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Government Sponsored Enterprises: A Discussion of the Federal Subsidy of Fannie Mae and Freddie Mac

“Whatever the verdict, it is important for people to understand the current debate. Fannie Mae and Freddie Mac were set up to produce a badly needed service to the United States financial system. It is ironic that they may wind up becoming its biggest threat.”¹ By all accounts, the United States has built a first-rate housing industry.² Indeed, by 2000, homeownership in the United States reached sixty-eight percent, the highest rate in history.³ By that statistic alone, the housing government-sponsored enterprises (GSEs) seem to be fulfilling their mission.⁴ Encouraged by this development, the Federal National Mortgage Association (Fannie Mae) has declared that “[t]he current public policy to expand homeownership and affordable rental housing by using private capital . . . has been a huge success.”⁵ However,

1. Eric Winig, *Cracks in the Fannie-Freddie Foundation*, WASH. BUS. J., Apr. 13, 2001, available at <http://washington.bizjournals.com/washington/stories/2001/04/16/story1.html> (last visited Feb. 24, 2002).

2. FANNIE MAE, THE FACTS ABOUT FANNIE MAE AND THE MORTGAGE MARKET: SETTING THE RECORD STRAIGHT 1 (citing U.S. Dep’t of Housing and Urban Development, Apr. 21, 1999) [hereinafter FANNIE MAE, FACTS ABOUT FANNIE MAE], at <http://www.fanniemae.com/global/pdf/media/ issues/archive/2001/010101.pdf> (last visited Feb. 23, 2002). A deputy chief economist at Fannie Mae, Fran K. Nothaft explains, “[i]n most countries of the world, you have to be in the upper reaches [of society] to get a home.” Patrick Barta & Gregory Zuckerman, *Homeownership: The Perils of Success?*, WALL ST. J., Jan. 22, 2001, at A1.

3. Barta & Zuckerman, *supra* note 2 at A1. Fannie Mae predicts that the homeownership rate will reach 70% within the decade. See FANNIE MAE, FACTS ABOUT FANNIE MAE, *supra* note 2, at 1.

4. See *infra* notes 20-21 and accompanying text.

5. FANNIE MAE, SPECIAL STATEMENT: THE FACTS ABOUT FANNIE MAE AND THE MORTGAGE MARKET: SETTING THE RECORD STRAIGHT, at <http://www.fanniemae.com/news/special/debt.html> (last visited Feb. 7, 2002). Echoing these sentiments, one member of Congress has proclaimed, “[b]ecause of Fannie Mae and Freddie Mac, the United States has the best mortgage markets in the world.” See *Government Sponsored Enterprises: Joint Hearing with Government Reform on Government Sponsored Enterprises Before the House Subcomm. on Capital Mkts., Secs., and Gov’t Sponsored Enterprises, Comm. on Banking and Fin. Services, and the Subcomm. on Gov’t Mgmt., Information, and Technology, Comm. on Gov’t Reform and Oversight*, 105th Cong. 7 (1997) (statement of Rep. Carolyn Maloney), available at http://commdocs.house.gov/committees/bank/hba42908.000/hba42908_0.htm (last visited Feb. 28, 2002) [hereinafter Maloney].

critics suggest that there is more to the story.⁶ GSEs have come under fire, and opponents have called for a series of reforms.⁷

This Note examines the heated debate involving GSEs. In particular, it outlines the criticisms leveled against government-sponsored enterprises and assesses their validity. In the first section, the Note defines government-sponsored enterprises, explains why the housing GSEs were created, and identifies Fannie Mae and the Federal Home Loan Mortgage Corporation (Freddie Mac) as the major housing GSEs.⁸ The Note then compares the GSEs' federal charters with some of the activities Fannie and Freddie are engaging in today, followed by an introduction to the charge that GSEs have moved beyond their public purpose.⁹ Next, the Note describes how critics have organized in opposition to the GSEs and focuses on three of their complaints.¹⁰ First, it explores whether subsidy dollars are going to shareholders instead of mortgage borrowers.¹¹ Second, it discusses the contention that GSEs exercise duopoly power over the industry.¹² And, finally, it inquires whether GSE activities could subject taxpayers to a huge bailout.¹³ The following section of the Note describes some reform proposals.¹⁴ Finally, the Note concludes that any changes to the structure and operation of GSEs should be implemented judiciously.¹⁵ In particular, it asserts that reforms should not be carried out at the expense of mortgage borrowers.¹⁶

6. *See infra* notes 50-67 and accompanying text.

7. *See infra* notes 168-90 and accompanying text.

8. *See infra* notes 17-45 and accompanying text.

9. *See infra* notes 46-57 and accompanying text.

10. *See infra* notes 58-167 and accompanying text.

11. *See infra* notes 72-109 and accompanying text.

12. *See infra* notes 110-25 and accompanying text.

13. *See infra* notes 126-67 and accompanying text.

14. *See infra* notes 168-90 and accompanying text.

15. *See infra* notes 191-200 and accompanying text.

16. *Id.*

I. WHAT ARE GOVERNMENT-SPONSORED ENTERPRISES?

A. *Definition*

“[GSEs] are financial intermediaries, established and granted preferential treatment by federal law to increase the flow of funds to specific uses but owned by investors to whom they owe a fiduciary responsibility.”¹⁷ Chartered by federal statute, GSEs are treated “as instrumentalities of the federal government, rather than fully private enterprises.”¹⁸ The first GSE, the Farm Credit System, was set up to provide real estate loans to ranchers and farmers.¹⁹ Subsequently, other GSEs were created to assist sectors that were not adequately served by private credit markets.²⁰ Clarifying the role of GSEs, Representative Carolyn Maloney explains, “a GSE should correct a market imperfection or credit gap whose existence is detrimental to an important *public purpose*. . . .”²¹ Therefore, the notion of serving a public purpose is inherent in the mission of every government-sponsored enterprise.

B. *Why were the housing GSEs created?*

The housing GSEs sought to ensure that money for mortgages was available to homebuyers throughout the United States.²² Before the creation of these entities, many institutions

17. CONGRESSIONAL BUDGET OFFICE, FEDERAL SUBSIDIES AND THE HOUSING GSEs 7 (May 2001) [hereinafter CBO REPORT], available at <http://www.cbo.gov/pubs.cfm> (last visited Feb. 28, 2002).

18. *Id.* at 13.

19. *Government Sponsored Enterprises: Joint Hearing with Government Reform on Government Sponsored Enterprises Before the House Subcomm. on Capital Mkts., Secs., and Gov't Sponsored Enterprises, Comm. on Banking and Fin. Services, and the Subcomm. on Gov't Mgmt., Information, and Technology, Comm. on Gov't Reform and Oversight*, 105th Cong. 2-3 (1997) (statement of Rep. Stephen Horn), available at http://commdocs.house.gov/committees/bank/hba42903.000/hba42903_0.htm (last visited Feb. 24, 2002).

20. *Id.* Homebuyers, students, and colleges are examples of the entities that have benefited from the creation of government-sponsored enterprises. *Id.*

21. See Maloney, *supra*, note 5 (emphasis added). Representative Carolyn Maloney (D-NY) was first elected in 1992 and serves on the House Financial Services Committee, the Government Reform and Oversight Committee, and the Joint Economic Committee. For more information about Representative Maloney, see <http://www.house.gov/maloney/bio.html> (last visited Feb. 24, 2002).

22. *Id.*

had trouble maintaining a reliable flow of mortgage credit to qualified homebuyers.²³ In particular, geography played a major role in determining who got lower rates.²⁴ Representative Maloney notes that institutions in areas with “a large volume of home buyers” or “a healthy supply of new depositors” were able to provide cheaper rates.²⁵ In contrast, institutions in areas lacking these conditions were forced to charge higher rates.²⁶ Thus, the mortgage market was inconsistent because people in some areas got lower rates than people in other areas.²⁷ Changing local economies exacerbated this problem further.²⁸ Since many localities took turns facing bad economic times, mortgage rates and availability fluctuated with shifting economic conditions.²⁹ These problems led to the inevitable conclusion that something had to be done in order to bring stability and consistency to the industry.³⁰

The creation of the housing GSEs addressed this dilemma by promoting liquidity in a secondary mortgage market.³¹ To

23. *Id.*

24. *Id.*

25. *See* Maloney, *supra*, note 5.

26. *Id.*

27. *See* FREDDIE MAC, WHY FREDDIE MAC [hereinafter FREDDIE MAC, WHY FREDDIE], at <http://www.freddiemac.com/corporate/vital/> (last visited Feb. 7, 2002). On its website, Freddie Mac explains the unpredictability of the mortgage market before the creation of GSEs:

Since the Great Depression, federal support for housing has been an enduring public policy objective. Even in the 1960's, interest rates varied widely from city to city across the country. The mortgage market was unpredictable, and loans were sometimes hard to get. Neither government nor private banking interests could address the nation's housing finance needs alone.

Id.

28. *Id.*

29. *See* Maloney, *supra*, note 5.

30. *See* Vern McKinley, *The Mounting Case for Privatizing Fannie Mae and Freddie Mac*, CATO POLICY ANALYSIS NO. 293, Dec. 29, 1997 [hereinafter McKinley, *Mounting Case*], available at <http://www.cato.org/pubs/pas/pa-293.html> (last visited Feb. 23, 2002). Vern McKinley argues that Congress was aware of the market failures in the mortgage industry. *Id.* He explains, “[m]embers of Congress believed that private markets alone were incapable of supporting such financial institutions, and only through continued government sponsorship could such entities survive.” *Id.*

31. FANNIE MAE, THE INDUSTRY [hereinafter FANNIE MAE, THE INDUSTRY], at <http://www.fanniemae.com/company/industry.html> (last visited Mar. 4, 2002).

understand how this process works, it is necessary to distinguish between the primary mortgage market and the secondary mortgage market.³² The primary mortgage market is the place where mortgages are originated and funds are loaned directly to borrowers.³³ In contrast, the secondary mortgage market is the place where mortgages are bought and sold.³⁴ When lenders in the primary market sell mortgages to secondary investors like GSEs, the lenders accumulate capital that can later be used to generate more loans.³⁵ Summing up its role, Fannie Mae insists, “[a]lthough we don’t lend money directly to home buyers, we ensure that mortgages are consistently available and affordable by buying mortgages from a variety of institutions that do lend money directly to home buyers.”³⁶ Since GSEs operate in every state in the country,³⁷ geography and changing local economic conditions should no longer hinder the market. Therefore, with the help of GSEs, mortgages should be accessible and affordable.

Currently, there are two major GSEs involved in the housing industry: Fannie Mae and Freddie Mac.³⁸ Fannie Mae was established in 1938 “to bolster the housing industry during the depression.”³⁹ In 1954, it became “a mixed ownership corporation owned partly by private shareholders.”⁴⁰ The company changed

32. *Id.*

33. *Id.* The primary mortgage market consists of mortgage companies, savings and loans, commercial banks, credit unions, and finance agencies. *See id.*

34. *Id.* Secondary market investors include GSEs, pension funds, insurance companies, securities dealers, and financial institutions. *See id.*

35. FANNIE MAE, MORTGAGE INDUSTRY PRIMER, [hereinafter FANNIE MAE, MORTGAGE INDUSTRY PRIMER], <http://www.fanniemae.com/faq/industry.jhtml> (last visited Mar. 4, 2002).

36. FANNIE MAE, THE INDUSTRY, *supra* note 31.

37. FANNIE MAE, MORTGAGE INDUSTRY PRIMER, *supra* note 35.

38. U.S. DEP’T OF HOUSING & URBAN DEVELOPMENT, REGULATION OF GOVERNMENT-SPONSORED ENTERPRISES (GSEs), at <http://www.hud.gov/progdese/govspon.cfm> (last visited Feb. 23, 2002). For a discussion of the evolution of GSE’s, see *Government Sponsored Enterprises: Joint Hearing with Government Reform on Government Sponsored Enterprises Before the House Subcomm. on Capital Mkts., Secs., and Gov’t Sponsored Enterprises, Comm. on Banking and Fin. Services, and the Subcomm. on Gov’t Mgmt., Information, and Technology, Comm. on Gov’t Reform and Oversight*, 105th Cong. 15-18 (1997) (statement of Thomas Woodward) (cited in CBO REPORT, *supra* note 17, at 7 n.1), available at http://commdocs.house.gov/committees/bank/hba42908.000/hba42908_0.htm (last visited Feb. 24, 2002).

39. FANNIE MAE, UNDERSTANDING FANNIE MAE, at <http://www.fanniemae.com/aboutfm/understanding/index.jhtml> (last visited Feb. 23, 2002).

40. FANNIE MAE, UNDERSTANDING FANNIE MAE: OUR HISTORY, at

again in 1968 when President Lyndon Johnson signed legislation that converted Fannie Mae into a private, shareholder owned company.⁴¹ Today, its mission is “to tear down barriers, lower costs, and increase the opportunities for homeownership and affordable rental housing for all Americans.”⁴² Like Fannie Mae, Freddie Mac was designed to deal with nation’s housing woes.⁴³ Freddie Mac was chartered in 1970 to stabilize mortgage markets and expand opportunity for home ownership and rental housing.⁴⁴ Since its inception, Freddie Mac has financed homes for millions of American families.⁴⁵

II. OPPOSITION TO GSEs

A. *What Fannie and Freddie are Chartered to Do Versus What They Do Today*

According to the GSEs’ charters, Fannie Mae and Freddie Mac are required to promote liquidity in the national secondary mortgage market.⁴⁶ Specifically, they are instructed to do the following:

- (1) provide stability in the secondary market for residential mortgages;
- (2) respond appropriately to the private capital market;
- (3) provide ongoing assistance to the secondary market for residential mortgages (including activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than

<http://www.fanniemae.com/aboutfm/understanding/history.jhtml> (last visited Feb. 23, 2002).

41. *Id.* At this time, Fannie Mae began to operate as a GSE. CBO REPORT, *supra* note 17, at 1.

42. FANNIE MAE, FREQUENTLY ASKED QUESTIONS: WHAT FANNIE MAE DOES [hereinafter FANNIE MAE, FREQUENTLY ASKED QUESTIONS], at <http://www.fanniemae.com/Faq/231001a.jhtml?p=FAQ> (last visited Feb. 23, 2002).

43. FREDDIE MAC, WHY FREDDIE, *supra* note 27.

44. *Id.*

45. Freddie Mac, About Freddie Mac, at <http://www.freddiemac.com/corporate/about/> (last visited Feb. 23, 2002).

46. 12 U.S.C. § 1716 (2000).

the return earned on other activities) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing;

(4) promote access to mortgage credit throughout the Nation (including central cities, rural areas, and underserved areas) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing; and

(5) manage and liquidate federally owned mortgage portfolios in an orderly manner, with a minimum of adverse effect upon the residential mortgage market and minimum loss to the Federal Government.⁴⁷

Throughout the charter, the GSEs are called to carry out a public purpose.⁴⁸ Indeed, the provisions indicate that Fannie Mae and Freddie Mac should “provide stability,” “promote access to mortgage credit,” and assist in “mortgages for low- and moderate income families.”⁴⁹

In spite of these targeted goals, GSEs are engaging in a variety of other activities.⁵⁰ For instance, Fannie Mae and Freddie Mac have entered into subprime and home equity loans.⁵¹ Additionally, it is alleged that the GSEs are taking other unusually large risks such as assuming both the credit and interest rate risk

47. *Id.*

48. *Id.*

49. *Id.*

50. FM WATCH, THE VITAL ROLE OF FM WATCH 4 (Oct. 1999) [hereinafter FM WATCH, THE VITAL ROLE OF FM WATCH], <http://128.121.228.117/resources/vitalrole.phtml> (follow link to pdf file) (last visited Feb. 22, 2002). Vern McKinley details recent trends in the GSEs' risk assumption. McKinley, *Mounting Case*, *supra* note 30. He explains, “[i]t is clear that many of the activities that the GSEs are getting involved in are increasing their risk exposure. But, some activities are also getting the GSEs increasingly far afield from what has been the core of their existence—to sustain a liquid secondary market” *Id.*; see also Vern McKinley, *Privatize Fannie Mae and Freddie Mac*, USA TODAY MAGAZINE, July 1, 1993, at 16, LEXIS News, Magazines, Stories, Combined (arguing that the GSEs have moved beyond their core function) [hereinafter McKinley, *Privatize Fannie Mae and Freddie Mac*].

51. The subprime mortgage market involves “lending to riskier applicants who have been late on paying monthly credit cards or other debt.” See McKinley, *Mounting Case*, *supra* note 30; see also Winig, *supra* note 1.

by holding more of their mortgage-backed securities in portfolio and engaging in non-mortgage investments like Freddie Mac's purchase of tobacco bonds.⁵² The GSEs do not deny that these endeavors are risky.⁵³ In fact, they suggest that engaging in risky propositions is necessary to maintain a strong housing system in the United States.⁵⁴ Critics of GSEs suggest another theory.⁵⁵ They maintain that Fannie Mae and Freddie Mac have moved beyond their public purpose of serving homebuyers and are now accommodating the needs of private stockholders.⁵⁶ Moreover, it is their contention that these new activities are outside the scope of the GSEs' charter.⁵⁷

B. *Opposition Groups*

Frustrated by the GSEs' activities, a number of groups have organized in opposition.⁵⁸ One of the most outspoken critics, FM Watch, describes itself as an alliance of financial sector and housing-related trade associations working to ensure that Fannie Mae and Freddie Mac put the interests of homebuyers and taxpayers above the interests of their investors.⁵⁹ FM Watch has

52. FM WATCH, THE VITAL ROLE OF FM WATCH, *supra* note 50, at 5.

53. Winig, *supra* note 1.

54. *Id.*

55. See FM WATCH, THE VITAL ROLE OF FM WATCH, *supra* note 50, at 5.

56. *Id.* This argument forms the backbone of many criticisms leveled against GSEs. *Id.* Opponents have described this gradual move into lines of business as "mission creep." *Id.*

57. *Id.* The Heritage Foundation has expressed its concern that the GSEs are moving away from their public policy goal of making mortgages more available. JOHN S. BARRY, WHY CONGRESS SHOULD PRIVATIZE FANNIE MAE AND FREDDIE MAC, THE HERITAGE FOUNDATION COMMITTEE BRIEF NO. 27 (Jul. 24, 1996), available at, <http://www.heritage.org/library/categories/regulation/cbrief27.html> (last visited Feb. 23, 2002). Mr. Barry mentions a need to "ensure that the GSEs do not . . . stray from their original charters." *Id.*

58. Winig, *supra* note 1. Perhaps, the oldest nemesis of the GSEs is the National Taxpayers Union (NTU). See Catherine Edwards, *Fannie & Freddie in the Hot Seat*, INSIGHT ON THE NEWS, May 14, 2001, at 16. The NTU has been critical of GSEs for over 25 years. *Id.* In 2001, the group alleged that the GSEs gave large sums of illegal political contributions. *Id.*

59. For more information about FM Watch, visit www.fmwatch.org. FM Watch is by no means the only group that has formed in opposition to the GSEs. For the Competitive Enterprise Institute's position on the subject, see FRED L. SMITH, JR., COMPETITIVE ENTERPRISE INSTITUTE, FANNIE AND FREDDIE: FISCAL FRAUD (Aug. 31, 2000), available at <http://www.cei.org/gencon/005,01855.cfm> (last visited Feb. 23,

attacked Fannie Mae and Freddie Mac for moving beyond their charters into competitive private markets and subjecting American taxpayers to unnecessary risk.⁶⁰ In response, Fannie Mae insists that these criticisms are self-serving.⁶¹ It describes FM Watch as “[a] group of mortgage insurers, high-cost lenders, and their allies who want to roll back Fannie Mae policies to cut costs to consumers. We call them the Coalition for Higher Mortgage costs because if they had their way, the costs that Fannie Mae lowers for consumers would go up.”⁶² This rhetoric reveals the animosity that exists between the two groups.⁶³

Other groups and individuals have voiced concerns about GSEs.⁶⁴ A recent article in the *Washington Business Journal* identifies a “growing contingent of critics—from scholars at the American Enterprise Institute to the über-liberal Ralph Nader.”⁶⁵ Finally, a number of think tanks have expressed their discontent with Fannie Mae and Freddie Mac.⁶⁶ The Cato Institute, the Heritage Foundation, and the Competitive Enterprise Institute (CEI) have recently published papers calling for changes in how the GSEs operate.⁶⁷

2002).

60. See FM WATCH, THE VITAL ROLE OF FM WATCH, *supra* note 50, at 6. FM Watch contends that Fannie Mae and Freddie Mac have taken on these risks “in order to maintain high profits and meet Wall Street’s expectations.” *Id.* at 4. Similarly, the American Enterprise Institute has focused on the risk GSEs pose to taxpayers. Lew Sichelman, *American Enterprise Institute Warns of the Danger of a GSE Bailout*, NAT’L MORTGAGE NEWS, Mar. 13, 2000, at 30.

61. FANNIE MAE, FREQUENTLY ASKED QUESTIONS, *supra* note 42.

62. *Id.*

63. *Id.*

64. Winig, *supra* note 1.

65. *Id.* In 1998, Ralph Nader cosponsored a forum on government-sponsored enterprises. Ralph Nader, *GSEs Warrant Public Scrutiny*, NAT’L MORTGAGE NEWS, May 11, 1998, at 4. His purpose was “to open a long-overdue dialogue on a critically important sector of our economy [the housing finance industry].” *Id.*

66. Winig, *supra* note 1.

67. *Id.* Both the Cato Institute and the Heritage Foundation have called for the privatization of Fannie Mae and Freddie Mac. See McKinley, *Mounting Case*, *supra* note 30; Barry, *supra*, note 57. The GSEs have questioned the objectivity of these papers. See Winig, *supra* note 1. In particular, they allege that corporate entities, such as big money banks, are sponsoring studies that are sympathetic to their views. *Id.* Moreover, the GSEs insist that the papers are little more than veiled attacks from competitors afraid of losing market share. *Id.*

III. CALLS FOR REFORM

In spite of their success in building the nation's thriving housing industry, GSEs now confront a number of criticisms.⁶⁸ First, critics claim that subsidy dollars are going to shareholders instead of mortgage borrowers.⁶⁹ Second, opponents argue that Fannie Mae and Freddie Mac have duopoly power over the mortgage industry.⁷⁰ Finally, detractors worry that GSE activities could subject taxpayers to a huge bailout.⁷¹

A. *The Subsidy Issue*

Of all the criticisms leveled against GSEs, the subsidy issue is perhaps the most contentious.⁷² FM Watch insists that Fannie Mae and Freddie Mac are misusing their federal subsidies to make profits for stockholders.⁷³ In response, the GSEs deny that they receive any subsidy from the federal government.⁷⁴

68. See *infra* notes 69-71 and accompanying text. Fannie Mae has not shied away from these criticisms. In one piece, the company notes:

Lately, a lot of stories are being told. You may have heard some of them: stories about how Fannie Mae's debt skyrocketing out of control and increasing the federal deficit, or how it is taking on risks that will lead to its collapse, or how it grabs huge federal subsidies with no return to homeowners.

FANNIE MAE, FACTS ABOUT FANNIE MAE, *supra* note 2, at 1.

69. FM WATCH, RESOURCES: FACT SHEETS: THE VITAL ROLE OF FM WATCH [hereinafter FM WATCH, FACT SHEETS], <http://128.121.228.117/resources/vitalrole.phtml> (last visited Feb. 23, 2002). The President of the Citizens Against Government Waste also alludes to this point: "[t]heir need for incentives to retain a high level of profitability is an obstacle to their performance." Catherine Edwards, *Fannie & Freddie in the Hot Seat*, INSIGHT ON THE NEWS, May 14, 2001, at 16.

70. See FM WATCH, FACT SHEETS, *supra* note 69; see also Steve Bergsman, *Big Competition: Fannie Mae and Freddie Mac*, MORTGAGE BANKING NO.8 VOL. 61, May 1, 2001, at 35. (discussing the charge the GSEs are squeezing out competitors).

71. Winig, *supra* note 1. It is important to note that these are not the only criticisms GSEs face. *Id.* For example, Ronald K. Schuster examines the possibility that GSEs may actually be hindering many minorities from becoming homeowners. See Ronald K. Schuster, *Lending Discrimination: Is the Secondary Mortgage Market Helping to Make the "American Dream" a Reality?*, 36 GONZ. L. REV. 153, 155 (2000).

72. CBO REPORT, *supra* note 17, at preface. In fact, this issue became the subject of Congressional Budget Office studies in 1996 and 2001. *Id.*

73. FM WATCH, FACT SHEETS, *supra* note 69. The CEI also alleges that Fannie Mae and Freddie Mac "misallocate capital" to "management and shareholders." See

In presenting this allegation, FM Watch relies on two studies conducted by the Congressional Budget Office (CBO).⁷⁵ The CBO found that Fannie Mae and Freddie Mac received an estimated \$6.8 billion subsidy in 1995.⁷⁶ In May of 2001, the CBO updated its findings, and the results were not favorable to Fannie Mae and Freddie Mac.⁷⁷ The CBO found that the GSEs total subsidy was valued at \$13.6 billion in 2000.⁷⁸ More importantly, the report indicated, “[n]ot all of the subsidy is passed through to mortgage borrowers in the form of lower interest rates and fees on mortgages.”⁷⁹ In fact, the CBO estimated that in 2000, mortgage borrowers retained about half of the total subsidy,⁸⁰ while stockholders and shareholders netted thirty-seven percent of the money.⁸¹ Groups like FM Watch have gained ammunition from the CBO report.⁸² If the GSEs do receive a subsidy and part of that money ends up in the hands of stockholders, then GSEs are serving more than just a public purpose; they are also accommodating the needs of private interests.⁸³

SMITH, JR., *supra* note 59.

74. FANNIE MAE, SETTING THE RECORD STRAIGHT: AN ANALYSIS OF CBO'S 2001 REPORT ON FANNIE MAE AND FREDDIE MAC 1 (May 23, 2001) [hereinafter FANNIE MAE, SETTING THE RECORD STRAIGHT], at www.fanniemae.com/ir/issues/cboresponses/jhtml (last visited Mar. 3, 2002) (follow link to the pdf file).

75. CBO REPORT, *supra* note 17, at preface.

76. *Id.* at preface & 1.

77. *Id.*

78. *Id.* at 1.

79. *Id.* at 25. The report also indicates that shareholders and stockholders of Fannie Mae and Freddie Mac retain a portion of the subsidy because the special legal status of those GSEs puts them at an advantage over competitors. *Id.* at 3.

80. *Id.* at 1.

81. *Id.* at 5. It is important to note how the CBO determined the portion of the subsidy retained by stockholders and shareholders. *Id.* Because conforming mortgages are Fannie and Freddie's only line of business, the CBO assumes that the portion of the subsidy not passed through to mortgage borrowers is retained by shareholders and stakeholders. *Id.*

82. See FM WATCH, FACT SHEETS, *supra* note 69. The CBO report has bolstered FM Watch's resolve. *Id.* The group points out that its membership list is "growing" and now includes nine financial services and housing related associations. *Id.*

83. Winig, *supra* note 1. Others have made similar observations. *Id.* For example, critics have argued that government subsidies "often wind up not in the pockets of prospective home buyers, but in the coffers of Fannie, Freddie, and their shareholders." *Id.*

The GSEs defend this accusation by denying that they receive any subsidy from the federal government.⁸⁴ In response to the CBO study, Fannie Mae released its own report lambasting the CBO for attempting to estimate the value of a subsidy that does not explicitly exist.⁸⁵ The Fannie Mae report proposes that the GSEs do not benefit from any appropriation of federal funds.⁸⁶ It further states that, “[i]f the government were to revoke the Fannie Mae charter, it [the government] would not receive a single ‘subsidy’ dollar. . . .”⁸⁷ Technically, the report is accurate. Fannie Mae and Freddie Mac do not receive a standard amount of money from the government each year.⁸⁸ Therefore, the government would not be able to recapture money if the GSE charters were revoked.⁸⁹

On the other hand, although they do not receive a fixed allocation of funds, the GSEs could still be receiving a subsidy.⁹⁰ First, the U.S. Treasury is authorized to lend \$2.25 billion to both Fannie Mae and Freddie Mac.⁹¹ More importantly, GSEs receive direct benefits from their special legal status which treats them as instrumentalities of the federal government, rather than fully private entities.⁹² Chartered by federal statute, Fannie Mae and Freddie Mac are exempt from a number of fees and taxes that would otherwise be collected by federal, state, and local governments.⁹³ For instance, GSEs are exempt from state and local income taxes, exempt from the Securities and Exchange

84. See FANNIE MAE, SETTING THE RECORD STRAIGHT, *supra* note 74 at 1.

85. *Id.*

86. *Id.* at 5.

87. *Id.* at 5. Fannie Mae also tries to bolster this argument by pointing out that it paid \$1.6 billion in taxes last year. *Id.* The implication is that the GSEs do not receive money from the government. *Id.* Instead, they pay money to the government. *Id.*

88. See Julie Kosterlitz, *Siblings Fat and Sassy*, NAT’L J., May 12, 2000, at 5. Julie Kosterlitz explains that Fannie Mae and Freddie Mac “get no direct cash handouts from the federal government.” *Id.*

89. See FANNIE MAE, SETTING THE RECORD STRAIGHT, *supra* note 74 at 5.

90. CBO REPORT, *supra* note 17, at 13.

91. *Id.* at 13-14. A senior columnist for TheStreet.com insists that “untapped credit lines” with the U.S. Treasury serve as a major operating advantage for Fannie Mae and Freddie Mac. See Peter Eavis, *Derivatives Risk Casts Long Shadow Over Fannie, Freddie*, THESTREET.COM, July 10, 2001, at <http://www.thestreet.com/comment/detox/1486090.html> (last visited Feb. 24, 2002).

92. CBO REPORT, *supra* note 17, at 13.

93. *Id.*

Commission's (SEC's) regulation requirements and fees, and may use the Federal Reserve as their fiscal agent.⁹⁴ The value of the subsidy is also determined by the opportunity cost of providing free credit enhancement to the GSEs because other institutions would pay to receive similar treatment.⁹⁵ These benefits provide the GSEs with a major competitive edge over other institutions.⁹⁶ Therefore, although they do not get a fixed allocation of money, the GSEs receive a tangible financial benefit from the government.⁹⁷ In fact, the CBO estimated that the savings from the exemption of state and local income taxes, the exemption from SEC regulation, and the lower cost of obtaining credit ratings for debt and Mortgage-Backed Securities issues was \$1.2 billion in 2000.⁹⁸

The Chairman of the Federal Reserve, Alan Greenspan, has also expressed his belief that Fannie Mae and Freddie Mac receive a subsidy from the federal government.⁹⁹ He explains:

The GSE subsidy is unusual in that its size is determined by market perceptions, not by legislation. Indeed, the prospectuses of the debentures issued by GSEs explicitly state that they are not backed by the full faith and credit of the United States government. Accordingly, the extent to which the subsidy is exploited is determined by the extent to which GSEs choose to issue debt and mortgage-based securities, not by legislation.¹⁰⁰

94. *Id.* GSEs are also exempt from many state investor protection laws. *Id.* at 13-14.

95. *Id.* at 13. The credit enhancement allows GSEs to receive lower borrowing rates and higher profits than a non-chartered enterprise would receive. *Id.*

96. McKinley, *Privatize Fannie Mae and Freddie Mac*, *supra* note 50. Vern McKinley argues that "[w]ith these privileges granted to Freddie Mac and Fannie Mae, other potential competitors in their market are 'crowded out' because they simply can not compete. It is no wonder that, with their many special benefits, they have no direct competition from private, non-sponsored entities" *Id.*

97. See Kosterlitz, *supra* note 88. (explaining that Fannie Mae and Freddie Mac "reap hefty benefits from their government lineage," even though they do not receive "direct cash handouts.").

98. CBO REPORT, *supra* note 17, at 15.

99. CBO REPORT, *supra* note 17, at 2 n.3 (quoting a letter to Congressman Richard H. Baker).

100. *Id.*

Greenspan makes an important point.¹⁰¹ Although the amount of the subsidy is not determined by legislation and fluctuates according to market perceptions, GSEs are receiving some financial benefit from the government.¹⁰² Greenspan's statement also undercuts Fannie Mae's argument that the subsidy does not explicitly exist.¹⁰³ Whether explicit or not, Greenspan has acknowledged that GSEs do receive a subsidy.¹⁰⁴

Although there is some controversy surrounding this issue, it does appear that GSEs get some kind of subsidy from the federal government.¹⁰⁵ Even though a number of critics have questioned the validity of the CBO report,¹⁰⁶ the present data suggests that some subsidy dollars are ending up in the hands of shareholders, rather than mortgage borrowers.¹⁰⁷ Perhaps homebuyers are still the major beneficiaries of Fannie Mae and Freddie Mac's activities.¹⁰⁸ However, the fact that stockholders

101. *Id.*

102. *Id.*

103. See FANNIE MAE, SETTING THE RECORD STRAIGHT, *supra* note 74, at 1.

104. CBO REPORT, *supra* note 17, at 2 n.3 (citing a letter to Congressman Baker).

105. See *supra* notes 72-104, *infra* notes 105-09 and accompanying text (discussing arguments regarding the existence of a subsidy and the value of the alleged subsidy). *Id.*

106. See James C. Miller & James E. Pearce, *5 Years Later, CBO No Wiser on Fannie, Freddie*, AM. BANKER, May 23, 2001, at 16. For example, James Miller and James Pearce suggest that the CBO report overestimated the alleged subsidies to the GSE's, inflated its estimate of the GSE's funding value, and failed to consider the activities of Fannie Mae and Freddie Mac that make the mortgage market more cost effective. *Id.* They state that the CBO "missed the boat in 1996 and has done so again in 2001. Its analysis is fundamentally flawed, and any policy change made on the basis of the latest report could carry a big price tag for the American public." *Id.* Others criticize the CBO report for posing the wrong question. Instead of trying to measure a subsidy, the CBO should have explored what benefits would end if the GSEs' special status were removed. See Alden Toevs, *A Critique of the CBO's 2001 Study on "Federal Subsidies and the Housing GSEs"* May 22, 2001, at 2 (on file with the N.C. Banking Institute).

107. SMITH, JR., *supra* note 59; see also FM WATCH, THE VITAL ROLE OF FM WATCH, *supra* note 50, at 4.

108. FM WATCH, THE VITAL ROLE OF FM WATCH, *supra* note 50, at 4. The GSEs have tried to deflect the subsidy issue by emphasizing that the homebuyers are still the major beneficiaries. See FANNIE MAE, SETTING THE RECORD STRAIGHT, *supra* note 74, at 2. "Fannie Mae provides more benefits than it realizes from any theoretical 'subsidy.' Fannie Mae clearly adds value to the mortgage market far beyond the confines of any theoretical model that the CBO has posited, even if that model were accurately applies." *Id.*

may also be benefiting implies that GSEs may have expanded beyond their public purpose of serving homebuyers.¹⁰⁹

B. Duopoly Power

The second criticism of GSEs is that Fannie Mae and Freddie Mac have become so large and so powerful that they now exercise duopoly power over the entire industry.¹¹⁰ Furthermore, critics suggest that the GSEs' operating advantages squeeze out competition to the detriment of consumers.¹¹¹

The size and strength of GSEs is indisputable.¹¹² Fannie Mae and Freddie Mac either own or insure the risk on forty to forty-five percent of America's residential mortgages.¹¹³ Further, Fannie Mae is the largest investor in home mortgages today.¹¹⁴ Keenly aware of the GSEs' prowess, critics have accused Fannie Mae and Freddie Mac of exercising "duopoly power."¹¹⁵ The implication is that Fannie and Freddie utilize their special status to dominate the market.¹¹⁶ But, this argument is extended further. Critics proclaim that the GSEs' operating advantages squeeze out

109. FM WATCH, THE VITAL ROLE OF FM WATCH, *supra* note 50, at 4; *see also* SMITH, JR., *supra* note 59.

110. FM WATCH, THE VITAL ROLE OF FM WATCH, *supra* note 50, at 4. By 2005 or earlier, FM Watch estimates that the GSEs will own or guarantee nearly half of all mortgages in America. *Id.* at 3; *see also* Steve Bergsman, *Big Competition; Fannie Mae and Freddie Mac*, 61 MORTGAGE BANKING NO. 8, May 1, 2001, at 36.

111. *See* Bergsman, *supra* note 110, at 36.

112. *See* FANNIE MAE, THE INDUSTRY, *supra* note 31. Even Fannie Mae has acknowledged its own prowess: "[w]e are at the heart of the U.S. housing industry—an enormous industry that is \$4.5 trillion strong." *Id.* Likewise, Freddie Mac has become an industry mogul. Erick Bergquist, *Can Brendsel (and Freddie) Stay on a Roll?*, AM. BANKER, Dec. 6, 2001, at 1. The company has tripled in size every three years in the 1990's and is now seventy percent of Fannie Mae's size. *Id.*

113. *Big Scary Monsters*, THE ECONOMIST, Jul. 21, 2001, at 59-60 [hereinafter *Big Scary Monsters*]. According to its figures, Fannie Mae currently owns in portfolio or holds in trust for investors one out of every five mortgages in the United States. *See* FANNIE MAE, MORTGAGE INDUSTRY PRIMER, *supra* note 35.

114. *See* FANNIE MAE, MORTGAGE INDUSTRY PRIMER, *supra* note 35.

115. FM WATCH, THE VITAL ROLE OF FM WATCH, *supra* note 50, at 5. Other critics have made similar suggestions. Fred Smith contends, "[t]he rapid growth of Fannie and Freddie during the 1990's suggests that the agencies are well on their way to becoming just that [monopolists]." SMITH, JR., *supra* note 59.

116. A Policy Analyst for the Heritage Foundation has noted Fannie Mae and Freddie Mac's domination by referring to them as "800-pound gorillas in the capital markets." Barry, *supra*, note 57.

competition to the detriment of consumers.¹¹⁷ In other words, without competition, the goal of reducing consumer costs cannot be fully achieved.¹¹⁸

For their part, the GSEs seem unmoved by this criticism.¹¹⁹ In fact, they argue that the U.S. mortgage market is in good shape¹²⁰ and that consumer prices have been reduced by the activities of GSEs.¹²¹ Additionally, on its website, Fannie Mae explains that in the 1990's alone, it helped twenty-three million families become homeowners, assisted two million families in obtaining affordable rental housing, and directly saved consumers twenty billion dollars by lowering mortgage costs.¹²² The argument that Fannie Mae and Freddie Mac are becoming too big is compelling for its competitors in the industry.¹²³ They believe that GSEs unfairly dominate the market, and reforming GSEs will benefit their businesses.¹²⁴ However, for the typical homebuyer, this criticism may be less important. If GSEs are helping to keep mortgage costs down, the average consumer is unlikely to be concerned about any alleged "duopoly power."¹²⁵

117. FM WATCH, *THE VITAL ROLE OF FM WATCH*, *supra* note 50, at 5. Mr. Barry also notes that this lack of competition harms private firms themselves: "[p]rivate firms cannot compete with Fannie Mae and Freddie Mac. The federal government, in essence, has created a duopoly that hinders innovation and prevents consumers from obtaining the most efficient delivery of home mortgages." Barry, *supra*, note 57.

118. FM WATCH, *THE VITAL ROLE OF FM WATCH*, *supra* note 50, at 5.

119. See FANNIE MAE, *THE INDUSTRY*, *supra* note 31. On its website, Fannie points out that the company is "a secondary market lender" that plays a "critical role in providing a steady stream of mortgage funds to lenders across the country. . . ." *Id.*

120. See generally *supra* notes 2-3 and accompanying text (describing the increase in homeownership). Compared to the state of the mortgage industry before the creation of the GSEs, today's market is in relatively good shape. *Id.*

121. FANNIE MAE, *FREQUENTLY ASKED QUESTIONS*, *supra* note 42. According to Fannie Mae, the company "lowers the cost of homeownership on average by \$15,000 on every 30-year mortgage it funds." *Id.*

122. FANNIE MAE, *FREQUENTLY ASKED QUESTIONS*, *supra* note 42.

123. See *supra* notes 110-22, *infra* notes 124-25 and accompanying text.

124. *Id.*

125. See FANNIE MAE, *FOR THE MEDIA: FREQUENTLY ASKED QUESTIONS*, at <http://www.fanniemae.com/news/media/faqs/faqs.html> (last visited Feb. 6, 2002). For a different perspective on this issue, see Robert Julavits, *MPF Gaining Steadily on Fannie and Freddie*, *AM. BANKER*, Jan. 22, 2002, at 10 (noting that a growing threat to GSE dominance gained ground in 2001).

C. Taxpayer Bailout

The third criticism of GSEs is much more ominous.¹²⁶ Essentially, opponents argue that GSEs have taken on so much risk that they now pose a serious threat to the United States economy.¹²⁷ The crux of this argument is that if the GSEs' riskier investments fail, then taxpayers are likely to foot the bill.¹²⁸ This section looks at two issues related to the taxpayer bailout issue: the government guarantee and new activities of GSEs.

1. Government Guarantee

The issue of a taxpayer bailout is directly related to the question of whether GSEs are backed financially by the federal government.¹²⁹ Because of their size and quasi-governmental status, some people believe that GSEs have an implied guarantee from the Federal government.¹³⁰ Accordingly, "if the GSEs ever default on their debts, the Federal government would step in, and the U.S. taxpayer would pay the cost."¹³¹ However, GSEs reject

126. Winig, *supra* note 1.

127. *Id.* Critics have argued that this systemic risk to the United States economy is "akin to the savings and loan debacle of a decade ago." *See id.* Undoubtedly, these fears were exacerbated in light of the September 11 attacks on Washington, D.C. and New York City. *See* Richard Cowden, *Falcon Says GSEs Operated Normally in Aftermath of Sept. 11 Terror Attacks*, BANKING REPORT, Oct. 22, 2001, at 645-46. However, according to OFHEO's Director, Armando Falcon Jr., the events had little or no effect on the safety and soundness of Fannie Mae and Freddie Mac. *Id.* Falcon explained, "As you might guess, there were disruptions to the enterprises' normal operations, but there was nothing that threatened their safety and soundness. In general terms, the problems encountered were solved through alternatives and work-arounds." *Id.*

128. FM WATCH, THE VITAL ROLE OF FM WATCH, *supra* note 50, at 5. The President of the Citizens Against Government Waste, Tom Schatz, contends that American taxpayers are at risk since the GSEs operate under a congressional charter. Edwards, *supra* note 69, at 16.

129. McKinley, *Privatize Fannie Mae and Freddie Mac*, *supra* note 50, at 16. Vern McKinley addresses the possibility of a government bailout. *Id.* He explains that Congress may choose to bail out Fannie Mae and Freddie Mac if it "is convinced that the failure of one of these financial giants would disrupt the mortgage markets." *Id.*

130. SMITH, JR., *supra* note 59. Fred Smith suggests that this implicit guarantee leads the market to believe that Fannie Mae and Freddie Mac "are safer investments than other ventures."

131. FM WATCH, THE VITAL ROLE OF FM WATCH, *supra* note 50, at 5.

the notion of an implied governmental guarantee.¹³² At least two commentators argue, “GSE markets are ‘made’ by sophisticated market participants who know very well there is no legal obligation of the U.S. Government to back GSE debt.”¹³³ Whether market participants are aware of this fact may be open to debate, but disclaimers in Fannie Mae and Freddie Mac’s literature support their argument.¹³⁴ For example, in its circulars for debt and mortgage-backed securities, Fannie Mae includes the statement: “[t]he Securities . . . are not guaranteed by the United States and do not constitute a debt or obligation of the United States.”¹³⁵ This disclaimer explicitly states that the United States is not obligated to bail out Fannie Mae and Freddie Mac.¹³⁶

However, the idea of an implied guarantee suggests that in spite of such disclaimers, the federal government would intervene in the event of a major catastrophe.¹³⁷ In 1991, Senator Herb Kohl¹³⁸ explained, “[w]hile it is not explicitly stated, the market believes, and it is true that were a GSE to go belly up it would have the full faith and credit of the Government behind it.”¹³⁹ To

132. JAMES C. MILLER & JAMES E. PEARCE, FREDDIE MAC, RESPONSE TO CBO’S DRAFT REPORT: FEDERAL SUBSIDIES AND HOUSING GSES (May 18, 2001) [hereinafter MILLER & PEARCE, RESPONSE TO CBO’S DRAFT REPORT], at http://www.freddiemac.com/news/analysis/gse_benefits2.htm (last visited Feb. 23, 2002).

133. *Id.* James C. Miller is the director of the Law and Economics Consulting Group in Washington, D.C. *Id.* James E. Pearce is the Vice President of Welch Consulting which is located in College Station, Texas. *Id.*

134. FANNIE MAE, FACTS ABOUT FANNIE MAE, *supra* note 2, at 4.

135. *Id.*

136. *Id.*

137. See Kosterlitz, *supra* note 88, at 15. This reasoning has persuaded some Wall Street analysts. *Id.* For instance, a consumer finance analyst at Paine Webber, Gary Gordon, told CNN, “[t]here’s no explicit guarantee of their [GSEs’] debt, but that implied guarantee is pretty powerful.” *Id.*

138. Herb Kohl (D-WI) was first elected in 1988 and currently serves on the Senate Appropriations Committee, Judiciary Committee, and the Special Committee on Aging. For more information about Senator Kohl, see <http://www.senate.gov/~kohl/bio.html> (last visited Feb. 23, 2002).

139. *Various Proposals to Regulate GSE’s and to Examine the Risk These Entities Pose to U.S. Taxpayers, Hearing Before the Subcomm. on Government Information and Regulation of the Comm. on Governmental Affairs*, 102d Cong. 1 (1991) (statement of Senator Herb Kohl) [hereinafter *Proposals to Regulate GSEs*]. Commentators have also espoused the notion that GSEs’ are “too big to fail.” See Carrie Stradley Lavargna, *Government-Sponsored Enterprises are “Too Big To Fail”*: *Balancing Public and Private Interests*, 44 HASTINGS L. J., 992, 992 (1993). Under this view, the federal government voluntarily keeps troubled institutions operating

further substantiate this assertion, Senator Kohl noted that in 1987, the Government provided billions of dollars to bail out the Farm Credit System, even though this system was not subject to an explicit government guarantee.¹⁴⁰ Certainly, this evidence of past history strengthens the claim that the government would step in if a GSE collapsed.¹⁴¹ In fact, some evidence shows that the government has already interceded to help the housing GSEs.¹⁴² For example, between 1979 and 1984, rising interest rates left Fannie Mae insolvent.¹⁴³ In response, the federal government granted Fannie Mae tax relief until falling interest rates rescued the company.¹⁴⁴ This example is particularly compelling because it is direct evidence of the government's willingness to bail out Fannie Mae.

In response to this reasoning, the GSEs make one final rebuttal: if the disaster was grave enough, the government would intervene to bail out any major financial institution, even those that do not have a guarantee from the federal government.¹⁴⁵ This argument suggests that bailing out the GSEs would not differ from federal intervention when other events have threatened the stability of financial markets.¹⁴⁶ As recently as 1998, the federal government intervened to assist Long Term Capital Management (LTCM), a hedge fund that caused a worldwide crisis when it

because their failure would have a worse effect on the economy than would the cost of rescuing them. See Cheryl D. Block, *Overt and Covert Bailouts: Developing a Public Bailout Policy*, 67 IND. L. J. 951, 968-72 (1992).

140. *Proposals to Regulate GSE's*, *supra* note 139. Vern McKinley also mentions the Farm Credit System debacle to illustrate his contention that the GSEs are "financial time bombs." McKinley, *Mounting Case*, *supra* note 30. He explains that in the 1980's, the federal government paid billions of dollars to bail out the Farm Credit System. *Id.* McKinley concludes, "Clearly, the possibility of the failure of a GSE is more than a theoretical notion." *Id.*

141. *Proposals to Regulate GSE's* (statement of Senator Herb Kohl), *supra* note 139.

142. Kosterlitz, *supra* note 88, at 15.

143. *Id.*

144. *Id.*

145. MILLER & PEARCE, RESPONSE TO CBO'S DRAFT REPORT, *supra* note 132. Miller and Pearce contend, "[m]arket participants might believe it likely the federal government would step in should there be a catastrophic failure, but the same argument would apply to other financial institutions. Indeed, the argument might apply to Freddie Mac and Fannie Mae even if the charter were removed." *Id.*

146. *Id.*

became insolvent.¹⁴⁷ If the Federal government intervened to save LTCM, why would it refuse to bail out Fannie Mae and Freddie Mac? Perhaps the notion of an implied guarantee is less significant in determining when the government will bail out an institution. More importantly, if the government is willing to bail out all financial institutions, then the fear of a taxpayer bailout is not as strong of an argument for opponents.

2. New Activities

Evidence that GSEs are engaging in riskier endeavors supports those who fear a taxpayer bailout.¹⁴⁸ One commentator suggests that the GSEs are engaging in a “moral hazard,” or a situation in which one takes on more risks because one is not fully responsible for them.¹⁴⁹ Some evidence supports this contention.¹⁵⁰ For instance, Fannie Mae and Freddie Mac have entered into subprime and home-equity loans.¹⁵¹ Additionally, it is alleged that the GSEs have begun assuming both the credit and interest rate risk by holding more of their mortgage-backed securities in portfolio and engaging in non-mortgage investments like Freddie Mac’s purchase of tobacco bonds.¹⁵² Critics contend that if these investments fail, taxpayers are likely to bear the cost.¹⁵³

147. Winig, *supra* note 1.

148. SMITH, JR., *supra* note 59.

149. *Id.* Mr. Smith notes that other institutions have engaged in moral hazards. *Id.* For instance, the IMF and the World Bank have shown a willingness to lend to developing countries. *Id.*

150. Winig, *supra* note 1.

151. *Id.* It is important to note why these endeavors are more risky. FM WATCH, THE VITAL ROLE OF FM WATCH, *supra* note 50, at 5. According to critics, the GSEs have little capital or loss reserves. *Id.* Thus, if these investments fail, taxpayers are likely to bear the cost. *Id.* For more information on GSEs’ engagement in risky endeavors, see McKinley, *Mounting Case*, *supra* note 30 and McKinley, *Privatize Fannie Mae and Freddie Mac*, *supra* note 50.

152. FM WATCH, THE VITAL ROLE OF FM WATCH, *supra* note 50, at 5. In 1998, Freddie Mac’s congressional overseers criticized the company’s decision to add \$340 million in tobacco company bonds in its investment portfolio. Bergquist, *supra* note 112. Republican Congressman, Jim Leach commented, “[s]houldn’t there be a specific obligation to maintain a culture that’s above reproach?” Bergquist, *supra* note 112.

153. Sichelman, *supra* note 60. A recent study by the American Enterprise Institute bolsters this claim. *Id.* The report suggests that Fannie Mae and Freddie Mac are “a disaster waiting to happen.” *Id.* They suggest that if Congress does not intervene, taxpayers will have to pay the companies’ \$1.8 trillion debt. *Id.*

Both Fannie Mae and Freddie Mac dismiss this rhetoric as alarmist and inaccurate.¹⁵⁴ They contend that engaging in risky endeavors is necessary to maintain a strong housing system in the United States.¹⁵⁵ Perhaps, some risky endeavors are necessary to promote liquidity in the secondary mortgage market.¹⁵⁶ If so, the GSEs may be justified in taking on some risk.¹⁵⁷ In response to the fear of a taxpayer bailout, the GSEs also cite experts who attest to the company's ability to manage risk.¹⁵⁸ For example, Fannie Mae's regulator, the Office of Federal Housing Enterprise Oversight (OFHEO),¹⁵⁹ explained in its 1999 report to Congress, "[t]he 1998 examinations found both enterprises to be financially sound and well managed. . . . The results of the 1998 examination show that in all categories, Fannie Mae exceeds safety and soundness standards."¹⁶⁰ Undoubtedly, this endorsement from OFHEO undercuts opponents' grim predictions.¹⁶¹ It is reasonable to infer that if GSEs presented a grave danger, then their regulator would be the first to warn members of Congress and the public.¹⁶² Finally, Fannie Mae's Chief Financial Officer, J. Timothy Howard, maintained the firm "could endure the worst economic shocks in history—shocks that few other institutions

154. Winig, *supra* note 1.

155. *Id.*

156. See FANNIE MAE, FACTS ABOUT FANNIE MAE, *supra* note 2, at 15. In spite of these potentially necessary risks, the GSEs maintain that they are "regulated, transparent companies with a narrow charter and a simple and safe product line." *Id.*

157. *Id.* at 24. Fannie Mae is quick to point out that taking risks has led to positive results. *Id.* The company argues that the current system has produced the most sophisticated housing finance system in the world. *Id.*

158. *Id.* at 14. For a listing of these experts, see FANNIE MAE, FACTS ABOUT FANNIE MAE, *supra* note 2, at 14.

159. See U.S. DEP'T OF HOUSING & URBAN DEVELOPMENT, *supra* note 38. OFHEO is an independent regulatory office within HUD that monitors the financial safety and soundness of GSEs. *Id.*

160. FANNIE MAE, FACTS ABOUT FANNIE MAE, *supra* note 2, at 14.

161. *Id.* Receiving approval from OFHEO is also important because OFHEO has a broad range of authority including the power to conduct examinations, issue subpoenas, report to Congress, and limit GSE executive pay levels. See U.S. DEP'T OF HOUSING & URBAN DEVELOPMENT, *supra* note 38.

162. FANNIE MAE, FACTS ABOUT FANNIE MAE, *supra* note 2, at 14. Recently, Congress passed a five million dollar budget increase for the OFHEO. See *Congress Increases Agency Funding to Check Government Sponsored Enterprises*, BANKING REPORT, Nov. 11, 2001, at 803. Perhaps, this additional funding will be helpful in regulating the activities of the GSEs. *Id.*

could survive—with significant capital left over.”¹⁶³ This statement reveals the company’s self-confidence in its ability to handle risk.

The concern about a taxpayer bailout is a serious allegation.¹⁶⁴ While the idea of an implicit guarantee is vigorously debated, it may not be so significant.¹⁶⁵ If the GSEs pose a major threat to world markets, the federal government is likely to intervene, regardless of any explicit or implicit guarantee.¹⁶⁶ What is more important is whether the GSEs’ expansion into new activities poses a serious economic risk.¹⁶⁷ Unfortunately, the plausibility of the taxpayer bailout theory depends largely upon whose rhetoric you believe. Therefore, it is very difficult to determine how serious the threat of a taxpayer bailout really is.

IV. REFORM PROPOSALS

In light of the criticisms launched against GSEs, some opponents have called for reform.¹⁶⁸ Although there are a number of proposals being considered, this section emphasizes three possibilities: privatizing the institutions, doing nothing, and creating competitors for Fannie Mae and Freddie Mac.

A. *Privatization*

Under a privatization scheme, the government would sever the GSEs’ links to the Treasury and allow them to operate as private enterprises.¹⁶⁹ One plan suggests splitting Fannie Mae and Freddie Mac into several smaller privately held companies.¹⁷⁰ Proponents contend that this plan would provide liquidity in the housing market without the dangers of having a huge amount of

163. Winig, *supra* note 1.

164. *Id.*

165. MILLER & PEARCE, RESPONSE TO CBO’S DRAFT REPORT, *supra* note 132.

166. *Id.*

167. SMITH, JR., *supra* note 59.

168. See *supra* notes 68-71 and accompanying text.

169. Winig, *supra* note 1.

170. *Id.* Some critics have noted that this plan resembles the recent proposal to break Microsoft into smaller pieces. *Id.* The plan is also analogous to the 1980’s breakup of AT&T. *Id.*

mortgages in one place.¹⁷¹ However, like any public policy, it is difficult to account for unforeseen consequences. For example, could four smaller companies really deliver the same benefits to mortgage borrowers? Expressing her reservations about privatization, Representative Maloney noted, “[a] privatized world would be a far different, more segmented housing finance system than the reliable and consistent one we have today.”¹⁷² Maloney’s statement implies that the “solution” of privatization may be more dangerous than the “problem” it seeks to resolve.¹⁷³

The biggest challenge to the privatization plan is that it may be politically infeasible.¹⁷⁴ However, one analyst insists, “[w]ere Fannie and Freddie broken into four or so private firms nationwide, each assigned a diversified share of the holdings of the current monopolies, privatization would be much less traumatic and far less risky politically.”¹⁷⁵ In spite of this optimism, Fannie Mae and Freddie Mac appear unwilling to stay out of the privatization fight.¹⁷⁶ The GSEs urge Congress to support their position on the issue: do nothing.¹⁷⁷

171. *Id.* Proponents also suggest that privatization would remove the burden of having an implied guarantee from the government. *Id.* However, governmental bailouts are possible with or without an implied guarantee. *Id.* Indeed, if the four companies’ failure threatened the U.S. economy, it is likely that the federal government would intervene. *Id.* In short, removing the implied guarantee does not remove the potential for risk. *Id.*

172. See Maloney, *supra*, note 5.

173. *Id.*

174. Kosterlitz, *supra* note 88. Fannie Mae and Freddie Mac have been successful in their efforts to shoot down reform legislation. *Id.* The companies have done so by forging friendships with powerful members of Congress and attacking those who undermine their interests. *Id.* For these reasons, Julie Kosterlitz concludes that it is difficult to envision Congress taking action on any legislative proposal. *Id.*

175. SMITH, JR., *supra* note 59.

176. Kosterlitz, *supra* note 88. The GSEs yield a tremendous amount of influence over members of Congress. *Id.* A Lehman Brothers analyst, Kim N. Wallace explains, “Fannie Mae and Freddie Mac at a moment’s notice can inform all 535 elected members of Congress just how many houses in their districts and states save how much money every month by having [government-sponsored enterprises] in the secondary market.” *Id.*

177. Winig, *supra* note 1.

B. *Do Nothing*

Fannie Mae and Freddie Mac urge Congress to refrain from making changes that could adversely affect the thriving housing finance system in the United States.¹⁷⁸ The CEO of Fannie Mae, Franklin D. Raines opines, “[w]e don’t think that you ought to start pulling threads from this tapestry that makes up the U.S. housing finance system unless you have a really good reason.”¹⁷⁹ Raines’s statement is a reminder that the GSEs play an integral role in the U.S. housing industry.¹⁸⁰ Moreover, the statement suggests that changing the structure of GSEs could have far-reaching effects.¹⁸¹ New legislation will not only affect employees and stockholders of Fannie Mae and Freddie Mac; it will also influence the entire mortgage industry and potentially every homebuyer in the United States. The creation of the GSEs transformed an unstable housing industry into one that is revered around the globe.¹⁸² In their efforts to deal with the shortcomings of GSEs, Congress should exercise restraint. Any abrupt changes could shake the foundation of the U.S. housing industry.

C. *Create Competitors for Fannie and Freddie*

Recognizing the problems associated with GSEs, some leaders have suggested forming competitors to Fannie Mae and Freddie Mac.¹⁸³ For instance, the Bush administration has spoken privately about licensing new rivals that would put competitive pressure on Fannie Mae and Freddie Mac.¹⁸⁴ Similarly, at a

178. *Id.*

179. Winig, *supra* note 1.

180. *Id.*

181. *Id.*

182. In 1999, the United States had its highest homeownership rate in history. FANNIE MAE, FACTS ABOUT FANNIE MAE, *supra* note 2, at 1.

183. *Big Scary Monsters*, *supra* note 113, at 59-60.

184. *Id.* The Bush administration has already taken a tougher stance toward GSEs. *Id.* On July 17, 2001, the administration backed new rules related to risk-based capital adequacy. *Id.* These rules will become effective one year from that date. *Id.* However, there is a strong possibility that the administration will not do anything else. Nicholas Kulish, *Prospect of Rivals to Fannie, Freddie Is Raised by Baker*, WALL ST. J., July 12, 2001, at A6. Glenn Hubbard, the Chairman of the White House Council on Economic Advisors, suggested that President Bush may prefer to spend political capital on other issues. *Id.*

hearing on July 11, 2001, Representative Richard Baker¹⁸⁵ mentioned the possibility of licensing new home-loan agencies to compete with Fannie Mae and Freddie Mac.¹⁸⁶ This measure may assuage the complaint that the GSEs exercise duopoly power.¹⁸⁷ With more players in the game, Fannie Mae and Freddie Mac would have a harder time dominating the mortgage industry.¹⁸⁸ On the other hand, the proposal would do little for those institutions who currently compete with GSEs. In fact, licensing more GSEs may be harmful to groups that lack the advantages of being government sponsored. Supporters of this plan also contend that it would infuse enough competition to "force Fannie and Freddie to pass more of their subsidy on to consumers."¹⁸⁹ Certainly, this would be a positive step in forcing GSEs to serve their public purpose of serving mortgage borrowers. On the other hand, this is a speculative prediction at best. There is no way to know what effects competitors might have on the industry.¹⁹⁰

V. CONCLUSION

Government-sponsored enterprises were set up to carry out a badly needed service.¹⁹¹ By most accounts, the GSEs have been successful.¹⁹² More Americans are homeowners, and the mortgage

185. *Big Scary Monsters*, *supra* note 113, at 59-60. Congressman Baker is the Chairman of the House Banking Committee. *Id.* Before this hearing, he had been advocating the creation of a tough new regulator for Fannie Mae and Freddie Mac. *Id.* However, he appears to be considering the Bush proposal. *Id.*

186. *Big Scary Monsters*, *supra* note 113, at 59-60. Recently, Rep. Marge Roukema (R-N.J.) and Sen. Wayne Allard (R-Colo.) offered legislation that would place the Government National Mortgage Association (Ginnie Mae) in direct competition with Fannie Mae and Freddie Mac. Tommy Fernandez, *Move to Let Ginnie Rival Big Cousins*, AM. BANKER, Nov. 5, 2001, at 1. A part of the Department of Housing and Urban Development, Ginnie Mae, "provides credit guarantees for securities backed by mortgages issued by other governmental agencies." *Id.* This legislation is significant because it would give Ginnie Mae access to a large portion of the secondary mortgage industry. *Id.* Officials from Fannie Mae and Freddie Mac rapidly responded by questioning "the need for the legislation." *Id.*

187. *See supra* notes 110-25 and accompanying text.

188. *Id.*

189. *Big Scary Monsters*, *supra* note 113, at 59-60.

190. Fernandez, *supra* note 186, at 1. Indeed, Fannie Mae and Freddie Mac have argued that the presence of a competitor, such as Ginnie Mae, would "not enhance the mortgage market and would create a huge risk for taxpayers." *Id.*

191. *See supra* notes 17-45 and accompanying text.

192. *See supra* notes 2-5 and accompanying text.

system is stable as a result of Fannie Mae and Freddie Mac.¹⁹³ However, the GSEs have not been a perfect solution.¹⁹⁴ First, some subsidy dollars appear to be ending up in the hands of stockholders rather than mortgage borrowers.¹⁹⁵ Similarly, Fannie Mae and Freddie Mac practically dominate the market.¹⁹⁶ Finally, there are critics who fear a taxpayer bailout.¹⁹⁷ Unfortunately, there are no easy solutions to these problems.¹⁹⁸ Any changes to the current system will have dramatic effects on mortgage borrowers, stockholders, taxpayers, and participants within the mortgage industry.¹⁹⁹ Therefore, decision makers should use prudence before making changes to the structure and operation of GSEs.²⁰⁰

BRADLEY K. KREHELY

193. *Id.* Homeownership brings about a number of social and economic benefits including the creation of wealth for individual homeowners and stability within communities. Barta & Zuckerman, *supra* note 2, at A1. Some studies have also shown that homeowners are more likely to vote and to get involved in parent-teacher associations. Barta & Zuckerman, *supra* note 2, at A1.

194. *See supra* notes 68-71 and accompanying text (listing the criticisms of GSEs).

195. *See supra* notes 72-109 and accompanying text.

196. *See supra* notes 110-25 and accompanying text.

197. *See supra* notes 126-67 and accompanying text.

198. *See supra* notes 168-90 and accompanying text.

199. *See supra* note 186 and accompanying text.

200. *See supra* note 179 and accompanying text.