Mac's assets are typically considered low risk. *Id.* However, the firms' portfolios are not very diversified which implies increased risk. *Id.* at 519.

82. See Dwyer, *supra* note 15, at 115-16

83. See *id.* at 16.

substitute for adequate capital.<sup>84</sup> Other critics contend that because Fannie Mae and Freddie Mac hold the mortgages they securitize in their own portfolios, they are concentrating risk rather than spreading it.<sup>85</sup> This is due to the fact that rather than diffusing the risks of mortgage defaults to Mortgage Backed Securities (MBSs) holders, Fannie Mae and Freddie Mac are aggregating the risks by holding the MBSs in their portfolios.<sup>86</sup> A Senate bill would allow the agency overseeing Fannie Mae and Freddie Mac to set certain minimum capital levels with more flexibility.<sup>87</sup>

Others have argued that too many of the benefits that spring from Fannie Mae's and Freddie Mac's special advantages — exemption from local taxes, ability to borrow at favorable rates from the U.S. treasury, light regulation, and implicit government guarantee — are accruing to shareholders and not to homeowners, the intended beneficiaries of these benefits.<sup>88</sup> Fannie Mae and Freddie Mac are able to retain some of the value of these benefits and pass them on to shareholders, rather than passing the benefits directly to homeowners, because there is no statutory requirement or market force requiring them to do otherwise.<sup>89</sup> There is legislation in Congress that would eliminate some or all of these special benefits.<sup>90</sup>

The sheer size of the firms also raises the question of whether the federal government could allow one to fail. Because of the fallout to the economy if Fannie Mae or Freddie Mac were to collapse,<sup>91</sup> the argument runs that the federal government would have no choice but to step in.<sup>92</sup> This implicit guarantee allows the firms and investors to take risks that they might not otherwise take, thereby risking the very kind of collapse that would require a

84. *Id.*

85. *Id.*

86. *Id.*

87. See *infra* notes 110-116 and accompanying text.

88. See Krehely, *supra* note 5, at 522-23; *Federal Subsidies and the Housing GSEs*, *supra* note 77.

89. See *Federal Subsidies and the Housing GSEs*, *supra* note 77.

90. See *infra* notes 117-139 and accompanying text.

91. See *supra* notes 1-19 and accompanying text.

92. See *supra* notes 1-19 and accompanying text.

government bailout.<sup>93</sup> Ironically, this would put the government in the position of having to fulfill the guarantee.<sup>94</sup> Legislation seeking to eliminate some or all of the firms' special benefits is partially intended to reduce the public perception of a federal guarantee.<sup>95</sup>

## V. PROPOSED LEGISLATION

In response to these concerns, legislation is currently being debated in Congress that would significantly change the framework around Fannie Mae and Freddie Mac.<sup>96</sup> Four separate bills have been introduced in the House and one bill has been introduced in the Senate.<sup>97</sup>

### A. *Transfer of OFHEO Functions to the Treasury Department*

House Bill 2803 and Senate Bill 1508 would move OFHEO from the Department of Housing and Urban Development to the Treasury Department.<sup>98</sup> Although not identical, both bills would make the office an independent department within the Treasury Department.<sup>99</sup> The President would appoint the director of the new department, subject to approval by the Senate.<sup>100</sup> The director would act autonomously from the Secretary of the

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93. See Krehely, *supra* note 5, at 535-38. Insofar as there is an implicit Federal guarantee of these firms, it is noteworthy that their debt, at approximately \$1.4 trillion, *supra* note 14, is not reported as part of the official Federal debt. See *Debt Limit Follies*, WALL ST. J., May 7, 2003, at A16.

94. See Krehely, *supra* note 5, at 535-38.

95. See *infra* notes 117-139 and accompanying text.

96. Leave No Securities Behind Act, H.R. 2022, 108th Cong. (2003); Secondary Mortgage Market Fair Competition Act, H.R. 2117, 108th Cong. (2003); Housing Finance Regulatory Restructuring Act of 2003, H.R. 2803, 108th Cong. (2003); Free Housing Market Enhancement Act, H.R. 3071, 108th Cong. (2003); Federal Enterprise Regulatory Reform Act of 2003, S. 1508, 108th Cong. (2003). Despite indications that some version of this legislation would be passed by Congress in 2003, at the close of the year, it seemed unlikely that any legislation concerning the regulation of Fannie Mae and Freddie Mac would pass before the year was out. See Mike McNamee & Paula Dwyer, *supra* note 71, at 55.

97. H.R. 2022; H.R. 2117; H.R. 2803; H.R. 3071; S. 1508.

98. H.R. 2803; S. 1508.

99. H.R. 2803; S. 1508.

100. H.R. 2803.

Treasury, unless otherwise provided by law.<sup>101</sup> The new department would continue to be funded by assessments from Fannie Mae and Freddie Mac, but the director would be given more flexibility in determining the assessments.<sup>102</sup> The director would be prohibited from having any financial interest in either firm.<sup>103</sup>

The House bill would specifically charge the director with the duty of ensuring “that the enterprises . . . are adequately capitalized and operating safely.”<sup>104</sup> To meet this duty, the director, through the new agency, would be allowed to “issue cease-and-desist orders, temporary cease-and-desist orders (including order to take affirmative action), and suspension and removal orders, and assess civil money penalties . . . under the same procedures and conditions” as the federal banking agencies are authorized to do “with respect to insured depository institutions.”<sup>105</sup> Furthermore, the director would be empowered to establish “safety and soundness standards” in the same manner as federal banking agencies do for “insured depository institutions.”<sup>106</sup> Thus, this new oversight agency would have the power to regulate Fannie Mae and Freddie Mac in the same manner and using the same powers with which federal agencies regulate banks.

The bill would also require major new programs or product offerings within Fannie Mae and Freddie Mac to first receive approval from the new regulatory office within the Treasury Department.<sup>107</sup> The director would be allowed to use informed,

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101. Housing Finance Regulatory Restructuring Act of 2003, H.R. 2803, 108th Cong. (2003).

102. *Id.*

103. Federal Enterprise Regulatory Reform Act of 2003, S. 1508, 108th Cong. (2003).

104. H.R. 2803. Currently, the director does not have the power to approve new programs. 12 U.S.C. § 4513 (2000). His ability to change capital requirements is limited. *Id.* His role is primarily limited to reviewing and approving their financial statements, monitoring of executive compensation, conducting research, conducting “examinations” of the enterprises, submission of reports to Congress, and the bringing of limited enforcement actions against the firms. *Id.*

105. H.R. 2803.

106. Housing Finance Regulatory Restructuring Act of 2003, H.R. 2803, 108th Cong. (2003).

107. *Id.*

flexible tests when making a decision about whether or not to approve a new program.<sup>108</sup> Were the Director to deny a request or a new program, he would have to provide the GSE with notice and an opportunity to be heard on the issue.<sup>109</sup>

### *B. Increased Capital Levels*

Senate Bill 1508 also proposes to increase certain minimum and critical capital levels at Fannie Mae and Freddie Mac.<sup>110</sup> This change would allow the director of OFHEO (or its equivalent successor agency) to set these capital levels with more flexibility.<sup>111</sup> Currently, these capital levels are fixed by statute at minimal amounts.<sup>112</sup> This would likely increase the amount of capital Fannie Mae and Freddie Mac must maintain to support the massive amounts of liabilities for which they are responsible.<sup>113</sup> This change also answers Alan Greenspan's call for increased capital levels.<sup>114</sup> However, if the firms are required to maintain higher capital ratios, this would reduce the amount of assets they could support with a given amount of capital.<sup>115</sup> This could reduce the amount of capital the firms are able to move to the housing market, reducing liquidity and increasing borrowing costs.<sup>116</sup>

### *C. Elimination of Exemption From State Income Tax*

House Bill 2117 seeks to eliminate Fannie Mae's and Freddie's Mac's exemption from state and local taxes.<sup>117</sup> This would put Fannie Mae and Freddie Mac on more equal footing with their competitors, reducing the imputed "subsidy" they

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108. *Id.*

109. *Id.*; Federal Enterprise Regulatory Reform Act of 2003, S. 1508, 108th Cong. (2003).

110. Federal Enterprise Regulatory Reform Act of 2003, S. 1508 § 110.

111. *Id.*

112. 12 U.S.C. § 4613 (2000); 12 U.S.C. § 4502 (2000); *see also supra* note 81.

113. *See supra* note 81.

114. *See Dwyer, supra* note 15, at 115-16.

115. *See supra* notes 79-87 and accompanying text.

116. *See supra* notes 5-10 and accompanying text.

117. Secondary Mortgage Market Fair Competition Act, H.R. 2117, 108th Cong. (2003); *see also* 12 U.S.C. § 1723a(c) (2003); 12 U.S.C. § 1452 (2003).

receive from the federal government.<sup>118</sup> Arguably, this would increase competition in the secondary mortgage market while lessening Fannie Mae's and Freddie Mac's ties to the government.<sup>119</sup>

#### D. *Elimination of Exemption from SEC Regulation*

House Bill 2022 would eliminate Fannie Mae's and Freddie Mac's exemption from regulation by the Securities and Exchange Commission (SEC).<sup>120</sup> Although providing no guarantees against failure, this would increase their disclosure requirements and provide the transparency many have been seeking.<sup>121</sup> After the accounting scares at Freddie Mac and Fannie Mae, and given the significant effects these firms can have on the economy, this would be a welcome change for many.<sup>122</sup>

The SEC registration requirements would apply to Fannie Mae's and Freddie Mac's stock, MBSs, and debt issuances.<sup>123</sup> The increased filing costs would represent a negligible amount for each

118. H.R. 2117; see Krehely, *supra* note 5, at 530-33 (discussing the effects of Fannie Mae's and Freddie Mac's state income tax exemption).

119. H.R. 2022. The bill's sponsor, California Representative Pete Stark, argues that when Fannie Mae and Freddie Mac were chartered, it was necessary to give them tax benefits so that they could attract investors for their MBSs allowing them to thrive and meet the goal of increasing home ownership in the United States. 149 CONG. REC. E972-01 (daily ed. May 15, 2003). Now that both firms are "thriving, successful private corporations... these two entities are strong and profitable enough to provide a steady stream of home loan revenue without the state tax-exempt privilege." *Id.* Stark further argues that the tax exemption is not warranted on incentive grounds because Fannie Mae and Freddie Mac "underperform the conventional conforming market in funding the affordable home purchase loans for borrowers and neighborhoods targeted by the housing goals." *Id.* Stark finally argues that with states facing fiscal crises it would only be appropriate to "level the playing field for Fannie and Freddie's competitors" by exposing "Fannie and Freddie to the rigors of the marketplace." *Id.*

120. Leave No Securities Behind Act, H.R. 2022, 108th Cong. § 2 (2003); *Effects of Repealing Fannie Mae's and Freddie Mac's SEC Exemptions – A CBO Paper*, *supra* note 34. Fannie Mae and Freddie Mac have already begun to voluntarily comply with some of the registration requirements that would be imposed by enactment of this legislation. *Id.*

121. See H.R. 2022; *Effects of Repealing Fannie Mae's and Freddie Mac's SEC Exemptions – A CBO Paper*, *supra* note 34.

122. *Effects of Repealing Fannie Mae's and Freddie Mac's SEC Exemptions – A CBO Paper*, *supra* note 34.

123. *Id.*



firm.<sup>124</sup> These new registration and disclosure requirements would likely have little effect on the price of the firms' stock or debt, as purchasers of those securities already have sufficient information to adequately price the instruments.<sup>125</sup>

The increased disclosure requirements would, therefore, be primarily directed at and have the greatest effect upon the price of the firms' MBSs.<sup>126</sup> The additional disclosure requirements could eliminate the "discount" that currently inures to the MBSs because of buyers' lack of information concerning the underlying mortgages.<sup>127</sup> Alternatively, enhanced information could allow investors to infer that MBSs backed by mortgages of different maturities are more or less likely to be repaid earlier.<sup>128</sup> The risk of early repayment is known as "prepayment risk."<sup>129</sup> This could lead to segmentation in the MBS market, thereby decreasing the value of the MBSs and overall market liquidity.<sup>130</sup> Increased disclosure requirements could also cause investors to discount the

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124. *Id.* According to the CBO report, SEC registration fees for debt and MBSs could reach \$250 million in 2004. *Id.* Fannie Mae and Freddie Mac could end up paying half of these fees. *Id.* If these costs were passed on to borrowers, then the closing cost of a \$200,000 mortgage would rise by less than \$25. *Id.*

125. *Id.*

126. *See id.*; *infra* notes 127-134 and accompanying text.

127. *See Effects of Repealing Fannie Mae's and Freddie Mac's SEC Exemptions – A CBO Paper, supra* note 34. There is some evidence that the MBSs trade at a discount because buyers of MBSs lack adequate information on the maturities of the different mortgages in a MBS pool. *Id.* Buyers are, therefore, unable to accurately gauge the effect of repayment risk on MBSs and tend to overweigh that risk in their evaluation of the MBSs' value. *Id.*

128. *See Effects of Repealing Fannie Mae's and Freddie Mac's SEC Exemptions – A CBO Paper, supra* note 34. Currently, prepayment risk is disseminated across the MBSs in the market. *Id.* Increased disclosure requirements would better enable investors to determine the maturities of the different mortgages in each MBS. *Id.* This would allow investors to more easily and adequately determine the overall prepayment risk associated with a given MBS and better allocate prepayment risk to MBSs based on the average maturities of the underlying mortgages. *Id.*

129. *Id.*

130. *Id.* Different investors have different goals and therefore favor different investments; e.g., risk adverse investors might accept lower returns (greater risk typically implies greater return) and seek out securities with less repayment risk (shorter maturities), and investors seeking a higher return might accept higher prepayment risk and therefore seek out securities with more repayment risk (longer maturities). *Id.* Currently most investors are forced to treat the MBS market as one with somewhat uniform prepayment risk. *Id.* Increased disclosure requirements would allow investors to better determine which MBSs better fit their investment goals. *Id.* The MBS market would thus segment more with investors targeting their money at the MBSs fitting their investment goals. *Id.*

value of the “imputed” federal guarantee<sup>131</sup> of Fannie Mae and Freddie Mac.<sup>132</sup> Increased MBS prices would imply some decrease in the amount of capital flowing to the mortgage market.<sup>133</sup> However, based on the amount of anticipated reduction in the money flowing to the mortgage market, the new disclosure requirements are not anticipated to have significantly adverse effects on mortgage rates.<sup>134</sup>

#### E. *Repeal of Special Borrowing Provisions*

House Bill 3071 would repeal Fannie Mae’s and Freddie Mac’s ability to borrow directly from the United States Treasury.<sup>135</sup> The benefit provided by the favorable rates is estimated to be worth as much as \$2 billion.<sup>136</sup> This bill would also eliminate Fannie Mae’s and Freddie Mac’s ability to sell their debt to the Federal Reserve.<sup>137</sup> This change would require Fannie Mae and Freddie Mac to compete exclusively on the open market, like all other firms, for funds to meet their debt and financing needs.<sup>138</sup> There is no phase-in provision for this change and it is uncertain how quickly Fannie Mae and Freddie Mac would be required to replace the debt owed the Federal treasury with privately funded debt.<sup>139</sup>

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131. See Krehley *supra* note 5, at 530-33.

132. *Effects of Repealing Fannie Mae’s and Freddie Mac’s SEC Exemptions – A CBO Paper*, *supra* note 34

133. See *supra* notes 7-10 and accompanying text.

134. *Id.*

135. Free Housing Market Enhancement Act, H.R. 3071, 108th Cong. (2003).

136. 149 Cong. Rec. E1767 (daily ed. Sept. 11, 2003) (statement of Rep. Paul). The bill’s sponsor, Texas Representative Ron Paul, argues that “[t]he connection between the GSE’s and the government helps isolate the GSE management from market discipline. This isolation from market discipline is the *root cause* of the recent reports of mismanagement at Fannie and Freddie.” *Id.* (emphasis added). Paul further argues that the privileges extended to Fannie Mae and Freddie Mac have “distorted the housing market” because the institutions are able to attract capital not under “pure market conditions.” *Id.* This has led to a bubble in the housing market that will burden homeowners when it collapses. *Id.* According to Paul, the ability of Fannie Mae and Freddie Mac to procure inexpensive debt from the United States Treasury is effectively an unconstitutional transfer of wealth from tax payers to holders of the GSEs’ debt and MBSs. *Id.*

137. *Id.*

138. *Id.*

139. *Id.*

## VI. OTHER PROPOSED CHANGES

Beyond the significant changes being proposed in Congress, other suggestions have been made for additional, sometimes drastic, changes.<sup>140</sup> Given the importance of hedging activities at Fannie Mae and Freddie Mac and the ease of manipulation, some commentators have called for increased transparency in these hedging activities.<sup>141</sup> If the firms' SEC exemption is repealed as proposed, the increased disclosure would certainly be as much or more than what is being sought.<sup>142</sup> Some legislators are calling for the government to sever its ties with Fannie Mae and Freddie Mac,<sup>143</sup> causing the firms to become completely privatized.<sup>144</sup> Some have gone so far as to argue that Fannie Mae and Freddie Mac should be broken into four separate entities that would then compete against one another to a greater extent.<sup>145</sup> They believe that the increased competition would lead to even more benefits to homeowners, while still rewarding shareholders.<sup>146</sup>

## VII. CONCLUSION

A. *Preferred Solution(s)*

The removal or elimination of Fannie Mae's and Freddie Mac's privileges<sup>147</sup> would seem to be the least controversial of the reform proposals. Rather than impose regulation or restrictions on the firms, these proposals would seem to place the firms on a

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140. See, e.g., Dwyer, *supra* note 15, at 115-16. See generally Krehley, *supra* note 5, at 528-43 (discussing the problems with and suggested reforms of Fannie Mae and Freddie Mac at that time).

141. See Dwyer, *supra* note 15, at 115-16.

142. See *id.*; *Effects of Repealing Fannie Mae's and Freddie Mac's SEC Exemptions - A CBO Paper*, *supra* note 34.

143. See John D. McKinnon & Dawn Kopecki, *Fannie Mae, Freddie Mac Targeted by Republicans To Curb Taxpayer Exposure*, WALL ST. J., Sept. 10, 2003, at A2.

144. *Id.*; see also Krehely, *supra* note 5, at 540-41.

145. See Dwyer, *supra* note 15, at 115-16.

146. *Id.*

147. *Id.* The privileges include exemption from state and local income tax, the exemption from SEC regulation, and the privilege of borrowing debt directly from the U.S. Treasury at favorable rates. See *supra* notes 117-138 and accompanying text.

more level playing field with competing firms. This would eliminate the actual or imputed federal “subsidy” that arguably transfers wealth from taxpayers to holders of MBSs, GSE stock, and GSE debt.<sup>148</sup> Such changes would also reduce market distortions. However, any change that increases the cost of MBSs could reduce the amount of liquidity in the housing market and increase the costs of borrowing for homeowners, even if only slightly. This may be a necessary consequence of having Fannie Mae and Freddie Mac operate in a non-subsidized manner.

Congress should strive to minimize the short-term impact of any changes by becoming fully informed about the likely consequences. Congress should also consider the possibility of proceeding incrementally. If Fannie Mae and Freddie Mac gradually become true market competitors, and the market is allowed more time to adjust, the likelihood of a debilitating shock to the housing market or the economy as a whole will be reduced.

The resources and expertise in the Treasury Department make it a more logical home for Fannie Mae’s and Freddie Mac’s regulator than the Department of Housing and Urban Development. However, due to the highly independent status the director would receive under the pending legislation,<sup>149</sup> it is less important which federal department handles the oversight.

Fannie Mae and Freddie Mac are two of the largest financial institutions in the country.<sup>150</sup> It would seem altogether fitting and proper for them to be regulated in a manner similar to banks. The seemingly “hands off” nature of the firms’ current regulator, OFHEO, may have facilitated, or at least allowed, the accounting problems at Freddie Mac in the spring of 2003 and at Fannie Mae in the fall of 2003.<sup>151</sup> Whatever the final shape of any new regulator, it should use its power to ensure that Fannie Mae and Freddie Mac operate with the soundness expected of large

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148. See *supra* note 89 and accompanying text. If the imputed subsidies were eliminated there would be nothing to pass on. See *Federal Subsidies and the Housing GSEs*, *supra* note 77. Furthermore, if the two firms were to compete on a more level market with other firms, benefits would be allocated to shareholders and homeowners in a manner fairly determined by that market. *Id.*

149. See *supra* notes 100-109 and accompanying text.

150. See *supra* note 14.

151. See *supra* notes 56-65 and accompanying text.

banks and consistent with the low risk investors expect from GSE securities. The regulator should proceed cautiously and not attempt massive overhaul in a short period of time; small, sequential change would reduce the likelihood that markets would be disrupted and would help to ensure that any change would be warranted.<sup>152</sup>

It is uncertain whether Fannie Mae and Freddie Mac are truly under-capitalized.<sup>153</sup> Compared to financial institutions of similar size, they operate with significantly less capital.<sup>154</sup> These institutions are truly unique, however, and given the low risk of the investments they deal in (primarily home loans),<sup>155</sup> lower capital levels may be warranted. Fannie Mae and Freddie Mac have exhibited an impressive ability to support significant assets and liabilities with small amounts of capital, thereby allowing lower borrowing costs than might otherwise be possible.<sup>156</sup> Though Fannie Mae and Freddie Mac should be required to maintain higher levels of capital, these levels should be raised slowly and sparingly. A sharp rise in their capital requirements could force the firms to reduce their leverage, causing a short-term shock or panic in the market.

### B. Summary

Fannie Mae and Freddie Mac were chartered by Congress to facilitate the flow of capital to the housing market, thereby facilitating the dream of home ownership for more Americans.<sup>157</sup> Fannie Mae and Freddie Mac have been instrumental over the last thirty years in helping to bring that dream to millions of Americans.<sup>158</sup> To support their mission, Congress granted these GSEs certain privileges and advantages.<sup>159</sup> Partly due to these advantages, Fannie Mae and Freddie Mac have grown to dominate

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152. See, e.g., *supra* notes 58, 65 and accompanying text.

153. See *supra* notes 80-85 and accompanying text.

154. See *supra* note 81.

155. See *supra* notes 7-8 and accompanying text.

156. See *supra* note 9 and accompanying text.

157. See *Understanding Fannie Mae*, *supra* note 14; *Our Mission*, *supra* note 5.

158. See *Understanding Fannie Mae*, *supra* note 14; *Our Mission*, *supra* note 5.

159. See *supra* note 5.

the market.<sup>160</sup> Due to their advantages, and more recently their market dominance, Fannie Mae and Freddie Mac have become the subject of criticism and targets for tighter regulation.<sup>161</sup> Freddie Mac's and Fannie Mae's accounting problems in the spring and fall of 2003, respectively, only intensified the criticism.<sup>162</sup>

Fannie Mae and Freddie Mac have likely outgrown the light regulatory oversight originally given to them by Congress. Furthermore, the justifications for some of their preferential treatment are no longer as compelling, and such treatment may now be unwarranted. Such preferential treatment may be responsible for market distortions that do a disservice to the goals Fannie Mae and Freddie Mac were originally chartered to serve.<sup>163</sup> Congress is right to address these issues and act in a preventive manner to ensure that a failure or disruption at one of these firms does not cause serious harm to the economy, or to American homeowners and investors.

Though Fannie Mae and Freddie Mac may have grown beyond their roots, they continue to play a vital role in our economy.<sup>164</sup> Congress should act to overhaul the regulatory and subsidy frameworks around these firms, but should do so carefully, to insure that the harm sought to be preempted is not caused by the solution.

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160. *See supra* notes 12-16 and accompanying text.

161. *See supra* note 66-93 and accompanying text.

162. *See supra* notes 56-65 and accompanying text.

163. *See supra* note 5 and accompanying text.

164. *See supra* note 9 and accompanying text.

