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Fannie Mae and Freddie Mac: What Happens When the Time-Out is Over?

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The recent housing and financial crisis has reignited a debate involving the two housing Government Sponsored Enterprises ("GSEs"), Freddie Mac and Fannie Mae. Problems escalated with the downturn in the U.S. housing economy which forced the U.S. government to take extreme measures. Freddie Mac and Fannie Mae were placed into conservatorship, providing them a temporary time-out. This Paper examines the options that exist for Freddie Mac and Fannie Mae when the conservatorship ends.

Section I reviews the business practices and characteristics of the GSEs that may have led to conservatorship. The Paper then discusses the Housing and Economic Recovery Act (HERA), passed by Congress in July 2008. HERA created a new regulator, the Federal Housing Finance Agency (FHFA), with expanded authority over the GSEs. Next, the Paper analyzes conservatorship, the FHFA's short-term solution to rehabilitate the GSEs, and summarizes the actions taken under the conservatorship.

The Paper continues with an evaluation of the possible long-term solutions for the GSEs: (1) Return to pre-conservatorship status; (2) Privatization; (3) Nationalization; or (4) Mixed-Model. Section IV critically analyzes the advantages and disadvantages of each long-term solution, and provides ideas on implementation of the solutions. Lastly, the Paper discusses which long-term solution the Obama administration may choose. The Paper then concludes that all of the possible long-term solutions present both distinct advantages and difficulties for the GSEs, their shareholders, and taxpayers, with no single solution resolving all conflicts and issues.

I. **Brief History**

The Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac") are GSEs chartered by Congress to increase liquidity, promote affordability, and provide stability in residential mortgage financing.[1] The GSEs currently achieve these goals through two main forms of business: (1) guaranteeing mortgage-backed securities (MBSs); and (2) buying and holding mortgages on their balance sheets.[2]

Although both GSEs are now publicly traded corporations,[3] they have retained special government features which have given them a competitive advantage over banks, thrifts, and other institutional investors. These features include: (i) special federal charters that help to protect them from other entrants who do not benefit from the same system of statutory privileges; (ii) exemption from state and local income taxes; (iii) exemption from the jurisdiction of the Securities and Exchange Commission; and (iv) a line of credit with the U.S. Treasury for up to $2.25 billion.[4] To be sure, some disadvantages of the GSE structure also exist. The GSEs (i) are restricted to residential mortgage finance; (ii) cannot originate mortgages; (iii) are subject

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[1] The charters for Freddie Mac and Fannie Mae can be found at 12 § U.S.C. 1716 (2006) (specifically authorizing the GSEs to take certain steps to create an efficient and fluid secondary mortgage market). A third GSE exists, the Federal Home Loan Banks (FHLB), but is beyond the scope of this paper.

[2] For a general discussion of the two lines of business, see N. ERIC WEISS & MICHAEL V. SEITZINGER, CONGRESSIONAL RESEARCH SERVICE, FANNIE MAE AND FREDDIE MAC: A LEGAL AND POLICY OVERVIEW (2008). For a discussion on the profit structures of the two lines of business, see Dwight M. Jaffee, *The Interest Rate Risk of Fannie Mae and Freddie Mac*, 24 J. FIN.SERVICE RES. 5, 6-7 (2003).

[3] Fannie Mae was created in 1938 and remained a unit within the federal government until 1968, when the Housing and Urban Development Act authorized its spin off from the federal government. Freddie Mac was created in 1970 and became a publicly traded company in 1989. *See* Lawrence J. White, CATO Institute, *Fannie Mae, Freddie Mac, and Housing Finance: Why True Privatization Is Good Public Policy*, POLICY ANALYSIS, Oct. 2004, at 3-4, *available at* http://www.cato.org/pub_display.php?pub_id=2467.

[4] *See generally* THOMAS H. STANTON, GOVERNMENT-SPONSORED ENTERPRISES: MERCANTILIST COMPANIES IN THE MODERN WORLD 23 (2002) [hereinafter STANTON, GOVERNMENT-SPONSORED ENTERPRISES].

to a maximum size of mortgage and minimum percent down payment they can guarantee; and (iii) subject to safety and soundness regulation.[5]

Notwithstanding these disadvantages, the special government characteristics have created an "implicit" government guarantee.[6] Despite specific language on each of its obligations that the securities are not guaranteed by or otherwise an obligation of the federal government,[7] the perception of government backing remains strong.[8] Because of this low-risk perception of the GSEs, they have been able to borrow funds at rates lower than those of private corporations that are rated AAA. The borrowing advantage has led to substantial growth of the GSEs through the use of leverage.[9] Further growth has occurred with the GSEs expanding their retained investment portfolios by buying and holding MBSs containing Alt-A and subprime mortgages in addition to mortgages which meet their guarantee guidelines.[10] Between them, as of February 2009, the GSEs have guaranteed mortgage-backed securities and debt outstanding which total

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[5] The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 created OFHEO as an independent agency within HUD to monitor the GSEs' safety and soundness. The Act provided OFHEO with two main responsibilities: (i) establish minimum capital standards and (ii) establish an examination program. *See* Pub. L. No. 102-550, 106 Stat. 3672.

[6] The fact that this line of credit from the U.S. Treasury is small in comparison to the GSEs' balance sheets is often ignored when formulating the "implicit" government guarantee argument. *See infra* note 11 and accompanying text (citing the current balance sheet size of the GSEs).

[7] Each security guaranteed by the GSEs expressly states that they are "not guaranteed by the U.S. and do not constitute a debt or obligation of the U.S." *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, 1023-24 (2008) (discussing the interpretation of this disclaimer).

[8] Some would argue that recent activities by the U.S. government have strengthened the perception of a government backing. *See infra* notes 54 and accompanying text.

[9] *See* Lawrence J. White, *On Truly Privatizing Fannie Mae and Freddie Mac: Why It's Important, and How to Do It* 5-6 (NYU Working Paper No. 2451/26102, 2009), *available at* http://ssrn.com/abstract=1282533 [hereinafter White, *On Truly Privatizing Fannie Mae and Freddie Mac*].

[10] The GSEs began to invest in Alt-A and subprime mortgages in an effort to increase returns to shareholders. The riskier investments produced higher returns than the mortgages which the GSEs guarantee, but they also exposed them to different (and riskier) borrower qualities and loan dynamics.

$6.7 trillion.[11] Their market share of all new mortgages reached over eighty percent in the second quarter of 2008.[12]

It is true that the GSEs pass through some of their borrowing advantages to residential mortgage borrowers. In April 2009, for example, conforming loans were 150 basis points lower than non-conforming ("jumbo") loans.[13] The GSE structure, however, has created a confusing dichotomy of receiving public support to operate for shareholder gain, leaving many critics to question socializing losses and privatizing profits.[14]

With the downturn in the U.S. housing economy, this dichotomy and other GSE-related problems escalated.[15] Auditors discovered accounting manipulations, excessive leverage, and "opaque financial instruments," all of which strained the GSE structure of Freddie Mac and Fannie Mae.[16] Similarly, in expanding business, the GSEs began to retain MBSs which

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[11] James B. Lockhart, Director, Federal Housing Finance Agency, Address at the American Securitization Forum, Las Vegas, Nevada (Feb. 9, 2009), at 1, *available at* http://www.fhfa.gov/webfiles/823/ASFSpeech2909.pdf [hereinafter Lockhart, American Securitization Forum].

[12] Press Release, Federal Housing Finance Agency, Statement of FHFA Director James B. Lockhart (Sept. 7, 2008), at 1, *available at* http://www.fhfa.gov/webfiles/23/FHFAStatement9708final.pdf [hereinafter Press Release, Lockhart]. This number has since declined. *See id.*

[13] *See* Wachovia, Mortgage Rates (April 15, 2009, 10:30 pm EST), https://sites.wachovia.com/mortgage/rates.html. To date, jumbo mortgages are loans with a principal amount over $417,000, and conforming mortgages have a principal amount below $417,000. In some metropolitan "high-cost" areas, however, the conforming mortgage limit is set above $417,000. *See* Federal Housing Finance Agency, Metropolitan Statistical Areas, Micropolitan Statistical Areas and Rural Counties Where Loan Limits are Set Based on High-Cost Area Provisions of HERA, http://www.fhfa.gov/GetFile.aspx?FileID=134. One may question the significance of the 150 basis point spread, as comparisons between jumbo and conforming mortgages contain many variables. Because conforming loans are smaller, can receive an agency guarantee, and need less capital to support the loan, they are likely to have a lower interest rate. Comparison to Alt-A or subprime loans is also difficult, as those borrowers are considered riskier and lenders demand a higher interest rate in return for extending credit. *See also infra* notes 89-94 (discussing other ways in which the GSEs have benefited home owners).

[14] For an insightful discussion of government money going to shareholders rather than mortgage borrowers, see Bradley K. Krehely, *Comment, Government Sponsored Enterprises: A Discussion of the Federal Subsidy of Fannie Mae and Freddie Mac* 6 N.C. BANKING INST. 519, 528-33 (2002).

[15] *See* Peter J. Wallison, *Private Profits, Public Risks*, WALL ST. J., March 24, 2008, at *1 ("When the housing market was growing and housing prices rising, the contradiction between performing a government mission and serving the interests of private shareholders was obscured . . . Now that housing values are falling, the losses inherent in the GSEs' risk-taking are coming to light.").

[16] *See* Ben S. Bernanke, Chairman, Federal Reserve, The Future of Mortgage Finance in the United States, Address at the UC Berkeley/UCLA Symposium: The Mortgage Meltdown, the Economy, and Public Policy (Oct. 31, 2008), at *1, *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20081031a.htm [hereinafter Bernanke

contained Alt-A and subprime mortgages and created a certain level of risk. Climbing foreclosure rates and falling home prices have made this risk a reality and caused the value of their portfolios to fall.[17] In addition, the GSEs' stock prices plummeted as investors became more uncertain about the GSEs' future profitability and viability.[18] Ultimately, despite lowering borrowing costs, the GSEs' operations were creating significant risks for the shareholders, federal government, and taxpayers, as the GSEs suffered from declining asset prices and falling stock values.

II. Housing and Economic Recovery Act

In response to the worsening housing market and the weakening GSEs, Congress passed the Housing and Economic Recovery Act (HERA) in July 2008.[19] Title 1 of HERA, "Housing Finance Reform: Reform of Regulation of Enterprises," specifically provides mechanisms to strengthen the housing GSEs. The key provisions include: (i) creation of the Federal Housing Finance Agency (FHFA) as the new regulator for Fannie Mae, Freddie Mac, and the Federal Home Loan Banks with broad increased authority to ensure the safety and soundness of the GSEs; (ii) increased authority for the Treasury Department to fund the GSEs in a variety of ways; and (iii) the expansion of the GSEs' housing mission.[20]

Speech]; *see also* Judah Skoff, *Developments in Banking and Financial Law*, 25 ANN. REV. BANKING & FIN. L. 146, 146 (2006).

[17] *A Single Regulator Will Better Ensure Safety and Soundness and Mission: Hearing Before the S. Comm. on Banking, Housing, & Urban Affairs*, 110th Cong. 3-5 (1998) (statement of William B. Shear, Director, Financial Markets and Community Investment).

[18] See N. ERIC WEISS, CONGRESSIONAL RESEARCH SERVICE, FANNIE MAE'S AND FREDDIE MAC'S FINANCIAL PROBLEMS: FREQUENTLY ASKED QUESTIONS 1-2 (2008). Between the end of 2007 and August 1, 2008, Fannie Mae's stock lost 72% of its value, while Freddie Mac's stock fell by 77%. *See id.*

[19] Pub. L. No. 110-289, 122 Stat. 2654 (2008). Numerous sources provide concise summaries of HERA. See, for example, Mike Wallace, *President Signs Federal Housing Bill*, NATION'S CITIES WEEKLY, Aug. 4, 2008, at *1.

[20] Expansion of the GSEs' housing mission is beyond the scope of this paper.

FHFA,[21] as the new GSE regulator, has expanded authority to set capital requirements,[22] impose restrictions on the amount and type of mortgages the GSEs retain in their portfolios,[23] and establish prudential management standards, including internal controls, audits, risk management, and management of the portfolio.[24] In addition, FHFA has increased enforcement authority through cease and desist authority, civil money penalties, and removal of officers and directors.[25] Further corrective authority provides that, upon the GSE meeting any of the grounds for discretionary appointment, FHFA may place the GSE into conservatorship or receivership for the purpose of "reorganizing, rehabilitating, or winding up the affairs" of the GSE.[26] HERA provides an expansive list of conditions in which FHFA may place the GSEs into conservatorship or receivership.[27]

To further stabilize the market and provide confidence in the GSEs, HERA authorizes the Secretary of the Treasury to "purchase obligations and other securities" from the GSEs upon determination that an emergency exists and action is necessary to stabilize markets, maintain liquidity, and protect taxpayers.[28] HERA gives the Secretary broad authority to determine the conditions and amounts of such purchases.[29]

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[21] FHFA replaces the Office of Federal Housing Enterprise Oversight (OFHEO), the Department of Housing and Urban Development (HUD), and the Federal Housing Finance Board (FHFB) as regulator of Freddie Mac, Fannie Mae, and the Federal Home Loan Banks (FHLB), except to the extent that HUD regulates fair housing responsibilities. HERA, sec. 1112, 15 U.S.C.A. § 7800 (2009).
[22] HERA, sec. 1110, 12 U.S.C.A. § 4611 (2009); HERA, sec. 1111, 12 U.S.C.A. § 4612 (2009).
[23] HERA, sec. 1109, 12 U.S.C.A. § 4624 (2009).
[24] HERA, sec. 1108, 12 U.S.C.A. § 4513b (2009). Portfolio controls include requiring Freddie Mac and Fannie Mae to obtain prior written approval before offering any new product except for products related to either their automated loan underwriting systems or modification to mortgage terms, conditions, or underwriting criteria. *See id.*
[25] HERA, secs. 1151 - 56, 12 U.S.C.A. § 4631 - 36 (2009).
[26] HERA, sec. 1145, 12 U.S.C.A. § 4617 (2009).
[27] HERA, sec. 1145, 12 U.S.C.A. § 4617 (2009). Grounds for discretionary appointment of conservator or receiver include: (a) assets insufficient for obligations; (b) substantial dissipation; (c) unsafe or unsound condition; (d) cease and desist orders; (e) concealment; (f) inability to meet obligations; (g) losses; (h) violations of law; (i) consent; (j) undercapitalization; (k) critical undercapitalization; or (l) money laundering. *Id.* See also *id.* for grounds for mandatory appointment of conservator or receiver.
[28] HERA, sec. 1117, 12 U.S.C.A. § 1719 (2009).
[29] *See id.* ("on such terms and conditions as the Secretary may determine and in such amounts as the Secretary may determine"). It is important to note that outside of conservatorship, mutual agreement must exist for such stock to

As a comparison, the Office of Federal Housing Enterprise Oversight (OFHEO), the predecessor to FHFA, was limited as a regulator. OFHEO was not authorized to declare bankruptcy[30] or impose a receivership.[31] Similarly, a limited number of situations existed under which it could impose a conservatorship.[32] OFHEO had weak capital requirements[33] and limited enforcement powers.[34] Perhaps most significant, OFHEO did not have the authority to sell securities and other obligations to the Treasury to raise equity for the GSEs.[35] As Lockhart, the director of OFHEO who later became the director of FHFA, explains, OFHEO "tenaciously used all the powers that [it] had and then some" to raise more than $20 billion,[36] but ultimately did not have enough authority to stabilize the GSEs or the housing market.

III. Short-Term Solution: Conservatorship

Immediately after passage of HERA, FHFA worked with the Federal Reserve, the Treasury, and the Office of the Comptroller of the Currency to comprehensively examine the

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be issued. *See id.* ("Nothing in this subsection requires the corporation to issue obligations or securities to the Secretary without mutual agreement between the Secretary and the corporation.").

[30] *See* Richard Scott Carnell, *Handling the Failure of a Government-Sponsored Enterprise*, 80 WASH. L. REV. 565, 609-13 (2005) (discussing GSEs role as "instrumentalities" and "government units", which precludes it from filing under Chapter 7 or 11).

[31] *See* 12 U.S.C. §§ 4616(b)(6), 4617(a)(1), 4619(a)(1) (2006).

[32] *See* 12 U.S.C. §§ 4617(a), 4619(a)(1) (2006). *Cf.* HERA, sec. 1145, 12 U.S.C.A. § 4617 (2009) (stating the grounds under which FHFA may declare conservatorship).

[33] *See* 12 U.S.C. §§ 4611-13 (2006). In fact, the 1992 law which established OFHEO required the agency to deem the GSEs adequately capitalized even if their mortgage credit exposure to capital was more than 100 to 1. *See* Lockhart, American Securitization Forum, *supra* note 11, at 3.

[34] *See generally A Framework for Strengthening GSE Governance and Oversight: Hearing Before the S. Comm. on Banking, Housing & Urban Affairs*, 108th Cong. (2004) (statement of David M. Walker, Comptroller General of the U.S.); *see also* Carnell, *supra* note 30, at 614.

[35] *Cf.* HERA, sec. 1117, 12 U.S.C.A. § 1719 (2009). As Secretary Paulson stated "[conservatorship] would have been impossible to implement were it not for the GSE reform legislation that gave FHFA the expanded power to make qualitative and quantitative judgments about capital and also gave Treasury the financial authorities necessary to make conservatorship a stabilizing . . . event." Henry M. Paulson, Jr., Treasury Secretary, The Role of the GSEs in Supporting the Housing Recovery, Remarks before the Economic Club of Washington (Jan. 7, 2009), at *2, *available at* http://www.ustreas.gov/press/releases/hp1345.htm [hereinafter Paulson Remarks].

[36] Lockhart, American Securitization Forum, *supra* note 11, at 3. OFHEO imposed an extra thirty percent capital requirement, capped the GSE portfolios, stopped them from investing in below AAA-rated private-label securities, and encouraged them to not increase dividends. *Id.*

financial condition of the GSEs.[37] The assessment revealed that both Freddie Mac and Fannie Mae were operating in an unsafe and unsound condition, with "no reasonable prospect of raising private capital" to meet concerns in the foreseeable future such as "market fragility and the GSEs' deteriorating balance sheets."[38] In addition, capital was found to be inadequate, "in terms of both the quality of capital and the embedded losses stemming from worsening mortgage market conditions."[39] FHFA Director, James B. Lockhart, emphasized that "pervasive weaknesses across the board" existed when measured on FHFA's rating system, "G-Seer" (Governance, Solvency, Earnings and Enterprise Risk).[40] Although the GSEs had made some progress in rectifying their accounting, systems, controls and risk management issues, "market conditions [had] overwhelmed that progress."[41]

Consequently, acting under authority from HERA, the FHFA placed Fannie Mae and Freddie Mac into conservatorship on September 7, 2008.[42] The agencies clearly stated that the conservatorship would be a temporary time-out for the GSEs. Treasury Secretary Henry Paulson stated that they had "sought a temporary solution that would achieve three goals: (1) stabilize markets; (2) promote mortgage availability; and (3) protect the taxpayer."[43] Similarly, FHFA Director James Lockhart announced that "conservatorship will give the Enterprises the time to

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[37] Paulson Remarks, *supra* note 35, at *2.
[38] *Id.*
[39] *Id.*
[40] Press Release, Lockhart, *supra* note 12, at 2.
[41] *Id.* See Press Release, Lockhart, *supra* note 12, at 3-4 for an informative and concise summary of key events that have demonstrated "the increasing challenge faced by [GSEs] in striving to balance mission and safety and soundness, and the ultimate disruption of that balance" that led to conservatorship.
[42] The day before, the Boards of both GSEs had consented to conservatorship. A conservatorship is the legal process in which a person or corporate entity is appointed to establish control and oversight of a company to put it in a sound and solvent condition. The powers of the company's directors, officers, and shareholders are transferred to conservator. *See* Press Release, Federal Housing Finance Agency, Questions and Answers on Conservatorship (Oct. 6, 2008), available at http://www.fhfa.gov/webfiles/116/FHFAMPFSTMT100708.pdf.
[43] Paulson Remarks, *supra* note 35, at 2.

restore the balances between safety and soundness and [their] mission [to provide affordable housing and stability and liquidity to the mortgage markets]."[44]

As conservator, FHFA has taken over the assets and assumed all the powers of the directors and officers of Freddie Mac and Fannie Mae.[45] Stockholders' voting rights have been suspended and both firms' CEOs have been replaced while FHFA takes any action necessary to restore the GSES to a sound and solvent condition.[46] The Treasury Department immediately announced three ways in which it would provide funding and support to Freddie Mac and Fannie Mae.[47] First, Senior Preferred Stock Purchase Agreements (SPSPAs) between Freddie Mac and Fannie Mae and the Treasury, in which the Treasury agreed to, purchase $100 billion of preferred stock in each GSE.[48] Next, the Treasury agreed to purchase GSE-guaranteed mortgage-backed securities from Fannie Mae and Freddie Mac.[49] And third, the Treasury established an unlimited secured credit facility to serve as a liquidity backstop for the GSEs.[50] Then, in November 2008, the Federal Reserve announced it would further support the GSEs by purchasing $100 billion of debt issued by the housing GSEs[51] and $500 billion of MBSs guaranteed by Fannie Mae, Freddie Mac, and Ginnie Mae over the next six months.[52] In March

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[44] Press Release, Lockhart, *supra* note 12, at 5.

[45] *See* MARK JICKLING, CONGRESSIONAL RESEARCH SERVICE, FANNIE MAE AND FREDDIE MAC IN CONSERVATORSHIP (2008).

[46] *Id.* Note that mutual agreement to stock purchases by the Treasury was no longer an issue, as the FHFA, rather than the GSEs former board of directors, was making the management decisions.

[47] *See* Federal Housing Finance Agency, U.S. Treasury Support for Fannie Mae and Freddie Mac, Mortgage Market Note 09-1 (Feb. 18, 2009), *available at* http://www.fhfa.gov/webfiles/1240/mmnote091_218091.pdf [hereinafter Mortgage Market Note 09-1].

[48] *Id.* at 2. FHLB is not affected by this action, although it *can* benefit from the remaining two credit facilities from the Treasury. This number was later increased to $200 billion each.

[49] Through December 2008, the Treasury had purchased $71 billion in GSE MBSs.

[50] Mortgage Market Note 09-1, *supra* note 47, at 3. The Treasury will provide funding directly to the GSE (either Freddie Mac, Fannie Mae, or FHLB) from its general fund at the Federal Reserve Bank of New York in exchange for eligible collateral from the GSE. This facility will provide secured funding on an as-needed basis, and remains available until December 31, 2009. *Id.* Through February 2009, this facility had not yet been used. *Id.*

[51] Through December 2008, the Federal Reserve had purchased nearly $29 billion in Fannie Mae, Freddie Mac, and FHLB notes.

[52] Through January 2009, the Federal Reserve has purchased $94.2 billion in GSE MBSs.

2009, these numbers were increased to an additional $750 billion of GSE mortgage-backed securities (for a total of $1.25 trillion), and an additional $100 billion of GSE debt (for a total of $200 billion).[53]

Most people would argue that these actions from the Treasury and the Federal Reserve turned the implicit government guarantee into an express (albeit temporary) backing of the GSEs. Secretary Paulson and FHFA Director Lockhart released statements showing that they seemed to agree.[54] Lockhart, however, quickly amended his statement. He declared that the actions from the Treasury and the Federal Reserve, although "an effective federal guarantee," did not, in fact, place the "full faith and credit" of the U.S. government behind the GSEs' debt.[55]

In analyzing the situation, traders have emphasized that the Federal Reserve is buying the GSE debt on the open market, rather than tendering the debt.[56] Tendering the debt retires it permanently, while an open market purchase means that the government can sell the debt back at some point in the future.[57] Until Congress mandates that the debt is a full faith and credit obligation of the U.S. Treasury, the government is not responsible for making payments on the outstanding obligations.[58] It is highly unlikely, however, that the government would not help pay, as the GSEs, like Citigroup and Bank of America, are "systemically significant" and "too big to fail."[59] Regardless of the classification, the Treasury argues that such action is necessary: "That guarantee is intended to improve investor confidence in the ability of each housing GSE to

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[53] *See* Press Release, Board of Governors of the Federal Reserve System, (March 18, 2009), *available at* http://www.federalreserve.gov/newsevents/press/monetary/20090318a.htm.

[54] Secretary Paulson stated that these actions have "essentially guaranteed Fannie Mae and Freddie Mac securities." *See* Mortgage Market Note 09-1, *supra* note 47, at 1. Similarly, Lockhart called this funding an "effective" guarantee. Lockhart, American Securitization Forum, *supra* note 11, at 4.

[55] Dawn Kopecki, *Lockhart's Fannie, Freddie Guarantee Remarks Stir Up Confusion*, BLOOBERG.COM, Oct. 23, 2008, *available at* http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ajIEoZCommlk#.

[56] E-mail from Jon Wakim, Trader, Keybanc Capital Markets to Fixed Income Group, Earnest Partners (April 14, 2009, 10:15 am) (on file with author).

[57] *Id.*

[58] *Id.*

[59] Lissa L. Broome, *Extraordinary Government Intervention to Bolster Bank Balance Sheets*, 13 N.C. BANKING INST. 138, 153 (2009) [hereinafter Broome, *Extraordinary Government Intervention*].

continue to provide liquidity to mortgage markets and to meet its obligations. Investor confidence is essential to liquid and well-functioning mortgage markets, which in turn benefit homeowners and qualified mortgage borrowers by lowering borrowing costs and supporting home prices."[60]

Each SPSPA commits the Treasury to purchase up to $100 billion in senior preferred shares and warrants for 79.9% of the common stock of the respective GSEs.[61] If the GSE becomes insolvent (according to generally accepted accounting principles), then the Treasury must provide sufficient cash capital to eliminate that deficit in exchange for the senior preferred stock. The SPSPAs guarantee the credit interests of senior and subordinated debt and MBS holders by ensuring the GSEs' solvency and positive net worth.[62] After all, the $100 billion commitment per GSE is over three times Fannie Mae's and Freddie Mac's statutory minimum capital requirements (as of June 30, 2008).[63] In addition, the SPSPAs also protect *future* debt and MBS holders because the Treasury's commitment to provide capital pursuant to the SPSPAs has no set expiration date.[64] The Justice Department has affirmed that the SPSPA binds the Treasury to provide the financial backstop without time limit, for the duration of the SPSPA, as well as the liabilities protected by the SPSPA.[65] On February 18, 2009, the Treasury announced that it was doubling the size of its commitment to $200 billion to both Freddie Mac and Fannie

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[60] *See* Mortgage Market Note 09-1, *supra* note 47, at 1.

[61] *See* MARK JICKLING, CONGRESSIONAL RESEARCH SERVICE, FANNIE MAE AND FREDDIE MAC IN CONSERVATORSHIP 3 (2008) ("This means that if the GSEs emerge from conservatorship as stock corporations, the government will be the majority owner, and will have the option of selling its shares at a profit.").

[62] *See* Mortgage Market Note 09-1, *supra* note 47, at 2.

[63] Lockhart, American Securitization Forum, *supra* note 11, at 4.

[64] The commitment terminates only when the facility is fully used, all debt and MBSs are paid off, or the GSE liquidates its assets (during which the Treasury would fund any capital deficiency up to its commitment under the agreement and then terminate). *See* Mortgage Market Note 09-1, *supra* note 47, at 3; *see also* Lockhart American Securitization Forum, *supra* note 11, at 4.

[65] See Steven G. Bradbury, Principal Deputy Assistant Attorney General, Enforceability of Certain Agreements Between the Dep't of the Treasury and Government Sponsored Enterpirses (Sept. 26, 2008), *available at* http://www.usdoj.gov/olc/2008/treasury-gse-ltr-opinion.pdf.

Mae.[66] As of March 11, 2009, Freddie Mac has requested $45.6 billion of preferred stock.[67] As of February 26, 2009, Fannie Mae has requested $15.2 billion.[68]

These assurances do not come without cost to the GSEs. In return for the Treasury's support, the Treasury receives the senior preferred stock, which pays an annual dividend of ten percent in cash or twelve percent in additional senior preferred stock.[69] And, beginning March 31, 2010, the GSEs will need to pay a commitment fee as compensation for Treasury's ongoing support provided by the SPSPA beyond December 31, 2009.[70] The commitment fee shall accrue from January 1, 2010 and be paid to the Treasury on a quarterly basis.[71] It appears that the commitment fee has not yet been set, but must be established no later than December 31, 2009.[72] According to the SPSPA's, the commitment fee "shall be determined with reference to the market value of the [requested senior preferred stock] as then in effect."[73] The SPSPAs further restrict the GSEs by (i) limiting the amount of debt that can be issued to no more than 110% of its debt outstanding as of June 30, 2008,[74] and (ii) requiring that the retained mortgage portfolio may not exceed $900 billion as of December 31, 2009, [75] and must decline by ten percent each year until it reaches $250 billion, which must be reached no later than 2021.[76]

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[66] As was the case under the original SPSPAs, the capital supports all past and future debt and MBS issues with no set expiration date. *See* Mortgage Market Note 09-1, *supra* note 47, at 2.
[67] Freddie Mac Reports Fourth Quarter and Full-Year 2008 Financial Results, http://www.freddiemac.com/news/archives/investors/2009/2008er-4q08.html;
[68] Fannie Mae Reports Fourth Quarter and Full-Year 2008 Financial Results, http://www.fanniemae.com/media/pdf/newsreleases/form10k_newsrelease_022609.pdf.
[69] *See* Mortgage Market Note 09-01, *supra* note 47, at 3.
[70] *Id.*
[71] Execution Version, Amended and Restated Senior Preferred Stock Purchase Agreement for Freddie Mac, *available at* http://www.fhfa.gov/webfiles/823/ASFSpeech2909.pdf. The Execution Version for Fannie Mae is available at http://www.fhfa.gov/webfiles/1031/FNMSrPrefStockA92608.pdf.
[72] *Id.*
[73] *Id.* at 3.2(b).
[74] This number will be increased due to the doubling of the SPSPAs in February 2009.
[75] The original limit was $850 billion, but increased with the doubling of the SPSPAs in February 2009. *See* Mortgage Market Note 09-1, *supra* note 47, at 3.
[76] As of December 31, 2008, Fannie Mae's consolidated balance sheet included retained mortgage assets of $782 billion. *See* Federal National Mortgage Association, Form 10-k, *available at* http://www.fanniemae.com/ir/pdf/earnings/2008/form10k_022609.pdf. Freddie Mac's included retained mortgage

The current GSE shareholders are also hurt by the SPSPAs. Under the terms of the SPSPAs, common stock dividends are eliminated and existing preferred stock dividends are deferred.[77] Because the current shareholders will not get a dividend until all the government money is paid back and the warrants issued to the Treasury will dilute current shareholders, the current shares may be worth nothing when Freddie Mac and Fannie Mae come out from under conservatorship.[78] At current market prices, the shareholders of the GSEs have already paid a significant price, as shares traded under $1 on April 15, 2009,[79] down over 95% from one year ago.[80] Another potential problem for the current GSE shareholders is the replacement of management. The FHFA's purpose, as conservator, is to guide a company back to stability.[81] The FHFA is not likely to run the GSEs for the profit of the shareholders as the prior management might have. Rather, the FHFA will likely work to support and stabilize the overall housing market.

Has the conservatorship and the accompanying monetary infusion into the GSEs been successful? According to both the FHFA and the Treasury, the answer is yes. Since the U.S. Government made it clear that it was supporting the GSEs through the infusion of capital and outright purchases of MBSs, mortgage rates have fallen more than 100 basis points.[82] The 30-year fixed rate fell from 6.04% the week before the additional funding sources were announced

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assets of $756 billion. *See* Federal Home Loan Mortgage Corporation, Form 10-K, *available at* http://www.freddiemac.com/investors/er/pdf/10k_031109.pdf.

[77] *See* Michelle Singletary, *Be Wary of Buying When Shares Tank*, THE WASH. POST, Sept. 14, 2008, at F01.

[78] Many commentators opine that this is a positive result of the conservatorship. After all, they argue, for decades the shareholders of the GSEs have profited, while the public (and taxpayers) bore the risk of the GSEs. *See* Lawrence B. Lindsey, *The Fannie and Freddie Follies: Spare the Rod, Spoil the Child*, THE WEEKLY STANDARD, July 28, 2008. at *2 ("The key to repairing the GSEs is to make sure that existing shareholders and management pay a price if they get bailed out. Ideally common shareholders should see the values of their shares reduced to zero, or close to zero . . . . But the bondholders, who supply the capital to homeowners, should be largely protected.").

[79] According to Bloomberg.com, at the close of April 15, 2009, Freddie Mac was trading at 0.89 and Fannie Mae was trading at 0.88.

[80] According to Bloomberg.com, between April 15, 2008 and April 15, 2009, Freddie Mac stock was down 95.99% and Fannie Mae stock was down 96.47%.

[81] Peter J. Wallison, *A Failed Business Model*, FORBES.COM, Sept. 8, 2008.

[82] Lockhart, American Securitization Forum, *supra* note 11, at 4.

in November 2008 to 5.1% in January 2009, and eventually 4.4% in May 2009.[83] Secretary Paulson argues that this is a "vitally important step in addressing this housing correction," as the lower mortgage rates will bring additional creditworthy buyers into the housing market.[84]

On the other hand, others advocate that receivership of the GSEs may have been a better choice than conservatorship, as both are authorized under HERA. They argue that conservatorship reinforces the idea of socializing losses and privatizing profits. If Freddie Mac and Fannie Mae do survive conservatorship,[85] the government's infusion of money (at the taxpayers' expenses) will benefit the private shareholders. Thus, the chance exists that neither the management nor shareholders will ever have to pay fully for their failures. Receivership, on the other hand, wipes out the shareholders' interests, and accordingly the shareholders would bear their own risk for failure, rather than U.S. taxpayers providing a subsidy.[86]

Ultimately, although receivership is theoretically a viable option, it never gained government support. Practically speaking, given the current economic environment and the overall plummeting of the housing market, temporary conservatorship was the best option because it did "not prejudice the ultimate fate of Fannie Mae and Freddie Mac."[87] The economy needed a time-out to consider the GSEs' futures, not an immediate liquidation of the two biggest

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[83] *Open Forum: Behind the GSE Takeover*, NAT'L MORTGAGE NEWS, Jan. 19, 2009, at *1. More specifically, the Fannie Mae 30-year fixed rate mortgage, 60 day commitment rate as of May 15, 2009 was 4.43%. *See* Historical Required Net Yields: May 2009, https://www.efanniemae.com/syndicated/documents/mbs/apeprices/archives/cur30.html.

[84] *Id.*

[85] That is, if they evolve from conservatorship with money to pay back the Treasury for the SPSPAs, as well as money for the subordinated preferred and common shareholders.

[86] Michael Sisk, *Breaking Up is Hard to Do*, US BANKER, Sept. 2008, at *2 ("[W]hat's good enough for Bear Stearns investors is good enough for those of Fannie and Freddie."). *But see, supra* note 80 and accompanying text (discussing a 95% drop of Freddie Mac and Fannie Mae stock in the last year).

[87] Peter J. Wallison, *A Failed Business Model*, FORBES.COM, Sept. 8, 2008.

forces in the housing market.[88] The important question remains, however: What happens to Freddie Mac and Fannie Mae when this time-out is over?

IV. Long-Term Solutions

A. Return to Pre-Conservatorship Status

The conservatorship of Freddie Mac and Fannie Mae does not currently have a termination date.[89] Nonetheless, some scholars argue that upon stabilization of the GSEs, they should return to pre-conservatorship status as private corporations with government features. This argument is centered on the theory that the GSEs play an important role in the U.S. housing market, and with a few adjustments the GSEs can again function safely and effectively.

Data support the finding that the GSEs do meet their public mission of increasing liquidity, promoting affordability, and providing stability in residential mortgage financing.[90] Freddie Mac and Fannie Mae have helped the U.S. build a "first-rate housing industry" and have assisted homebuyers beyond what the private sector could produce.[91] The GSEs have lowered mortgage rates, as the spread between conforming loans and non-conforming ("jumbo") loans is currently 150 basis points.[92] In addition, the GSEs' activities have increased the supply of

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[88] Receivership would have "great potential for delay and market disruption," especially when the GSEs were insolvent. *See* Carnell, *supra* note 30, at 616 n.340. Secretary Paulson reiterates the current importance of the GSEs: "[they] are playing a necessary role supporting the mortgage availability which is essential to eventually turning the corner on the housing correction, reducing the stress in our capital markets and returning to growth in our economy . . . We [must] use this period to decide what role government in general, and these entities in particular, should play in the housing market." *See* Paulson Remarks, *supra* note 35, at *4.

[89] HERA simply provides that receivership will end conservatorship. HERA, sec. 1145, 12 U.S.C.A. § 4617 (2009).

[90] "The current public policy to expand homeownership and affordable rental housing by using private capital . . . has been a huge success." *See* Krehely, *supra* note 14, at 519; *see also supra* note 1 and accompanying text (discussing the housing mission of the GSEs articulated in their federal charters).

[91] Krehely, *supra* note 14, at 519, 521.

[92] *See The Role of the Government Sponsored Enterprises in the Mortgage Market: Hearing Before the S. Comm. on Banking, Housing, & Urban Affairs*, 109th Cong. 5-8 (2005) (statement of Anthony B. Sanders) (discussing calculations to determine the spread between the mortgage rate consumers would receive by receiving a conforming loan (a loan that qualifies for Freddie Mac and Fannie Mae mortgage programs) versus a jumbo mortgage (which is a mortgage that is larger than the conforming loan limit). *But see supra* note 13 and accompanying text (discussing that this spread measurement may be faulty because of the difference in principal amounts and borrower risk factors).

mortgage credit available, especially to low-and moderate-income households.[93] Importantly, GSEs were able to continue to securitize (and thus provide liquidity to the market) at a time when private firms were no longer able to securitize.[94] Proponents argue that "[t]here's no question that both Fannie and Freddie have been a cornerstone of the American dream and contributed to widespread homeownership."[95]

This data does not go unchallenged, as some scholars argue that the GSEs are no longer meeting their housing missions. Critics state that the beneficial spread between conforming loans and non-conforming loans is not worth the risks that the GSEs impose. For example, the Federal Reserve Board, in lowering interest rates as part of its monetary policy responsibilities, could potentially have the same effect on the ability of homeowners to afford a home as the activities of Freddie Mac and Fannie Mae.[96] Also, because the limit for conforming loans far exceeds the median price of new homes, critics question if the GSEs have truly helped low- and moderate-income households.[97] Rather, some scholars suggest that the broadly-focused mission of the GSEs is encouraging households who would likely purchase a home anyway to purchase a larger or more expensive home.[98]

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[93] *See* Brent W. Ambrose & Thomas G. Thibodeau, *Have the GSE Affordable Housing Goals Increased the Supply of Mortgage Credit?* 34 REGIONAL SCIENCE & URBAN ECON. 263, 263 (2004) ("Our analysis indicated that the goals increased the supply of mortgage credit available . . . after controlling for other mortgage market factors.").

[94] *See* Bernanke Speech, *supra* note 16, at *3. Bernanke does admit, however, that this advantage was a result of the implied government guarantee rather than a "superior business model[] or management." *Id.*

[95] Steven Sloan, *Legislation Inspires a New GSE Debate*, AM. BANKER, Aug. 6, 2008, at *2 (quoting Jim Carr, the chief operating officer of the National Community Reinvestment Coalition).

[96] *See* PETER J. WALLISON ET AL., PRIVATIZING FANNIE MAE, FREDDIE MAC, AND THE FEDERAL HOME LOAN BANKS: WHY AND HOW 16 (2004) [hereinafter WALLISON ET AL., PRIVATIZING FANNIE MAE]. The authors also argue that the GSEs' pass-through savings in a reduction of rates may actually assist home sellers more than home buyers, as the lower interest rates simply allow the sellers of homes to raise their prices. *See id.*

[97] *See* Dwight M. Jaffee, *Comments on the Paper by Lawrence White: 'On Truly Privatizing Fannie Mae and Freddie Mac: Why It's Important, and How to Do It'* (Wharton Financial Institutions Working Paper No. 05-33, 2005), *available at* http://ssrn.com/abstract=830864.

[98] A more focused program, which provided a direct subsidy to lower and middle income borrowers, would push these borrowers from renting to ownership. *See* Lawrence J. White, *Fannie Mae, Freddie Mac, and Housing: Good Intentions Gone Awry* (NYU Working Paper No. 2451/26073, 2009), *available at* http://ssrn.com/abstract=1281955 [hereinafter White, *Good Intentions Gone Awry*].

Regardless of the validity of the current data, the question is whether the benefits of the GSEs (at their pre-conservatorship status) outweigh the risks they present.[99] The inherent struggle between the private shareholders and the public mission to promote homeownership is a major source of conflict, and one that many argue creates extreme risk.[100] For example, although raising additional capital in 2008 may have stabilized the GSEs, its shareholders were unmotivated to do so, as such an action would have diluted their interests.[101] Similarly, the GSEs are able to operate with enormous leverage (to the benefit of the shareholders) because of the implicit guarantee of the government. By taking advantage of such leverage, the GSEs have grown their portfolios tremendously.[102] Ultimately, both Fannie Mae and Freddie Mac pose systemic risk to the entire financial system,[103] as well as a direct risk to the U.S. taxpayers.

Some scholars suggest that these risks can be solved with (i) a stronger regulator; (ii) capital standards adequate for the risks the GSEs assume; and (iii) explicit and measurable public purposes for the GSEs' portfolios.[104] HERA certainly seems to be a step in the right direction. The Act created FHFA, a strong regulator with power to establish more stringent capital standards and evaluation criteria to ensure that the portfolios are consistent with the mission and

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[99] See *A Framework for Strengthening GSE Governance and Oversight: Hearing Before the S. Comm. on Banking, Housing & Urban Affairs*, 108th Cong. 18 (2004) (statement of David M. Walker, Comptroller General of the U.S.) ("In important cases, it is clear that the GSEs have fulfilled the public missions for which they were initially created . . . In other areas, however, there is substantially greater uncertainty regarding the benefits of the GSEs' activities . . . Although the GSEs have expanded rapidly and become more complex in recent years, for example, it is not always clear how the GSEs' growth and complexity have enhanced their public missions.").

[100] *See* WALLISON ET AL., PRIVATIZING FANNIE MAE, *supra* note 96, at 2-13. (generally discussing the "risks created by the Housing GSEs").

[101] *See* Bernanke Speech, *supra* note 16, at *3.

[102] *See id*; *see also* Dwight M. Jaffee, *The Interest Rate Risk of Fannie Mae and Freddie Mac*, 24 J. FIN.SERVICE RES. 5 (2003) (discussing interest rate risk created by the GSEs).

[103] "Systemic risk" refers to the danger that because the GSEs are so large that if they fail, then shock waves will be sent throughout the entire financial community. *See id.* at 6.

[104] *See generally* Bernanke Speech, *supra* note 16, at *3 (discussing the Federal Reserve Boards three-part approach to GSE oversight); *see also* White, *On Truly Privatizing Fannie Mae and Freddie Mac, supra* note 9, at 19-20 (discussing the "second-best policy" of maintaining GSE structure and what factors must but considered to alleviate the risk); W. Scott Frame & Lawrence J. White, *Regulating Housing GSEs: Thoughts on Institutional Structure and Authorities*, ECON. REVIEW, Sec. Quarter 2004, at 87, 93-96, *available at* http://www.frbatlanta.org/filelegacydocs/er04_framewhite.pdf (analyzing factors such as (i) the location of a regulator; (ii) the funding mechanism for the regulator; and (iii) who the regulator should supervise).

safe and sound operations of the GSEs.[105] The FHFA proved it was not afraid to use its authority, as it acted quickly to place Fannie Mae and Freddie Mac into conservatorship.[106]

HERA, however, does not solve all problems related to GSE risk. First, it leaves the express public mission of the GSEs' portfolios unclear, especially during times when financial conditions are relatively normal.[107] Perhaps most importantly, neither HERA nor the FHFA has yet to resolve the deep-seated conflict between private shareholders and public purpose; if private market participants are not held accountable for their risks, they have no incentive to act responsibly.[108] Ultimately, if HERA provides enough solutions to sufficiently mitigate the risk of the GSE structure, then returning to pre-conservatorship status may be a viable option for Fannie Mae and Freddie Mac.

Aside from HERA, comparisons to other government agencies may support the return of Freddie Mac and Fannie Mae to pre-conservatorship GSE status. For example, the Farm Credit System, a GSE which was established to provide real estate loans to ranchers and farmers, became insolvent in 1987. At that time, Congress "developed and implemented a $4 billion bailout plan,"[109] along with new legislation that "established new guidelines governing the role of the federal government and the role and responsibilities of the farmer borrower/owners of the System."[110] Similar to HERA, the Act established the Farm Credit Administration as an independent regulator to establish minimum capital standards and other safety, soundness, and

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[105] *See supra* Part II (discussing the details of HERA); *see also* Bernanke Speech, *supra* note 16, at *3 (discussing the "progress that has been made" in mitigating some risk).
[106] One criticism of HERA is that it gave the regulator "more teeth," but provided few mechanisms to assure that the regulator would use its authority. *See* Sisk, *supra* note 86, at 1.
[107] *See* Bernanke Speech, *supra* note 16, at *3 (observing that GSE oversight still lacking "an explicit and measurable public purpose for the GSEs' portfolios").
[108] *See* Sisk, *supra* note 86, at 1.
[109] *See* WALLISON ET AL., PRIVATIZING FANNIE MAE, *supra* note 96, at 3.
[110] *See* Hearing before the Subcomm. on Conservation, Credit, Rural Development & Research of the H. Comm. on Agriculture, 108th Cong. 2-3 ((2004) (statement by Roger D. Monson, American Bankers Association).

mission standards for Farm Credit System institutions.[111] Today, the Farm Credit System is "a large, sophisticated and highly profitable financial services institution."[112]

In addition, the FDIC may provide lessons to help in a return to pre-conservatorship status. The Banking Act of 1933 implemented federal deposit insurance which insures the banks' depositors' funds up to a certain amount.[113] In return, the FDIC assesses insured banks for deposit insurance based on risk of the bank.[114] Until the FDIC Improvement Act of 1991 (FDICIA) established such an assessment system, the FDIC assessed insured banks on a flat rate basis. [115] With a system for assessment and a maximum limit on coverage, the FDIC insurance reduces the potential costs to taxpayers in case of a bank or thrift failure.

The FHFA could mandate similar practices for the government's "insurance" of the GSEs.[116] Such implementation would require: (i) establishing a system in which the government could "tax" the GSEs in order to fund recovery efforts without taxpayer dollars; and (ii) setting a limit on the "implicit" government guarantee to an identified maximum.[117] For the first requirement, the FHFA currently has one way to "tax" the GSEs. Beginning March 31, 2010, the GSEs will need to pay a commitment fee, based on the market value of the GSE's requested senior preferred stock from the Treasury, as compensation for Treasury's explicit support

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[111] *See id.* at 3.
[112] *Id.*
[113] LISSA L. BROOME & JERRY W. MARKHAM, REGULATION OF BANK FINANCIAL SERVICE ACTIVITIES 462-63 (3d ed.2008). The insurance coverage was increased to $100,000 per account in 1980 and remained at such a level until the recent financial crisis. It was raised to $250,000 in 2008. Furthermore, the FDIC is temporarily providing unlimited deposit insurance to qualifying non-interest bearing transaction accounts until December 31, 2009. See Broome, *Extraordinary Government Intervention*, *supra* note 59, at 143-44.
[114] LISSA L. BROOME & JERRY W. MARKHAM, REGULATION OF BANK FINANCIAL SERVICE ACTIVITIES 462-63 (3d ed.2008).
[115] *Id.* at 97.
[116] STANTON, GOVERNMENT-SPONSORED ENTERPRISES, *supra* note 4, at 105-06 (discussing "the creation of an FDIC-type organization and an insurance fund to provide a cushion to pay for GSE financial failures").
[117] *See* Peter J. Wallison, American Enterprise Institute for Public Policy Research, *Fannie and Freddie By Twilight*, FINANCIAL SERVICES OUTLOOK, Aug. 2008 [hereinafter Wallison, *Fannie and Freddie by Twilight*] (stating that the GSEs differ from the FDIC system because (i) the FDIC has the power to tax the insured banks and (ii) the deposit insurance system only covers $100,000).

provided by the SPSPA.[118] As the level of government support increases, the direct cost to the GSEs also increases. An extended version of this commitment fee might be established beyond the SPSPAs.

Second, the government must expressly identify the exact amount and form of its guarantee. One possibility is a system in which the government would guarantee a certain percentage or maximum dollar amount per mortgage loan or security to those who buy GSE mortgage and debt obligations. The program could be similar to the insurance program run by the Federal Housing Administration (FHA) on multi-family loans which insures 99% of the loan's principal with the remaining 1% acting as a deductible.[119] The system would likely be more difficult to implement than federal deposit insurance coverage, however, because the GSEs currently have $6.7 trillion of guaranteed MBSs and debt outstanding. One could argue that in order to sufficiently insure the GSEs, the government's tax on them would be too high and eventually detrimental to the GSEs. In the end, comparisons to other government agencies are creative and promising, yet the question remains how similar the U.S. housing market is to either the agricultural or bank insurance markets.[120]

B. Privatization

Another long-term option for Fannie Mae and Freddie Mac is privatization, which put simply, involves removing any government ties and allowing the enterprises to compete in the market as private mortgage insurers and securitizers. It is the most frequently examined alternative structure for the GSEs. In fact, the executive branch, under both Republican and

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[118] *See supra* notes 70-73 and accompanying text (discussing the terms of the SPSPAs).

[119] MERRILL LYNCH, AN OVERVIEW OF FHA PROJECT LOANS 1 (1995) ("FHA's coverage on fully insured loans typically covers only 99% of the loan balance since a 1% "assignment fee" is generally levied on the lender when a loan defaults.").

[120] Importantly, one thing that must be considered in such a comparison is the size of the housing market as compared to the other markets.

Democratic administrations, has continuously floated the idea of removing government sponsorship.[121] The Federal Housing Enterprises Financial Safety and Soundness Act of 1992, the legislation which created OFHEO, mandated that a privatization study be performed immediately.[122] A compilation of papers, all analyzing the results of the study, was published in 1996, and provides an insightful summary of the pros and cons of privatization.[123] Although the study results list numerous advantages to privatization of the GSEs, ultimately none of the agencies involved made a formal privatization proposal and Congress took no action.[124] The study does suggest, however, that the privatization alternative should be examined periodically.[125]

Although removal of the implicit government guarantee may cause an increase in interest rates in the short-term, privatization provides numerous long-term advantages.[126] Competition will increase if special charters no longer protect the GSEs. Privatization will likely lead to greater innovation and efficiency.[127] Systemic risk may lessen because the GSEs will be unable to grow at the pace they had in the past. Without the implicit government guarantee, the GSEs would no longer be able to take such advantage of low risk perception or high leverage.[128] It is common perception that privatization would also eliminate the conflict between private

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[121] STANTON, GOVERNMENT-SPONSORED ENTERPRISES, *supra* note 4, at 93 (2002) ("The Treasury has for a number of years, in Democratic and Republican Administrations, believed that it is appropriate to wean a GSE from government sponsorship once the GSE becomes economically viable and successfully fulfills the purpose for which it was created with Federal sponsorship, or when the purpose for which it was created ceases to exist.").
[122] Pub. L. No. 102-550, 106 Stat. 3672.
[123] See U.S. DEP'T OF HOUSING AND URBAN DEV., STUDIES ON PRIVATIZING FANNIE MAE AND FREDDIE MAC (1996) [hereinafter, HUD, STUDIES ON PRIVATIZING].
[124] *Id.*
[125] *Id.*
[126] For a general discussion on the advantages of privatization, see White, *On Truly Privatizing Fannie Mae and Freddie Mac supra*, note 9 and Dwight M. Jaffee, *Comments on the Paper by Lawrence White: 'On Truly Privatizing Fannie Mae and Freddie Mac: Why It's Important, and How to Do It'* (Wharton Financial Institutions Working Paper No. 05-33, 2005), *available at* http://ssrn.com/abstract=830864.
[127] So long as the GSEs retain their special status and advantages, it will never be clear how much of what they do is based on true efficiency and how much is based on their special advantages. *See* White, *On Truly Privatizing Fannie Mae and Freddie, supra* note 9.
[128] *See supra* notes 6-10 and accompanying text (discussing the benefits of an implicit government guarantee).

shareholders and a public mission, and the need for taxpayer support.[129] However, the current financial crisis has shown that private institutions may still receive government support and pose a liability for taxpayers.[130]

In support of privatization, some scholars argue that the GSEs have fulfilled their public purpose.[131] As one scholar states, "[i]f there was ever was a good social reason for the special GSE status of Fannie Mae and Freddie Mac – arguably, they helped unify local and regional mortgage markets at a time when banks and S&Ls could not due to regulatory barriers, and their special GSE status may well have helped the worthwhile technology of mortgage securitization gain traction in the financial markets – that time has since passed."[132] Proponents of privatization argue that the GSEs now simply "add to an already excessive amount of encouragement for housing" in the U.S.[133] Even without the GSEs, other incentives of a strong "government push for increased rates of homeownership" have provided mortgage credit for many borrowers who would not have received such credit several decades ago.[134]

It is hard to ignore the benefits of privatization. Perhaps another time in history, the long-term structure of privatization for the GSEs would be the obvious answer. We are, however, currently facing unprecedented problems in the U.S. housing market. What may have been described as a "stable mortgage market" tens years, or even twelve months, ago no longer exists. Thus, despite the seemingly numerous benefits of privatization, it is difficult to envision a

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[129] *See, for example,* Wallison, *Fannie and Freddie by Twilight, supra* note 117.

[130] For example, AIG received $173 billion in total federal aid and the U.S. government has purchased preferred stock of $45 billion in each Citigroup and AIG. *See infra*, notes 204-05 and accompanying text.

[131] The legislatively mandated privatization studies, in fact, concluded in 1996 that an efficient secondary mortgage market had already been created. *See* HUD, STUDIES ON PRIVATIZING, *supra* note 123. Despite this finding, the studies did not propose a formal privatization of the GSEs for reasons including lack of political support for viable options for the privatization restructuring. *Id.*

[132] White, *Good Intentions Gone Awry, supra* note 98, at 21.

[133] *See* Lawrence J. White, CATO Institute, *Fannie Mae, Freddie Mac, and Housing Finance: Why True Privatization Is Good Public Policy*, POLICY ANALYSIS, Oct. 2004, at 15., *available at* http://www.cato.org/pub_display.php?pub_id=2467.

[134] Melissa B. Jacoby, *Bankruptcy Reform and Homeownership* 324 (UNC Legal Studies Research Paper No. 918006, 2007), *available at* http://ssrn.com/abstract=918006.

successful transition in the near future.[135] Securitization, which has helped to increase the availability of credit and decrease interest rates, may prove to be an important force in getting the economy back on its feet. It seems doubtful that mortgage securitization could continue under the highly stressed financial conditions without some sort of government guarantee.[136] Similarly, investor confidence is currently a major problem in the housing market. Providing a temporary explicit government guarantee of the GSEs was an action intended to increase confidence and improve the mortgage market.[137] Accordingly, removing all government guarantee of the GSEs does not seem to be an action that will help increase confidence or return the markets back to normalcy.

Even in a troubled economy, alternative solutions to the current securitization structure of the U.S. housing economy (for which government support is not needed) may exist, and make privatization of Freddie Mac and Fannie Mae a viable option. Covered bonds may provide "an alternative source of funding for institutions that can complement other sources of financing for a wide range of high-quality assets."[138] A covered bond is a debt issued by a financial institution and secured by a cover pool, consisting of high quality mortgages. [139] Unlike like MBSs, covered bonds stay on the issuing institution's balance sheet.[140] If the issuing institution defaults

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[135] Secretary Paulson stated that given the current conditions, he is "skeptical" that the privatization model "will prove to be a robust or even viable model of any substantial scale, without some sort of government support or protection." Paulson Remarks, *supra* note 35, at *5. Professor White provides a slightly more cynical view. Congress, especially in difficult times, will not want to eliminate the government ties to GSEs. He explains that the GSEs "have been the source of considerable campaign funding, . . . lucrative jobs for congressional staffers, and good publicity for incumbents in their districts and states." Wallison, *Fannie and Freddie by Twilight*, *supra* note 117, at 6.

[136] *See* Bernanke Speech, *supra* note 16, at *3 (discussing how the GSEs were relatively successful in continuing to produce and sell MBSs, even when the private markets had completely stopped).

[137] *See supra* note 60 and accompanying text.

[138] DEP'T OF THE TREASURY, BEST PRACTICES FOR RESIDENTIAL COVERED BONDS 5 (July 28, 2008), *available at* http://www.ustreas.gov/press/releases/reports/uSCoveredBondBestPractices.pdf.

[139] *See Id*.; *see also* JPMorgan, An Introduction to U.S. Covered Bonds MBS Research, at 2 (July 29, 2008) ("Covered bonds are bank-issued debt with security interest in a pool of collateral, e.g. high quality mortgages.").

[140] Miller Jefferson, *Comment, The Emerging U.S. Market for Covered Bonds,* 13 N.C. BANKING INST. 263, 264 (2009). For an insightful discussion on the differences between covered bonds and MBS, see *id.* at 274-77.

or becomes insolvent, the cover pool serves as recourse for the bondholder.[141] The Department of the Treasury requires that the cover pool be overcollateralized.[142] In addition, covered bonds provide an additional level of recourse. If the cover pool does not provide sufficient funds, the bondholders "may recover from the issuer along with other unsecured creditors."[143]

While the covered bond business in Europe has been estimated at $3.3 trillion, it has been slow to catch on in the United States.[144] Because the GSEs and securitization "successfully injected liquidity into the housing market . . . for many years," issuers never turned to covered bonds which did not offer the same risk mitigation and capital relief as securitization.[145] Although no legislation currently governs the issuance of covered bonds in this country, the Treasury and the FDIC recently issued guidelines for the issuance of covered bonds.[146] If these guidelines can increase certainty and ease fears about covered bonds, then government support may no longer be necessary to guarantee mortgages.

If (or when) privatization becomes the long-term option for Freddie Mac and Fannie Mae, the most difficult question is "how." That is, by what process can two gigantic GSEs successfully become privatized entities? Complex issues surround any attempt to privatize the GSEs: (i) how to separate the assets and liabilities based on whether they relate to existing portfolio and MBS or to the generation of future business; and (ii) how to dispose of the

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[141] *Id.* at 265.
[142] DEP'T OF THE TREASURY, BEST PRACTICES FOR RESIDENTIAL COVERED BONDS 7 (July 28, 2008), *available at* http://www.ustreas.gov/press/releases/reports/uSCoveredBondBestPractices.pdf ("[t]he issuer must maintain a [c]over [p]ool in excess of the notional value of the [c]overed [b]ond . . . at all times.").
[143] Jefferson, *supra* note 140, at 265.
[144] *Id.* at 263.
[145] Avi Salzman, *Covered Bonds: What the Paulson Plan Means for You*, BUS. WK., July 30, 2008; JPMorgan, *An Introduction to U.S. Covered Bonds*, MBS RESEARCH, July 29, 2008, at 1.
[146] See DEP'T OF THE TREASURY, BEST PRACTICES FOR RESIDENTIAL COVERED BONDS 5 (July 28, 2008), *available at* http://www.ustreas.gov/press/releases/reports/uSCoveredBondBestPractices.pdf.; Fed. Deposit Ins. Corp. Final Statement of Policy, 73 Fed. Reg. 43754 (July 28, 2008).

outstanding GSE guarantees.[147] Three main models seem to exist for GSE privatization: (1) a gradual Sallie Mae model; (2) Professor White's immediate elimination model; and (3) the American Enterprise Institute for Public Policy Research's middle-of-the-road model.

A Sallie Mae model is the first option. In the mid-1990s, Congress began the process of privatizing Sallie Mae, a GSE that provided loans for higher education.[148] Congress allowed Sallie Mae to create a corporate holding company, which was free of any government restrictions or regulation.[149] Under the holding company was a temporary GSE subsidiary, which allowed the original GSE to continue functioning to satisfy the existing GSE obligations.[150] Once all the obligations were satisfied and assets liquidated, the GSE subsidiary was terminated and Sallie Mae became identical to any other private company.[151]

The Sallie Mae experience provides a successful model of GSE privatization.[152] Privatization allowed Sallie Mae the freedom to expand to other activities, during a time when the benefits of remaining a GSE were being substantially reduced.[153] Such a model may prove to benefit Freddie Mac and Fannie Mae in a similar manner, especially if FHFA begins to set

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[147] *See generally* HUD, STUDIES ON PRIVATIZING *supra* note 123.
[148] For a concise and insightful summary of the privatization of Sallie Mae, see *Mark Overend, the Privatization of Sallie Mae, in* SERVING TWO MASTERS, YET OUT OF CONTROL: FANNIE MAE AND FREDDIE MAC 170 (Peter J. Wallison ed., 2001).
[149] Peter J. Wallison, American Enterprise Institute for Public Policy Research, *The Case for Privatizing Fannie Mae and Freddie Mac Grows Stronger*, FINANCIAL SERVICES OUTLOOK, May 2004, at 5.
[150] *See id.* The GSE subsidiary provided the parent company with strong cash flow, which allowed shareholders to profit. Accordingly, if anything, the GSEs would likely request this model from Congress as an option for privatization. *Id.*
[151] *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, 1080 (2008).
[152] *See id.* ("Both the ultimate privatization and the process of privatization were considered a great success by legislators and Sallie Mae's employees and shareholders."). *But see Mark Overend, the Privatization of Sallie Mae, in* SERVING TWO MASTERS, YET OUT OF CONTROL: FANNIE MAE AND FREDDIE MAC 170, 173 (Peter J. Wallison ed., 2001) ("Privatization may or may not be the natural conclusion of the public-private partnership embodied in all GSEs.").
[153] *See Introduction to Part Three, in* SERVING TWO MASTERS, YET OUT OF CONTROL: FANNIE MAE AND FREDDIE MAC 169 (Peter J. Wallison ed., 2001).

overly-restrictive limits on the GSEs.[154] Two important differences exist between Sallie Mae and the housing GSEs, however. First, 73.5% of Sallie Mae's balance sheet is comprised of student loans that have the explicit guarantee of the U.S. government (e.g., Stafford and Perkins loans).[155] Therefore, in order to fully replicate the Sallie Mae model of privatization, the U.S. government would need to start explicitly guaranteeing mortgages beyond the subset which Ginnie Mae guarantees.[156] In addition, the sheer size of the housing GSEs is significantly different than the student loan market. It may be difficult for the private market to absorb two companies, each with obligations in the trillions.[157]

Professor Lawrence J. White, Professor of Economics at the NYU Stern School of Business and a former board member of Freddie Mac, advocates a different approach for GSE privatization. He suggests not using special transition rules as was the case in Sallie Mae, but rather enacting legislation that immediately eliminates all of the GSEs' special features.[158] Freddie Mac and Fannie Mae would then need to register for state corporate charters to continue business.[159] Freddie Mac and Fannie Mae would operate like any other corporation – owners and creditors would bear the full risk, and the corporation would be subject to private market forces in addition to the bankruptcy laws.[160] Professor White explains that without government

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[154] HERA provides increased regulatory authority for the FHFA. It is likely that some of its regulatory powers may become restrictive on the GSEs. *See, for example*, HERA, sec. 1108, 12 U.S.C.A. § 4513b (2009).
[155] SLM Corporation, Form 10-k, *available at* http://www.salliemae.com/about/investors/stockholderinfo/annualreports/annualreports.htm.
[156] Such insurance might be created by an agency within the Department of Housing and Urban Development.
[157] Judy Kennedy, who led Sallie Mae's government relations team from 1991 to 1997 further discusses why privatizing the housing GSEs would be "far more difficult" than privatizing Sallie Mae. "It was a whole lot easier when Sallie was solvent and at the top of its game." Sloan, *supra* note 95, at *1.
[158] For a concise explanation of Professor White's theory, see Lawrence J. White, CATO Institute, *Fannie Mae, Freddie Mac, and Housing Finance: Why True Privatization Is Good Public Policy*, POLICY ANALYSIS, Oct. 2004, at 15, *available at* http://www.cato.org/pub_display.php?pub_id=2467.
[159] *See* White, *Good Intentions Gone Awry, supra* note 98, at 22 ("In essence, their past and present senior managements would be . . . publicly patted on the back for a job well done in bringing about securitization and the national integration of residential mortgage markets (but not for the accounting scandals) and then pointed toward the office of the secretary of state in Dover, Delaware, to seek a corporate charter.").
[160] *Id.* at 23.

support, Freddie Mac and Fannie Mae's presence in the mortgage market would shrink, which would make it easier to absorb the two GSEs.[161] Further, he advocates that private market participants would have time to adjust to such an arrival of the two GSEs. Rather than a sudden bankruptcy filing overnight, privatization would require several years between initial consideration and Presidential signing, giving the markets time to hedge their bets on "the likelihood that this idea would be converted to reality."[162]

Professor White proposes a valid alternative to privatization in case Congress does not accept a Sallie Mae model. He proposes alternatives for serving the populations that will no longer be served when government regulation is removed from Freddie Mac's and Fannie Mae's structure. For example, he suggests that Congress could expand the American Dream Downpayment Act of 2003 to make more funding available to assist low- and moderate- income first-time home buyers. An "explicit on-budget program" is a better way for the government to operate than an "implicit off-budget contingent liability approach that the GSE route represents."[163] It is also possible for Ginnie Mae to expand the population which it serves with its conforming loans.

This model of privatization poses some problems, however. First, it does not provide a mechanism to protect the housing GSEs' guarantees. Presumably, these guarantees would remain in place. However, without the implicit government backing, their value to the investors would change drastically. The guarantees would become only as good as the operations of the newly privatized company, rather than the U.S. Government. Second, even if Freddie Mac and Fannie Mae lose some presence in the mortgage market, they will remain very large companies.

[161] Freddie Mac and Fannie Mae might be able to apply their expertise to grow in other markets (such as mortgage origination or consumer lending). *See id.* at 22.
[162] *Id.* at 23.
[163] *Id.* at 24.

It may be necessary to break the GSEs into smaller units before privatizing. Not only will this help the private market better absorb them, but it will also eliminate any presumption that the GSEs are still "too big to fail." AT+T's division of business into long-distance and regional operating companies and a manufacturing unit in the 1980s may serve as an example.[164] Freddie Mac and Fannie Mae would likely divide the portfolios by business function, investment portfolio vs. mortgage guarantee business. A regional separation would likely eliminate the value created by the GSEs' ability to operate nationwide.[165]

A third model, promoted by the scholars at the American Enterprise Institute for Public Policy Research (AEI), advocates a middle-of-the-road approach. It creates gradual privatization through a holding company like the Sallie Mae model, but does not propose terms as beneficial for the GSEs as the Sallie Mae model.[166] A corporate holding company would acquire the GSEs, while a temporary GSE subsidiary would be established. The GSE subsidiary would not acquire mortgages or MBSs for its own portfolio, but would continue to securitize mortgages and issue MBSs for six months.[167] For the next two and a half years, the GSE subsidiary would gradually be forced to phase down its securitization. By the three-year mark, any remaining obligations on the GSEs' securitization guarantees would be defeased with (either replaced or funded by) U.S. government securities.[168] For the guarantees, a more complex issue exists because the guarantees against individual mortgage loans can last through their maturity, which can be as long as forty years.[169] This model of privatization suggests that some way must be created to provide the mortgage holders with a guarantee similar to the implicit government

[164] *See* HUD, STUDIES ON PRIVATIZING, *supra* note 123, at 189 (discussing other approaches to privatization beyond the Sallie Mae model).
[165] *Id.*
[166] For an in depth summary of this plan, see WALLISON ET AL., PRIVATIZING FANNIE MAE, *supra* note 96, at 21-26.
[167] This process lessens the disruption of the residential mortgage market. *Id.* at 21.
[168] *See* Wallison, *Fannie and Freddie by Twilight*, *supra* note 117, at 6.
[169] Defeasance is not an option here because the obligations can only be eliminated through refinancing, payoff, or sale of the underlying residence. *See id.*

guarantee. One possibility is to convey existing Fannie Mae and Freddie Mac guarantees to Ginnie Mae which already has the explicit backing of the Government.[170]

This model may be a necessary compromise between the Sallie Mae model and the Professor White model. On one hand, it provides a mechanism to slowly phase out the portfolios while continuing to enforce the existing guarantees. On the other hand, this model places many restrictions the GSE subsidiary, and does not allow it to further grow or transfer assets to the corporate holding company. Accordingly, the shareholders receive fewer benefits at the cost of the taxpayers.[171]

C. Nationalization

Nationalizing the GSEs would provide an explicit, rather than implicit, government guarantee and eliminate all private shareholders.[172] While privatization has been analyzed for decades, the idea of nationalizing Freddie Mac and Fannie Mae has only been raised in the past year.[173] To many, nationalization is "un-American."[174] History supports this connotation. While wholly government-owned corporations such as the National Railroad Passenger Corporation (Amtrak), the Corporation for Public Broadcasting, and the Tennessee Valley Authority exist, they are not the product of nationalization. That is, they were all created by federal charter rather than nationalized from a private entity.[175] Ginnie Mae, which guarantees VA and FHA loans, is in a similar situation – a wholly government-owned corporation which

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[170] *See id.*
[171] *See* WALLISON ET AL., PRIVATIZING FANNIE MAE, *supra* note 96, at 26.
[172] *See* Paulson Remarks, supra note 35, at *4.
[173] Expansive research dating back to the 1980s analyzes privatization. To my knowledge, few (if any) articles mentioned, let alone critiqued, the idea of nationalization until 2008.
[174] "Nationalism evokes immediate negative connotations. Americans basically don't believe in socialism." Sloan, *supra* note 95, at *1.
[175] The Rail Passenger Service Act of 1970 created Amtrak. *See* Pub. L. No. 91-518, 84 Stat. 1327. The Public Broadcasting Act of 1967 created the Corporation for Public Broadcasting. *See* Pub. L. No. 90-129, 81 Stat. 365. The Tennessee Valley Authority Act of 1933 created the Tennessee Valley Authority. *See* Pub. L. No. 94-274, 48 Stat. 58.

was always chartered to fall within the Department of Housing and Urban Development. Thus, while fully nationalized corporations exist, none can serve as a true model of nationalizing Freddie Mac and Fannie Mae from a GSE to a true government agency.[176] Actions during the recent credit crisis may provide the closest model of nationalizing a private company. For example, the government has purchased $45 billion of preferred stock in Citigroup and currently owns over one-third of Citigroup's stockholders' equity.[177]

The actual process of nationalizing the housing GSEs seems relatively straightforward. The U.S. Government would purchase all of the outstanding shares of the GSEs or, if they did not survive conservatorship, acquire the shares through a receivership authorized under HERA.[178] Then, the GSEs could either become a separate government entity, or their functions could be "absorbed by FHA/Ginne Mae."[179] A possible conflict of interest may arise, however, if the government, which acted as the regulator and conservator, becomes owner. It is arguable that as regulator, the government may allow the GSEs to fail under conservatorship to wipe out the shareholders' interests, and then benefit from the newly nationalized GSEs when they again become profitable.[180]

Supporters of nationalization argue that the GSEs still serve a necessary purpose, especially in difficult economic times.[181] Because Freddie Mac and Fannie Mae play an essential role in the U.S. housing market, Congress should remove the confusion and uncertainty

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[176] In fact, because the housing market covered by Freddie Mac and Fannie Mae is significantly larger than the constituencies of any of the above mentioned government-owned corporations, the problems of nationalized corporations would only be exacerbated in the housing GSEs.
[177] *See infra* notes 204-06 and accompanying text.
[178] Wallison, *Fannie and Freddie by Twilight*, *supra* note 117, at. 4. Notice that as of April 15, 2009 Freddie Mac and Fannie Mae are trading at $0.89 and $0.88 respectively, so this would not be as big a purchase for the government has it would have been in the past..
[179] Paulson Remarks, *supra* note 35, at *4.
[180] This scenario seems unlikely, however, because the existing shareholders' interests have already been significantly diluted by the terms of the SPSPAs which provided the Treasury with warrants for 79.9% of the common stock. *See supra* note 61 and accompanying text (discussing terms of the SPSPAs).
[181] *See supra* notes 135-37 (discussing why privatization may not be an option during the current financial crisis).

of the "implicit" government guarantee.[182] In addition, nationalization may help to restore confidence in the housing market because as government agencies, Freddie Mac and Fannie Mae would no longer be subject to quarterly reporting and the country would no longer be able to track their losses.

On the other hand, critics of nationalization emphasize that it would increase the national debt tremendously, as Freddie Mac and Fannie Mae would be consolidated onto the government's balance sheet.[183] In addition, government agencies tend to be less innovative and efficient than private enterprises.[184] It is also possible that nationalization would lead to political pressure to support lending to riskier borrowers than the GSEs do now. Ultimately, increasing national debt, losing innovation, and risky lending practices can all hurt the economy in the long run, rather than improve the housing market.

D. Or Somewhere In Between

All the options -- returning to pre-conservatorship status, privatization, and nationalization -- each present distinct difficulties for Freddie Mac and Fannie Mae. Accordingly, "there has been no shortage of" proposals for long-term solutions that combine characteristics of nationalization, privatization, and the status quo.[185] Two models seem to be the most promising: (i) the public utility model and (ii) the middle-income mortgage program.

In the public utility model, the GSEs would remain a corporation with shareholders but would be overseen by a public board. The board would provide restrictions covering safety and

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[182] Wallison, *Fannie and Freddie by Twilight*, *supra* note 117, at 4 (discussing how Congress should nationalize the housing GSEs if it believes they still serve a necessary purpose).
[183] *See* Sloan, *supra* note 95, at *2; see also STANTON, GOVERNMENT-SPONSORED ENTERPRISES, supra note 4, at 95 (discussing how the implicit government guarantee has allowed the government to provide subsidy while evading budgeting rules).
[184] *See* Sloan, *supra* note 95, at *2 ("With nationalization, I would just say look at the Federal Housing Administration . . . I don't think anyone would want to see Fannie or Freddie turn into another FHA.").
[185] *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, 1076-77 (listing examples of reform proposals).

soundness, rate of return for shareholders, product innovation, and other issues such as executive compensation.[186] The transition into such a model has not been extensively analyzed. To date, the suggested process would entail Congress replacing Freddie Mac and Fannie Mae with one or two private sector entities; the entities would "purchase and securitize mortgages with a credit backed by the federal government, and would not have investment portfolios."[187] Importantly, this process does not yet address (i) transition of the shares from the GSE to a private corporation; or (ii) the fate of the outstanding GSE guarantees.[188]

Former Treasury Secretary Paulson expressly stated that he believes this public utility-like mortgage credit guarantor is the best way to resolve the inherent conflict between public purpose and private gain.[189] The basic structure of the current GSE model is retained, but because the public board establishes the targeted rate of return and other tightly monitored evaluations for safety and soundness, the public-private conflicts subside.[190] Other possible advantages of this model include an ability to better resist political influence, as well as the retention of some flexibility and innovation associated with private-sector enterprises.[191] Critics

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[186] *See generally* Dwight M. Jaffee, *Reforming Fannie and Freddie*, REG., Winter 2008-2009, at 53 [hereinafter Jaffee, *Reforming Fannie and Freddie*]. *See* Paulson Remarks, *supra* note 35, at *5 ("This commission would also approve mortgage product and underwriting innovations to continually improve the availability of mortgage finance for a population to be defined by Congress."); *see* Bernanke Speech, *supra* note 16, at *5 ("Beyond simply monitoring safety and soundness, the regulator would also establish pricing and other rules consistent with a promised rate of return for shareholders.").

[187] Paulson remarks, *supra* note 35, at *5.

[188] Professor Jaffee points out another difficult issue that this model raises. He states that "an explicit guarantee on the entities' capital market obligations would seem unavoidable. Otherwise, it is unclear how the firms could succeed while facing much higher regulatory standards than their private sector companies." *See* Jaffee, *Reforming Fannie and Freddie*, *supra* note 186, at 55-56.

[189] Paulson remarks, *supra* note 35, at *5.

[190] *See id.*; *see also* Steven Sloan & Emily Flitter, *Paulson's Third Way: GSEs Taking Utility Role*, AM. BANKER, Jan. 8, 2009 (A senior economist at UCLA states that this model "solves some of the public-private issues. This is a reasonable way of thinking about it, where you retain Fannie or Freddie as a private entity and it's run more as an insurance company, which is more like what the original function was."). *But see* Bernanke Speech, *supra* note 16, at *5 ("Nor does this [public utility] model completely eliminate the private-public conflict of the current GSE structure.").

[191] See Bernanke Speech, *supra* note 16, at *5.

point out, however, that this model leads to reduced incentives to control costs.[192] The biggest issue with this model is how well the utility model, which originated from the regulation of power companies or other natural monopolies, can be applied to the housing market.[193]

Another "mixed" characteristic model is the Middle-Income Mortgage Program (MIMP), proposed by Dwight M. Jaffee, Professor of Banking, Finance, and Real Estate at the Haas School of Business, University of California, Berkeley.[194] The central idea of this program is to (i) move the issuing and guaranteeing of MBSs explicitly to a government agency; and (ii) spin off and privatize the retained GSE portfolio.[195] Like the public utility model, MIMP has not yet been extensively researched, but contains promising ideas. By moving the GSEs' MBS issue and guarantee programs to a government agency, the agency could expressly guarantee the new mortgages, as well as likely support the outstanding GSE guarantees. The government guarantee would satisfy the public mission of supporting the mortgage market for middle-income borrowers in a safe and efficient manner. Without the retained portfolio, though, the new GSE structure is not likely to impose as great a systemic risk on the financial markets.[196] Similarly, because of the government guarantee, it is likely that the MBSs could be readily securitized just as FHA and VA mortgages are securitized today under the Ginnie Mae programs.[197]

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[192] *Id.*
[193] *See* Sloan & Flitter, *supra* note 190, at *1 ("We have public utilities because of economics of scale in power and utility production and distribution and because everyone needs it. So you need a common capital pool to produce utilities. I'm not sure how mortgages fit into any of those economic categories unless we've just changed the whole nation's housing system."); *see also* Jaffee, *Reforming Fannie and Freddie*, *supra* note 186, at 55 (the public utility model "arises only because there are really no other viable regulatory models for dealing with natural monopolies such as water, gas, and electric providers).
[194] *See generally* Jaffee, *Reforming Fannie and Freddie*, *supra* note 186.
[195] *Id.* at 54.
[196] *Id.* at 54-55. ("In brief, the MIMP would simply and efficiently replace the existing Fannie and Freddie programs, while avoiding the systemic risks that the two GSEs now create.").
[197] *See id.* at 54 (Professor Jaffee discussing how the MIMP model would function similarly to Ginnie Mae).

MIMP also proposes to transfer all "net assets and technology" of the retained portfolio to the private sector with no implicit or explicit links to the federal government.[198] This method seems to respect the interests and property rights of the GSEs' shareholders and other investors. And without links to the federal government, the GSEs would no longer be constrained by federal charters or regulatory oversights. The companies could originate mortgages directly and operate solely for shareholder profit.

MIMP is not fully developed, however. It is unclear how moving the MBS issue and guarantee programs to a government agency will affect competition and innovation in the market. Professor Jaffee does note that "private mortgage insurers have co-existed with the low-income FHA programs for over 50 years."[199] In addition, although Professor Jaffee describes the spun-off mortgage portfolio as "the equivalent of mortgage real estate investment trusts or hedge funds,"[200] the problem of separating assets and liabilities between the existing portfolio and future business seems to remain. Ultimately, both the public utility model and the MIMP should be further analyzed as potential long-term solutions for Freddie Mac and Fannie Mae.

V. What Will the Obama Administration Decide?

The temporary conservatorship has given the current administration the opportunity to carefully choose the most beneficial long-term solution for Freddie Mac and Fannie Mae. As of March 20, 2009, no significant comments have been made by President Obama directly regarding the status of the housing GSEs.[201] However, an analogy may be drawn to the Obama administration's attitude on the nationalization of banks.

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[198] *Id.*
[199] *Id.* at 55.
[200] *Id.*
[201] Former Secretary Paulson's express support of the public utility probably does not represent the feelings of the Obama administration, as Paulson was the Bush appointee and later replaced with Secretary Geithner.

The current Treasury Secretary, Timothy Geithner, has made it clear that the Obama administration "does not plan to nationalize banks or wipe out the value of bank stocks."[202] President Obama himself, on ABC Nightline, explained that nationalization is not the answer for the U.S. banking system.[203] But, do actions speak louder than words? In the past year, the U.S. government has purchased preferred stock in numerous financial institutions, with investments in Citigroup and Bank of America of $45 billion each.[204] AIG has received $173 billion in total federal aid.[205] The government is "by far the largest equity holder" in both Citigroup and Bank of America, [206] and has shown its ability to make influential management decisions.[207]

Despite this large ownership interest, Federal Reserve Chairman Benjamin Bernanke insists that the government's stake in a number of large financial institutions does not demonstrate that the administration is leaning toward nationalization.[208] In fact, Bernanke stated "there is a very strong commitment on the part of the administration to try and return banks to private hands as quickly as possible."[209] He reiterates that these actions were simply temporary ways to provide capital to highly stressed institutions in an effort "to lend and complete economic recovery."[210]

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[202] Mike Allen, *Geithner: Banks Won't be Nationalized*, POLITICO, Jan. 28, 2009.
[203] Transcript, ABC Nightline, Obama on Bank Nationalization: Too Many Banks/Republicans (February 10, 2009), http://paul.kedrosky.com/archives/2009/02/10/obama_on_bank_n.html (discussing how the U.S. has different "culture," traditions," and "investment needs" than countries with nationalized banks).
[204] *See* Broome, *Extraordinary Government Intervention, supra* note 59, at 137, 153-54.
[205] *See* Meena Thiruvengadam, *U.S. Bailouts So Far Total $2.98 Trillion, Official Says*, WALL ST. J., March 31, 2009, *available at* http://online.wsj.com/article/SB123851108664173877.html.
[206] *See* Broome, *Extraordinary Government Intervention, supra* note 59, at 137, 153 (stating that the government owns over one-third of Citigroup's stockholders' equity and one-fifth of Bank of America's consolidated equity post-Merrill Lynch merger).
[207] Even though the government does not have a controlling stake, Citigroup agreed to change its Board of Directors. *See* Press Room, U.S. Dept. of the Treasury, Treasury Announces Participation in Citigroup's Exchange Offering (Feb. 27, 2009).
[208] Stacy Kaper, *Bernanke Rejects Nationalization, Defends Actions*, BANK INVESTMENT CONSULTANT, Feb. 19, 2009.
[209] *Id.*
[210] *Id.*

The government's infusion of monetary support into the GSEs[211] analogously does not necessarily support the nationalization of Freddie Mac and Fannie Mae. Although these actions may be a wink at nationalization, they are likely, in reality, the only viable option for the government to keep the mortgage market functioning. Like the support of the major banks, the GSEs play an integral role in economic recovery and the administration cannot let them fail.[212] Furthermore, it does not appear that the current administration has room in the budget or under the debt ceiling for the nationalization of the housing GSEs.[213] Despite the speculation, the nation must wait to see which long-term solution the Obama administration chooses for Freddie Mac and Fannie Mae.

VI. Conclusion

The Housing and Economic Recovery Act of 2008 created the FHFA, a new regulator with expanded authority over the GSEs.[214] After a comprehensive examination revealed that both Freddie Mac and Fannie Mae were operating in an unsafe and unsound condition, the FHFA placed the GSEs into conservatorship on September 7, 2008.[215] The conservatorship provided Freddie Mac and Fannie Mae with a temporary time-out, during which the Treasury and the Federal Reserve provided large amounts of funding and support to the GSEs.[216] The question remains: what happens to the GSEs when this time-out is over? Given the size and scope of the GSEs' operations, no easy answer exists for a long-term solution for Freddie Mac and Fannie Mae.

[211] *See supra* notes 47-53 and accompanying text.
[212] *See supra* notes 59-60 and accompanying text.
[213] *See supra* notes 183-84 and accompanying text.
[214] *See supra* notes 19-27 and accompanying text.
[215] *See supra* notes 37-42 and accompanying text.
[216] *See supra* notes 45-68 and accompanying text.

All of the options present both distinct advantages and difficulties for the GSEs, their shareholders, and taxpayers, with no single solution resolving all conflicts and issues. One possibility is a return to pre-conservatorship status, which emphasizes the idea that the GSEs continue to play an important role in the U.S. housing market.[217] Even with HERA's mandate for a stronger regulator and more stringent capital requirements though, the conflict between private shareholders and a public purpose still remains.[218] Another long-term solution may be privatization, which is the most frequently examined alternative structure for the GSEs. Privatization provides numerous long-term advantages, including increased competition, greater efficiency, and lessened systemic risk.[219] It is questionable, however, if the current economy could absorb a privatization of the GSEs, especially when private institutions (such as Citigroup) are accepting historic levels of government support.[220] Furthermore, the process of GSE privatization may take many forms. The chosen model must successfully (i) separate assets and liabilities based on whether they relate to existing or future business and (ii) dispose of the outstanding GSE guarantees.[221] Next, nationalization, a long-term solution raised only in the past year, emphasizes the advantages of creating a clear, express government guarantee.[222] It may lead to increased national debt, decreased innovation, and risky lending practices, however.[223] Lastly, two promising mixed-model solutions exist, but both require more extensive research and analysis. The public utility model, a favorite long-term solution of former Treasury Secretary Paulson, mitigates the public-private conflict by establishing a public board which sets

[217] *See supra* notes 90-95 and accompanying text.
[218] *See supra* notes 104-08 and accompanying text.
[219] *See supra* notes 126-34 and accompanying text.
[220] *See supra* notes 129-30, 135-37 and accompanying text.
[221] *See supra* notes 147-71 and accompanying text.
[222] *See supra* notes 181-82 and accompanying text.
[223] *See supra* notes 183-84 and accompanying text.

targeted rates of returns and other evaluations for safety and soundness.[224] Professor Jaffee's proposed Middle-Income Mortgage Program advocates a dual approach of (i) moving the issuing and guaranteeing of MBSs explicitly to a government agency, and (ii) spinning off and privatizing the retained GSE portfolio.[225]

The Obama administration has yet to formally comment on long-term solutions for Freddie Mac and Fannie Mae.[226] Its actions towards other critical private financial institutions may serve as a model for future treatment of the GSEs, but even then, the nation must wait to see which long-term solution the Obama administration chooses.[227] Infusion of monetary support into the private financial institutions may be a wink at nationalization; or, in reality, it may be the only viable option to keep the mortgage market functioning.[228]

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[224] *See supra* notes 187-90 and accompanying text.
[225] *See supra* notes 194-98 and accompanying text.
[226] *See supra* Section V.
[227] *Id.*
[228] *Id.*