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Shifting Losses: The Impact of Fannie's and Freddie's Conservatorships on Commercial Banks Articles, Essays, and Transcripts

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SHIFTING LOSSES: THE IMPACT OF FANNIE'S AND FREDDIE'S CONSERVATORSHIPS ON COMMERCIAL BANKS

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In fall 2008, the Federal Housing Finance Agency (FHFA) placed mortgage giants Fannie Mae and Freddie Mac in conservatorship. As conservator, the FHFA has control over the operations of both companies, but it faces conflicting mandates. On the one hand, the FHFA is tasked with stabilizing the secondary mortgage market and providing access to mortgage credit. Achieving this task encourages Fannie and Freddie to absorb some mortgage-related losses. On the other hand, the FHFA is tasked with returning Fannie and Freddie to financial health. For Fannie and Freddie to return to financial health, they must minimize their losses, perhaps by passing those losses along to commercial banks.

This Article examines how the FHFA as conservator resolves its conflicting mandates. The Article examines the FHFA's key loss-shifting decisions and the impact of those decisions on commercial banks. In particular, it inspects: (1) the FHFA's decision to allow Fannie and Freddie to continue their activity in the secondary mortgage market; (2) the FHFA's decision to allow the Department of the Treasury to recapitalize Fannie and Freddie in a way that resulted in large losses for holders of Fannie and Freddie stock; and (3) the FHFA's decision to enforce Fannie's and Freddie's rights against sellers of mortgages and private-label mortgage-backed securities.

The Article concludes that as a result of its conflicting mandates, the FHFA has allowed Fannie and Freddie to absorb losses—particularly when those losses would otherwise have been transferred to the large, systemically important banks. In other instances, the FHFA has shifted Fannie and Freddie losses to small community banks. Such loss transfer practices have the potential to cause undue consolidation in the banking industry and exacerbate the problem of financial institutions that are too big to fail.

While such loss transfer practices may be consistent with the FHFA's conflicting mandates, they are troubling because the FHFA's decisions are often made behind closed doors with little opportunity for the public to determine whether the FHFA is striking the right balance between its market stabilization and loss prevention goals. This Article urges the FHFA to adopt disclosure practices that will allow the public to evaluate the Enterprises' loss-shifting policies.

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I. INTRODUCTION

As the United States neared the tipping point of the 2008 home mortgage crisis, Fannie Mae (Fannie) and Freddie Mac (Freddie) (collectively the Enterprises) were on the brink of failure. These secondary-market mortgage giants had come to play a critical role in housing finance. The Enterprises encouraged liquidity in the mortgage market by purchasing mortgages from banks and securitizing them, creating mortgage-backed securities. Investors then bought the mortgage-backed securities with a guarantee from Fannie or Freddie. The Enterprises also bought and held mortgage-backed securities in their own investment portfolios.[1] By fall 2008, the Enterprises owned or guaranteed more than $5 trillion in residential mortgages—more than forty percent of the residential mortgage market.[2] But as housing prices collapsed and homeowners increasingly defaulted on mortgages, losses mounted at the Enterprises. Common stock for both Enterprises

[1] *See* CONG. BUDGET OFFICE, CBO STUDY: FANNIE MAE, FREDDIE MAC, AND THE FEDERAL ROLE IN THE SECONDARY MORTGAGE MARKET 1–2 (Dec. 2010) (describing the Enterprises' business activities).

[2] *Oversight Hearing to Examine Recent Treasury and FHFA Actions Regarding the Housing GSEs: Hearing Before the H. Comm. on Fin. Servs.*, 100th Cong. 11 (2008) [hereinafter *Oversight Hearing*] (testimony of James B. Lockhart, III, Dir., Fed. Hous. Fin. Agency).

traded at under five dollars a share,[3] and both Enterprises had trouble raising additional capital.[4]

Concerned that either Enterprise's failure could cripple the entire economy, the Federal Housing Finance Agency placed Fannie and Freddie in conservatorship.[5] In addition, the United States Department of the Treasury (Treasury) agreed to provide capital as necessary to keep the Enterprises afloat.[6]

The conservatorships transformed the role of government in the Enterprises' operations. Before the conservatorships, the Enterprises were government-sponsored enterprises—private companies with government charters and tax benefits.[7] The FHFA acted as their regulator.[8] In conservatorship, the FHFA acquired the expanded powers of "conservator." As conservator, the FHFA has control of the Enterprises' boards of directors and authority to operate the Enterprises until they are financially healthy.[9]

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[3] Ben Levisohn, *The Final Fate of Fannie and Freddie*, BLOOMBERG BUSINESSWEEK ONLINE (Aug. 22, 2008, 12;01 AM EST), http://www.businessweek.com/investor/content/aug2008/pi20080821_660796.htm.

[4] *See* James R. Hagerty & Aparajita Saha-Bubna, *Fannie Mae, Freddie Mac Are Pounded: Two Stocks Plunge on Growing Fears of a U.S. Bailout*, WALL ST. J., Aug. 19, 2008, at A3.

[5] Press Release, James B. Lockhart, Dir., Fed. Hous. Fin. Agency, Statement Announcing the Conservatorship of Fannie Mae and Freddie Mac 5 (Sept. 7, 2008), *available at* http://www.fhfa.gov/webfiles/23/FHFAStatement9708final.pdf [hereinafter Lockhart Statement].

[6] Press Release, Henry M. Paulson, Jr., Sec'y, Dep't of the Treasury, Statement on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers (Sept. 7, 2008), *available at* http://www.treasury.gov/press-center/press-releases/Pages/hp1129.aspx [hereinafter Paulson Statement]. Initially Treasury agreed to provide up to $100 billion in capital for each company. *See* Fannie Mae Amended and Restated Senior Preferred Stock Purchase Agreement ¶ 2.1 (Sept. 26, 2008), *available at* http://www.fhfa.gov/webfiles/1031/FNMSrPrefStockPA92608.pdf [hereinafter Fannie Mae Senior Preferred Stock Agreement]; Freddie Mac Amended and Restated Senior Preferred Stock Purchase Agreement ¶ 2.1 (Sept. 26, 2008), *available at* http://www.fhfa.gov/webfiles/1033/FRESrPrefStockPA92608.pdf [hereinafter Freddie Mac Senior Preferred Stock Agreement]. Later, the $100 billion cap was eliminated. *See* Press Release, Treasury Dep't, Treasury Issues Update on Status of Support for Housing Programs (Dec. 24, 2009), *available at* http://www.treasury.gov/press-center/press-releases/Pages/200912241534592453.aspx.

[7] "Broadly defined, a [government-sponsored enterprise] is a corporation chartered by the federal government to achieve public purposes that has nongovernmental status, is excluded from the federal budget, and is exempt from most, if not all, laws and regulations applicable to federal agencies, officers, and employees." CONG. BUDGET OFFICE, CONTROLLING THE RISKS OF GOVERNMENT-SPONSORED ENTERPRISES 2 (1991); *see also* 2 U.S.C. § 622(8) (2006) (defining "government-sponsored enterprise" for federal budgetary purposes).

[8] *See* Housing and Economic Recovery Act of 2008, Pub. L. No. 110–289, § 1101, 122 Stat. 2654, 2661 (codified at 12 U.S.C. § 4511) (creating the Federal Housing Finance Agency as a new regulator for Fannie and Freddie).

[9] *See* Lockhart Statement, *supra* note 5, at 5–6; Press Release, Fed. Hous. Fin. Agency, Questions and Answers on Conservatorship 2 (Sept. 7, 2008), *available at* http://www.fhfa.gov/GetFile.aspx?FileID=35 [hereinafter Q&A on Conservatorship].

As the Enterprises' conservator, the FHFA must perform a delicate balancing act.[10] On the one hand, the government has sometimes used the Enterprises as tools to aid recovery of the housing market and stabilize the economy.[11] This sometimes requires the Enterprises to absorb losses, effectively passing those losses on to the government, and eventually the American taxpayer. On the other hand, the FHFA, as conservator, has a duty to return the Enterprises to financial health—a task which likely includes limiting the Enterprises' losses.[12] In order to reduce losses, the FHFA can sometimes shift losses to other mortgage-market participants.

One potential target for absorbing the Enterprises' losses is commercial banks. When the government first announced the conservatorship, Treasury recognized that the Enterprises' conservatorships could impact banks. However, it concluded that because banks sell mortgages to the Enterprises, banks would benefit from the conservatorships. As then-Treasury Secretary Henry Paulson explained, "By stabilizing [the Enterprises] so they can better perform their mission, [the conservatorships] should accelerate stabilization in the housing market, ultimately benefiting financial institutions."[13]

Treasury's "rising tide lifts all boats"[14] explanation of the conservatorships is not complete. It conceives of banks as merely conduits of mortgages sold to the Enterprises, with the Enterprises bearing the ultimate risk associated with the mortgages. However, the connection and allocation of risk between banks and the Enterprises is more complex. In some instances, banks bear some risk. For example, banks repurchased risk from the Enterprises by investing in the Enterprises' debt and equity securities.[15] In addition, when the Enterprises purchase mortgages or private-label mortgage-backed securities, they acquired rights that may be enforced against the sell-

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10 *See* Lockhart Statement, *supra* note 5, at 5 (stating that the purpose of the conservatorships was to "restore the balance between safety and soundness and mission"); *see also* Bob Davis, Deborah Solomon, & John Hilsenrath, *After the Bailouts, Washington's the Boss*, WALL ST. J., Dec. 28, 2009, at A1 (noting that "the government is torn between its roles as shareholder and guardian of the public interest").

11 *See* Lockhart Statement, *supra* note 5, at 1 (describing the Enterprises' "critical mission of providing stability and liquidity to the housing market").

12 *See* FED. HOUS. FIN. AGENCY, REPORT TO CONGRESS 2010, at i (June 13, 2011), *available at* http://www.fhfa.gov/webfiles/21572/FHFA2010_RepToCongress6_13_11.pdf [hereinafter FHFA 2010 Report to Congress] (stating that the FHFA's "obligation as conservator . . . requires it to minimize credit losses to the enterprises, which minimizes losses to the government").

13 Paulson Statement, *supra* note 6.

14 This phrase, popularized by President John F. Kennedy, is often used to describe the idea that helping one sector of the economy will benefit others. *See* TED SORENSEN, COUNSELOR: A LIFE AT THE EDGE OF HISTORY 140 (2008).

15 *See* Michael Padhi, *Fannie Mae and Freddie Mac at Work in the Secondary Mortgage Market*, FIN. UPDATE (Fed. Reserve Bank Atlanta), Mar. 31, 2001, at 2 ("Commercial banks interact extensively with Fannie Mae and Freddie Mac as mortgage sellers, mortgage servicers, and investors in Fannie Mae and Freddie Mac debt securities and, to a very limited degree, equity securities.").

er, often a commercial bank.[16] Thus, the FHFA can, in some instances, shift losses from Fannie and Freddie to banks.

This Article first describes the Enterprises and the FHFA's authority as conservator, including its conflicting mandates to stabilize the mortgage industry while returning the Enterprises to financial health.[17] The Article then examines three of the FHFA's key decisions in allocating losses between the Enterprises and commercial banks. First, it inspects FHFA's decision to enable Fannie and Freddie to continue their secondary mortgage market activities.[18] Second, it examines FHFA's decision to allow Treasury to recapitalize the Enterprises in a way that resulted in large losses for Enterprise stockholders.[19] Third, it studies the FHFA's efforts to enforce the Enterprises' rights against sellers of mortgages and private-label mortgage-backed securities.[20]

These decisions show that in some instances the government allowed the Enterprises to absorb losses even when the losses could be transferred to large banks. Presumably this is part of the government's larger efforts to stabilize systemically important banks. On the other hand, the government allowed the Enterprises to transfer some losses to small banks, even when the losses ultimately resulted in bank failures. The FHFA has likely allowed risk shifting to small banks in part because it determined that even if some small banks fail, the economic impact will not be widespread. Such loss shifting practices have the potential to cause undue consolidation in the banking industry and exacerbate the problem of financial institutions that are too big to fail.

This Article asserts that the FHFA's loss shifting practices are particularly troubling because the FHFA's decision-making process occurs behind closed doors. There is little opportunity for outside comment before the FHFA acts. Even once the FHFA makes loss-shifting decisions, the Enterprises rarely release enough information for outside observers to accurately assess any windfall transferred to large commercial banks. Government policymakers should realize their economic and housing goals through means that are more transparent than the FHFA's decision-making process. In particular, this Article urges the FHFA to adopt disclosure practices that will allow the public to evaluate the Enterprises' settlements of mortgage repurchase and private-label mortgage-backed securities claims.

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16 *See* FANNIE MAE, SELLING GUIDE: FANNIE MAE SINGLE FAMILY § A2-2 (Jan. 27, 2011), *available at* https://www.efanniemae.com/sf/guides/ssg/sg/pdf/sel012711.pdf [hereinafter FANNIE MAE SELLING GUIDE] (describing representations and warranties made by mortgage sellers to Fannie); FREDDIE MAC, SINGLE-FAMILY SELLER/SERVICER GUIDE § 6.11 (2011), *available at* http://www.freddiemac.com/sell/guide/ (follow AllRegs hyperlink) [hereinafter FREDDIE MAC SELLER GUIDE] (describing representations and warranties made by mortgage sellers to Freddie).

17 *See infra* Part I.

18 *See infra* Part II.A.

19 *See infra* Part II.B.

20 *See infra* Part II.C.

II. CONSERVATORSHIP AND CONFLICTING MANDATES

Prior to the conservatorships, Fannie and Freddie were both privately-owned companies that operated with public mandates to achieve affordable housing goals.[21] Others have long noted that the Enterprises' hybrid status created conflicting priorities.[22] On the one hand, the Enterprises (like most privately-owned companies) wanted to maximize shareholder value. On the other hand, the Enterprises' government-developed affordable housing goals focused on expanding the availability of home mortgages. As conservator, the FHFA has largely inherited these conflicting priorities. This Part first provides a brief historical description of Fannie and Freddie, including the events leading to the conservatorships. It then examines the FHFA's responsibilities and powers as conservator.

A. The Enterprises' Conflicting Mandates

Although the federal government originally created and capitalized the Enterprises, private capital later emerged to fund the Enterprises.[23] What resulted were privately-owned Enterprises with duties to both their shareholders and to the public as a whole.

Fannie began life as a government-owned company designed to increase mortgage lending during the Great Depression.[24] At its inception, Fannie's business model was simple: it took money from public coffers and purchased mortgages insured by the Federal Housing Administration.[25] However, over the years, Congress authorized Fannie to purchase an increasing variety of mortgages and eventually allowed Fannie to become a securitization engine for a huge portion of the mortgage market.[26] Often Congress's

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21 *See infra* Part I.A.

22 *See infra* notes 51–52 and accompanying text.

23 For more complete histories of Fannie and Freddie see: FED. NAT'L MORTG. ASS'N, BACKGROUND AND HISTORY (1973); Richard W. Bartke, *Fannie Mae and the Secondary Mortgage Market*, 66 NW. U. L. REV. 1, 16–65 (1971) (explaining the historical perspective of the Federal National Mortgage Association from its inception through the 1968 Act); Julie Andersen Hill, *Bailouts and Credit Cycles: Fannie, Freddie, and the Farm Credit System*, 2010 WISC. L. REV. 1, 17–23, 27–34, 49–60.

24 President Franklin D. Roosevelt authorized the government to charter a mortgage association known as the National Mortgage Association of Washington in 1938. *See* FED. NAT'L MORTG. ASS'N, *supra* note 23, at 3. Shortly thereafter the Enterprise was renamed the Federal National Mortgage Association. *Id.* at 2 n.10. Today it is known as Fannie Mae. *See* Karen Larsen, *Miss Grammar: The Name Game*, 57 OR. ST. B. BULL. 33, 33 (1997).

25 *See* National Housing Act, Pub. L. No. 73–479, § 301, 48 Stat. 1246, 1253 (1934) (authorizing national mortgage associations to purchase Federal-Housing-Administration-guaranteed mortgages); FED. NAT'L MORTG. ASS'N, *supra* note 23, at 3; SAUL B. KLAMAN, THE POSTWAR RESIDENTIAL MORTGAGE MARKET 218 (1961).

26 Over the years, Congress repeatedly increased the types of mortgages Fannie could purchase. *See, e.g.*, Act of July 1, 1948, Pub. L. No. 80–864, 62 Stat. 1206, 1207 (authorizing Fannie to purchase mortgages insured by the Veterans Administration); Emergency Home Finance Act of 1970, Pub. L. No. 91–351, § 201, 84 Stat. 450, 450 (authorizing Fannie

decision to increase Fannie's scope of business was tied to specific public policy goals. For example, following World War II, Congress authorized Fannie to purchase loans guaranteed by the Veterans Administration in order to ensure that there was adequate capital to fund mortgages for World War II veterans.[27]

However, as Fannie grew, it became an increasingly large cost for the federal government.[28] The problem came to a head in the late 1960s when a new unified budget would have required Fannie's operations to be included in the federal government's budget.[29] Instead of reporting a much larger federal budget, President Lyndon B. Johnson urged Congress to privatize Fannie.[30] Fannie became a private company in 1968.[31]

Freddie's story is linked to Fannie's. Congress chartered Freddie Mac in 1970[32] as a supplement to Fannie.[33] At that time, high interest rates and inflation threatened the affordability of home mortgages.[34] Congress hoped a larger secondary mortgage market would alleviate these concerns. Although Freddie was originally owned by the Federal Home Loan Banks,[35]

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to purchase non-government guaranteed loans). In 1968, Congress authorized Fannie to begin securitizing mortgages. *See* Housing and Urban Development Act of 1968, Pub. L. No. 90–448, § 804, 82 Stat. 476, 542. Securitization is the process of bundling assets together and then selling securities backed by those assets. *See* BLACK'S LAW DICTIONARY 1384 (8th ed. 2004).

27 *See* H.R. Rep. No. 80-2389, at 1 (1948), *reprinted in* 1948 U.S.C.C.A.N. 2351, 2351.

28 *See* CHARLES M. HAAR, FEDERAL CREDIT AND PRIVATE HOUSING: THE MASS FINANCING DILEMMA 93 (1960).

29 Bartke, *supra* note 23, at 31; FED. NAT'L MORTG. ASS'N, *supra* note 23, at 5.

30 *See* LYNDON B. JOHNSON, A MESSAGE ON HOUSES AND CITIES, H.R. DOC. NO. 90-261 (2d Sess. 1968); Edwin L. Dale, Jr., *U.S. Aides Concede Budget 'Gimmicks,'* N.Y. TIMES, Sept. 12, 1968, at 1.

31 *See* Housing and Urban Development Act of 1968, Pub. L. No. 09–448, 82 Stat. 476 (authorizing the sale of Fannie Mae debentures that could be converted to common stock); John H. Allan, *Credit Markets: Fanny May Sells $250-Million Bond Offering*, N.Y. TIMES, Sept 20, 1968, at 72 (explaining that private investors purchased $250 million of Fannie's debentures).

32 Emergency Home Finance Act of 1970, Pub. L. No. 91–351, §§ 301–310, 84 Stat. 450, 451–58. Freddie Mac is officially known as the Federal Home Loan Mortgage Corporation.

33 *See* S. REP. NO. 91-761, at 7 (1970), *reprinted in* 1970 U.S.C.C.A.N. 3488, 3495.

34 *See* Peter M. Carozzo, *Marketing the American Mortgage: The Emergency Home Finance Act of 1970, Standardization and the Secondary Market Revolution*, 39 REAL PROP. PROB. & TR. J. 765, 769 (2005).

35 *See* Emergency Home Finance Act of 1970 § 304(a), 84 Stat. at 454 (explaining that the Federal Home Loan Banks owned Freddie); Federal Home Loan Bank Act, Pub. L. No. 72–304, §§ 2(4), 4(a), 6(c), 42 Stat. 725, 725, 726–27 (1932) (explaining that the Federal Home Loan Banks were owned by commercial banks and thrifts who borrowed from the Federal Home Loan Banks).

Freddie went fully public in 1989.[36] Like Fannie, Freddie became an important player in the mortgage securitization market.[37]

As privately-owned companies, both Fannie and Freddie had duties to their shareholders. Corporate law dictates that directors and officers owe a duty of care and a duty of loyalty to shareholders.[38] More broadly, shareholders generally expect that corporate directors and officers will seek to maximize shareholder wealth.[39] Fannie's and Freddie's management understood that shareholders expected a return on their investments. The Enterprises' executives often provided indications that they were seeking to maximize shareholder value.[40]

Yet even as Fannie and Freddie sought to increase shareholder value, they retained close ties to the federal government. Their federal charters continued to provide statutorily-defined public missions to, among other things, "provide stability in the secondary market for residential mortgages" and "promote access to mortgage credit throughout the Nation."[41] To promote access to mortgages, the government set affordable housing goals that en-

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[36] Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101–73, § 731, 103 Stat. 183, 432.

[37] From its inception, Freddie had authority to securitize home mortgages. *See* Emergency Home Finance Act of 1970 § 306, 84 Stat. at 455.

[38] "A board member's obligation to a corporation and its shareholders has two prongs, generally characterized as the duty of care and the duty of loyalty." Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255, 264 (2nd Cir. 1984). "The duty of care refers to the responsibility of a corporate fiduciary to exercise, in the performance of his tasks, the care that a reasonably prudent person in a similar position would use under similar circumstances." *Id.* The duty of loyalty prohibits self-dealing. *See id.*

[39] *See, e.g.*, Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) ("A business corporation is organized and carried on primarily for the profit of the stockholders."); Kelli A. Alces, *Beyond the Board of Directors*, 46 WAKE FOREST L. REV. 783, 796 (2011) ("Both directors and officers are supposed to be working toward the goal of shareholder wealth maximization."); Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423, 1423 (1993) ("Shareholder wealth maximization long has been the fundamental norm which guides U.S. corporate decisionmakers.").

[40] *See* FREDDIE MAC, CONTINUING PROGRESS: 2005 ANNUAL REPORT 5–6 (2005), *available at* http://www.freddiemac.com/investors/ar/2005/2005annualrpt.pdf. For example, Freddie's 2005 Annual Report had a section entitled "Building Shareholder Value." *Id.* The section detailed plans to increase market share and manage credit and interest rate risk. *Id.* Similarly, Fannie under the direction of Chief Executive Officer Franklin D. Raines, pursued an aggressive goal of doubling its earnings per share. *See* OFFICE OF FED. HOUS. ENTER. OVERSIGHT, REPORT OF THE SPECIAL EXAMINATION OF FANNIE MAE 39–42 (May 2006). Fannie's regulator later noted that "[earnings per share] goals are appropriate and are typical goals for corporations. Improving shareholder value is one of the primary goals for any board of directors, and increasing [earnings per share] is a recognized way to improve shareholder value." *Id.* at 43. Nevertheless, the regulator concluded that Fannie went too far and engaged in inappropriate accounting. *See id.* at 1–10.

[41] *See* 12 U.S.C. §§ 1716(1), (4) (2006) (describing Fannie's public purpose); Emergency Home Finance Act of 1970 § 301, 84 Stat. at 451 (describing Freddie's public purpose).

couraged Fannie and Freddie to purchase mortgages given to low- and moderate-income households.[42]

Linked with their continuing public purpose, Fannie and Freddie enjoyed many government benefits.[43] They did not pay most state and local taxes.[44] Their securities were exempt from Securities and Exchange Commission registration requirements.[45] They were eligible to borrow directly from the Treasury.[46] And, their securities could be purchased by banks[47] and the Federal Reserve.[48] In short, Fannie and Freddie were government-sponsored enterprises.[49] This special status allowed the Enterprises to borrow money at lower interest rates than purely private corporations.[50]

As Fannie and Freddie grew, more and more observers noted the Enterprises' hybrid status created conflicting goals. In 1999 and 2000 the American Enterprise Institute published a compilation of articles entitled Serving Two Masters, Yet Out of Control: Fannie Mae and Freddie Mac.[51] In particular, critics began to argue that the Enterprises' hybrid structure ensured that government benefits provided to Fannie and Freddie resulted in increased value for Enterprise shareholders but few public benefits.[52] Others argued that the Enterprises' affordable housing goals encouraged them to take excessive risk that would eventually result in a government bailout.[53]

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42 Housing and Community Development Act of 1992, Pub. L. No 102–550, § 1332, 106 Stat. 3672, 3956–57; Floyd Norris, *The Dilemma of Fannie & Freddie*, N.Y. TIMES, Sept. 8, 2008, at C1.

43 *See* David Reiss, *The Federal Government's Implied Guarantee of Fannie Mae and Freddie Mac's Obligations: Uncle Sam Will Pick Up the Tab*, 42 GA. L. REV. 1019, 1053–68 (2008) (providing an in-depth examination of the Enterprises' regulatory privileges).

44 *See* 12 U.S.C. §§ 1452(e), 1723a(c).

45 *See id.* §§ 1719(d), 1723(c).

46 *See id.* §§ 1455(c), 1719(c).

47 *See id.* §§ 24 (Seventh), 335(2), 1464(c).

48 *See id.* § 355(2).

49 *See supra* note 7 (defining the term "government-sponsored enterprise").

50 *See, e.g.*, Brent W. Ambrose & Arthur Warga, *Pricing Effects in Fannie Mae Agency Bonds*, 11 J. REAL EST. FIN. & ECON. 235 (1995); Wayne Passmore, *The GSE Implicit Subsidy and the Value of Government Ambiguity*, 33 REAL EST. ECON. 465 (2005).

51 Peter J. Wallison, *Introduction* to SERVING TWO MASTERS, YET OUT OF CONTROL: FANNIE MAE AND FREDDIE MAC 1, 1 (Peter J. Wallison ed. 2001).

52 *See* Richard Scott Carnell, *Federal Deposit Insurance and Federal Sponsorship of Fannie Mae and Freddie Mac: The Structure of Subsidy, in* SERVING TWO MASTERS, YET OUT OF CONTROL: FANNIE MAE AND FREDDIE MAC 56, 68–70 (Peter J. Wallison ed. 2001).

53 *See, e.g.*, Reiss, *supra* note 43, at 1043 (arguing that the Enterprises' government privileges evidence an implied federal guarantee of the Enterprises themselves); Winston Sale, *Effect of Conservatorship of Fannie Mae and Freddie Mac on Affordable Housing*, 18 J. Affordable Hous. & Cmty. Dev. L. 287, 288 (2009) ("The conflict of interest between the [Enterprises'] profit motives and their obligations to meet demanding affordable housing goals set forth by the Department of Housing and Urban Development . . . led to business practices that undermined the [Enterprises'] security and soundness and amplified the damage done by the subprime lending boom.").

Notwithstanding criticism, Fannie and Freddie became major players in the secondary mortgage market. Because of their regulatory privileges, the Enterprises faced little meaningful competition in the "conforming" mortgage securitization market.[54] If a mortgage conformed to Fannie's and Freddie's requirements for securitization,[55] it was likely that the mortgage would be securitized by Fannie or Freddie rather than one of their purely private competitors.[56] In addition, the Enterprises often purchased mortgage-backed securities that other financial institutions securitized.[57] These investments are often referred to as private-label mortgage-backed securities, or private-label securities.[58] By fall 2008, the Enterprises owned or guaranteed more than $5 trillion in residential mortgages.[59]

Because both Fannie and Freddie were heavily invested in the mortgage market, they were especially hard hit when the housing market began collapsing in 2007.[60] In fall 2008, the Enterprises' regulators, the Federal Housing Finance Agency, decided that the Enterprises both lacked adequate

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54 Reiss, *supra* note 43, at 1032–33 (noting that "Fannie Mae and Freddie Mac can price their securities more attractively than private label issuers, and therefore have nearly the entire prime, conforming market to themselves—a market in which they can effectively act as duopolists").

55 Fannie and Freddie face statutory restrictions on the types of mortgages they can purchase. For example, the Enterprises generally cannot purchase mortgages where the amount of the mortgage exceeds eighty percent of the value of the mortgaged property. *See* 12 U.S.C. §§ 1454(a)(2), 1717(b)(2).

56 *See* Brent J. Horton, *In Defense of Private-Label Mortgage-Backed Securities*, 61 FLA. L. REV. 827, 860 (2009) (noting that "private-label issuers may originate conforming mortgages, but they sell them to [Fannie and Freddie] to securitize while keeping and securitizing the more risky non-conforming mortgages"); Marsha Courchane et al., *Industry Changes in the Market for Mortgage Loans*, 41 CONN. L. REV. 1143, 1158 (2009). By 2007, conventional, conforming mortgages made up 86% of the mortgage market, and the Enterprises purchased 40% of all mortgages. *See id.* at 1158.

57 *See* Christopher L. Peterson, *Fannie Mae, Freddie Mac, and the Home Mortgage Foreclosure Crisis*, 10 LOY. J. PUB. INT. L. 149, 162–63 (2009). "From 2004 to 2007, no less than 51 percent of Fannie Mae's mortgage-related securities purchases were private label, totaling over $229 billion in purchases. Freddie Mac's investment purchases were similarly aggressive, with an average 15 percent investment in private label securities from 2001 to 2003 jumping to an average of 48 percent from 2004 to 2007." Sale, *supra* note 53, at 291.

58 *See* W. Scott Frame, *The 2008 Federal Intervention to Stabilize Fannie Mae and Freddie Mac* 13 n.26 (Fed. Res. Bank of Atlanta, Working Paper No. 2009-13, Apr. 2009), *available at* http://www.frbatlanta.org/filelegacydocs/wp0913.pdf ("Private-label mortgage securities are those not guaranteed by Fannie Mae, Freddie Mac, or Ginnie Mae.").

59 *Oversight Hearing*, *supra* note 2, at 11(testimony of James B. Lockhart, III, Dir., Fed. Hous. Fin. Agency).

60 FANNIE MAE, QUARTERLY REPORT (FORM 10-Q) at 3 (Nov. 9, 2007) (reporting a nearly $1.4 billion loss in the third quarter of 2007); FREDDIE MAC, CONSOLIDATED STATEMENTS OF INCOME 1 (Nov. 20, 2007) (reporting an unaudited loss of $2 billion in the third quarter of 2007); *see also* Sale, *supra* note 53, at 297 (noting that the Enterprises' aggressive investments in private-label mortgage-backed securities led to losses); James R. Hagerty, *Fannie, Freddie Feel Default Heat*, WALL ST. J., Nov. 19, 2007, at A14 (reporting that "unprecedented foreclosures and declines in home prices" led to Fannie and Freddie losses).

capital.[61] The Enterprises also faced increased borrowing costs[62] that made it difficult for them to continue securitizing new mortgages. Moreover, losses at the Enterprises were still increasing.[63]

If Fannie and Freddie had been ordinary companies, they would have failed. Instead, as scholars long predicted,[64] the federal government rescued the two companies. On September 7, 2008, the FHFA announced that it had placed Fannie and Freddie into voluntary conservatorships.[65]

B. The Conservator's Conflicting Mandates

As conservator, the FHFA has largely inherited the Enterprises conflicting purposes. Although the Enterprises are in conservatorship, they have maintained the government charters and the public purpose to, among other things, stabilize the housing markets. At the same time, a conservatorship is, by definition, "a statutory process designed to stabilize a troubled institution with the objective of returning the entit[y] to normal business operations."[66] This section describes the FHFA's authority and responsibilities when acting as conservator.

Federal law grants the FHFA broad powers when acting as conservator. Many of these powers are quintessential conservatorship powers—that is, powers that are designed to allow the FHFA to operate the companies[67] and return them to health.[68] In some ways, these powers approximate the powers that the Enterprises exercised independently in order to increase shareholder value prior to the conservatorships. In particular, the FHFA may:

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[61] *See* Jeffrey H. Birnbaum & Neil Irwin, *Despite Lifelines, Concerns Linger on Mortgage Giants*, WASH. POST, July 15, 2008, at D1; Charles Duhigg, *Pressured to Take More Risk, Fannie Reached Tipping Point*, N.Y. TIMES, Oct. 5, 2008, at A1.

[62] *See* David Cho & Jeffrey H. Birnbaum, *Treasury's Vigil on Fannie, Freddie: Paulson Watches Preferred Stock, Debt Sales for Signs of Trouble*, WASH. POST, Aug. 23, 2008, at D1; Paul Muolo & Brian Collins, *New Concerns On GSEs*, NAT'L MORTGAGE NEWS, Aug. 25, 2008, at 1.

[63] *See* Walter Hamilton, *Stocks Plummet on Oil, Credit Worries*, L.A. TIMES, June 21, 2008, at 4 (reporting that Lehman Brothers forecasted increasing losses for Fannie and Freddie).

[64] *See, e.g.*, Carrie Stradley Lavargna, *Government-Sponsored Enterprises Are "Too Big to Fail": Balancing Public and Private Interests*, 44 HASTINGS L.J. 991, 1038 (1993) (concluding that Fannie and Freddie "are clearly 'too big to fail,' as liquidating an enterprise would significantly disrupt the nation's economy"); Reiss, *supra* note 43, at 1025 ("The once seemingly remote possibility of a bailout has become more likely as a result of the ongoing meltdown in the mortgage markets.").

[65] Lockhart Statement, *supra* note 5, at 7; Q&A on Conservatorship, *supra* note 9, at 1–3.

[66] Lockhart Statement, *supra* note 5, at 5–6.

[67] 12 U.S.C § 4617(b)(2)(D)(ii) (West Supp. 2009) (stating that the FHFA, as conservator, may take any action that is "appropriate to carry on the business of the regulated entity"); *see also* 12 C.F.R. § 1237.3(a)(7) (2011).

[68] 12 U.S.C. § 4617(b)(2)(D)(i) (stating that the FHFA, as conservator, may take any actions "necessary to put the regulated entity in a sound and solvent condition"); *see also* 12 C.F.R. § 1237.3(a)(4).

> (i) take over the assets of and operate the regulated entity with all the powers of the shareholders, the directors, and the officers of the regulated entity and conduct all business of the regulated entity;
> (ii) collect all obligations and money due the regulated entity;
> (iii) perform all functions of the regulated entity in the name of the regulated entity which are consistent with the appointment as conservator or receiver;
> (iv) preserve and conserve the assets and property of the regulated entity; and
> (v) provide by contract for assistance in fulfilling any function, activity, action, or duty of the Agency as conservator or receiver.[69]

The FHFA can "transfer or sell any asset or liability of the regulated entity in default" and can "pay all valid obligations of the regulated entity."[70] In addition, the FHFA as conservator can also "repudiate or disaffirm any contract or lease to which [Fannie or Freddie] is a party."[71] Finally, the FHFA has subpoena and "incidental powers" that are necessary to carry out its above enumerated powers.[72] It is authorized to take any action that it "determines is in the best interest of the regulated entity."[73]

While the conservatorship statute focuses primarily on the conservator's duty to return Fannie and Freddie to health, regulations make it clear that the FHFA should continue to consider the public mission that both companies held before conservatorship.[74] According to regulations, the FHFA may "[c]ontinue the missions of the regulated entity [and e]nsure that the operations and activities of each regulated entity foster liquid, efficient, competitive, and resilient national housing finance markets."[75]

During the financial strain of the Great Recession, it is difficult for the FHFA to ensure that the Enterprises fully achieve both the mission of stabilizing the mortgage market and the mission of returning to financial health. Fannie and Freddie, like other mortgage-market participants, tend to fund mortgages in a pro-cyclical manner. When the economy is good, the

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69 12 U.S.C. § 4617(b)(2)(B); *see also* 12 C.F.R. § 1237.3(a)(1), (5)–(8).

70 12 U.S.C. § 4617(b)(2)(G), (H); *see also* 12 C.F.R. §§ 1237.3(d), 1237.6.

71 12 C.F.R. § 1237.5 (noting that the power must be exercised within "18 months following the appointment of a conservator").

72 12 U.S.C. § 4617(b)(2)(I), (J).

73 *Id.* § 4617(b)(2)(J).

74 When the FHFA proposed the applicable rules, it reasoned that the conservatorship consideration of the public mission of Fannie and Freddie was warranted because the companies "continue to operate under their charters." Notice of Proposed Rulemaking: Conservatorship and Receivership, 75 Fed. Reg. 39,462, 39,465 (proposed July 9, 2010). These charters specify that Fannie and Freddie should help stabilize the secondary mortgage market and improve access to mortgage credit. *See supra* note 41 and accompanying text.

75 12 C.F.R. § 1237.3(a)(2), (3).

Enterprises can use private investment to purchase mortgages.[76] When the economy is bad, private sources of investment dry up, the value of the Enterprises' investment portfolios decline, and the Enterprises restrict their investment.[77] For Fannie and Freddie to continue their public missions by purchasing mortgages during an economic downturn, the Enterprises must be able to acquire capital from and shift losses to the government.[78]

On the other hand, the Enterprises cannot be considered financially healthy if they must acquire capital from and shift losses to the government in order to stay afloat. Progress away from reliance on government assistance will require that the Enterprises earn profits, minimize credit losses, and restrict mortgages purchased.[79]

However, efforts to reduce losses or restrict mortgage purchases could run counter to the Enterprises' public missions. In an effort to reduce the Enterprises' losses, the FHFA might adopt policies that shift losses to other mortgage-market participants, especially banks. If other mortgage-market participants are unable to bear those losses, the mortgage market will be destabilized. Similarly, if Fannie and Freddie restrict their mortgage purchases, mortgages will be less available. In other words, "the FHFA is stuck between the narrow needs of Fannie and Freddie and the broader needs of the housing market."[80]

III. LOSS SHIFTING: A BALANCING ACT

According to the FHFA, one purpose of the conservatorship is to "restore the balance between safety and soundness and mission."[81] This section explores how the FHFA as conservator has balanced its competing mandates when influencing policy decisions[82] at the Enterprises. In particular, it

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[76] *See* Hill, *supra* note 23, at 27–34, 66–67.

[77] *See id.* at 51–55, 66–67.

[78] *See id.* at 67–68.

[79] *See* FHFA 2010 REPORT TO CONGRESS, *supra* note 12, at i (describing FHFA policies to limit Enterprise losses).

[80] Brad Plumer & Ezra Klein, *An Unlikely Powerhouse in Housing Policy*, WASH. POST, Aug. 31, 2011, at A14.

[81] Lockhart Statement, *supra* note 5, at 5.

[82] As the Enterprises' conservator, the FHFA's most visible exercise of power has been its appointment of top-level management to oversee major policy decisions. One of its first acts as conservator was to replace the chief executive officers at both Enterprises. *Id.*; James R. Hagerty et al., *U.S. Seizes Mortgage Giants: Government Ousts CEOs of Fannie, Freddie: Promises Up to $200 Billion in Capital*, Wall St. J., Sept. 8, 2008, at A1. In subsequent months, the FHFA also replaced members of the boards of directors and developed new board committee structures. FED. HOUS. FIN. AGENCY, REPORT TO CONGRESS 2008, at 80 (May 18, 2009), *available at* http://www.fhfa.gov/webfiles/2331/FHFAReportToCongress 2008final.pdf [hereinafter FHFA 2008 REPORT TO CONGRESS]. With these executives in place, the FHFA delegated the task of operating Fannie and Freddie to the companies' boards of directors, managers, and employees. *See* Fed. Hous. Fin. Agency, Office of Conservatorship Operations, http://www.fhfa.gov/Default.aspx?Page=344 (last visited Mar. 27, 2012) ("While the FHFA has very broad authority, the focus of the conservatorships is not to manage every

considers three instances in which the FHFA has been faced with the decision of whether to allow Fannie and Freddie to absorb losses or to attempt to shift losses to commercial banks. First, it examines the FHFA's decisions that allow the Enterprises to continue their activities in the secondary mortgage market.[83] Next, it examines the FHFA's decision to allow the Treasury to purchase senior preferred stock in Fannie and Freddie.[84] The decision preserved value for bondholders, but harmed banks that had invested in the companies' common and preferred stock. Finally, this Part examines the FHFA's attempts to limit credit losses by transferring losses back to banks that sold mortgages or private-label securities to the Enterprises.[85]

A. Continued Securitization

When the FHFA announced the Enterprises' conservatorships, government officials explained that the conservatorships would aid commercial banks by continuing the Enterprises' purchases of mortgages and mortgage-backed securities in the secondary market. Then-Treasury Secretary Henry Paulson explained that "[b]y stabilizing [Fannie and Freddie] so they can better perform their mission, [the conservatorships] should accelerate stabilization in the housing market, ultimately benefiting financial institutions."[86] The FHFA Director explained that the Enterprises would "be allowed to grow their guarantee [mortgage-backed securities] books without limits and continue to purchase replacement securities for their portfolios, about $20 billion per month without capital constraints."[87] To make new mortgage purchases, the Enterprises needed access to additional funding.[88] The FHFA enhanced the Enterprises' ability to issue debt by entering into agreements with Treasury, whereby Treasury would provide the Enterprises additional capital

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aspect of the Enterprises' operations. Instead, under conservatorship, FHFA is responsible for the overall management of the Enterprises and has delegated many operational and other duties to the Enterprises' management and boards.").

Less visible is the FHFA's control over major policy decisions at Fannie and Freddie. The Enterprises "must consult with, and obtain approval from, FHFA, as conservator, on critical matters." *Id.* The Director of the FHFA "meets weekly with the chief executives of Fannie and Freddie and signs off on everything from major lending rules to public appearances by their executives." Nick Timiraos, *An Accidental Housing Chief Embraces the Power of 'No'*, Wall St. J., Aug. 31, 2011, at A1; *see also* FHFA 2010 Report to Congress, *supra* note 12, at 2 ("FHFA works with the executive management of the Enterprises and their boards regularly, attending board of directors meetings, committee meetings, and weekly senior executive meetings at the Enterprises."). This Article focuses primarily on how the FHFA weighs its conflicting priorities in reaching its policy decisions.

83 *See infra* Part II.A.

84 *See infra* Part II.B.

85 *See infra* Part II.C.

86 Paulson Statement, *supra* note 6.

87 Lockhart Statement, *supra* note 5, at 7.

88 *See id.* at 5 (noting the Enterprises' inability to "fund themselves according to normal practices and prices").

if they became insolvent.[89] In addition, Treasury and the Federal Reserve have purchased the Enterprises' debt and mortgage-backed securities.[90]

In the first few months of the conservatorships, the FHFA suggested that, consistent with efforts to stabilize the housing markets, the Enterprises would make it easier and less costly for banks to sell mortgages to the Enterprises. The FHFA hinted that it would instruct Fannie and Freddie to loosen underwriting criteria to make it possible for the Enterprises to securitize more mortgages.[91] The FHFA also encouraged the Enterprises to abandon plans to increase the guarantee fees paid by banks that sold loans to the Enterprises.[92] Guarantee fees are the fees that the enterprises charge mortgage originators who sell mortgages to the Enterprises.[93] These fees are designed to compensate the Enterprises for guaranteeing payments on mortgage-backed securities issued by the Enterprises.[94] Fannie and Freddie independently set their guarantee fees using their proprietary risk models.[95] Consistent with FHFA statements, Freddie decreased its guarantee fees slightly.[96]

Soon, however, the FHFA indicated that it expected the Enterprises to reduce their role in the secondary mortgage market over time in order to stabilize the financial condition of the Enterprises. Agreements that Fannie and Freddie entered with Treasury at the FHFA's direction provide that the Enterprises' retained mortgage portfolio could not exceed $850 billion each at the end of 2009.[97] Thereafter, Fannie and Freddie must shrink their retained mortgage portfolios by ten percent per year until each portfolio reaches $250 billion.[98]

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89 *See infra* notes 119–125 and accompanying text. Part II.B discusses the impact of this investment on banks that invested in the Enterprises' stock.

90 *See* James Lockhart, *Open Forum: The Present and Future of the GSEs*, NAT'L MORTGAGE NEWS, June 22, 2009, at 4.

91 *Turmoil in U.S. Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions: Hearing Before the S. Comm. on Banking, Hous. & Urban Affairs*, 100th Cong. 117–18, 123(2008) (statement of James B. Lockhart, III, Dir., Fed. Hous. Fin. Agency) (indicating that "Freddie Mac and Fannie Mae, in order to try to build capital, may have raised prices and tightened credit standards beyond what was necessary for sound underwriting" and reporting that the FHFA was examining the companies' "underwriting standards and pricing").

92 *See* Harris Terris, *Fannie and Freddie Say Fees Won't Rise After All*, AM. BANKER, Oct. 6, 2008, at 10.

93 *See* FED. HOUS. FIN. AGENCY, FANNIE MAE AND FREDDIE MAC SINGLE-FAMILY GUARANTEE FEES IN 2008 AND 2009 at 10 (July 2010), *available at* http://www.fhfa.gov/ webfiles/15918/ [hereinafter FHFA, SINGLE-FAMILY GUARANTEE FEES].

94 *See id.* Guarantee fees have two parts, an upfront fee and ongoing monthly payments. *Id.*

95 *See id.* at 13–15 (stating that "Fannie Mae and Freddie Mac consider many factors in determining the guarantee fees they charge").

96 *See* Allison Bisbey Colter et al., *Pipeline*, AM. BANKER, Jan. 1, 2009, at 8.

97 *See* Fannie Mae Senior Preferred Stock Agreement, *supra* note 6, ¶ 5.7; Freddie Mac Senior Preferred Stock Agreement, *supra* note 6, at ¶ 5.7.

98 Fannie Mae Senior Preferred Stock Agreement, *supra* note 6, ¶ 5.7; Freddie Mac Senior Preferred Stock Agreement, *supra* note 6, ¶ 5.7.

Next, the FHFA began actively encouraging Fannie and Freddie to tighten underwriting standards.[99] In response, the Enterprises largely eliminated their purchase of "no-income documentation [and] interest only mortgages."[100] "[C]redit scores of mortgages guaranteed [by the Enterprises] in 2006-2007 averaged around 715, while [in 2009] they average[d] around 750."[101] The FHFA also lowered the Enterprises' affordable housing goals.[102]

At the same time, the FHFA allowed Fannie and Freddie to increase guarantee-fee pricing.[103] In 2009, both Enterprises increased upfront fees to adjust for the increased credit risk caused by troubled real estate and mortgage markets.[104] The FHFA may allow Fannie and Freddie to implement further guarantee-fee increases in the future.[105]

Notwithstanding more restrictive underwriting and higher pricing policies, the Enterprises' new business acquisitions continue to approximate seventy percent of all single-family mortgage originations.[106] The Enterprises' continued presence in the secondary mortgage market has undoubtedly benefited banks. As Fannie explains, "[a]s other sources of liquidity have left the market, Fannie Mae has continued to buy or securitize mortgage loans originated by credit unions, community banks, commercial banks and other

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99 *See* FED. HOUS. FIN. AGENCY, REPORT TO CONGRESS 2009, at v (May 25, 2010), *available at* http://www.fhfa.gov/webfiles/15784/FHFAReportToCongress52510.pdf [hereinafter FHFA 2009 REPORT TO CONGRESS] ("Since the Enterprises were placed into conservatorship, in accordance with guidance provided by FHFA to ensure conservation of assets and minimization of future loss, the Enterprises have tightened their underwriting standards.").

100 FHFA 2010 REPORT TO CONGRESS, *supra* note 12, at iv.

101 FHFA 2009 REPORT TO CONGRESS, *supra* note 99, at v ("Average loan-to-value (LTV) ratios . . . also decreased by about 5 percentage points in the postconservatorship time period (and 89 percent of new mortgages had an LTV of 80 percent or less in 2009, as compared to 76 percent of new mortgages with LTV ratios of 80 percent or less in 2007).").

102 *See* 2010–2011 Enterprise Housing Goals; Enterprise Book-Entry Procedures, 75 Fed. Reg. 55,892, 55,892–939 (Sept. 14, 2010) (codified at 12 C.F.R. pts. 1249, 1282); FHFA 2010 REPORT TO CONGRESS, *supra* note 12, at 97 (explaining that the new goals contain a "look back" procedure whereby the Enterprises can fall short of benchmark levels but still satisfy housing goals if their "performance equals or exceeds the corresponding share of mortgages originated in the primary mortgage market, as based on FHFA's analysis of [Home Mortgage Disclosure Act] data").

103 FHFA 2009 REPORT TO CONGRESS, *supra* note 99, at v.

104 *See id.* at 18–19; Colter et al., *supra* note 96, at 8.

105 *See* Zachary A. Golfarb, *Fighting for Fannie, Freddie*, WASH. POST, Feb. 10, 2011, at A12 (stating that "[t]he administration will propose baby steps toward reducing government support [for the Enterprises], such as raising fees that Fannie and Freddie charge lenders and borrowers for the government guarantee").

106 The Enterprises' market share was 37% in 2006, 54% in 2007, 73% in 2008, 76% in 2009, and 70% in 2010. *See* FHFA 2008 REPORT TO CONGRESS, *supra* note 82, at ii, 18; FHFA 2009 REPORT TO CONGRESS, *supra* note 99, at v; FHFA 2010 REPORT TO CONGRESS, *supra* note 12, at 3.

institutions."[107] This liquidity has likely slowed the downward trend in housing prices, helping the economy, banks, and consumers generally.[108]

More specifically, the Enterprises' continued activity in the secondary market allows banks to offer loans by continuing to purchase those loans. Fannie purchases mortgages from more than 1,000 lenders, including both large and small financial institutions.[109] Likewise, Freddie acquires loans from a variety of lenders, including "mortgage banking companies, commercial banks, savings banks, community banks, credit unions, [housing finance agencies], and savings and loan associations."[110]

While both large banks and small banks sell mortgages to the Enterprises, large banks have benefitted the most. "The top 10 mortgage players—including Wells Fargo, Bank of America, JPMorgan Chase and Citigroup—together control 90 percent of all originations and servicing."[111] The Enterprises' purchases come heavily from this group of large banks.[112] Community banks, on the other hand, are less active in the residential mortgage market. "Nationally, approximately 4,000 small banks made 100 or fewer mortgages in 2007."[113] When community banks do offer mortgages they often prefer to hold at least a portion of their originated mortgages rather than sell them for securitization.[114] This means that "the absence of a securitization

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[107] FANNIE MAE, HELPING HOUSING RECOVER: A REPORT ON FANNIE MAE'S MISSION PERFORMANCE 2 (Mar. 2010), *available at* http://www.fanniemae.com/media/pdf/2010/mission-performance-report.pdf.

[108] *See* Andrea J. Boyack, *Laudable Goals and Unintended Consequences: The Role and Control of Fannie Mae and Freddie Mac*, 60 AM. U. L. REV. 1489, 1526 (2011) ("Rescuing Fannie Mae and Freddie Mac in 2008 was necessary to keep the residential mortgage market machinery from grinding to a halt and to mitigate the impact of the crash on homeowners and homebuyers.").

[109] *See* FANNIE MAE, *supra* note 107, at 4.

[110] Fed. Home Loan Mort. Corp., Annual Report (Form 10-K) 12 (Mar. 9, 2012).

[111] John Engen, *Response Time*, AM. BANKER MAG., Aug. 2011, at 18, 20.

[112] *See* Fed. Home Loan Mort. Corp., Quarterly Report (Form 10-Q) 49 (Aug. 8, 2011) ("We acquire a significant portion of our single-family mortgage purchase volume from several large lenders, or seller/servicers. Our top 10 single-family seller/servicers provided approximately 85% of our single-family purchase volume during the six months ended June 30, 2011."); Fed. Nat'l Mort. Ass'n., Quarterly Report (Form 10-Q) 81 (Aug. 5, 2011) ("Our business with our mortgage seller/servicers is concentrated. Our ten largest single-family mortgage servicers, including their affiliates, serviced 76% of our single family guaranty book of business as of June 30, 2011 . . . .").

[113] *The Effect of Dodd-Frank on Small Financial Institutions and Small Business: Hearing Before the Subcomm. on Fin. Inst. and Consumer Credit of the H. Comm. on Fin. Servcs.*, 112th Cong. 170 (2011) (written testimony of Peter Skillern, Exec. Dir., Cmty. Reinvestment Ass'n of N.C.). Likewise, credit unions tend to sell fewer mortgages to the Enterprises. The Credit Union National Association, a trade group, "estimates that its members sold between 25 and 40 percent of their loans before the financial crisis." Danielle Douglas, *Community Banks and Credit Unions Brace for End of Fannie, Freddie*, WASH. POST., Feb. 13, 2012, at A13. While credit unions have increased their sales to the Enterprises in recent years, they still sell far fewer loans than the largest banks. *See id.*

[114] *See* Engin, *supra* note 111, at 21, 23 (explaining that it is often profitable for community banks to hold non-conforming loans); CONG. OVERSIGHT PANEL, NOVEMBER OVERSIGHT REPORT: EXAMINING THE CONSEQUENCES OF MORTGAGE IRREGULARITIES FOR

market is less limiting to [community banks] than it is to the big institutions."[115]

Increases in the Enterprises' guarantee fees could also impact community banks more than their larger rivals. Under both Enterprises' guarantee-fee pricing structures, "lenders that sell smaller volumes of single-family mortgages to the Enterprises tend to pay higher guarantee fees on loans of similar credit quality."[116] The Enterprises explicitly consider the number of mortgages sold by a bank in setting the guarantee fee "because the larger a seller's delivery volume, the more the Enterprise's business with that seller contributes to the liquidity that supports the demand for the Enterprise's outstanding [mortgage-backed securities], which benefits all lenders that do business with the Enterprise."[117] In addition, "the largest sellers have achieved a degree of influence that can be used to negotiate better terms of business."[118] With guarantee fees already heavily influenced by the number of mortgages sold, it is reasonable to suspect that increases in guarantee fees would be structured to impact smaller banks more than the influence-wielding larger banks.

In sum, the FHFA's decision to allow Fannie and Freddie to continue their activities in the secondary mortgage market has benefitted most banks, including banks that sell few, if any, mortgages to the Enterprises. However, because a small number of large banks provide the bulk of the mortgages purchased by the Enterprises, these large banks have likely benefitted the most from the Enterprises' continued purchases. In addition, the FHFA's efforts to decrease the Enterprises' market share by increasing guarantee fees could potentially harm smaller banks more than the largest banks because the largest banks have the influence to negotiate favorable pricing terms.

B. Recapitalization

The FHFA's next major decision impacting banks was its decision concerning the structure of new outside investment in the Enterprises. When the FHFA announced the conservatorships, Treasury also announced that it would provide capital for the Enterprises if they became insolvent.[119] The method by which Treasury would invest in the companies was set by con-

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FINANCIAL STABILITY AND FORECLOSURE MITIGATION 51 (Nov. 16, 2010) ("Generally, small community banks, as well as credit unions, are more likely to keep mortgage loans on their books as opposed to selling them in the secondary market.").

[115] *Id.* at 21. Of course, if the Enterprises' securitization efforts were instead performed by the largest financial institutions, the large financial institutions might squeeze smaller banks and credit unions from the mortgage market. *See* Douglas, *supra* note 113, at A13.

[116] FHFA, SINGLE-FAMILY GUARANTEE FEES, *supra* note 93, at 8.

[117] *Id.* at 34.

[118] *Id.*

[119] Paulson Statement, *supra* note 6.

tracts, with the FHFA acting on behalf of Fannie and Freddie.[120] Under the terms of the contracts, if either Fannie or Freddie became insolvent, Treasury would purchase senior preferred shares of the insolvent Enterprise.[121] In exchange for this promise of future assistance, each Enterprise gave Treasury $1 billion in senior preferred shares[122] and warrants for the purchase of common stock representing a 79.9% interest in each company at a nominal price.[123] Within months of conservatorship, both Fannie and Freddie announced they were insolvent and needed government capital.[124] To date, the government has invested roughly $111.6 billion in Fannie and $71.2 billion in Freddie.[125]

The FHFA's decision to allow Treasury to purchase preferred stock protected the investments of those who have previously bought Fannie and Freddie debt and mortgage-backed securities.[126] With constant access to government capital, the Enterprises' debts became essentially guaranteed by the federal government. Those protected debt holders included a significant number of central banks and foreign investors.[127] However, domestic commercial banks also held a large amount of the Enterprises' debt and mortgage-backed securities.[128] While it is unclear which banks held the bulk of

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120 *Id.*

121 *See* Fannie Mae Senior Preferred Stock Agreement, *supra* note 6, ¶ 2.1; Fannie Mae Second Amendment to Amended and Restated Senior Preferred Stock Purchase Agreement (Dec. 24, 2009), *available at* http://www.treasury.gov/initiatives/financial-stability/programs/housing-programs/mha/Documents/Fannie.pdf; Freddie Mac Senior Preferred Stock Agreement, *supra* note 6, ¶ 2.1; Freddie Mac Second Amendment to Amended and Restated Senior Preferred Stock Purchase Agreement (Dec. 24, 2009), *available at* http://www.treasury.gov/initiatives/financial-stability/programs/housing-programs/mha/Documents/Freddie.pdf.

122 Fannie Mae Senior Preferred Stock Agreement, *supra* note 6, ¶ 3.1; Freddie Mac Senior Preferred Stock Agreement, *supra* note 6, ¶ 3.1.

123 Federal National Mortgage Association Warrant to Purchase Common Stock (Sept. 7, 2008), *available at* http://www.treasury.gov/press-center/press-releases/Documents/warrantfnm3.pdf; Federal Home Loan Mortgage Corporation Warrant to Purchase Common Stock (Sept. 7, 2008), *available at* http://www.treasury.gov/press-center/press-releases/Documents/warrantfrec.pdf.

124 *See* James R. Hagerty & Aparajita Saha-Bubna, *Freddie Needs $13.8 Billion as Mortgage Defaults Worsen*, WALL ST. J., Nov. 15, 2008, at A3.

125 FED. HOUS. FIN. AGENCY, CONSERVATOR'S REPORT ON THE ENTERPRISES' FINANCIAL PERFORMANCE, THIRD QUARTER 2011, at 9, *available at* http://www.fhfa.gov/ webfiles/22855/Conservator'sReport3Q2011F122111F.pdf.

126 *See* Dale Arthur Oesterle, *The Collapse of Fannie Mae and Freddie Mac: Victims or Villains?* 5 ENTREPRENEURIAL BUS. L. REV. 733, 744 (2010).

127 *See* Steven M. Davidoff & David Zaring, *Regulation by Deal: The Government's Response to the Financial Crisis*, 61 ADMIN. L. REV. 463, 488–89 (2009); Craig Karmin, *Small Fannie, Freddie Holder Take Issue With Washington*, WALL ST. J., Sept. 12, 2008, at C1 ("The bailout proved a boon for Fannie and Freddie bond prices, which have rallied on news of the government's support. These bonds are widely held by central banks and other foreign investors, and their pressure on the U.S. Treasury was instrumental in promoting the government action, people familiar with the matter say.").

128 James B. Lockhart III, Dir., Office of Fed. Hous. Enter. Oversight, GSE Reform Critical to Reducing Risks, Speech Before the New York Bankers Association Annual

these securities,[129] it is likely that the largest banks had significant holdings. Large banks often received Enterprise mortgage-backed securities when they sold mortgages to the Enterprises,[130] and large banks sold the Enterprises a substantial part of the Enterprises' mortgage portfolios.[131]

At the same time, Treasury's large investment in senior preferred stock made existing investments in the Enterprises' common and preferred stock nearly worthless. The issuance of new shares diluted existing shares. Under the terms of the stock purchase agreements no dividend can be paid on equity securities without Treasury's consent.[132] Conservatorship even prevents stockholders from exercising any voting rights.[133] One of Freddie's directors has gone so far as to state that he has no legal duty to consider the concerns of Freddie's non-government shareholders.[134] Unsurprisingly, after entering conservatorship, both Enterprises' common and preferred stock shares fell below $1 per share and the Enterprises' were delisted from the New York Stock Exchange.[135]

More than a quarter of U.S. banks held Fannie or Freddie stock.[136] Indeed bank capital regulations had encouraged banks to purchase Enterprise

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Convention (Nov. 9, 2006), *available at* http://www.fhfa.gov/webfiles/1419/ NYBankers11906.pdf ("As of year-end 2005, over 60 percent of banks held Enterprise debt and MBS worth over 50 percent of those banks' Tier 1 capital."); VIRAL ACHARYA ET AL., FANNIE MAE, FREDDIE MAC AND THE DEBACLE OF MORTGAGE FINANCE 52–53 (2011) (noting that FDIC insured banks held 17% of outstanding Enterprise debt and $852 billion in Enterprise mortgage-backed securities).

[129] *See* ACHARYA ET AL., *supra* note 128, at 58 (stating that "the problem was that no one knew which institutions were exposed to the 17% of Fannie and Freddie's debt").

[130] *See* FHFA, SINGLE-FAMILY GUARANTEE FEES, *supra* note 93, at 10 (explaining that while "[s]ome lenders sell single-family mortgages outright to the Enterprises for cash . . . [l]arger lenders primarily swap loans for [mortgage-backed securities]").

[131] *See supra* notes 111–113 and accompanying text.

[132] *See* Fannie Mae Senior Preferred Stock Agreement, *supra* note 6, ¶ 5.1; Freddie Mac Senior Preferred Stock Agreement, *supra* note 6, ¶ 5.1.

[133] *See* 12 U.S.C.A. § 4617(b)(2)(A)(i) (West 2012) (noting that the FHFA "shall, as conservator . . . immediately succeed to . . . all rights, titles, powers, and privileges of the regulated entity, and of any stockholder, officer, or director of such regulated entity with respect to the regulated entity and the assets of the regulated entity").

[134] Michael J. de la Merced, *Freddie Official Says He Has No Duty to Shareholders*, N.Y. TIMES DEALBOOK, Feb. 9, 2011, http://dealbook.nytimes.com/2011/02/09/freddie-director-no-fiduciary-duty-to-shareholders/ (reporting a CNBC interview of Clayton S. Rose, Dir., Freddie Mac).

[135] *See* Nick Timiraos, *Fannie, Freddie to Delist from NYSE*, WALL ST. J., June 17, 2010, at C3 (reporting that Fannie and Freddie elected to delist after their stock share fell below the required $1 level).

[136] *See* John Hechinger, *The Financial Crisis: Fannie Mae, Freddie Mac Takeovers Cost U.S. Banks Billions*, WALL ST. J., Sept. 23, 2008, at A4 (reporting that an American Bankers Association survey found that 27% of the nation's banks held Fannie or Freddie preferred stock). Professor Dale Oesterle has criticized the government's decision to protect the Enterprises' debt holders while not protecting the Enterprises' preferred stock holders. Oesterle, *supra* note 126, at 747. He maintains that the structure of investment means that "the Chinese government and German banks get the benefit of taxpayer dollars and [U.S.] retirees and local banks do not." *Id.*

stock. While banks are not ordinarily allowed to invest in equity securities, federal law created a special exception that allowed banks to invest in the Enterprises.[137] In addition, capital regulations treated Enterprise stock favorably—more favorably even than mortgages.[138] These benefits, combined with regular dividend payments, made Fannie and Freddie preferred stock especially popular with banks.[139]

Treasury's decision to take Fannie and Freddie senior preferred stock cut off stock dividends to banks and forced banks to realize losses as the stock dropped in value. The reduced income, combined with the loss in value, had the potential to cause capital concerns for banks that held the stock.[140] Treasury Secretary Henry Paulson recognized the concern but concluded it would not pose a significant burden for many banks. He explained that, "the agencies believe that, while many institutions hold common or preferred shares of [the Enterprises], only a limited number of smaller institutions have holdings that are significant compared to their capital."[141] Secretary Paulson's assessment that the burden of stock losses would fall primarily on smaller community banks was correct. Of those holding preferred stock, 85% were community banks with less than $1 billion in assets.[142] "According to the Independent Community Bankers of America, small banks lost $16 billion because of the government takeover [of Fannie and Freddie]."[143]

The banking industry sought legislative and regulatory help to minimize the impact of Fannie and Freddie stock losses.[144] These efforts yielded

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[137] *See* RICHARD SCOTT CARNELL, JONATHAN R. MACEY & GEOFFREY P. MILLER, THE LAW OF BANKING AND FINANCIAL INSTITUTIONS 132–34 (4th ed. 2009) (explaining that banks cannot generally invest in equity securities for their own account); 12 U.S.C. §§ 24(Seventh), 1718(d) (allowing bank investment in Fannie and Freddie stock).

[138] In general, a bank must have capital equal to 10% of all risk-weighted assets. *See* 12 C.F.R. §§ 6.4, 208.43, 325.3, 325.103 (2009) (requiring 10% risk-weighted capital to be classified as well-capitalized). Fannie and Freddie stock is risk-weighted at 20% of its actual value. *See* 12 C.F.R. pt. 3, App. A; 12 C.F.R. pt. 208, App. A; 12 C.F.R. pt. 325, App. A. This means that for every $100 held in Fannie or Freddie stock, a bank would need to maintain only $2 in capital ($100*20% (risk-weight)*10% (capital requirement) = $2). In comparison, first mortgages on single-family homes have a 50% risk-weight, requiring more than twice as much capital. *See* 12 C.F.R. pt. 3, App. A; 12 C.F.R. pt. 208, App. A; 12 C.F.R. pt. 325, App. A. For a further discussion of capital calculation, see Julie Andersen Hill, *Bank Capital Regulation by Enforcement: An Empirical Study*, 87 IND. L.J. 645, 650–56 (2012).

[139] *See* Paul Gores, *Three Banks Get FDIC Warnings Federal Agency Scrutinizes Practices of Institutions*, MILWAUKEE J. & SENTINEL, Aug. 29, 2009, at B6 (noting that "[m]any banks . . . invested in Fannie Mae and Freddie Mac preferred stock, which was considered financially solid and paid dividends of more than 8%").

[140] Hagerty et al., *supra* note 82, at A1.

[141] Paulson Statement, *supra* note 6.

[142] Hechinger, *supra* note 136, at A4.

[143] Jeff Blumenthal, *Big Banks Paid Back TARP Money, Not So the Smaller Ones*, PHILADELPHIA BUS. J., Aug. 12, 2011, *available at* 2011 WLNR 16025654.

[144] *See, e.g.*, Letter from the Independent Community Bankers of America to Christopher Dodd and Richard Shelby (Sept. 15, 2008), *available at* http://www.icba.org/files/ICBASites/PDFs/letter091508.pdf; Memorandum from the Inde-

two provisions in the Emergency Economic Stabilization Act of 2008. First, banks were allowed to treat losses on the Enterprises' stock as ordinary losses rather than capital losses.[145] These ordinary losses could be used to offset income, rather than to simply offset capital gains.[146] This provision was important because few small banks had significant capital gains against which to deduct a capital loss.[147] Second, the Emergency Economic Stabilization Act provided that in awarding banks funds from the Troubled Asset Relief Program (TARP), Treasury should give special TARP consideration to community banks (banks with less than $1 billion in assets) hard hit by Fannie and Freddie stock losses.[148] Some banks, like Midwest Banc Holding Inc. (a bank holding company with $3.6 billion in assets), received TARP assistance quickly.[149] Treasury, however, was slow to provide TARP assistance to many small banks. Small banks organized as S corporations[150] could not even apply for TARP money until February 13, 2009, about four months af-

pendent Community Bankers of America to President-Elect Obama's Treasury Transition Team (Dec. 15, 2008), *available at* 2008 WLNR 24059761.

[145] Emergency Economic Stabilization Act of 2008, Pub. L. No. 110–343, § 301, 122 Stat. 3765, 3802–03 (codified at 12 U.S.C. § 5261).

[146] *See* 26 U.S.C. § 1211(a) (2006) ("In the case of a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of gains from such sales or exchanges.").

[147] *See* Cheryl Block, *Measuring the True Cost of Government Bailout*, 88 WASH. U. L. REV. 149, 210–11 (2010) (explaining that although normally "a corporation with no capital gains cannot deduct capital losses from its ordinary income" the Emergency Economic Stabilization Act of 2008 allowed banks to deduct losses on Fannie and Freddie preferred stock from ordinary income); John Hechinger, *Small Banks Hobbled by Fannie, Freddie—Rivals Take Over After Capital is Hit by Big Stock Losses*, WALL. ST. J., Sept. 29, 2008, at C1 (reporting that "few community banks have meaningful capital gains to report").

[148] Emergency Economic Stabilization Act of 2008 §103(6), 122 Stat. at 3770 (codified at 12 U.S.C. § 5213) ("In exercising the authorities granted in this Act, the [Treasury] Secretary shall take into consideration . . . providing financial assistance to financial institutions, including those serving low- and moderate-income populations and other underserved communities, and that have assets less than $1,000,000,000 that were well or adequately capitalized as of June 30, 2008, and that as a result of the devaluation of the preferred government-sponsored enterprise stock will drop one or more capital levels, in a manner sufficient to restore the financial institutions to at least an adequately capitalized level . . . .")

[149] *See* Robert Barba, *Crushed by GSEs, Saved by Tarp Funds*, AM. BANKER, Nov. 4, 2008, at 1 (discussing TARP Funds provided to Midwest Banc Holding Inc.); *see also* Richard Newman, *Regional Banks Join Bailout; $330M Infusion for Valley National*, RECORD (BERGEN COUNTY, N.J.), Oct. 28, 2008, at B01 (describing TARP funds provided to "Valley National Bankcorp, the largest New Jersey-based commercial bank); Neil H. Simon, *Banks Use TARP Funds Variously: In Va., Bailout Money Has Funded Acquisitions and 'Plain Vanilla' Loans*, RICHMOND TIMES-DISPATCH, Feb. 8, 2009, at D1 (reporting that Central Virginia Bankshares received $11.4 million in TARP after losing $17.8 million in Fannie and Freddie preferred stock).

[150] An S corporation is a business that has elected to have its income "taxed through its shareholders rather than through the corporation itself." BLACK'S LAW DICTIONARY 1384 (8th ed. 2004); *see also* 26 U.S.C.A. § 1361(b)(2) (West 2012) (allowing banks to elect subchapter S tax treatment unless they use the "reserve method of accounting for bad debts").

ter the program was announced.[151] In addition, not all small banks with significant Fannie and Freddie losses were granted TARP money. The small Madisonville State Bank, North Houston Bank, and National Bank of Commerce all applied for TARP money following losses on Enterprise stock, but they were denied TARP funds.[152] Perhaps these banks were denied TARP funds because Treasury officials imposed stricter qualifications for TARP recipients as the program progressed.[153]

Banks also sought more far-reaching assistance, but these requests went unheeded. For example, banks have been unsuccessful in convincing the FHFA to continue dividends on the Enterprises' junior preferred stock.[154] Banks have also been unsuccessful in securing significant regulatory capital forbearance from regulators.[155] Instead, regulators have sometimes ordered banks to raise capital as a result of Fannie and Freddie losses.[156]

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[151] *See* CONG. OVERSIGHT PANEL, OVERSIGHT REPORT: SMALL BANKS IN THE CAPITAL PURCHASE PROGRAM 11–14 (July 14, 2010).

[152] *See* OFFICE OF INSPECTOR GEN., FED. DEPOSIT INS. CORP., REP. NO. MLR-10-036, MATERIAL LOSS REVIEW OF NORTH HOUSTON BANK, HOUSTON, TEXAS, AND MADISONVILLE STATE BANK, MADISONVILLE, TEXAS 23–24 (May 20, 2010 [hereinafter NORTH HOUSTON BANK AND MADISONVILLE STATE BANK MATERIAL LOSS REVIEW]); OFFICE OF INSPECTOR GEN., DEP'T OF THE TREASURY, REP. NO. OIG-09-042, SAFETY & SOUNDNESS: MATERIAL LOSS REVIEW OF NATIONAL BANK OF COMMERCE 6–7(Aug. 6, 2009) [hereinafter NATIONAL BANK OF COMMERCE MATERIAL LOSS REVIEW].

[153] According to one bank executive:

> [F]rom the beginning, [the OCC] acknowledged that our issue was [Enterprise stock] only. They referred to us as a well-managed bank with strong asset quality and a good track record.
>
> And they strongly recommended us for TARP approval in October. We were approved for TARP approval by the regulatory committee. But because we were not a publicly traded bank, they had no rules in place to deal with private banks that did not have a stock price.
>
> Therefore, we were deferred, and that deferral took us into January and February. The rules totally changed. The rules became so restrictive that the only way you get TARP is you had to be well-capitalized. We, by virtue of the [Enterprise stock] losses, were not well-capitalized. Therefore, we didn't qualify. The rules were vastly different for the larger, publicly traded banks than they were subsequently for the smaller banks and privately-traded.

The Condition of Financial Institutions: Examining the Failure and Seizure of an American Bank: Hearing Before the Subcom. on Fin. Insts. and Consumer Credit, of the H. Comm. on Fin. Servcs., 111th Cong. 22 (2010) (testimony of Michael E. Kelly, Chairman and CEO, FBOP Corp.).

[154] *See Commercial Real Estate: A Chicago Perspective on Current Market Challenges and Possible Responses: Field Hearing Before Subcomm. on Oversight and Investigation of the H. Comm. on Fin. Servs.*, 111th Cong. 167 (2010) (prepared statement of Greg Ohlendorf, President & CEO, First Community Bank, on behalf of Indep. Community Bankers Ass'n and Community Bankers Ass'n of Illinois) (stating that "[d]ividend payments should be resumed for [Fannie and Freddie] preferred shares").

[155] Banks requested this relief shortly after the FHFA announced the conservatorships. *See* Letter from the Independent Community Bankers of America to Ben S. Bernanke (Chairman, Federal Reserve System), John C. Dugan (Comptroller of the Currency), John M. Reich (Dir., Office of Thrift Supervision), and Sheila C. Bair (Chairman, Federal Deposit

Some banks, however, were unable to recover from the losses. According to material loss reports and in-depth loss reviews prepared by bank regulators,[157] Fannie and Freddie losses contributed to the failure of at least eight banks.[158] These bank failures are detailed in Figure 1. Because regulators prepare material loss reports only for those bank failures that result in a "material loss" to the federal deposit insurance fund,[159] it is likely that Figure 1 under-reports the number of banks that failed due in part to losses on Enterprise stock.[160]

Insurance Corporation) (Sept. 9, 2008), *available at* http://www.icba.org/files/ICBASites/PDFs/ltr090908.pdf.

[156] *See, e.g.*, *In re* Nevada Security Bank, Order No. FDIC-09-173b (June 29, 2009) (cease-and-desist order); Judy Newman, *FDIC Orders Evergreen State Bank to Take Prompt Corrective Action*, WIS. ST. J., Jan. 28, 2011, *available at* 2011 WLNR 1793236 (reporting that Evergreen Bank received consent and cease-and-desist orders based in part on Fannie and Freddie losses); Laurie Winslow, *Fix Problems, Exchange Bank Told*, TULSA WORLD, Jan.8, 2010, at E1 (reporting that Exchange Bank received a cease-and-desist consent order from the FDIC after losing $4 million on Fannie and Freddie stock); *see also* Donna Block, *FDIC Grilled on Community Bank Seizures*, DAILY DEAL, Jan. 21, 2010, *available at* 2010 WLNR 1681342 (stating that "then-Treasury Secretary Henry Paulson's promise to help community banks by developing capital restoration plans in the wake of Fannie and Freddie's seizures never materialized").

[157] *See* 12 U.S.C.A. § 1831o(k)(1)(A) (West 2012) (requiring "the office of the inspector general of the appropriate Federal banking agency [to] make a written report to . . . ascertain why the institution's problems resulted in a material loss to the Deposit Insurance Fund [and] make recommendations for preventing any such loss in the future"); *id.* § 1831o(k)(5) (instructing bank regulators to prepare an "in-depth review of the loss" when the loss is not material, but "unusual circumstances exist").

[158] An additional bank, PFF Bank and Trust, failed after its plan to be acquired by another branch fizzled. The acquirer was unable to complete the transaction due to its losses on Fannie and Freddie preferred stock. *See* OFFICE OF INSPECTOR GEN., DEP'T OF THE TREASURY, REP. NO. OIG-09-038, SAFETY & SOUNDNESS: MATERIAL LOSS REVIEW OF PFF BANK AND TRUST 3–7(June 12, 2009).

[159] At the time Fannie and Freddie were taken into conservatorship, "material loss" was defined as $25 million, or 2% of the bank's total assets at the time of failure. *See* 12 U.S.C. § 1831o(k)(2)(B) (2006). However, Congress has since amended the definition of "material loss." For banks that failed between January 1, 2010 and December 31, 2011, "material loss" means a loss greater than $200,000,000. *See* 12 U.S.C.A. § 1831o(k)(2)(B) (West 2012). Under the new definition, regulators are less likely to prepare a material loss report for small banks.

[160] For example, North Houston Bank and Madisonville State Bank were both owned by the same financial holding company. *See* NORTH HOUSTON BANK AND MADISONVILLE STATE BANK MATERIAL LOSS REVIEW, *supra* note 152, at 3. The holding company also owned the failed Community Bank of Lemont. *Id.* at 1. Although the Community Bank of Lemont's failure was also likely precipitated by investments in Enterprise stock, the FDIC did not prepare a material loss review for Lemont because its loss was not "material" to the deposit insurance fund. *See id.* (stating that the Lemont failure was not material to the deposit insurance fund); Becky Yerak, *Buried by Bank's Death Two Founders of Failed Community Bank of Lemont Blame Regulators for the Loss of Their Investments and Potentially Big Profits*, CHICAGO TRIB., Nov. 29, 2009, at 1 (noting Lemont's trouble with Enterprise stock losses).

Figure 1: Bank Failures Due to Losses on Fannie and Freddie Stock[161]

Bank Name	Fannie & Freddie Loss (in millions)	Total Assets (in millions)	Primary Federal Regulator
Midwest Bank and Trust Co.	$84.6	$3,100	Federal Reserve
Venture Bank	$40.1	$992.4	FDIC
Cooperative Bank	$9.1	$973.6	FDIC
North Houston Bank	$42.9	$325.3	FDIC
Madisonville State Bank	$25.5	$237.8	FDIC
Great Basin Bank of Nevada	$2.1	$228.8	FDIC
National Bank of Commerce	$93.7	$163.1	OCC
The Gordon Bank	$1.8	$30.5	FDIC

These failures illustrate the burden of Fannie and Freddie losses on small banks. Of the eight failed banks, only one had more than $1 billion in assets. The Gordon Bank and Madisonville State Bank each had only a single location in a rural area.[162] Regulatory reports explain that the failed banks' investments in Fannie and Freddie stock were part of conservative investment strategies.[163] Before Fannie's and Freddie's conservatorships, bank

161 *See* OFFICE OF INSPECTOR GEN., BD. OF GOVERNORS OF THE FED. RESERVE SYS., MATERIAL LOSS REVIEW OF MIDWEST BANK AND TRUST COMPANY 17 (Dec. 8, 2010); OFFICE OF INSPECTOR GEN., FED. DEPOSIT INS. CORP., REP. NO. MLR-10-029, MATERIAL LOSS REVIEW OF VENTURE BANK, LACEY, WASHINGTON 1–10 (Apr. 9, 2010); OFFICE OF INSPECTOR GEN., FED. DEPOSIT INS. CORP., REP. NO. MLR-10-013, MATERIAL LOSS REVIEW OF COOPERATIVE BANK, WILMINGTON, NORTH CAROLINA 9 (Jan. 6, 2010); NORTH HOUSTON BANK AND MADISONVILLE STATE BANK MATERIAL LOSS REVIEW, *supra* note 152, at 7; OFFICE OF INSPECTOR GEN., FED. DEPOSIT INS. CORP., REP. NO. MLR-10-008, MATERIAL LOSS REVIEW OF GREAT BASIN BANK OF NEVADA, ELKO, NEVADA 11 (Dec. 4. 2009); NATIONAL BANK OF COMMERCE MATERIAL LOSS REVIEW, supra note 152, at 4; OFFICE OF INSPECTOR GEN., FED. DEPOSIT INS. CORP., REP. NO. AUD-11-006, IN-DEPTH REVIEW OF THE FAILURE OF THE GORDON BANK, GORDON, GEORGIA 3 (May 11, 2011) [hereinafter THE GORDON BANK IN-DEPTH REVIEW].

162 *See* NORTH HOUSTON BANK AND MADISONVILLE STATE BANK MATERIAL LOSS REVIEW, *supra* note 152, at 4; THE GORDON BANK IN-DEPTH REVIEW, *supra* note 161, at 2.

163 *See* NORTH HOUSTON BANK AND MADISONVILLE STATE BANK MATERIAL LOSS REVIEW, *supra* note 152, at 16 ("Like many insured institutions, North Houston and Madisonville invested in the preferred shares of Fannie Mae and Freddie Mac because the securities were generally viewed as having low credit risk at the time the investments were made."); NATIONAL BANK OF COMMERCE MATERIAL LOSS REVIEW, *supra* note 152, at 2 ("All things considered, we believe that NBC acted in good faith when it invested in the GSE securities.").

regulators raised few concerns about the riskiness of the Enterprises' stock.[164]

Other community banks with large losses on the Enterprises' stock escaped failure by selling themselves to other banks. For example, State of Franklin Bankshares Inc. (a bank holding company with $330 million in assets) agreed to sell to Jefferson Bankshares Inc. after realizing a $10 million loss on the Enterprises' preferred shares.[165] Similarly, Gateway Financial Holding Inc. (a bank holding company with $2.1 billion in assets) agreed to sell to Hampton Roads Bankshares Inc. after realizing a $40 million loss on the Enterprises' preferred shares.[166] Camden Fine, president of the Independent Community Bankers of America, estimated that forty community banks would be forced to sell due to Fannie and Freddie stock losses.[167]

In conclusion, the FHFA's decision to allow Treasury to purchase the Enterprises' senior preferred stock resulted in significant protection for those that owned Enterprise debt, including large financial institutions. At the same time, Treasury's investment in senior preferred stock resulted in losses for banks that held the Enterprises' stock. While both small and large banks experienced losses, small banks were harder hit because their investments in the Enterprises' stock sometimes constituted a significant portion of their assets. The FHFA's decision to require banks to bear Enterprise stock losses caused some banks to fail and other banks to consolidate.

C. Enforcing Rights against Sellers

The FHFA's most recent loss-shifting decisions involve the Enterprises' efforts to collect claims they have against those who sold the Enterprises mortgages or mortgage-backed securities. Currently, the Enterprises' losses come from two primary sources. First, as mortgages the Enterprises purchased default, Fannie and Freddie recognize losses, either because they carry the mortgages on their books, or because they guarantee the mortgage-backed securities created with the mortgages.[168] Second, the Enterprises incur losses as the private-label securities they purchased decline in value due

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[164] *See* NORTH HOUSTON BANK AND MADISONVILLE STATE BANK MATERIAL LOSS REVIEW, *supra* note 152, at 16 (acknowledging that "no serious concerns regarding the [Fannie and Freddie] securities were raised [by the banks' regulators]"); NATIONAL BANK OF COMMERCE MATERIAL LOSS REVIEW, *supra* note 152, at 8–9 ("[A]t the time NBC made the purchases of the GSE securities, there would have been little basis to criticize the bank given the regulatory standards and perception of minimal risk associated with these holdings. Therefore, we do not fault OCC for not taking issue with NBC's investment practices.").

[165] *See* Hechinger, *supra* note 147, at C1.

[166] *See id.*

[167] *See id.*

[168] *See* FHFA 2009 REPORT TO CONGRESS, *supra* note 99, at iv–v; Frame, *supra* note 58, at 12.

to mortgage defaults and market conditions.[169] In both of these cases, the Enterprises might have rights enforceable against the entities (often commercial banks) from which they purchased the mortgages or private-label securities.[170] The FHFA has instructed the Enterprises to enforce their rights against banks who breached contractual warranties or other laws when selling mortgages or private-label securities to the Enterprises.[171] Yet in some instances the FHFA allows the Enterprises to settle such claims for what appears to be a fraction of their face value.[172] The following sections describe the FHFA's and the Enterprises' efforts to shift credit losses to banks in greater detail.

1. Mortgage Repurchases

The "FHFA has determined as conservator that the Enterprises should actively enforce lender compliance with contractual obligations, which include pursuing repurchases from those institutions whose loans did not meet the Enterprises' underwriting and eligibility guidelines."[173]

When an Enterprise purchases mortgages, the seller makes various representations and warranties to that Enterprise. Among other things, the seller warrants that the mortgages meet Fannie's or Freddie's underwriting and documentation criteria.[174] If Fannie or Freddie later discovers that mortgages do not comply with the representations and warranties, the seller is legally obligated to repurchase the mortgages.[175] "[T]riggers that may force put-backs include undisclosed liabilities, income or employment misrepresentation, property value falsification, and the mishandling of escrow funds."[176] If the seller is unable or unwilling to repurchase the mortgages, the Enterprise might refuse to purchase further mortgages from that seller.[177]

To ensure that mortgage sellers adhere to their representations and warranties, both Fannie and Freddie review a sample of mortgages for com-

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[169] *See* FHFA 2009 REPORT TO CONGRESS, *supra* note 99, at iv–v; Frame, *supra* note 58, at 12–14.

[170] *See* FHFA 2010 REPORT TO CONGRESS, *supra* note 12, at 3–4.

[171] *See id.*

[172] *See infra* notes 202, 214–217, 266, and accompanying text.

[173] FHFA 2010 REPORT TO CONGRESS, *supra* note 12, at 3.

[174] FANNIE MAE SELLING GUIDE, *supra* note 16, § A2-2; FREDDIE MAC SELLER GUIDE, *supra* note 16, § 6.11.

[175] FANNIE MAE SELLING GUIDE, *supra* note 16, § A2-3.2-01; FREDDIE MAC SELLER GUIDE, *supra* note 16, § 72.1. In some instances, an Enterprise may purchase a mortgage with recourse. For these mortgages, the seller "agrees to repurchase any mortgage that is delinquent for more than a specified period (usually 120 days), regardless of whether there has been a breach of representations and warranties." Fed. Home Loan Mort. Corp., Annual Report (Form 10-K) 57 (Mar. 9, 2012).

[176] CONG. OVERSIGHT PANEL, *supra* note 114, at 65.

[177] *See* Floyd Norris, *Sticking Banks with the Bill*, N.Y. TIMES, Aug. 20, 2010, at B1; Dale A. Whitman, *How Negotiability Has Fouled Up the Secondary Mortgage Market, and What to Do About It*, 37 PEPP. L. REV. 737, 746 (2010).

pliance.[178] Both Enterprises use sampling techniques that review a greater number of underperforming loans.[179] If either Enterprise discovers a breach, the Enterprise can immediately request that the seller repurchase the mortgage.[180] Both Enterprises have requested that sellers repurchase performing mortgages as well as mortgages in default.[181]

Since entering conservatorship, the Enterprises have collected billions from their mortgage repurchase requests. In 2009, "the Enterprises' lenders repurchased $8.7 billion of single-family mortgages[.]"[182] In 2010, lenders reimbursed the Enterprises for losses on $15.2 billion of loans.[183] In 2011, lenders reimbursed the Enterprises for losses on $11.5 billion of loans.[184] Because many of the mortgages originated during the housing boom are still outstanding, it is likely that high levels of repurchase requests will continue.[185] A 2010 government report estimated that banks will ultimately pay $71 billion to repurchase deficient loans that the Enterprises purchased during the housing boom.[186]

Banks that repurchase mortgages often realize a loss. However, the loss is typically lower than the outstanding balance on the loan. First, not all repurchased loans are in default.[187] Second, even if the borrower does not pay, the lender can still attempt to collect the loan through foreclosure. If the amount received through foreclosure (less the expenses of the foreclosure process) is less than the outstanding balance, the lender will often realize a loss.[188] Estimates suggest that lenders are able to recover about fifty percent

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178 *See* FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT 224–25 (2011).

179 *See id.*

180 *See* FANNIE MAE SELLING GUIDE, *supra* note 16, § A2-3.2-01; FREDDIE MAC SELLER GUIDE, *supra* note 16, § 72.1.

181 *See American Mortgages: Return to Lender*, ECONOMIST, Feb. 6, 2010, at 82; Paul Muolo, *Stung by Investor Loan Buybacks, Wisconsin Lender Closes Its Doors*, NAT'L MORTGAGE NEWS, May 17, 2010, at 2.

182 *The Future of Housing Finance: A Progress Update on the GSEs: Hearing Before the Subcomm. on Capital Mkts., Ins., and Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.*, 111th Cong. 59 (2010) (statement of Edward J. DeMarco, Acting Dir., FHFA).

183 *See* Fed. Nat'l Mort. Ass'n, Annual Report (Form 10-K) 16 (Feb. 24, 2011) (reporting settlement of repurchase requests on $8.8 billion in mortgages during 2010); Fed. Home Loan Mort. Corp., Annual Report (Form 10-K) 108 (Feb. 24, 2011) (reporting settlement of repurchase requests on $6.4 billion in mortgages during 2010).

184 *See* Fed. Nat'l Mort, Ass'n, Annual Report (Form 10-K) 175 (Feb. 29, 2012) (reporting settlement of repurchase requests on $11.5 billion in mortgages during 2011); Fed. Home Loan Mort. Corp., Annual Report (Form 10-K) 130 (Mar. 9, 2012) (reporting settlement of repurchase request on $4.5 billion in mortgages during 2011).

185 *See* Fed. Nat'l Mort. Ass'n, Annual Report (Form 10-K) 57 (Feb. 29, 2012) (predicting that repurchase requests will remain high).

186 CONG. OVERSIGHT PANEL, *supra* note 114, at 72.

187 *See supra* notes 180–181 and accompanying text.

188 *See* Christian Conte, *Fannie/Freddie Loan Buybacks Hurt Local Banks' Profits*, JACKSONVILLE BUS. J., Feb. 4, 2011, *available at* 2011 WLNR 2300311.

of the value of the loan.[189] Even so, the potential impact to banks is large—an estimated $36 billion according to a congressional oversight panel.[190]

Unsurprisingly then, some banks are unable or unwilling to repurchase loans from Fannie and Freddie. At the end of 2011, the Enterprises had $13.1 billion in outstanding repurchase requests.[191] For repurchase requests that remain outstanding, the Enterprises foreclose on the mortgaged properties and then seek to recoup actual losses from the seller.[192]

In attempting to collect outstanding repurchase requests, the Enterprises have some leverage. For example, an Enterprise may threaten to limit a delinquent seller's ability to sell new mortgages to the Enterprise or service mortgages owned by the Enterprise.[193] However, the Enterprises and the FHFA face a dilemma as they seek to collect from banks. On the one hand, any amounts collected from banks reduce the Enterprises' losses and help the Enterprises return to financial health. On the other hand, if the FHFA forces a large number of repurchases, it could destabilize the mortgage market. When the FHFA forces a lender to bear losses, the losses can potentially cause the lender to fail. For example, Universal Mortgage, a Wisconsin-based nonbank lender, failed after two secondary market investors demanded that Universal repurchase mortgages it had sold to them.[194] Anonymous sources suggest that Fannie was one of the investors that demanded repurchases from Universal.[195] While commercial banks may be able to handle repurchase requests better than other nonbank lenders, like Universal,[196]

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[189] *See* CONG. OVERSIGHT PANEL, *supra* note 114, at 71 (stating that [t]he blended average [loss] severity rate [for loans that are successfully put-back to banks] used by analysts for both [Enterprise] and the private-label loans is 50 percent"); *Obama Should Focus on Sluggish Housing to Boost Economy*, WINNIPEG FREE PRESS, Sept. 9, 2011, at B6 ("Paul Miller of FBR Capital Markets, an investment bank, calculated that banks have incurred losses of roughly 50 per cent on the $31 billion of loans they have repurchased from the GSEs since the beginning of 2009.").

[190] CONG. OVERSIGHT PANEL, *supra* note 114, at 72.

[191] *See* Fed. Nat'l Mort. Ass'n, Annual Report (Form 10-K) 16 (Feb. 24, 2011) (reporting $10.4 billion in outstanding mortgage repurchase requests); Fed. Home Loan Mort. Corp., Annual Report (Form 10-K) 130 (Mar. 9, 2012) (reporting $2.7 billion in outstanding repurchase requests).

[192] Fed. Nat'l Mort. Ass'n, Annual Report (Form 10-K) 172 (Feb. 24, 2011) (stating that "[l]enders have the option to remit payment equal to our loss, including imputed interest, on the loan after we have disposed of the [foreclosed property], which is less than the unpaid principal balance of the loan"); Fed. Home Loan Mort. Corp., Annual Report (Form 10-K) 47 (Feb. 24, 2011) ("In lieu of repurchase, we may agree to allow a seller/servicer to indemnify us against losses on such mortgages or otherwise compensate us for the risk of continuing to hold the mortgages.").

[193] *See supra* note 177 and accompanying text (describing the Enterprises' rights); Fed. Home Loan Mort. Corp., Annual Report (Form 10-K) 108 (Feb. 24, 2011) (describing Freddie's potential avenues for collecting outstanding mortgage repurchase requests).

[194] Muolo, *supra* note 181, at 2.

[195] *Id.*

[196] For a performing mortgage, a bank might repurchase the mortgage and hold it in its own loan portfolio. Nonbank lenders might not hold a portfolio of mortgages, and therefore have less ability to hold even performing mortgages. *See* Paul Muolo, *Boom Times for*

banks are still impacted by repurchase requests.[197] Losses may cause banks to reduce lending,[198] and if extreme, losses may even contribute to some banks' failures.[199] If too many lenders are impacted or if the losses are too large, repurchase requests could threaten the stability of the mortgage market.[200]

In addition, if at the direction of the FHFA, the Enterprises seek to collect from failed banks, any collection may come from the already-taxed federal deposit insurance fund. For example, both Fannie and Freddie made repurchase requests to IndyMac Bank, a large thrift that failed in July 2008.[201] Fannie ultimately settled its claim by accepting payment from the FDIC that "was significantly less than . . . existing and projected losses related to the repurchases."[202]

The Enterprises could also be negatively impacted by their collection efforts. If the Enterprises terminate contracts with lenders to induce the lenders to resolve outstanding repurchase requests, the Enterprises might cause even further consolidation in the primary mortgage market.[203] The Enterprises might also destroy the pipeline of available loans, making the Enterprises unable to reach their affordable housing goals.[204]

February 2012, Bank of America announced that as a result of conflict over repurchase requests, it would no longer sell certain mortgages to Fannie Mae.[205] Bank of America complained that Fannie's mortgage repur-

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GSE, Bank Buybacks, NAT'L MORTGAGE NEWS, Feb. 22, 2010, at 1. In addition, banks' access to "deposits or other ready sources of cash" could help them weather losses. *See* Nick Timiraos & Aparajita Saha-Bubna, *Banks Face Fight Over Mortgage-Loan Buybacks*, WALL ST. J., Aug. 18, 2010, at C1.

197 *Cf.* Conte, *supra* note 188 (noting that mortgage repurchases can result in losses that reduce a bank's capital reserves).

198 *See* Hill, *supra* note 138, at 706 (describing how bank losses can cause banks to restrict lending).

199 *Cf.* Mark DeCambre, *Backdoor Bailout–Furor Over BofA's $2.8B Mortgage Settlement*, N.Y. POST, Jan. 5, 2011, at 27 (explaining that Edward Pinto of the American Enterprise Institute believes that if Fannie and Freddie aggressively pursued mortgage repurchases from Bank of America, "it would . . . really cause[] problems for" the bank).

200 *Cf.* Bradley Keoun, *Bad Mortgages Costing Lenders*, NEWS J. (Wilmington, DE), Mar. 6, 2010, *available at* 2010 WLNR 4762310 ("'It's a fine line you're walking, because the government's trying to recapitalize the banks, not put them in bankruptcy, and then here's Fannie and Freddie putting more pressure on the banks through these buybacks,' [Paul Miller, an analyst at FBR Capital Markets] said.").

201 *See* Kate Berry, *Freddie Presses IndyMac Case*, AM. BANKER, May 14, 2009, at 10; Teri Buhl, *FDIC Faces Up to $10B Whack on IndyMac Loans*, N.Y. POST, Jan. 11, 2009, at 32 (describing the Enterprises' repurchase requests).

202 Fed. Nat'l Mort. Ass'n, Quarterly Report (Form 10-Q) 93 (May 8, 2009).

203 *Cf.* Fed. Nat'l Mort. Ass'n, Annual Report (Form 10-K) 48 (Feb. 24, 2011) (noting "ongoing consolidation with the mortgage industry").

204 *See* Fed. Home Loan Mort. Corp., Annual Report (Form 10-K) 261 (Feb. 24, 2011) (stating that Freddie could "lose purchase volume to the extent that [purchase] arrangements are terminated without replacement from other lenders").

205 Bank of America Corp., Annual Report (Form 10-K) 5 (Feb. 23, 2012) ("Beginning in February 2012, we are no longer delivering purchase money and non-Making

chase requests were not consistent with the Enterprise's past practices or with Bank of America's contractual obligations.[206] Bank of America stated that its move away from Fannie Mae would have little impact on its mortgage business because the Bank would continue to sell mortgages to Freddie Mac.[207] At the time, at least one mortgage industry observer speculated that Bank of America's move was crafted to induce Fannie to move to more reasonable mortgage repurchase requests.[208]

A few days after Bank of America's announcement, Fannie Mae made its own public disclosure stating that it (rather than Bank of America) had decided to restrict the pipeline of new mortgages from Bank of America to the Enterprise.[209] Fannie explained that its move was motivated by Bank of America's failure to resolve outstanding mortgage repurchase requests.[210] In 2011, Bank of America accounted for "approximately 12% of [Fannie's] single-family business volume."[211] In addition, Bank of America and its affiliates "serviced approximately 21% of [Fannie's] single-family guaranty book of business . . . ."[212] Nevertheless, Fannie Mae predicted that the change would have little financial impact on the Enterprise.[213]

While Fannie's move with respect to Bank of America is aggressive, it does not appear that either Enterprise is willing to go to such extreme length to collect all repurchase claims. Perhaps motivated by its mandate to provide mortgage market stability or perhaps motivated by a desire to maintain a pipeline of mortgages for the Enterprises, FHFA authorized the Enterprises to enter some settlement agreements not just with the FDIC,[214] but also with banks. Prior to its falling out with Bank of America, Fannie had settled $3.9 billion in repurchase claims by agreeing to accept payment from Bank

Home Affordable Program (MHA) refinance first-lien residential mortgage products into [Fannie Mae] mortgage-backed securities (MBS) pools because of the expiration and mutual non-renewal or certain contractual delivery commitments and variances that permit efficient delivery of such loans to [Fannie Mae].").

206 *Id.*

207 *Id.*

208 David Benoit & Nic Timiraos, *Global Finance: BofA Pares Its Ties to Fannie*, WALL ST. J., Feb. 24, 2012, at C3 ("The decision to sharply curtail loan deliveries to Fannie is significant because 'to my knowledge, no lender large or small has ever taken that step' said Guy Cecala, publisher of Inside Mortgage Finance. 'Let's face it: This is a pretty big piece of artillery BofA is using.'").

209 Fed. Nat'l Mort. Ass'n, Annual Report (Form 10-K) 176–77 (Feb.2012).

210 Fannie explained that "[i]n the fourth quarter of 2011, Bank of America slowed the pace of its repurchases. As a result, the already high volume of [Fannie's] outstanding repurchase requests with Bank of America increased substantially," *Id.* at 52. In an effort to "address Bank of America's delays in honoring [its] repurchase requests [Fannie] did not renew [its] existing loan delivery contract with [the Bank]." *Id.* at 176.

211 *Id.* at 52.

212 *Id.* at 175.

213 *Id.* at 177 ("We do not expect the change in our agreement with Bank of America to be material to our business or results of operations as Bank of America represented less than 5% of our loan delivery volume in the quarter ended December 31, 2011.").

214 *See supra* note 202 and accompanying text.

of America totaling $1.5 billion.[215] Fannie also reached a settlement with Ally Financial, Inc., under which the Enterprise received $462 million to resolve $292 billion worth of repurchase requests.[216] Similarly, Freddie agreed to accept $1.28 billion from Bank of America to settled Freddie's demand for repurchase of $114 billion in mortgages.[217]

There is disagreement about whether the Enterprises' buyback demands and settlements strike the right balance of limiting the Enterprises' losses while recognizing the Enterprises' public purpose. Some criticize the repurchase requests as overaggressive moves by the Enterprises that unfairly burden banks during an economic downturn.[218] Others decry the settlements as sweetheart deals for banks that force the Enterprises and the taxpayers to realize losses.[219] Part of the disagreement stems from the fact that outsiders are unsure how much balancing the FHFA did in approving the settlements. Because neither the Enterprises nor the banks release proprietary information that would allow detailed loss estimates for the underlying mortgages, it is impossible to determine the amount of loss that the Enterprises may realize as a result of settlements. The FHFA has said only that the Enterprises' settlements with Bank of America were "consistent with market practice and FHFA's conservatorship responsibilities."[220] The FHFA's Office of Inspector General is reviewing the settlements,[221] but it is unclear whether this review will result in the public release of additional information concerning the settlements.

In any event, it is likely that large banks will receive the majority of the Enterprises' mortgage repurchase requests. As previously discussed, the

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[215] Fed. Nat'l Mort. Ass'n, Annual Report (Form 10-K) 173 (Feb. 24, 2011) ("Bank of America agreed, among other things, to a resolution amount of $1.5 billion, consisting of a cash payment of $1.3 billion made by Bank of America on December 31, 2010, and other payments recently made or to be made by them.").

[216] *See id.*; *Regulator Asked to Clarify Settlements*, BOSTON GLOBE, Jan. 13, 2011, at 6.

[217] Fed. Home Loan Mort. Corp., Annual Report (Form 10-K) 109 (Feb. 24, 2011). Freddie also reached settlements of an undisclosed amount with GMAC Mortgage, LLC and Residential Funding Company, LLC, subsidiaries of Ally Financial Inc. *Id.*

[218] *See* Muolo, *supra* note 196, at 1 (quoting a Wall Street managing director who said, "Three years after a loan is made and suddenly Fannie or Freddie wants a buyback. It seems ridiculous. Whose portfolio can stand that test of time?"); *see also* note 206 and accompanying text (discussing Bank of America's criticism of Fannie's buyback requests).

[219] DeCambre, *supra* note 199, at 27 ("'I'm concerned that the settlement between Fannie Mae and Freddie Mac and Bank of America over misrepresentations in the mortgages BofA originated may amount to a backdoor bailout that props up the bank at the expense of taxpayers,' Congresswoman Maxine Waters (D-Calif.) said . . . ."); David S. Hilzenrath, *Bank of America Settles Loan Dispute with Fannie and Freddie*, WASH. POST, Jan. 3, 2011, at A10 ("'This is a gift' from the government to the bank, said Christopher Whalen of Institutional Risk Analytics. 'We're all paying for this because it will show up in the losses from Fannie and Freddie,' he said.").

[220] Hilzenrath, *supra* note 220, at A10.

[221] *See* FED. HOUS. FIN. AGENCY OFFICE OF INSPECTOR GEN., INAUGURAL SEMIANNUAL REPORT TO THE CONGRESS 23, 43 (Mar. 31. 2011).

bulk of the Enterprises' mortgage purchases came from a handful of large banks, including Bank of America, JP Morgan Chase, Wells Fargo, and Citigroup.[222] Consequently, these banks will likely face most of the Enterprises' repurchase requests.[223] However, the Enterprises' repurchase requests do not fall solely on large banks. Fannie and Freddie have requested mortgage repurchases from smaller banks.[224] Moreover, large banks that receive mortgage repurchase requests from the Enterprises may not have originated the loans. Some large banks are already requesting that smaller banks and other mortgage originators repurchase loans.[225] Smaller banks are likely less able than their larger competitors to negotiate favorable settlements on loan repurchase requests because the Enterprises and large banks are unlikely to rely on a pipeline of loans from smaller banks.[226] In addition, the FHFA is unlikely to view the failure of a few smaller banks as a danger to the stability of the mortgage market. Thus, although the largest banks will face the bulk of repurchase requests, small banks and nonbank lenders are more likely to be fatally wounded by repurchase requests.

2. Private-Label Securities Litigation

The FHFA is also helping the Enterprises recoup losses on private-label securities. Fannie and Freddie, like many mortgage investors, purchased private-label securities issued by large financial institutions. Many of the mortgages backing these private-label securities were sub-prime or Alt-A mortgages.[227] The Enterprises' losses on these securities have been particularly steep.[228]

When an issuer offers private-label securities for sale, the issuer provides information to potential investors describing the securities. This information is contained in registration statements, prospectuses, and prospectus supplements filed with the Securities and Exchange Commission.[229] For

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[222] *See supra* notes 111–114 and accompanying text.

[223] *See* CONG. OVERSIGHT PANEL, *supra* note 114, at 66–67 (describing the Enterprises' repurchase requests to large banks).

[224] *See* Conte, *supra* note 188.

[225] *See* Amilda Dymi, *War Over Buybacks Add to Pressure*, NAT'L MORTGAGE NEWS, June 7, 2010, at 13.

[226] *See supra* notes 111–113 and accompanying text.

[227] *See* FINANCIAL CRISIS INQUIRY COMMISSION, *supra* note 178, at 225 ("[O]ver the course of the housing boom the [Enterprises] purchased $690 billion of subprime and Alt-A private-label securities."); Frame, *supra* note 58, at 13 ("As of mid-year 2007, the [Enterprises] held $252.7 billion in mortgage securities backed by subprime and Alt-A mortgages—virtually all of which were rated AAA.").

[228] "Market values of private-label mortgage-backed securities held by the Enterprises plummeted during [2008]." FHFA 2008 REPORT TO CONGRESS, *supra* note 82, at 29. Fannie lost "more than $26 billion," and Freddie lost "more than $53 billion." *Id.* at 32, 47.

[229] *See* TASK FORCE ON MORTGAGE-BACKED SECURITIES DISCLOSURE, STAFF REPORT: ENHANCING DISCLOSURE IN THE MORTGAGE-BACKED SECURITIES MARKETS 24–25 (Jan. 2003), *available at* http://permanent.access.gpo.gov/lps77447/disclosure.pdf ("Unlike

mortgage-backed securities, these documents describe the characteristics of the mortgages backing the securities, such as the underwriting guidelines that were used in originating the mortgages.[230] Issuers of private-label securities purchased by the Enterprises followed these same practices.[231] In addition "securities sold to the Enterprises were often customized for their purchase because of the conforming loan requirement of [the Enterprises'] charters."[232]

As the Enterprises experienced losses on the private-label securities, they began to "assess and enforce their rights as investors."[233] In particular, "the Enterprises . . . attempted to determine whether misrepresentations, breaches of warranties or other acts or omissions by [private-label securities] counterparties would require repurchase of loans underlying the [securities] by the counterparties and whether other remedies might be appropriate."[234] To determine whether misrepresentations or breaches of warranty occurred, the Enterprises needed to compare actual loan files with the sellers' representations. However, the servicers (often large banks) that held these files were unwilling to voluntarily provide the Enterprises with the requested documents.[235]

For other private-label securities investors, getting access to loan files has proved to be a large barrier to successful suits against the securities issuers.[236] The FHFA helped the Enterprises overcome this barrier by using

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[Enterprise mortgage-backed securities], offerings of private-label [securities] are subject to the registration requirements of the federal securities laws. As such the offer and sale of these securities must be done pursuant to a registration statement filed with the Commission or pursuant to an exemption. . . . Market participants have indicated that the vast majority of private-label [securities], over 98% in 2001, are sold in registered transactions with the remainder being sold in rule 144A transactions."); Steven L. Schwarcz, *Disclosure's Failure in the Subprime Mortgage Crisis*, 2008 UTAH L. REV. 1109, 1110 n.6 (noting that "the disclosure documents ordinarily consist of a prospectus and a prospectus supplement, each close to two-hundred pages long").

230 *See* TASK FORCE ON MORTGAGE-BACKED SECURITIES DISCLOSURE, *supra* note 230, at 26–27.

231 *See* Press Release, Fed. Hous. Fin. Agency, Federal Housing Finance Agency Statement on Recent Lawsuits Filed (Sept. 6, 2011), *available at* http://www.fhfa.gov/ webfiles/22606/LawsuitStatement9611.pdf [hereinafter FHFA Statement on Lawsuits].

232 *Id.*

233 Press Release, Fed. Hous. Fin. Agency, FHFA Issues Subpoenas for PLS Documents (July 12, 2010), *available at* http://www.fhfa.gov/webfiles/ 15935/PLS_subpoena_final__7_12_10.pdf [hereinafter FHFA Subpoena Press Release].

234 *Id.*

235 *See id.*

236 *See* Jia Lynn Yang, *Mortgage Scandal Aids Argument of Securities Investors*, WASH. POST, Oct. 17, 2010, at A19 (noting investors groups have "struggled to force the banking industry to hand over data critical to [mortgage-backed securities] lawsuit[s]"). In some cases, investors have sued the security issuer using statistical data and then sought loan file documents through discovery. *See, e.g.*, Complaint ¶ 7, Am. Int'l Group, Inc. v. Bank of Am. Corp., No. 652199/2011, (N.Y. Sup. Ct. Aug. 8, 2011), 2011 WL 3427135 (noting that "AIG is confident that a review of the complete loan files in discovery will demonstrate that the [mortgage-backed securities] fraud perpetrated by Defendants is even more rampant than

its conservator powers to subpoena the needed loan documents.[237] On July 12, 2010, the FHFA announced that it had used its subpoena powers to request documents from sixty-four entities.[238] Although the FHFA did not release a list of the subpoena recipients, a few banks, including JP Morgan Chase, disclosed that they received subpoenas.[239]

Using information they collected with the subpoenas, the FHFA and the Enterprises filed suit against eighteen large financial institutions, including Bank of America, Citigroup, and JPMorgan Chase.[240] Each of the complaints alleges that the defendants' offering documents contained untrue statements of material fact in violation of sections 11, 12(a)(2), and 15 of the Securities Act of 1933.[241] Seventeen of the complaints also allege that the defendants negligently represented the quality of the mortgages securitized.[242] Finally, some of the complaints contain allegations of state securities law

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AIG's forensic analysis reveals."). Alternatively, a quorum of investors (usually at least 25%) may demand that the security's trustee see access to loan files from the servicer. *See* Jeff Horwitz, *More Heat on Servicers: MBS Trustees Sue Them to Gain Access to Loan Files*, AM. BANKER, Feb. 7, 2011, at 1 (discussing trustees' actions to gain access to servicer documents).

237 *See supra* note 72 and accompanying text (discussing the FHFA's subpoena power as conservator).

238 FHFA Subpoena Press Release, *supra* note 234.

239 *See, e.g.*, *First Horizon Discloses Subpoena*, COM. APPEAL (Memphis, TN), Nov. 2, 2010, at C2 (reporting that First Horizon National Corp., parent company of First Tennessee Bank received a subpoena); Dave Reilly, *J.P. Morgan Growth Tale Unfinished*, WALL ST. J., July 16, 2010, at C10 (reporting that J.P. Morgan Chase & Co. received a subpoena).

240 Press Release, Fed. Hous. Fin. Agency, FHFA Sues UBS to Recover Losses to Fannie Mae and Freddie Mac (July 27, 2011), *available at* http://www.fhfa.gov/webfiles/21842/UBS072711FINAL.pdf; Press Release, Fed. Hous. Fin. Agency, FHFA Sues 17 Firms to Recover Losses to Fannie Mae and Freddie Mac (Sept. 2, 2011), *available at* http://www.fhfa.gov/webfiles/22599/PLSLitigation_final_090211.pdf [hereinafter FHFA Private-Label Securities Suits Press Release] (announcing suits against Ally Financial Inc.; Bank of America Corporation; Barclays Bank PLC; Citigroup, Inc.; Countrywide Financial Corporation; Credit Suisse Holdings (USA), Inc.; Deutsche Bank AG; First Horizon National Corporation; General Electric Company; Goldman Sachs & Co.; HSBC North America Holdings, Inc.; JPMorgan Chase & Co.; Merrill Lynch & Co. / First Franklin Financial Corp; Morgan Stanley; Nomura Holding America Inc.; The Royal Bank of Scotland Group PLC; and Société Générale).

241 *See* Complaint at 87–96, Fed. Hous. Fin. Agency v. UBS Americas Inc., No. 11 CIV 05201 (S.D.N.Y. July 27, 2011), 2011 WL 3117873 (alleging UBS violated sections 11, 12(a)(2), and 15 of the Securities Act of 1933); FHFA Private-Label Securities Suits Press Release, *supra* note 241 (noting that the seventeen suits filed in September contained securities claims similar to those in the UBS suit); *see also* 15 U.S.C. § 77k(a) (2006) (providing liability for registration statements that "contained an untrue statement of a material fact or omitted to state a material fact required to be stated"); *id.* § 77l(a)(2) (providing liability for "any person who . . . offers or sells a security . . . by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements . . . not misleading"); *id.* § 77o(a) (providing for joint and several liability of "controlling persons"—persons who control any person liable under other securities laws).

242 *See* FHFA Private-Label Securities Suits Press Release, *supra* note 241 (describing complaints). Negligent misrepresentation is a common law claim that in New York

violations and fraud.[243] The FHFA alleges the Enterprises were misled with untrue representations concerning the loan-to-value ratios,[244] the owner occupancy rates,[245] the credit ratings,[246] and the underwriting standards[247] of the underlying mortgages. While all of the complaints seek damages, only the UBS complaint provides a dollar figure.[248] The UBS complaint seeks to recover $900 million in losses from $4.5 billion in securities.[249]

Some of the banks the FHFA sued immediately denied responsibility. For example, Deutsche Bank called the FHFA claims "unfounded."[250] Some banks argued that the Enterprises were sophisticated investors who knew what they were purchasing. Deutsche explained, "Fannie Mae and Freddie Mac are the epitome of a sophisticated investor, having issued trillions of dollars of mortgage-backed securities and purchased hundreds of billions of dollars more, often after hand-picking the loans they now claim should not have been included in the offerings."[251]

The FHFA was irked enough by these statements that it released a response saying, "Under the securities laws at issue here, it does not matter

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requires "(1) the existence of a special or privity-like relationship imposing a duty on the defendant to impart correct information to the plaintiff; (2) that the information was incorrect; and (3) reasonable reliance on the information." J.A.O. Acquisition Corp. v. Stavitsky, 863 N.E.2d 585, 587 (N.Y. 2007).

243 *See* FHFA Private-Label Securities Suits Press Release, *supra* note 241.

244 *See, e.g.*, Complaint ¶¶ 116–21, Fed. Hous. Fin. Agency v. Bank of America, No. 11-CV-06195 (S.D.N.Y Sept. 2, 2011), 2011 WL 3873302.

245 *See, e.g.*, Complaint ¶¶ 109–12, Fed. Hous. Fin. Agency v. Citigroup, Inc., No. 11-CV-06196 (S.D.N.Y. Sept. 2, 2011), 2011 WL 3873301.

246 *See, e.g.*, Complaint ¶¶ 104–07, Fed. Hous. Fin. Agency v. Goldman, Sachs & Co., No. 11-CV-06198 (S.D.N.Y. Sept. 2, 2011), 2011 WL 3873305.

247 *See, e.g.*, Complaint ¶¶ 88–92, Fed. Hous. Fin. Agency v. Gen. Electric Co., No. 652439/2011, (N.Y. Sup. Ct. Sept. 2, 2011), 2011 WL 6738328.

248 *See* FHFA Statement on Lawsuits, *supra* note 232. The FHFA explained:

> FHFA seeks recoveries for losses associated with securities laws violations and other improper actions set forth in the complaints. Actual recoveries will be determined based on filings by the parties, evidence and judicial findings. At this time, it would be premature and potentially misleading to estimate the size of any potential recoveries. However, press reports that FHFA is seeking nearly $200 billion in damages or recoveries are excessive; such numbers reflect the original amount of such securities purchased, not the losses incurred or the potential recoveries at the end of this process.

Id.

249 *See* Complaint ¶ 331, Fed. Hous. Fin. Agency v. UBS Americas Inc., No. 11 CIV 05201 (S.D.N.Y. July 27, 2011), 2011 WL 3117873.

250 Nelson D. Schwartz & Kevin Roose, *U.S. Sues 17 Mortgage Institutions*, N.Y. TIMES, Sept. 3, 2011, at B1 (quoting Deutsche Bank spokesman Frank Kelly); *see also* Nick Timiraos et al., *U.S. Sues Big Banks Over Home Mortgages*, WALL ST. J., Sept. 3, 2011, at A1 (reporting that Bank of America released a statement denying any impropriety).

251 Schwartz & Roose, *supra* note 251, at B1; *see also* Timiraos et al., *supra* note 251, at A1 ("Bank of America issued a similar statement, noting that Fannie and Freddie 'continued to invest heavily in those securities even after their regulator told them they did not have the risk management capabilities to do so.'").

how 'big' or 'sophisticated' a security purchaser is, the seller has a legal responsibility to accurately represent the characteristics of the loans backing the securities being sold."[252]

Both sides may be partly right. Sophisticated investors can generally bring actions under sections 11, 12(a)(2), and 15 of the Securities Act of 1933.[253] However, a recent New York appellate court decision dismissed a negligent misrepresentation claim brought against Countrywide for statements it made to an insurer of mortgages that Countrywide securitized.[254] The court explained that "negligent misrepresentation requires a showing of a special relationship of trust or confidence[,]" but this type of relationship "does not arise out of an ordinary arm's length business transaction between two parties."[255] The court specifically noted that both Countrywide and the insurer were "sophisticated commercial entities" capable of bargaining with each other.[256] At any rate, with banks vowing to fight the complaints,[257] it may be years before the Enterprises receive payments as a result of this litigation.[258]

However, in pursuing the private-label securities claims and potentially negotiating settlements, the FHFA faces much the same dilemma it does in pursuing mortgage repurchases.[259] If the FHFA is too zealous in its efforts to minimize Enterprise losses, it may risk destabilizing the mortgage market. Some commentators worry that the FHFA suits could push some large banks to the brink of disaster. For example, "Tim Rood who worked at Fannie Mae until 2006 and is now a partner at the Collingwood Group," worries that the FHFA suits "risk pushing these [banks] off a cliff and we're go-

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252 *See* FHFA Statement on Lawsuits, *supra* note 232.

253 Sections 11, 12(a)(2), and 15 give standing to persons who purchase securities from the issuer. *See* 15 U.S.C. §§ 77k, 77l, 77o (2006). However, investors who "at the time of acquisition . . . knew of such untruth or omission" are precluded from recovery. *Id.* § 77k.

254 MBIA Ins. Corp. v. Countrywide Home Loans, Inc., 87 A.D.3d 287, 296–97 (N.Y. App. Div. 2011).

255 *Id.*

256 *Id.*

257 *See, e.g.*, Robin Sidel et al., *World-Wide, Bad News You Can Take to Bank*, WALL ST. J., Sept. 6, 2011, at C1 (reporting that "RBS said it believed it has 'substantial and credible legal and factual defenses to these claims and will defend them vigorously'"); Nick Timiraos & Al Yoon, *Global Finance: Big Banks Face Suits on Mortgage Bond Losses*, WALL ST. J., Sept. 2, 2011, at C3 (reporting that UBS stated it would "vigorously" defend the FHFA's suit).

258 Fed. Home Loan Mort. Corp., Annual Report (Form 10-K) 45 (Feb. 24, 2011) ("The effectiveness of . . . loss mitigation efforts [regarding private-label securities] is highly uncertain and any potential recoveries may take significant time to realize."); David Reilly, *No Respite as Bank Suits Continue to Pinch Investors*, WALL ST. J., Sept. 7, 2011, at C26 (noting that "the legal process [of the FHFA suits] could be protracted, so any losses [for banks] may be years away").

259 *See supra* notes 194–204 and accompanying text (describing the dilemma faced by the FHFA and Enterprises in collecting mortgage repurchase requests).

ing to have to bail out the banks again."[260] Others worry that protracted litigation will stall economic recovery as banks hoard capital in anticipation of potential losses. Crédit Agricole analyst Mike Mayo opines, "Banks should pay for what they did wrong, but at the same time they shouldn't be treated as a big piñata that has the effect of delaying the housing recovery. If banks have to pay for loans they made five years ago, are they going to make new ones?"[261]

The FHFA has acknowledged such worries but maintains that the suits will promote market stability by enforcing securities laws. FHFA explained:

> Some have claimed that these suits will disrupt economic recovery, or endanger the targeted banks, or increase their cost of capital. While everyone is concerned with these important issues, the long-term stability and resilience of the nation's financial system depends on investors being able to trust that the securities sold in this country adhere to applicable laws. We cannot overlook compliance with such requirements during periods of economic difficulty as they form the foundations for our nation's financial system. Therefore, through these lawsuits, FHFA turns to the courts to adjudicate the violations that it has alleged in its complaints.[262]

The statement seems to suggest that the FHFA will require all of the sued banks to completely cover losses on private-label securities and that the FHFA will resort to litigation, if necessary, to secure such payment.

Notwithstanding the FHFA's seemingly hard-line statement, it seems unlikely that the FHFA will be willing to litigate any of these suits to the death of a large bank. First, the Enterprises depend on many of the large banks as a source of new mortgages and as servicers of existing mortgages.[263] Collection efforts could, therefore, end up harming the Enterprises. Second, the FHFA has repeatedly stated that it hopes to encourage the return of the private-label securities market.[264] It may be difficult to encourage new

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260 Nelson D. Schwartz, *U.S. Is Set to Sue Dozen Big Banks Over Mortgages*, N.Y. TIMES, Sept. 2, 2011, at A1.

261 Schwartz & Roose, *supra* note 251, at B1. A similar sentiment has been expressed by banking attorney Andrew Sandler:

> The government is coming at the banks from every direction—the FHFA lawsuits being the most recent example—at the same time the government is putting enormous pressure on the banks to extend credit to help alleviate the housing crisis . . . . It constitutes a completely incoherent government approach to the housing crisis.

Timiraos et al., *supra* note 251, at A1.

262 FHFA Statement on Lawsuits, *supra* note 232.

263 *See supra* notes 111–113 and accompanying text.

264 *See, e.g.*, FHFA 2010 REPORT TO CONGRESS, *supra* note 12, at v (noting that "expanding private sector capital and participation is essential for the long-term health of the mortgage market").

private securitization if the primary participants in the market face uncertain or exorbitant losses. Moreover, the Enterprises have already started to reach settlements on private-label securities claims. Even before the suits were filed, Fannie had reached a settlement with Ally Financial that released "Ally affiliates from potential liability relating to certain private-label securities sponsored by the subsidiaries[.]"[265] It seems likely that other such settlements will be reached. It is still unclear whether the Enterprises or large banks will bear the bulk of losses on private-label securities.

IV. EVALUATING LOSS SHIFTING

An examination of the FHFA's key loss-shifting decisions shows that the FHFA's conflicting mandate gives it significant power to determine who will bear the financial impact of a huge number of soured mortgages. In general, the FHFA has been more willing to shift losses to small banks and less willing to shift losses to large banks, potentially exacerbating the problems of banks that are too big to fail. This Part explains why large bank favoritism is in some ways an inevitable result of the FHFA's conflicting mandates.

The Article then argues that the FHFA's loss-shifting practices are also troubling because the FHFA formulates its policies behind closed doors with little opportunity for public comment. Even once the FHFA reaches a loss-shifting decision, the FHFA rarely releases enough information for public observers to evaluate the decision. This Article urges the FHFA to adopt disclosure practices that will allow the public to evaluate the Enterprises' settlements of mortgage repurchase and private-label mortgage-backed securities claims.

A. Too Big to Fail

While acting as conservator, the FHFA's loss-shifting policies have often assisted large banks. The FHFA's decision to allow the Enterprises to continue their secondary market activity has been a boon to large banks that sell the vast majority of mortgages to the Enterprises.[266] The FHFA's decision to allow Treasury investment in the Enterprises protected a number of large banks that held Enterprise debt.[267] And the Enterprises' settlements regarding mortgage repurchases and private-label securities liability have, so far, seemed favorable to large banks.[268]

On the other hand, FHFA policies have sometimes strained small banks. The FHFA's decision to allow Treasury investment in the Enterprises hit small banks who owned the Enterprises' preferred stock especially

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[265] Fed. Nat'l Mort. Ass'n, Annual Report (Form 10-K) 173 (Feb. 24, 2011).

[266] *See supra* notes 106–115 and accompanying text.

[267] *See supra* notes 126–131 and accompanying text.

[268] *See supra* notes 215–217, 266, and accompanying text.

hard.[269] In spite of efforts by bank regulators to minimize the damage, some small banks still failed.[270] In addition the FHFA's decisions to allow the Enterprises to increase guarantee fees likely hurts small banks more than large banks because large banks receive substantial volume discounts when selling mortgages to the Enterprises.[271] At the same time, small banks are less likely to benefit from the Enterprises' continued securitization efforts because many small banks do not originate or sell a large volume of mortgages.[272]

To a certain extent, a preference for large banks is the naturally occurring result of the FHFA's mandate to stabilize the secondary mortgage market. Large financial institutions are more likely to pose systemic risk—that is the risk that the failure of the bank or banks would have "socially unbearable macroeconomic consequences."[273] If a large or interconnected bank fails, that failure could be disastrous to the entire economy. Thus, the FHFA's market stability mandate suggests that the FHFA should avoid policies that cripple systemically important institutions. Small banks, on the other hand, that are not interconnected do not pose the same risk. After all, the problem is popularly described as "too-big-to-fail," not "too-medium-to-fail" or "too-small-to-fail."[274] Because damaging small banks may not have any significant destabilizing impact on the broader market, the FHFA may be able to shift losses to small banks in order to satisfy its mandate to return the Enterprises to financial health.

Yet an approach that systematically shifts losses to smaller banks while protecting larger banks is troubling from a public policy perspective because it only exacerbates the too-big-to-fail problem. All bailouts tend to encourage entities to achieve too-big-to-fail status. However, bailouts coupled with policies that burden smaller competitors of the too-big-to-fail entities can cause even more consolidation and even more systemic risk.

B. Transparency

The FHFA's loss-shifting practices are also troubling because they are not transparent. The FHFA can make loss-shifting decisions that significantly impact the housing and financial markets as well as individual banks. Yet the FHFA's decision-making process and results of its loss-shifting decisions are largely hidden. Because the FHFA releases very little information, it is difficult to determine how much each of the large banks have benefitted

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[269] *See supra* notes 132–143 and accompanying text.

[270] *See supra* notes 144–167 and accompanying text.

[271] *See supra* notes 116–118 and accompanying text.

[272] *See supra* notes 111–115 and accompanying text.

[273] *See* Adam J. Levitin, *In Defense of Bailouts*, 99 GEO. L.J. 435, 446–47 (2011) (defining "systemic risk").

[274] For general discussions of the too-big-to-fail problem, see Ann Graham, *Bringing to Heel the Elephants in the Economy: The Case for Ending "Too Big to Fail,"* 8 PIERCE L. REV. 117, 118–129 (2010); Arthur E. Wilmarth Jr., *Reforming Financial Regulation to Address the Too-Big-To-Fail Problem*, 35 BROOK. J. INT'L L. 707, 739–47 (2010).

from the FHFA decisions to continue securitizations, to allow Treasury to effectively guarantee Enterprise debt, and to forgo mortgage repurchase requests and private-label securities claims.

The result is that while there is public concern about the Treasury dollars continuing to pour into Fannie and Freddie,[275] most of the blame for the Enterprises' continuing losses is placed at the feet of their flawed business models, political pressure, inept or unscrupulous management, or lax regulations and regulators.[276] Rarely do commentators acknowledge the continuing assistance that Fannie and Freddie provide to the largest banks. Even when press reports question FHFA settlements with sellers of mortgages and private-label securities, the FHFA does not disclose enough information to determine the actual loss the Enterprises are absorbing.[277]

It is generally believed that transparency encourages political accountability.[278] It is certainly possible that if the FHFA more clearly disclosed its loss-shifting decisions and the impact of those decisions, the FHFA would balance its mandates differently. For example, when Congress authorized Treasury's investment in banks through TARP, Congress explicitly stated that small banks must have equal access to TARP funds.[279] This type of Congressional action seems to be predicated on a belief that small banks should be treated at least as favorably as those financial institutions that enjoy too-big-to-fail status. It is possible that if the FHFA's decisions were subject to transparent disclosure, it too would adopt practices that treat small banks at least as favorably as larger banks.

It is important for policymakers to realize that Fannie and Freddie are not the government's only economic or housing policy tools. If the government wants to provide assistance to banks (or homeowners or auto companies) it has a variety of tools it can use. The FHFA's attempts to implement public policy goals through the Enterprises without meaningful disclosure are similar to Congress' attempts to implement public policy goals through the Enterprises while they were privately owned: they are both back-

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275 *See, e.g.*, *Posters Have a Dialogue on the Future of the Secondary Market*, NAT'L MORTGAGE NEWS, Aug. 15, 2011, at 8 ("Fannie Mae wants more money. This is what happens when politics trumps good business sense.").

276 *See* DEP'T OF THE TREASURY & U.S. DEP'T OF HOUS. AND URBAN DEVELOP., REFORMING AMERICA'S HOUSING FINANCE MARKET: A REPORT TO CONGRESS 8–9 (Feb. 2011), *available at* http://portal.hud.gov/hudportal/documents/huddoc?id=housingfinmarketreform.pdf.

277 *See supra* notes 221–222 and accompanying text.

278 *See, e.g.*, Margaret B. Kwoka, *The Freedom of Information Act Trial*, 61 AM. U. L. REV. 217, 219 (2011) (noting that government transparency would lead to accountability).

279 *See* 12 U.S.C.A. § 5213 (West 2012) (stating that Treasury should "ensur[e] that all financial institutions are eligible to participate in the [TARP] program, without discrimination based on size, geography, form of organization, or the size, type, and number of assets eligible for purchase under this chapter"). Although Congress' instruction was clear, Treasury acted more quickly to provide TARP funds to the largest banks. *See supra* notes 148–153 and accompanying text.

door approaches that deflect public scrutiny and provide little in the way of accountability.[280]

The FHFA as conservator should adopt a broad policy of disclosure to allow public evaluation of its loss-shifting decisions.[281] In particular, the FHFA should disclose the sources of its loan purchases and its guarantee fees, including how those fees differ depending on the number of mortgages purchased and the identity of the seller. The FHFA should also disclose enough information regarding its settlements of mortgage repurchase requests and securities claims to allow for a meaningful evaluation of the benefit provided to each bank that receives a settlement. Such disclosures introduce a level of accountability into FHFA decision making that is currently lacking.

V. CONCLUSION

For the last three years, the FHFA has operated under mandates to stabilize the mortgage market and return the Enterprises to financial health. So far, the result has been less than impressive. The Enterprises continue to require infusions of government capital,[282] and the housing market is still far from healthy.[283] Moreover, the FHFA's conflicting mandates encourage the Enterprises to shift losses to smaller banks while absorbing losses that could be passed on to large banks, potentially exacerbating the problem of banks that are too big to fail. At the same time, FHFA labors in obscurity. Because the FHFA does not disclose much information about its decisions, it is difficult to determine whether the FHFA strikes the appropriate balance between affordable housing and Enterprise health. The FHFA should adopt disclosure policies to allow the public to evaluate the benefits and burdens passed from Fannie and Freddie to commercial banks.

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[280] When the Enterprises were funded by purely private investment, it may have been appropriate for the Enterprises to conceal proprietary information in order to compete with other private companies.

[281] Nothing precludes the FHFA from adopting more fulsome disclosures on its own. This approach is preferable because disclosures could begin almost immediately. However, if the FHFA is slow to adopt disclosures, Congress should pass legislation requiring the FHFA to disclose a broad array of information when operating as conservator.

[282] *See* Jeff Clabaugh, *Freddie Mac Seeks Another $1.5B*, WASH. BUS. J., Aug. 9, 2011, *available at* 2011 WLNR 15746209 (noting that Fannie had also recently announced it would need $5.1 billion).

[283] *See* Nick Timiraos, *The Outlook: Economic Rx: More Refinancing*, WALL ST. J., Sept. 6, 2011, at A2.