

# Handling the Failure of a Government-Sponsored Enterprise

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# Handling the Failure of a Government-Sponsored Enterprise

Government-sponsored enterprises (or GSEs) are privately owned corporations with special ties to the United States Government.<sup>1</sup> GSEs are not part of the government, unlike executive departments<sup>2</sup> (e.g., the Department of the Treasury), independent agencies<sup>3</sup> (e.g., the Securities and Exchange Commission), or government corporations<sup>4</sup> (e.g., Amtrak, Ginnie Mae, the Tennessee Valley Authority, and the U.S. Postal Service). But GSEs' government ties enable them to borrow vast sums at interest rates below those available to even the most creditworthy fully private firms.<sup>5</sup>

Five GSEs exist<sup>6</sup>: the Federal National Mortgage Association (Fannie Mae or Fannie),<sup>7</sup> the Federal Home Loan Mortgage Corporation (Freddie Mac or Freddie),<sup>8</sup> the

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<sup>1</sup> For my definition of “government-sponsored enterprise,” see Part I-A *infra*.

<sup>2</sup> See 5 U.S.C. §§ 101 (defining “Executive department”), 105 (defining “Executive agency” as “an Executive department, a Government corporation, and an independent establishment”).

<sup>3</sup> *Id.* § 104 (defining “independent establishment”).

<sup>4</sup> *Id.* § 103(1) (defining “Government corporation”). For a lucid scholarly analysis of government corporations, with some attention to GSEs, see A. Michael Froomkin, *Reinventing the Government Corporation*, 1995 ILL. L. REV. 543.

<sup>5</sup> See, e.g., U.S. CONG. BUDGET OFFICE, ASSESSING THE PUBLIC COSTS AND BENEFITS OF FANNIE MAE AND FREDDIE MAC 10 (1996) [hereinafter CBO, PUBLIC COSTS AND BENEFITS]; Brent Ambrose & Arthur Warga, *Measuring Potential GSE Funding Advantages*, 25 J. REAL ESTATE FIN. & ECON. 129 (2002).

Fannie Mae's market-value insolvency during the early 1980s underscores how GSEs can borrow on favorable terms even when failing to meet basic standards of creditworthiness:

In 1981 ... the estimated market value of Fannie Mae's net worth was reported to have declined to a negative \$11 billion. Under these circumstances, a wholly private firm would typically be blocked from borrowing or ... permitted to borrow only at extremely high rates of interest. Indeed, some private firms in that situation would be forced into liquidation once the general creditors learned the facts. Fannie Mae, however, was able to continue borrowing very large amounts (\$31 billion in long-term debt and \$64 billion in short-term funds in 1981 and 1982) with only a brief increase in its borrowing costs. Throughout the episode, Fannie Mae retained the highest credit rating possible....

U.S. GEN. ACCOUNTING OFFICE, GOVERNMENT-SPONSORED ENTERPRISES: THE GOVERNMENT'S EXPOSURE TO RISKS, GAO/GGD-90-97, at 10 (1990) [hereinafter GAO, THE GOVERNMENT'S EXPOSURE TO RISKS].

<sup>6</sup> In referring to five GSEs, this article treats the Federal Home Loan Bank System and Farm Credit System each as a single enterprise, treats Farmer Mac as separate from the Farm Credit System, and disregards three pseudo-GSEs: the

Federal Home Loan Bank System,<sup>9</sup> the Farm Credit System,<sup>10</sup> and the Federal Agricultural Mortgage Corporation (Farmer Mac).<sup>11</sup> A sixth GSE, the Student Loan Marketing Association (Sallie Mae), dissolved itself in December 2004 after transferring its business to non-GSE affiliates.<sup>12</sup>

GSEs are huge. At the end of 2003, Fannie, Freddie, the Federal Home Loan Bank System, Farm Credit System, and Farmer Mac together had \$2.68 trillion in total assets and \$2.58 trillion in total liabilities.<sup>13</sup> By comparison, the federal government's entire

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Financing Corporation, Resolution Funding Corporation, and Financial Assistance Corporation. Although the Federal Home Loan Bank System and Farm Credit System each comprise multiple institutions, *see* Part I-C-3, -4 *infra*, those institutions have joint-and-several liability for the system's obligations. *See id.* §§ 1431(b)-(c) (FHLBS), 2155 (FCS). Farm Credit System institutions also have a common insurance fund. *See id.* §§ 2277a-1, 2277a-4, 2277a-9. Farmer Mac, although technically "an institution of the Farm Credit System," 12 U.S.C. § 2279aa-1(a)(2), is separately owned and economically independent. *See, e.g., id.* § 2279aa-1(a)(3) (Farmer Mac and Farm Credit System not liable for each other).

During the late 1980s Congress established three pseudo-GSEs designed to avoid the budgetary constraints of the Budget and Emergency Deficit Control Act of 1985, Pub. L. No. 99-177, 99 Stat. 1037 (1985). The Financing Corporation, 12 U.S.C. § 1441, and the Resolution Funding Corporation, *id.* § 1441b, facilitated assistance to depositors of failed savings-and-loan associations. The Financial Assistance Corporation, *id.* §§ 2278b to 2278b-11, helped rescue the Farm Credit System. Unlike real GSEs, these pseudo-GSEs had no business activities, no opportunity for profit, no voluntary shareholders, and no meaningful managerial discretion; they served merely as vehicles for a budgetary subterfuge. *See* Froomkin, *supra* note 4, at 615 (characterizing those entities as "little more than an accounting trick").

<sup>7</sup> 12 U.S.C. §§ 1716-1717, 1718, 1719, 1723(b), 1723a, 1723c. *See* Part I-C-1 *infra*.

<sup>8</sup> 12 U.S.C. § 1451-1459. *See* Part I-C-2 *infra*.

<sup>9</sup> 12 U.S.C. §§ 1421-1449. *See* Part I-C-3 *infra*.

<sup>10</sup> 12 U.S.C. §§ 2001-2279g. *See* Part I-C-4 *infra*.

<sup>11</sup> 12 U.S.C. §§ 2279aa-1 to-14. *See* Part I-C-5 *infra*.

<sup>12</sup> Congress chartered Sallie Mae in 1972 to create a secondary market for insured student loans. Education Amendments of 1972, Pub. L. No. 92-318, § 133(a), 86 Stat. 235, 265 (1972); H. Rep. 92-554, at 28-29 (1971), *reprinted in* 1972 U.S.C.C.A.N. 2462, 2489-90. In 1993 Congress curtailed federal student loan guarantees, authorized direct federal loans to students, and began charging Sallie an annual fee. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, §§ 4011-4112, 107 Stat. 312, 341-70 (1993). Faced with increased borrowing costs and the loss of its main business, *see generally* Mark Overend, *The Privatization of Sallie Mae*, in *SERVING TWO MASTERS YET OUT OF CONTROL: FANNIE MAE AND FREDDIE MAC* 170 (2001), Sallie agreed to 1996 legislation, Student Loan Marketing Association Reorganization Act of 1996, Pub. L. No. 104-208, tit. VI, § 602(a), 110 Stat. 3009-275 to 3009-290 (1996) (codified as 20 U.S.C. § 1087-3), under which Sallie dissolved in December 2004, *see, e.g.,* Dawn Kopecki, *Sallie Mae Completes Privatization 4 Years Early*, *WALL ST. J.*, Dec. 30, 2004, at C3.

<sup>13</sup> *See* table on p. 15 *infra*.

publicly held debt totaled \$4.07 trillion<sup>14</sup> and U.S. corporate stocks had a combined market value of \$13.06 trillion.<sup>15</sup> The three housing GSEs—Fannie, Freddie, and the Federal Home Loan Bank System—held 96% of all GSE assets.<sup>16</sup>

GSEs are highly leveraged: they rely heavily on borrowed money. The five GSEs together had a debt-to-equity ratio exceeding 25:1, meaning that they had more than \$25 in liabilities for each \$1 of shareholders' equity. (By contrast, FDIC-insured depository institutions, although more heavily leveraged than most firms, had a 10:1 debt-to-equity ratio.<sup>17</sup>) GSEs have also guaranteed prompt payment of principal and interest on \$1.64 trillion in outstanding mortgage-backed securities.<sup>18</sup> These guarantees create contingent liabilities—not included in the GSEs' total liabilities—that reflect the possibility that the GSEs might need to pay out money to make good on the guarantees. In sum, GSEs' slender equity capital and heavy reliance on debt increase their vulnerability to financial setbacks (e.g., from a sharp rise in interest rates that would reduce the value of GSEs' assets).

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<sup>14</sup> See FIN. MGMT. SERV., U.S. DEP'T OF THE TREASURY, TREASURY BULL., Dec. 2004, at 29 (table FD-1).

<sup>15</sup> Fed. Reserve Statistical Release Z.1, Flow of Funds Accounts of the United States 90, table L.213 (March 4, 2004), available at <http://www.federalreserve.gov/releases/Z1/20040304/z1r-4.pdf>.

<sup>16</sup> See table on p. 15 *infra*.

<sup>17</sup> See FED. DEPOSIT INS. CORP., FDIC QUARTERLY BANKING PROFILE 5 (4th quarter 2003).

<sup>18</sup> See table on p. 15 *infra*. To create mortgage-backed securities, the GSEs or others “purchase mortgages, bundle them together, and then sell claims on the cash flows to be generated by these bundles”—claims in the form of securities backed by the underlying mortgages. See Alan Greenspan, Statement Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, at 1 n.1 (Feb. 24, 2004), available at [http://banking.senate.gov/\\_files/ACF1BA.pdf](http://banking.senate.gov/_files/ACF1BA.pdf).

GSEs play a large and growing role in U.S. financial markets. For example, from 1993 through 2003:<sup>19</sup>

- the GSEs' combined total assets rose 393%, from \$545 billion to \$2.68 trillion;<sup>20</sup>
- the GSEs' combined total liabilities—mostly in the form of debt securities—rose 404%, from \$512 billion to \$2.58 trillion;<sup>21</sup>
- Fannie and Freddie's total annual issuance of mortgage-backed securities rose 672%, from \$248 billion to \$1.91 trillion;<sup>22</sup>
- Fannie and Freddie's total outstanding mortgage-backed securities rose 222%, from \$936 billion to \$3.01 trillion;<sup>23</sup> and
- the total market value of Fannie and Freddie's publicly traded stock rose 321%, from \$29 billion to \$113 billion.<sup>24</sup>

GSE growth far outstripped inflation<sup>25</sup> and macroeconomic growth.<sup>26</sup> The GSEs' combined share of total bond-market debt rose from 15% in 1985 to 27% in 1993 and 36% in 2003, as shown in the following chart:<sup>27</sup>

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<sup>19</sup> All data-comparisons in this paragraph compare Dec. 31, 1993, with Dec. 31, 2003—with the exception of annual issuance and average daily trading volume, which compare the calendar years 1994 and 2003.

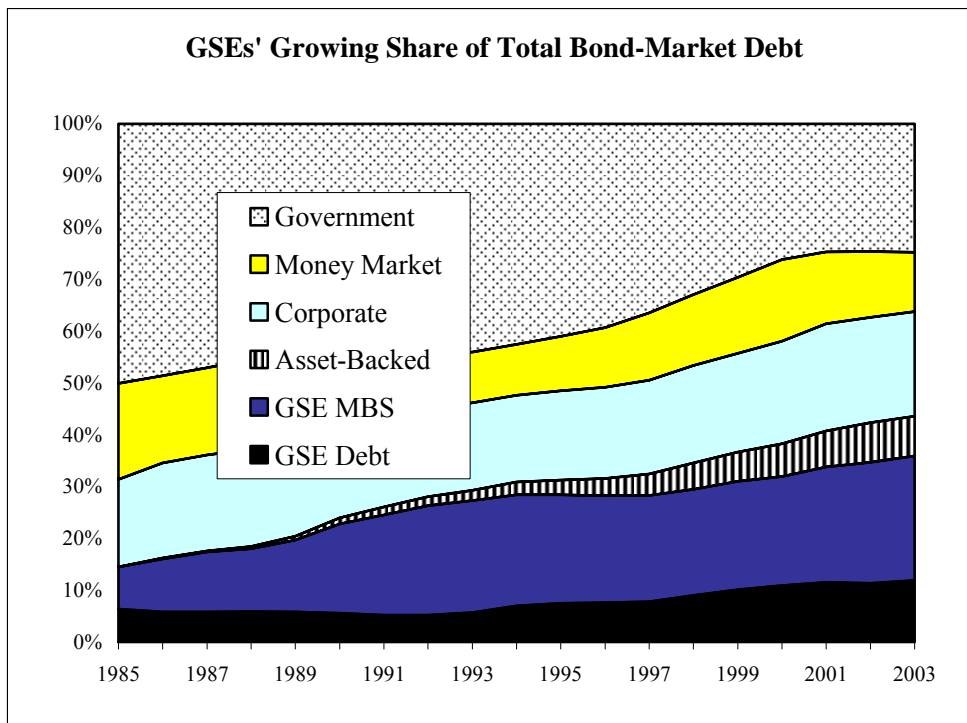
<sup>20</sup> See table on p. 15 *infra*.

<sup>21</sup> See *id.* By contrast, the federal government's publicly held debt increased 25 percent. See FIN. MGMT. SERV., U.S. DEP'T OF THE TREASURY, TREASURY BULL., Dec. 2004, at 29 (table FD-1).

<sup>22</sup> See Bond Mkt. Ass'n, BondMarkets.com, Issuance of Agency Mortgage-Backed Securities, available at <http://www.bondmarkets.com/story.asp?id=297>.

<sup>23</sup> See Bond Mkt. Ass'n, BondMarkets.com, Outstanding Volume of Agency Mortgage-Backed Securities, available at <http://www.bondmarkets.com/story.asp?id=1256>.

<sup>24</sup> See table on p. 15 *infra*.



GSEs' rapid growth has also outstripped the applicable legal and regulatory framework—a framework never really adequate to begin with. GSEs tend to be weakly regulated and poorly understood. They draw little scrutiny unless a crisis or scandal arises. GSE regulators tend to be small, hyperspecialized, and chronically vulnerable to

<sup>25</sup> The Consumer Price Index for All Urban Consumers, a measure of inflation, increased 26 percent. See Bureau of Labor Statistics, U.S. Dep't of Commerce, Consumer Price Index—All Urban Consumers (New Ser.): U.S. All Items, CUUR0000SA0, available at <http://data.bls.gov>.

<sup>26</sup> Real gross domestic product, reflecting economic growth, rose 38%. Nominal gross domestic product, reflecting both inflation and economic growth, rose 65%. See Bureau of Econ. Analysis, U.S. Dep't of Commerce, National Economic Accounts: Current-Dollar Gross Domestic Product, available at <http://www.bea.doc.gov/bea/dn1.htm>

<sup>27</sup> See Bond Mkt. Ass'n, BondMarkets.com, Outstanding Level of Public & Private Bond Market Debt, available at <http://www.bondmarkets.com/story.asp?id=323>. The chart subdivides bond-market debt into the following components, listed here as each appears from the top to the bottom of the chart: (1) federal, state, and local government securities; (2) money-market instruments; (3) corporate debt securities, excluding GSE debt; (4) asset-backed securities not guaranteed by a GSE; (5) GSE-guaranteed mortgage-backed securities; and (6) GSE debt securities. The debt securities data in the chart include debt securities issued by Sallie Mae, which remained a GSE until Dec. 2004, see p. 2 *supra*. But excluding Sallie Mae would not alter the basic trend, as Sallie Mae accounted for less than 2.3% of all GSE liabilities at the end of 2003.

intimidation or capture by the GSEs.<sup>28</sup> GSE regulation has had conspicuous failures, including Fannie's market-value insolvency during the early 1980s,<sup>29</sup> the Farm Credit System's need for a congressional rescue in 1987,<sup>30</sup> and recent accounting scandals at Fannie<sup>31</sup> and Freddie.<sup>32</sup>

The three housing GSEs together have, measured by total assets, become one-third the size of the entire U.S. commercial banking industry.<sup>33</sup> Yet GSEs have received remarkably little scrutiny from legal scholars<sup>34</sup>—far less than banks have. Few law review

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<sup>28</sup> For example, the Office of Federal Housing Enterprise Oversight (OFHEO), regulates only two firms—Fannie and Freddie—which are large, powerful, relatively homogeneous, and can easily unite to pressure OFHEO. OFHEO is a bureau of the Department of Housing and Urban Development, which has no institutional commitment to financial soundness regulation, little credibility to spare, and little ability to protect OFHEO against pressure from Fannie and Freddie. Although OFHEO receives no tax money, it must (unlike federal bank regulators) obtain an annual congressional appropriation for its budget. Fannie and Freddie have used the appropriations process to pressure OFHEO and limit OFHEO's capacity to scrutinize the GSEs' accounting. *See generally* Richard S. Carnell, Statement Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs 2, table 1 (Feb. 10, 2004), *available at* <http://banking.senate.gov/files/carnell.pdf>; U.S. Gen. Accounting Office, Government-Sponsored Enterprises: A Framework for Strengthening GSE Governance and Oversight, GAO-040269T, at 15-20 (Feb. 10, 2004).

Staffing and budget data underscore OFHEO's limited resources. For fiscal year 2003, OFHEO had a \$30 million operating budget and the equivalent of 126 full-time employees. *See* OFFICE OF FED. HOUS. ENTER. OVERSIGHT, U.S. DEP'T OF HOUS. AND URBAN DEV., REPORT TO CONGRESS 3-4 (2004). Fannie has 5,000 permanent employees. *See* FED. NAT'L MORTGAGE ASS'N, FORM 10-K FOR THE FISCAL YEAR ENDED DEC. 31, 2003, at 17 (2004). Fannie had administrative expenses of \$1.46 billion during 2003. *Id.* at 37. Twenty registered lobbying firms reported lobbying the U.S. Senate on Fannie's behalf during 2004. *See* U.S. Senate Office of Public Records, Lobby Filing Disclosure Program, <http://sopr.senate.gov>.

<sup>29</sup> *See* note 5 *supra* and p. 16 *infra*.

<sup>30</sup> *See generally* FARM CREDIT SYS. ASSISTANCE BD., FINAL REPORT TO CONGRESS: THE FARM CREDIT ASSISTANCE BOARD FROM BEGINNING TO END (1992). *See also* p. 20 *infra*.

<sup>31</sup> *See generally* OFFICE OF FED. HOUS. ENTER. OVERSIGHT, U.S. DEP'T OF HOUS. AND URBAN DEV., REPORT OF FINDINGS TO DATE: SPECIAL EXAMINATION OF FANNIE MAE (2004); John D. McKinnon & James R. Hagerty, *How Accounting Issue Crept up on Fannie's Pugnacious Chief*, WALL ST. J., Dec. 17, 2004, at A1.

<sup>32</sup> *See generally* OFFICE OF FED. HOUS. ENTER. OVERSIGHT, U.S. DEP'T OF HOUS. AND URBAN DEV., REPORT OF THE SPECIAL EXAMINATION OF FREDDIE MAC (2003); Baker Botts L.L.P., Report to the Board of Directors of the Federal Home Loan Mortgage Corporation: Internal Investigation of Certain Accounting Matters, December 10, 2002-July 31, 2003, *available at* [http://www.freddiemac.com/news/board\\_report/pdf/first.pdf](http://www.freddiemac.com/news/board_report/pdf/first.pdf); Patrick Barta et al., *Behind Freddie Mac's Troubles: A Strategy to Take On More Risk*, WALL ST. J., Sept. 22, 2003.

<sup>33</sup> *See* table on p. 15 *infra* (three housing GSEs together had \$2.57 trillion in total assets on Dec. 31, 2003); FED. DEPOSIT INS. CORP., FDIC QUARTERLY BANKING PROFILE 6 (4th quarter 2003) (FDIC-insured commercial banks had \$7.60 trillion in total assets).

<sup>34</sup> Thomas H. Stanton, a practicing lawyer with a particular interest in public administration, is the most knowledgeable, persistent, and prolific writer bringing legal insight to GSE policy issues. *See, e.g.*, THOMAS H. STANTON, GOVERNMENT-SPONSORED ENTERPRISES: MERCANTILIST COMPANIES IN THE MODERN WORLD (2002)

articles give GSEs any sustained attention.<sup>35</sup> Some articles focus on individual GSEs<sup>36</sup> or very specialized topics.<sup>37</sup> More commonly, scholars briefly discuss GSEs as they relate to some other topic.<sup>38</sup> No law review article deals adequately with GSEs' ambiguous relationship to the government. This scholarly neglect is particularly unfortunate given GSEs' size and importance—and the legal and policy issues posed by the inadequacy of the current regulatory structure.

Although GSE regulation raises important issues about financial policy and political economy, this article focuses on a single crucial weakness in such regulation: the lack of an adequate legal framework for handling the failure of Fannie or Freddie.<sup>39</sup> As a federal instrumentality, a GSE cannot liquidate or reorganize under the Bankruptcy Code.<sup>40</sup> No

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[hereinafter STANTON, GSEs]; A STATE OF RISK: WILL GOVERNMENT-SPONSORED ENTERPRISES BE THE NEXT FINANCIAL CRISIS? (1991).

<sup>35</sup> A. Michael Froomkin, *Reinventing the Government Corporation*, *supra* note 4, deals with GSEs as part of a larger study of government corporations. Bradley K. Krehely, *Government Sponsored Enterprises: A Discussion of the Federal Subsidy of Fannie Mae and Freddie Mac*, 6 N.C. Banking Inst. 519 (2002), focuses on policy issues involving Fannie and Freddie. Carrie Stradley Lavargna, *Government-Sponsored Enterprises Are "Too Big to Fail": Balancing Public and Private Interests*, 44 HASTINGS L.J. 992 (1993), misses many of the issues discussed in this article by proceeding from the unexamined, unsubstantiated assumption that GSEs are necessarily "too big to fail," *see id.* at 992 ("These part-private, part-public institutions are indispensable components of the nation's economy and are 'too big to fail'").

<sup>36</sup> *See, e.g.*, Richard W. Bartke, *Home Financing at the Crossroads—A Study of the Federal Home Loan Mortgage Corporation*, 48 Ind. L.J. 1 (1972); Richard W. Bartke, *Fannie Mae and the Secondary Mortgage Market*, 66 NW. U. L. REV. 1 (1971); Dirk S. Adams, *FIRREA and the New Federal Home Loan Bank System*, 32 SANTA CLARA L. REV. 17 (1992).

<sup>37</sup> *See, e.g.*, Cheryl D. Block, *Congress and Accounting Scandals: Is the Pot Calling the Kettle Black?*, 82 NEB. L. REV. 365, 435-39 (2003); John L. Brown, *Federal Preemption of State Agricultural Credit*, 7 DRAKE J. AGRIC. L. 563, 571-74 (2002). Block draws an intriguing parallel between the government's use of GSEs and the use of special-purpose vehicles by such corporations as Enron. Block, *supra*, at 422, 439-40.

<sup>38</sup> *See, e.g.*, Anthony D. Taibi, *Banking, Finance, and Community Economic Empowerment: Structural Economic Theory, Procedural Civil Rights, and Substantive Racial Justice*, 107 HARV. L. REV. 1465, 1530-31 (1994); Amy C. Bushaw, *Small Business Loan Pools: Testing the Waters*, 2 J. SMALL & EMERGING BUS. L. 197, 217-19, 252-55 (1998); Avery Wiener Katz, *An Economic Analysis of the Guaranty Contract*, 66 U. CHI. L. REV. 47, 56-57 (1999).

<sup>39</sup> The Federal Home Loan Banks' regulator has statutory authority but no implementing regulations. *See* Part IV-B *infra*. Only the regulator of the two agricultural GSEs has both statutory authority and implementing regulations. *See* Part IV-C, -D *infra*.

<sup>40</sup> *See* Part III *infra*.

adequate alternative mechanism exists for Fannie or Freddie.<sup>41</sup> By the time a “conservator” could take control of the firm, the firm’s problems might well have become too severe for the conservator to resolve. The conservatorship statute provides no means for effectuating a reorganization,<sup>42</sup> nor does it expressly authorize a liquidation. Uncertainty about the priority and process for handling claims could worsen the firm’s problems and increase the risk that those problems would disrupt financial markets and elicit a costly congressional rescue.<sup>43</sup>

This article will define “government-sponsored enterprise,” introduce the five GSEs, and discuss how their government sponsorship enriches the GSEs’ shareholders and distorts financial markets and government policy (Part I); explain why GSEs cannot liquidate or reorganize under the Bankruptcy Code (II); summarize the specialized insolvency regime for banks and note its importance as a model for GSE insolvency law (III); examine the legal mechanisms available for handling troubled GSEs (IV); explore the potential consequences of having inadequate insolvency mechanisms for Fannie and Freddie (V); discuss ways of correcting the deficiencies of current law and analyze recent congressional proposals (VI); consider whether GSEs are “too big to fail” in the sense that the government would have to rescue their creditors rather than risk the economic dislocation that might ensue if those creditors went unpaid (VII); and explain how ambiguity about government backing of GSEs, by blunting accountability for the risks and

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<sup>41</sup> See Part IV-A *infra*.

<sup>42</sup> In this article “reorganization” refers to modifying creditors’ claims, such as by extending repayment, varying other credit terms, or converting some debt to equity. It does not include a “recapitalization,” which here denotes raising equity without modifying creditors’ claims.

<sup>43</sup> See Part V *infra*.

other costs of government sponsorship, helps explain the central failures of GSE policy, including the lack of safeguards like an adequate insolvency mechanism for Fannie and Freddie (VIII).

## I. GOVERNMENT-SPONSORED ENTERPRISES

The federal government created GSEs to correct perceived defects of U.S. credit markets,<sup>44</sup> and it gives GSEs valuable benefits intended to further that mission.<sup>45</sup> These benefits (e.g., exemption from securities registration and most state and local taxes) reduce GSEs' expenses. More importantly, the benefits reduce GSEs' borrowing costs by persuading bond-market investors that the government implicitly backs GSEs.<sup>46</sup> This perception of implicit government backing (often mischaracterized as an "implicit government guarantee"<sup>47</sup>) impairs market discipline on the GSEs and helps them grow at the expense of better-capitalized competitors.<sup>48</sup> Traditional mechanisms of government accountability, such as budget rules and appropriations requirements, take no official notice of this perceived government backing or even of the costs of GSEs' explicit

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<sup>44</sup> See Part I-B *infra*.

<sup>45</sup> See Part I-D-1 *infra*.

<sup>46</sup> See pp. 23-24 *infra*.

<sup>47</sup> "Implicit government guarantee" suggests that the government has already guaranteed GSEs' obligations, albeit without formally expressing that guarantee. But from a legal standpoint an implicit financial guarantee is practically a contradiction in terms, akin to a "mental will" (purporting to dispose of one's property after one's death) or an "oral traveler's check." In fact, the true referent is investors' behavior, not the government's behavior. "Implicit guarantee" refers not to what the government *has done* but to investors' belief about what the government *would do* if a GSE failed—a belief manifest in investors' willingness to lend to GSEs on exceptionally favorable terms. Using "government guarantee" to describe investors' behavior has the potential to bias analysis by insinuating that the government has a moral obligation to honor the supposed guarantee. To avoid such problems, this article refers to investors' "perception of implicit backing" and GSEs' "perceived implicit backing."

<sup>48</sup> See Part I-D-3-a *infra*.

government benefits. These official blind spots bias government policy towards perpetuating and expanding GSEs,<sup>49</sup> despite good reasons to doubt GSEs' efficiency as instruments of public policy.<sup>50</sup>

### A. Defining GSEs

I define a GSE as a federally chartered, privately owned, privately managed financial institution that has only specialized lending and guarantee powers and that bond-market investors perceive as implicitly backed by the federal government.<sup>51</sup> This definition has six elements: a GSE is (1) federally chartered, (2) privately owned, (3) privately managed, (4) a financial institution, (5) granted only specialized lending and guarantee powers, and (6) perceived by bond-market investors as implicitly backed by the federal government.

Several aspects of the definition bear emphasis. First, GSEs have charters granted by or pursuant to an act of Congress; ordinary business corporations have state charters.<sup>52</sup> Second, GSEs' private ownership and private management underscore that they form no part of the government. Unlike a government agency<sup>53</sup> or government corporation, a GSE

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<sup>49</sup> See Part I-D-3-b *infra*.

<sup>50</sup> See Part I-D-2 *infra*.

<sup>51</sup> This definition is broadly consistent with definitions used in the Congressional Budget Act, 2 U.S.C. § 622(8), and by Stanton, GSEs, *supra* note 34, at 1-2. See also 12 U.S.C. § 2277a-4(a)(4) (insurance premium formula for Farm Credit System Insurance Corporation, defining a GSE as “an entity that is chartered by Congress to serve a public purpose and the debt obligations of which are not explicitly guaranteed by the United States”).

<sup>52</sup> See, e.g., Geoffrey P. Miller, *The Future of the Dual Banking System*, 53 BROOK. L. REV. 1, 12 (1987).

<sup>53</sup> Although GSEs are not government agencies, bond-market participants persist in referring to GSEs' debt securities as “agency securities,” see, e.g., MARCIA STIGUM, *THE MONEY MARKET* 41-42 (3rd ed. 1990), often lumping them together with securities of government corporations like Ginnie Mae—securities backed by the government's full faith and credit.

cannot exercise sovereign powers<sup>54</sup> and lacks authority to bind the government financially.<sup>55</sup> Third, although GSEs are financial institutions, they have only specialized lending and guarantee powers—powers much narrower than those (for example) of national banks, federal savings associations, and federal credit unions.<sup>56</sup> Fourth, and most importantly, bond-market investors believe that the government implicitly backs each GSE and would not let a GSE’s creditors go unpaid.<sup>57</sup> In the words of one reference work, GSEs “are regarded by most people who lend them money as the government in disguise.”<sup>58</sup> This perceived implicit backing is the GSEs’ most important and most distinctive characteristic.<sup>59</sup> It enables GSEs to borrow at rates below those available to the most creditworthy fully private firms, even though GSEs have much higher debt-to-equity ratios than those firms.<sup>60</sup>

Although the lack of an adequate insolvency mechanism for Fannie and Freddie strongly reinforces the perception of implicit backing, it is distinguishable from that perception. Investors perceive the government as implicitly backing even GSEs for which adequate insolvency mechanisms already exist, such as the Farm Credit System and

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<sup>54</sup> 2 U.S.C. § 622(8)(B)(i).

<sup>55</sup> 2 U.S.C. § 622(8)(B)(ii). “[W]hen Congress authorizes a federal agency or officer to incur obligations, those obligations are supported by the full faith and credit of the United States, unless the authorizing statute specifically provides otherwise.” 6 Op. Off. Legal Counsel 262, 264 (1982); *see* *Lebron v. National R.R. Passenger Corp.*, 513 U.S. 374, 392 (1995) (“the ordinarily presumed power of Government agencies authorized to incur obligations to pledge the credit of the United States”).

<sup>56</sup> For examples of the breadth of ordinary depository institutions’ powers, see OFFICE OF THE COMPTROLLER OF THE CURRENCY, ACTIVITIES PERMISSIBLE FOR A NATIONAL BANK (2003) (national banks), 12 U.S.C. §§ 1464(b), (c), (k), (l), (n) (federal savings associations), 1757 (federal credit unions).

<sup>57</sup> *See* Part I-D-1 *infra*.

<sup>58</sup> STIGUM, *supra* note 53, at 358.

<sup>59</sup> CBO, PUBLIC COSTS AND BENEFITS, *supra* note 5, at ix.

<sup>60</sup> *See* note 5 *supra*.

Farmer Mac.<sup>61</sup> The lack of an adequate insolvency mechanism for Fannie and Freddie could leave Congress little practical alternative to rescuing those firms' creditors. That lack therefore fortifies the perception of implicit backing and makes it more like an express guarantee. Enacting a workable insolvency mechanism for Fannie and Freddie would reduce pressure for a congressional rescue. But it would neither preclude such a rescue nor by itself eliminate the perception of implicit backing.

## **B. GSEs as Means for Improving Credit Markets**

Congress created GSEs to correct perceived defects of U.S. credit markets. The General Accounting Office has identified three key defects.<sup>62</sup> The first arose from restrictive bank branching laws. Banks' core business involves taking deposits and using the proceeds to make loans. But in many states laws prevailing for much of the twentieth century limited banks to taking deposits in a single local market.<sup>63</sup> These laws therefore precluded individual banks from bridging the gap between local markets with excess deposits and local markets with excess loan demand. Interbank deposits helped reduce the gap (e.g., a small rural bank with excess deposits could send the surplus to its big-city correspondent bank) but did not do enough to avoid regional disparities in credit availability.<sup>64</sup> Second, large-scale investors found agricultural, housing, and higher-education loans unattractive because those loans were small, illiquid (i.e., difficult to sell

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<sup>61</sup> See Part IV-C to -D *infra*.

<sup>62</sup> GAO, THE GOVERNMENT'S EXPOSURE TO RISKS, *supra* note 5, at 16-17.

<sup>63</sup> See U.S. DEP'T OF THE TREASURY, MODERNIZING THE FINANCIAL SYSTEM: RECOMMENDATIONS FOR SAFER, MORE COMPETITIVE BANKS XVII-5 to -6 (1991).

<sup>64</sup> GAO, THE GOVERNMENT'S EXPOSURE TO RISKS, *supra* note 5, at 16.

quickly at fair market value), labor-intensive, subject to unpredictable prepayment, or potentially difficult to collect.<sup>65</sup> Third, banks perceived such loans as riskier, less profitable, and harder to administer than such traditional lines of business as commercial lending and “tended to withdraw from these sectors when the need for funds was the greatest.”<sup>66</sup> “Congress created GSEs to overcome these basic problems” by operating nationwide, offering investors safe, liquid, large-denomination securities, and making housing, education, and agricultural loans “more appealing to lenders by creating efficient secondary markets for resale of the loans.”<sup>67</sup>

Vibrant secondary markets now exist for housing and education loans. Although Sallie Mae has relinquished its government sponsorship,<sup>68</sup> the housing GSEs continue to grow.<sup>69</sup> The GSEs’ persistence underscores Thomas H. Stanton’s observation that financial markets “are changing so quickly that the GSE becomes a long-term institutional solution for a problem that may be quite transitory.”<sup>70</sup>

Needed or not, GSEs operate in two basic ways: as portfolio lenders and as guarantors of mortgage-backed securities. Portfolio lending involves buying loans from other lenders (or in the case of some Farm Credit System institutions, making loans directly to borrowers), holding the loans, and earning interest on them.<sup>71</sup> Portfolio lenders

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<sup>65</sup> *Id.* at 17.

<sup>66</sup> *Id.*

<sup>67</sup> *Id.* at 17.

<sup>68</sup> *See* p. 2 *supra*.

<sup>69</sup> *See* table on p. 15 *infra*.

<sup>70</sup> STANTON, GSES, *supra* note 34, at xv.

<sup>71</sup> GAO, THE GOVERNMENT’S EXPOSURE TO RISKS, *supra* note 5, at 20.

raise money largely by issuing debt securities and use the proceeds to buy (or make) loans.<sup>72</sup> The risks borne by portfolio lenders include credit risk, the risk that borrowers will not repay their loans; interest-rate risk, the risk that a rise in interest rates will reduce the market value of loans; and prepayment risk, the risk that lower interest rates will prompt borrowers to pay off their loans.<sup>73</sup> Portfolio lending tends to be riskier and more profitable than acting as a guarantor.

In guaranteeing mortgage-backed securities, GSEs both securitize loans and guarantee the resulting securities. “Securitization” involves turning loans into securities by putting many loans of the same type (e.g., recently originated first mortgages on residential real estate) together in a loan “pool” and selling investors interests in that pool.<sup>74</sup> GSEs purchase loans originated by others, turn the loans into mortgage-backed securities, and guarantee that the holders of those securities will receive timely payments of principal and interest.<sup>75</sup> GSEs receive a fee for making such guarantees. Unlike portfolio lending, guaranteeing mortgage-backed securities is not capital-intensive. Such guarantees entail modest credit risk but little interest-rate or prepayment risk.<sup>76</sup>

### **C. The Five GSEs**

The following table summarizes the five GSEs’ assets, liabilities, guarantees, market

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<sup>72</sup> *Id.*

<sup>73</sup> *Id.* at 31.

<sup>74</sup> See generally TAMAR FRANKEL, SECURITIZATION: STRUCTURED FINANCING, FINANCIAL ASSETS POOLS, AND ASSET-BACKED SECURITIES (1991).

<sup>75</sup> GAO, THE GOVERNMENT’S EXPOSURE TO RISKS, *supra* note 5, at 23.

<sup>76</sup> CBO, PUBLIC COSTS AND BENEFITS, *supra* note 5, at 5.

capitalization (i.e., total market value of outstanding stock), debt-to-equity ratios, and recent growth.<sup>77</sup>

<b>GOVERNMENT-SPONSORED ENTERPRISES</b>					
As of Dec. 31, 2003; Billions of Dollars					
	<b>Fannie</b>	<b>Freddie</b>	<b>FHLBS</b>	<b>FCS</b>	<b>Farmer</b>
<b>Total Assets</b>	1,010	803	764	104	4.3
<b>Total Liabilities</b>	987	770	727	93	4.1
<b>Outstanding Guarantees</b>	850	752	0	0	1.0
<b>Market Capitalization</b>	73	40	n/a	n/a	0.5
<b>Shareholders' Equity</b>	22	31	36	7	0.2
<b>Debt-to-Equity Ratio</b>	44	24	20	13	19
<b>Annual Asset Growth Rate, 1993-2003</b>	37%	86%	33%	6%	85%

Market capitalization equals number of outstanding shares multiplied by closing share price

Debt-to-equity ratio equals total liabilities divided by shareholders' equity

Asset growth rate reflects average annual growth in total assets, Dec. 31, 1993-Dec. 31, 2003

As the table indicates, the GSEs differ greatly in size. All but one underwent extraordinary growth during the past decade. The outlier—the Farm Credit System—operates under financial-soundness rules modeled on those for commercial banks.<sup>78</sup>

### *1. Fannie Mae*

During the late 19th and early 20th century, bank loans secured by real property commonly had a short maturity and were not self-amortizing: when the loan came due, the

<sup>77</sup> In the table, “market capitalization” equals the number of shares outstanding on Dec. 31, 2003, multiplied by the closing share price. “Debt-to-equity ratio” equals total liabilities divided by shareholders’ equity. “Annual asset growth rate, 1993-2003” reflects the average annual growth in total assets from Dec. 31, 1993, through Dec. 31, 2003.

Data on total assets, total liabilities, outstanding guarantees, shareholders’ equity, and number of shares outstanding are from the following GSE reports: FARM CREDIT SYS., ANNUAL INFORMATION STATEMENT—1996, at 3 (1997); FARM CREDIT SYS., ANNUAL INFORMATION STATEMENT—2003, at F-32 (2004); FARMER MAC, 1996 ANNUAL REPORT 4 (1997); FED. AGRIC. MORTGAGE CORP., 2003 ANNUAL REPORT 9, 52 (1997); FED. NAT’L MORTGAGE ASS’N, [1994] INFORMATION STATEMENT, at 15, 39-40 (1995); FED. NAT’L MORTGAGE ASS’N, FORM 10-K FOR THE FISCAL YEAR ENDED DEC. 31, 2003, at 24-25 (2004); FED. HOME LOAN BANK SYS., 1995 FIN. REPORT 5, 20 (1996); FED. HOME LOAN BANK SYS., 2003 COMBINED FIN. REPORT 20, 38-39 (2004); FREDDIE MAC, 1993 ANNUAL REPORT 35 (1994); FREDDIE MAC, 2003 ANNUAL REPORT 29, 69 (2004). Fannie and Freddie will restate their financial statements, which may change data in the table.

<sup>78</sup> See, e.g., 12 C.F.R. pts. 614-616, 621.

borrower had to repay or refinance all or most of the original amount borrowed. In 1938 the government created the original Fannie Mae, a government corporation, as part of a program to promote home ownership by improving mortgage credit markets<sup>79</sup> and popularizing thirty-year fixed-rate, self-amortizing mortgages with relatively low down payments.<sup>80</sup> By buying and investing in such mortgages, Fannie made them more liquid and thus more attractive to lenders and other investors.

In 1968 Congress divided the original Fannie Mae in two.<sup>81</sup> One part remained a government corporation, renamed Ginnie Mae.<sup>82</sup> The other became a privately owned corporation called Fannie Mae.<sup>83</sup> Operating as a portfolio lender, the new Fannie Mae bought long-term mortgages with money raised by selling short-term debt securities. When short-term interest rates rose sharply during the early 1980s, Fannie's assets became worth less than its liabilities.<sup>84</sup> Fannie survived with some regulatory and tax relief but largely because its perceived government backing enabled it to continue borrowing money.<sup>85</sup>

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<sup>79</sup> See Part I-B *supra*.

<sup>80</sup> See generally Richard W. Bartke, *Fannie Mae and the Secondary Mortgage Market*, 66 NW. U. L. REV. 1 (1971).

<sup>81</sup> Housing and Urban Development Act of 1968, Pub. L. No. 90-448, §§ 802(o)-(s), 804(a), 805, 82 Stat. 538, 542, 543 (1968). 12 U.S.C. § 1716b.

The government made Fannie a private corporation to reduce the effect of budget reforms recommended in PRESIDENT'S COMM'N ON BUDGET CONCEPTS, REPORT OF THE PRESIDENT'S COMMISSION ON BUDGET CONCEPTS 48-49 (1967), and codified in the Congressional Budget Act, *see, e.g.*, 2 U.S.C. § 622(1) (defining "outlays" as "expenditures and net lending of funds"). These reforms treated direct loans by the government as a form of spending. Thus privatizing Fannie reduced the government's reported spending and budget deficit.

<sup>82</sup> See 12 U.S.C. §§ 1716b, 1717(a)(2)(A).

<sup>83</sup> See *id.* §§ 1716b, 1717(a)(2)(B).

<sup>84</sup> See GAO, THE GOVERNMENT'S EXPOSURE TO RISKS, *supra* note 5, at 10, 90.

<sup>85</sup> See *id.*

## 2. *Freddie Mac*

Congress chartered Freddie Mac in 1970<sup>86</sup> in response to credit contractions in which even creditworthy borrowers had had difficulty obtaining loans.<sup>87</sup> These “credit crunches” had occurred when banks and savings institutions, constrained by regulatory limits on deposit interest rates, could not retain or attract enough deposits to meet loan demand. Congress intended Freddie to help expand the secondary market in residential mortgages and thus give savings institutions an additional funding source.<sup>88</sup> During its first two decades Freddie operated only as a guarantor; it generally held loans only long enough to securitize them.<sup>89</sup> Freddie now has the same powers as Fannie and operates as both a guarantor and a portfolio lender.<sup>90</sup>

## 3. *Federal Home Loan Bank System*

Congress chartered the Federal Home Loan Bank System in 1932<sup>91</sup> to help savings institutions fund long-term home mortgages and withstand runs and other liquidity problems.<sup>92</sup> The system consists of twelve regional Home Loan Banks<sup>93</sup>. Each bank,

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<sup>86</sup> Emergency Home Finance Act of 1970, Pub. L. No. 91-351, § 303, 84 Stat. 450, 452 (1970).

<sup>87</sup> See Bartke, *Home Financing at the Crossroads*, *supra* note 36, at 4-5.

<sup>88</sup> STANTON, GSES, *supra* note 34, at 88. See generally Bartke, *Home Financing at the Crossroads*, *supra* note 36.

<sup>89</sup> See STANTON, GSES, *supra* note 34, at 81.

<sup>90</sup> *Id.* at 83-84.

<sup>91</sup> Federal Home Loan Bank Act, ch. 522, 47 Stat. 725 (1932).

<sup>92</sup> See generally *Creation of a System of Federal Home Loan Banks: Hearings on S. 2959 Before a Subcommittee of the Senate Committee on Banking and Currency, 72nd Cong. (1932)*. The Supreme Court has summarized the congressional objective as “placing ‘long-term funds in the hands of local institutions’ in order to alleviate the pressing need of home owners for ‘low-cost, long-term, installment mortgage money’ and to ‘decrease costs of mortgage money’ with a ‘resulting benefit to home ownership in the form of lower costs and more liberal loans.’” *Laurens Fed. Sav. & Loan Ass’n v. S. Carolina Tax Comm’n*, 365 U.S. 517, 522 (1961).

owned by its member depository institutions, has its own management and board of directors.<sup>94</sup> The system raises money by selling investors debt securities on which the twelve banks are jointly and severally liable.<sup>95</sup> The banks loan the proceeds to their member institutions and hold the loans in portfolio.<sup>96</sup>

Securitization and other changes in mortgage finance have tended to reduce demand for long-term loans from the Home Loan Banks. Moreover, savings institutions can now obtain loans from the Federal Reserve Banks.<sup>97</sup> Both developments tend to undercut the Home Loan Bank System's original rationale. In 1989 the system persuaded Congress to allow commercial banks and credit unions to join,<sup>98</sup> and acquiesced in the creation of an affordable housing program.<sup>99</sup> The system now promotes itself as "lender of first resort" for small depository institutions<sup>100</sup> and makes much of its profits from a large investment portfolio unrelated to its housing-finance functions.<sup>101</sup> Critics view the system as largely "serv[ing] virtually no public purpose" and assert that without government subsidies, "the

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<sup>93</sup> 12 U.S.C. § 1423.

<sup>94</sup> *Id.* § 1427(a).

<sup>95</sup> *Id.* § 1431(b)-(c). See generally David Nickerson & Ronnie J. Phillips, *The Federal Home Loan Bank System and the Farm Credit System: Historic Parallels and Implications for Systemic Risk*, in *TOO BIG TO FAIL: POLICIES AND PRACTICES IN GOVERNMENT BAILOUTS* 107 (Benton E. Gup ed. 2004) (discussing potentially problematic parallels between the Federal Home Loan Bank System and the Farm Credit System, including joint and several liability).

<sup>96</sup> GAO, *THE GOVERNMENT'S EXPOSURE TO RISKS*, *supra* note 5, at 22.

<sup>97</sup> See 12 U.S.C. § 461(b)(1)(A)(ii), (iii), (v), (vi), (7).

<sup>98</sup> *Id.* §§ 1422(12)(A)-(B), 1424(a)(1).

<sup>99</sup> *Id.* § 1430(j).

<sup>100</sup> See, e.g., Fed. Hous. Fin. Bd., Federal Home Loan Bank System, <http://fhfb.gov/FHLB/fhlbs.htm>

<sup>101</sup> See, e.g., STANTON, GSES, *supra* note 34, at 69.

Federal Home Loan Banks could probably not exist as functioning financial institutions in anything resembling their present form and size.”<sup>102</sup>

#### ***4. Farm Credit System***

Congress created the Farm Credit System (or FCS) in 1916<sup>103</sup> “to provide credit when electricity and automobiles were uncommon in rural America and farm communities were remote from competitive sources of credit.”<sup>104</sup> The system is organized as a network of cooperatives, which operate as portfolio lenders. It includes seventy-nine agricultural credit associations and eleven land credit associations, each owned by its farmer-borrowers; five farm credit or agricultural credit banks, each owned by its member associations; and the Federal Farm Credit Banks Funding Corporation, owned by its member banks.<sup>105</sup> The funding corporation raises money for the credit banks by selling investors debt securities,<sup>106</sup> on which the credit banks are jointly and severally liable.<sup>107</sup> The credit associations borrow from the credit banks and lend to farmers.<sup>108</sup>

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<sup>102</sup> See, e.g., *id.* See also Richard S. Carnell, Twelve Banks in Search of a Purpose, Remarks Before the American Enterprise Institute (Dec. 2, 1998), available at <http://www.treas.gov/press/releases/rr2841.htm>.

<sup>103</sup> Federal Farm Loan Act, ch. 245, 39 Stat. 360 (1916). See generally W. GIFFORD HOAG, THE FARM CREDIT SYSTEM: A HISTORY OF FINANCIAL SELF-HELP 211-14 (1976).

<sup>104</sup> STANTON, GSES, *supra* note 34, at 9-10.

<sup>105</sup> 12 U.S.C. § 2002(a) (defining “Farm Credit System”). For the number of Farm Credit System institutions of various types, see Farm Credit Admin., FCS Institutions, <http://www.fca.gov/FCS-Institutions.htm>.

<sup>106</sup> See 12 U.S.C. § 2160(b)(1).

<sup>107</sup> *Id.* § 2155.

<sup>108</sup> GAO, THE GOVERNMENT’S EXPOSURE TO RISKS, *supra* note 5, at 21-22.

The Farm Credit System has in substance failed twice: first during the Great Depression<sup>109</sup> and again during the mid-1980s.<sup>110</sup> The federal government rescued the system both times.<sup>111</sup> After the first rescue the system remained under government control until 1953.<sup>112</sup> The second rescue brought bank-type financial-soundness regulation, leaving the system’s regulator—the Farm Credit Administration—with the strongest legal tools of all GSE regulators.<sup>113</sup>

### 5. *Farmer Mac*

Congress chartered Farmer Mac in 1987 to create a secondary market for agricultural mortgage loans by guaranteeing securitized interests in such loans.<sup>114</sup> But the firm “has had trouble establishing itself in a cyclical rural market already served by another GSE, the Farm Credit System, and by rural commercial banks.”<sup>115</sup>

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<sup>109</sup> See STANTON, GSES, *supra* note 34, at 29. See generally *To Strengthen the Capital Structure of the Federal Land Banks: Hearings on S. 204, S. 280, and S. 1751 Before a Subcomm. of the Senate Comm. on Banking and Currency*, 72nd Cong. (1931).

<sup>110</sup> See STANTON, GSES, *supra* note 34, at 38. See generally FARM CREDIT SYS. ASSISTANCE BD., *supra* note 30.

<sup>111</sup> See STANTON, GSES, *supra* note 34, at 29; Agricultural Credit Act of 1987, Pub. L. No. 100-233, tit. II, 101 Stat. 1568, 1585-1608 (1988).

<sup>112</sup> STANTON, GSES, *supra* note 34, at 71, 123 n.23.

<sup>113</sup> Thus, for example, the Farm Credit Administration’s strong authority to set capital standards reflects “the financial failure of the FCS in the 1980s and ... the strong hand that Treasury took in crafting the remedial legislation.” STANTON, GSES, *supra* note 34, at 47. The large number of FCS institutions (particularly when combined with the system’s financial troubles during the 1980s) may itself encourage Congress to enact more rigorous rules than it has for the housing GSEs. See the discussion of “generic law” on p. 44 *infra*.

<sup>114</sup> Agricultural Credit Act of 1987, Pub. L. No. 100-233, tit. VII-A, 101 Stat. 1568, 1686-1707 (1988).

<sup>115</sup> STANTON, GSES, *supra* note 34, at 29. See generally *Interest rate farming*, GRANT’S INTEREST RATE OBSERVER, July 3, 1998, at 10-11.

## D. Consequences of Government Sponsorship

### 1. Government Subsidies to GSEs

Federal statutes give GSEs various benefits unavailable to ordinary private firms.

These benefits include:

- granting GSEs federal charters,<sup>116</sup> which can preempt state laws;<sup>117</sup>
- authorizing the Secretary of the Treasury to extend credit to GSEs;<sup>118</sup>
- exempting GSEs from most state and local taxes;<sup>119</sup>
- exempting GSEs from having to register their securities under the Securities Act of 1933<sup>120</sup> and the Securities Exchange Act of 1934;<sup>121</sup>

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<sup>116</sup> See notes 7-11 *supra*.

<sup>117</sup> See pp. 37-38 *infra*.

<sup>118</sup> 12 U.S.C. §§ 1431(i) (FHLBS), 1455(c) (Freddie), 1719(c) (Fannie), 2279aa-13 (Farmer Mac). The Treasury would extend credit to GSEs by purchasing their debt securities.

<sup>119</sup> *Id.* §§ 1433 (FHLBS), 1452(e) (Freddie), 1723a(c)(2) (Fannie), 2023, 2077, 2098, 2134 (Farm Credit System).

<sup>120</sup> All five GSEs' securities are exempt from registration under the Securities Act of 1933, 15 U.S.C. §§ 77a-77bbb. The act exempts from registration any security "issued or guaranteed ... by any person ... supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States." See *id.* § 77c(a)(2). As GSEs are federal instrumentalities supervised by the federal government, see Part II *infra*, 15 U.S.C. § 77c(a)(2) exempts their securities from registration. In addition, Congress has expressly designated as "exempted securities" securities issued by Fannie and Freddie. See 12 U.S.C. §§ 1455(g) (Freddie), 1719(d)-(e), 1723c (Fannie).

<sup>121</sup> Four of the five GSEs enjoy exemption from the registration and reporting requirements of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78mm. Congress has exempted Fannie and Freddie by designating their securities as "exempted securities," see note 120 *supra*. An issuer that has outstanding only "exempted securities" need not register under the act. See 15 U.S.C. § 78l(a), (g)(1). An issuer becomes subject to the act's reporting requirements only if it registers under the act or the Securities Act of 1933. See *id.* §§ 78m(a), 78o(d).

The Treasury Department has exempted the Federal Home Loan Bank System and Farm Credit System under 15 U.S.C. §§ 78c(a)(12)(A)(i) (defining "government securities" as "exempted securities") and (42)(B) (defining as "government securities" securities "issued ... by corporations in which the United States has a direct or indirect interest and which are designated by the Secretary of the Treasury for exemption as necessary or appropriate in the public interest or for the protection of investors") and 78l(a) (not requiring registration of "exempted securities").

- imposing no limits on federally chartered depository institutions' investments in GSE securities;<sup>122</sup>
- making GSEs' debt securities and mortgage-backed securities:
  - eligible for open-market purchase by the Federal Reserve Banks;<sup>123</sup>
  - eligible collateral for deposits of public funds<sup>124</sup> and for loans from Federal Reserve Banks;<sup>125</sup> and
  - lawful investments for fiduciaries;<sup>126</sup> and
- permitting GSEs to issue and transfer securities through the Federal Reserve's electronic book-entry system,<sup>127</sup> the system used for issuing and transferring U.S. Treasury securities.<sup>128</sup>

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Only Farmer Mac has no exemption from registration. *See* 12 U.S.C. § 2279aa-12(a)(1).

<sup>122</sup> 12 U.S.C. §§ 24(Seventh), 2158 (national banks), 1464(c)(1)(D)-(F), (M) (federal savings associations), 1757(7)(E) (federal credit unions); *see also id.* §§ 335, 2158 (state member banks).

In addition, federal banking statutes, although generally prohibiting FDIC-insured depository institutions from investing in equity securities, *see id.* §§ 24(7), 1831a(c)(1), 1831e(c)(1), permit such institutions to invest in Fannie and Freddie's equity securities and impose no quantitative limits on such investments. *See id.* §§ 1455(e)(1), 1464(c)(1)(D)-(F), 1718(d).

<sup>123</sup> *Id.* §§ 355(2) (obligations of "any agency of the United States"), 2158 (FCS). 12 U.S.C. § 355(2) authorizes Federal Reserve Banks to purchase obligations of "any agency of the United States," which the Federal Reserve Board construes as including obligations issued or guaranteed by Fannie, Freddie, and the Federal Home Loan Bank System. *See* 12 C.F.R. § 201.108(b)(2), (5), (16).

<sup>124</sup> 12 U.S.C. §§ 1435 (FHLBS) 1452(g) (Freddie), 1723c (Fannie), 2157 (FCS).

<sup>125</sup> *Id.* § 347 (Federal Reserve Banks may make loans secured by obligations "eligible for purchase" under § 355).

<sup>126</sup> 15 U.S.C. § 77r-1(a)(1)(D), (2)(D); 12 U.S.C. §§ 1435 (FHLBS), 1452(g) (Freddie), 1723c (Fannie), 2157 (FCS), § 2279aa-12(c) (Farmer Mac).

<sup>127</sup> *See id.* §§ 1435 (FHLBS), 1452(d) (Freddie), 1723a(g) (Fannie), § 2279aa-3(e) (Farmer); 12 C.F.R. §§ 615.5450(c), 615.5456.

<sup>128</sup> *See generally* 31 C.F.R. pt. 306.

By statute, the government also regulates GSEs, has the right to appoint a large minority of GSE directors,<sup>129</sup> and requires GSEs to obtain government approval (typically from the Secretary of the Treasury) before issuing debt securities.<sup>130</sup>

Bond-market investors infer from these statutes that the government implicitly backs each GSE—and would not let the GSE’s creditors go unpaid.<sup>131</sup> Why else, investors might ask, would Congress exempt GSEs and their securities from the federal securities laws? Why else would Congress exempt GSE securities from the usual limits on depository institutions’ investments in nongovernmental securities? These and other statutes<sup>132</sup> treat GSE securities as having little or no risk—like U.S. Government securities and unlike even the most highly rated corporate securities. Some statutes overtly equate GSE securities with government securities. The Securities Exchange Act of 1934 defines “government securities” in a way that includes GSE securities.<sup>133</sup> GSE charters exempt GSE securities from the securities laws “to the same extent as securities that are direct obligations of ...

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<sup>129</sup> The President can appoint directors of Fannie (five of eighteen directors), 12 U.S.C. § 1723(b); Freddie (five of eighteen), *id.* § 1452(a)(2)(A); and Farmer Mac (five of fifteen), *id.* § 2279aa-2(b)(2)(C). The Federal Housing Finance Board can appoint six of fourteen directors of each Federal Home Loan Bank. *Id.* § 1427(a). By contrast, the government cannot appoint directors of Farm Credit System institutions. *See, e.g.*, 12 U.S.C. §§ 2012 (credit banks), 2072 (production credit associations).

The Bush Administration no longer makes presidential appointments to GSE boards. *Cf.* John W. Snow, Statement Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs 3 (Oct. 16, 2003) (“The Administration is committed to make sure that the directors of publicly-traded corporations like Fannie Mae and Freddie Mac are elected by their shareholders, rather than selected by the President”), *available at* <http://banking.senate.gov/files/ACFB2.pdf>. The administration has recommended repeal of such appointment authority. *See* John W. Snow, Statement Before the U.S. House Committee on Financial Services (Sept. 10, 2003), *available at* <http://www.treas.gov/press/releases/js716.htm>.

<sup>130</sup> 12 U.S.C. §§ 1455(j) (Freddie), 1719(b) (Fannie). The Federal Home Loan Bank System and Farm Credit System need approval from their respective regulators.

<sup>131</sup> STANTON, GSEs, *supra* note 34, at 33; *accord*, CBO, PUBLIC COSTS AND BENEFITS, *supra* note 5, at 9; U.S. DEP’T OF THE TREASURY, REPORT OF THE SECRETARY OF THE TREASURY ON GOVERNMENT-SPONSORED ENTERPRISES 8 (1990) [hereinafter 1990 TREASURY GSE REPORT].

<sup>132</sup> Negligible risk also provides the evident rationale for allowing depository institutions to use GSE securities as collateral for government deposits and for loans from the Federal Reserve Banks.

<sup>133</sup> *See* 15 U.S.C. § 78c(a)(42).

the United States,”<sup>134</sup> and authorize anyone (e.g., a fiduciary) to invest in GSE securities “to the same extent that such person ... is authorized under any applicable law to ... invest in obligations issued ... or guaranteed ... by the United States.”<sup>135</sup>

Thus the Congressional Budget Office (CBO) concluded in 1996 that the federal government sent investors “a strong implication ... that GSE obligations are safe from the risk of default”—an “assurance ... conveyed” by statutes repeatedly treating GSEs like the government and unlike private firms.<sup>136</sup> These statutes “endow GSE securities with the appearance of being significantly safer than the intrinsic credit quality of the GSE would ordinarily warrant.”<sup>137</sup> Thus the CBO, like many financial analysts, regarded investors’ perception of government backing as entirely reasonable.

This perception persists despite repeated disclaimers of government liability for GSEs’ obligations,<sup>138</sup> disclaimers ostensibly designed to protect the government.<sup>139</sup> These disclaimers say nothing about implicit backing and instead focus on formal, legally enforceable liability. For example, securities of Fannie, Freddie, and Farmer Mac must include “appropriate language ... clearly indicating” that the securities “are not guaranteed by the United States and do not constitute a debt or obligation of the United States or of

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<sup>134</sup> 12 U.S.C. § 1455(g) (Freddie); *accord id.* § 1719(d)-(e), 1723c (Fannie).

<sup>135</sup> 15 U.S.C. § 77r(a)(1)(D) (Fannie and Freddie), *accord*, 12 U.S.C. § 2279aa-12(c)(1) (Farmer Mac).

<sup>136</sup> CBO, PUBLIC COSTS AND BENEFITS, *supra* note 5, at 9.

<sup>137</sup> *Id.* “Short of placing an explicit guarantee” on GSE obligations, the CBO declared (at some risk of overstatement), “the law could hardly be more clear”: the government’s stake in GSEs’ soundness keeps GSE obligations “safe from the risk of default.” *Id.* at 9-10 (referring to obligations of Fannie and Freddie).

<sup>138</sup> 12 U.S.C. §§ 1435, 1455(h)(1), 1719(b), (d)-(e), 2155(c), 2279aa-12(a)(2), 4501(4), 4503.

<sup>139</sup> *See, e.g.*, 12 U.S.C. § 4503 (proudly captioned “Protection of taxpayers against liability”).

any agency or instrumentality thereof” other than the GSE in question.<sup>140</sup> This disclaimer merely restates the obvious: that the government has no formal, legally enforceable liability for the GSEs’ securities. It does not disclaim implicit backing, nor does it signal that market participants err in perceiving such backing. It thus avoids the real issue: whether the government, although not legally bound to rescue the GSEs, would nonetheless do so (e.g., because it felt a moral obligation for their debts or feared that a GSE’s default might damage the nation’s financial system). “Indeed, the disclaimer itself hints at a special federal relationship; completely private firms do not need to disclaim federal backing because no one believes such backing exists.”<sup>141</sup> Thus the disclaimer—in disavowing only formal, legally enforceable liability—may, ironically, reinforce the perception of implicit backing.<sup>142</sup> Other required disclaimers have similar flaws.<sup>143</sup>

The explicit statutory benefits that the GSEs receive from the government impart a subsidy to the GSEs, as does the perception of implicit federal backing. Valuing these

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<sup>140</sup> *Id.* §§ 1455(h)(1) (Freddie), 1719(b), (d)-(e) (Fannie); *accord*, § 2279aa-12(a)(2) (Farmer Mac).

<sup>141</sup> Ronald C. Moe & Thomas H. Stanton, *Government-Sponsored Enterprises as Federal Instrumentalities: Reconciling Private Management with Public Accountability*, 49 PUB. ADMIN. REV. 321, 323 (1989).

<sup>142</sup> See STANTON, GSES, *supra* note 34, at 35.

<sup>143</sup> The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 declares that the three housing GSEs and their obligations are not “backed by the full faith and credit of the United States.” 12 U.S.C. § 4501(4). Thus the statute disclaims formal, legally enforceable liability (which no one believes exists here) even as it fails to disclaim implicit backing. Another statutory section specifies that the 1992 act “may not be construed as obligating the Federal Government, either directly or indirectly, to provide any funds” to Fannie, Freddie, or the Federal Home Loan Banks “or to honor, reimburse, or otherwise guarantee any obligation or liability” of those GSEs. *Id.* § 4503. This disclaimer also avoids the real issue. No one argues that the 1992 Act *created* implicit backing where it did not already exist. Market participants had long believed such backing to exist under the GSEs’ charters. Congress did not act to correct that perception.

By contrast, the tersest disclaimer—“The United States shall not be liable or assume any liability directly or indirectly” on Farm Credit System debt, 12 U.S.C. § 2155(c)—poses the fewest problems. Although not specifically mentioning implicit backing, this disclaimer is so categorical that it does not hint at such backing and can be read as precluding it.

subsidies poses significant methodological challenges.<sup>144</sup> But credible studies indicate a multi-billion-dollar subsidy. A recent study by Wayne Passmore,<sup>145</sup> a Federal Reserve economist, concludes that government sponsorship enables Fannie and Freddie to borrow money at considerably lower cost than fully private firms,<sup>146</sup> and that Fannie and Freddie receive an implicit subsidy capitalized at some \$122 billion to \$182 billion.<sup>147</sup> Using a different methodology, the Congressional Budget Office estimates that the three housing GSEs together received an implicit annual subsidy of \$16.7 billion<sup>148</sup> to \$45 billion<sup>149</sup> plus explicit tax and regulatory exemptions worth \$1.4 billion annually.<sup>150</sup> Passmore and the CBO “both ... conclude that the housing GSEs receive large subsidies and that only a

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<sup>144</sup> See generally Edward J. Kane, *Housing Finance GSEs: Who Gets the Subsidy?* 15 J. FIN. SERVICES RES. 197 (1999); Ron Feldman, *Estimating and Managing the Federal Subsidy of Fannie Mae and Freddie Mac: Is Either Task Possible*, 11 J. PUB. BUDGETING, ACCT. & FIN. MGMT. 81 (1999).

<sup>145</sup> Wayne Passmore, *The GSE Implicit Subsidy and Value of Government Ambiguity*, J. REAL ESTATE ECON. (forthcoming).

<sup>146</sup> Wayne Passmore, *The GSE Implicit Subsidy and Value of Government Ambiguity* 3 (Fed. Res. Board Fin. & Econ. Discussion Series Working Paper No. 2003-64; Dec. 2003), available at <http://www.federalreserve.gov/pubs/feds/2003/200364/200364abs.html>. Fannie and Freddie’s funding advantage “averaged roughly 40 basis points from 1998 through the first half of 2003.” *Id.*

<sup>147</sup> Passmore, *supra* note 145. Under a midpoint estimate, “shareholders retain roughly 53 percent of the gains ... or about \$79 billion.” *Id.*

<sup>148</sup> See U.S. Cong. Budget Office, *Updated Estimates of the Subsidies to the Housing GSEs* 5 (Apr. 8, 2004) (1998-2003 average of estimated annual subsidies on debt and mortgage-backed securities) [hereinafter 2004 CBO Estimates]. The CBO offers this explanation of how its estimates differ from Passmore’s:

While the gross estimates differ, CBO’s and Wayne Passmore’s results are generally consistent. Passmore’s study capitalizes the benefit to the GSEs on all outstanding debt and MBSs, whereas CBO’s capitalizes the benefit on the incremental change in outstanding issues for the current year. That difference—the value of the stock rather than the change in the value, or the flow—is the principal reason that Passmore’s estimate of the gross subsidy is higher. He also estimates the subsidy pass-through to be much lower—7 basis points versus the 25 basis points used by CBO. He employs a two-step process to reach the lower value. The first step estimates the spread between jumbo and conforming mortgages and finds that difference to be 15 basis points to 18 basis points. ... The second step attempts to take account of factors other than the GSEs’ sponsored status that affect the spread between conforming and jumbo mortgages, including differences in transaction cost, credit risk, and prepayment risk.

*Id.* at 3.

<sup>149</sup> See *id.* at 1, 5 (\$46 billion total subsidy for 2003 if GSEs continue to grow, minus \$1.3 billion in explicit tax and regulatory exemptions).

<sup>150</sup> See *id.* at 1.

portion of those subsidies reach borrowers,” with the rest going to GSEs’ shareholders.<sup>151</sup> In any event, the various benefits GSEs derive from their government sponsorship (ranging from tax and regulatory exemptions to reduced borrowing costs) have very real costs to the government if, as is almost certainly the case, both the GSEs and their competitors would be willing to pay for those benefits.<sup>152</sup> “If sold competitively, the benefits the ... government provides to the ... GSEs”—including the perception of implicit backing—”would command billions of dollars” annually.<sup>153</sup> Forgoing such revenue involves an opportunity cost just as real as explicit cash payments.<sup>154</sup>

## ***2. Who Benefits from Subsidies***

The GSEs contend that they provide benefits to borrowers—such as lower interest rates, nationwide credit availability, improved technology, and market stability—far exceeding the benefits the GSEs receive from the government.<sup>155</sup> The GSEs imply that if they lost their government sponsorship, markets would regress to the 1960s.<sup>156</sup> But such a notion is untenable. Depository institutions, formerly confined to local markets and constrained by regulatory limits on deposit interest rates, can now operate nationwide<sup>157</sup> and pay market interest rates. Loans that once had little or no secondary market are now

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<sup>151</sup> *See id.* at 3.

<sup>152</sup> CBO, PUBLIC COSTS AND BENEFITS, *supra* note 5, at x.

<sup>153</sup> *Id.* at 9.

<sup>154</sup> *Id.*

<sup>155</sup> *See id.* at 25-31.

<sup>156</sup> *See, e.g., id.* at 26-28.

<sup>157</sup> *See, e.g.,* 12 U.S.C. §§ 36(g), 1831u, 1842(d).

routinely securitized.<sup>158</sup> Ending GSEs' government sponsorship would change none of these realities. Thus, for example, many private firms can now "create profitable, high-volume links between the bond and mortgage markets."<sup>159</sup> If the government stopped subsidizing Fannie and Freddie, "the mortgage markets would not retrogress to a pre-GSE condition. Rather, fully private intermediaries ... would provide the funding links between markets. Improving access to mortgage finance may have been a social benefit worth paying for in the past. It is now available without subsidy from fully private firms."<sup>160</sup>

The GSEs are not essential to stabilize markets. Although the GSEs stress such a role, particularly as a justification for holding large portfolios, they have failed to show that they behave much differently than other profit-maximizing long-term investors. "Private firms ... are always willing to buy mortgages at prices that are consistent with their objective of building value for shareholders."<sup>161</sup> There is reason to believe that Fannie and Freddie's activities have little effect on mortgage interest rates, even in times of crisis.<sup>162</sup>

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<sup>158</sup> See, e.g., Greenspan, *supra* note 18, at 3.

<sup>159</sup> CBO, PUBLIC COSTS AND BENEFITS, *supra* note 5, at xii.

<sup>160</sup> *Id.* If so, subsidizing Fannie and Freddie now for their past role in developing mortgage securitization is akin to subsidizing AT&T now for Alexander Graham Bell's invention of the telephone. The know-how is already in the public domain and many competing firms stand ready to apply it.

<sup>161</sup> *Id.*

<sup>162</sup> See Andreas Lehnert, Wayne Passmore & Shane M. Sherlund, GSEs, Mortgage Interest Rates, and Secondary Market Activities 3-5, 21-23, 30-31 (Fed. Res. Board Fin. & Econ. Discussion Series Working Paper No. 2005-07; 2005), available at <http://www.federalreserve.gov/pubs/feds/2005/200507/200507pap.pdf>.

Nor are the GSEs a particularly efficient way of expanding home ownership. The GSEs retain much of their government subsidy<sup>163</sup> and have a relatively small effect on mortgage interest rates. Federal Reserve staff studies conclude that Fannie and Freddie reduce eligible borrowers' interest rates by only about seven basis points<sup>164</sup> and retain some \$53 billion to \$106 billion of a subsidy estimated at \$122 billion to \$182 billion.<sup>165</sup> The Congressional Budget Office estimates that Fannie and Freddie lower mortgage interest rates by twenty-five basis points and retain 40% of their government subsidy,<sup>166</sup> and finds the two GSEs an inefficient vehicle for increasing home ownership.<sup>167</sup> Lowering interest rates can have surprisingly little effect on long-term home ownership rates.<sup>168</sup> Even by their own estimates, the GSEs lower interest rates only slightly (e.g., twenty-five to thirty basis points).<sup>169</sup> When interest rates fall, housing prices rise—so that lower rates may benefit sellers rather than buyers. Nor do lower interest rates particularly benefit persons for whom low income, imperfect credit history, or lack of savings for a down payment represents the greatest barrier to home ownership. The real constraint on such persons' obtaining mortgage loans is finding lenders willing to bear the risk of default on

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<sup>163</sup> See Part I-D-2 *supra*. Thus the Congressional Budget Office called Fannie and Freddie “a spongy conduit—soaking up nearly \$1 for every \$2 delivered.” CBO, PUBLIC COSTS AND BENEFITS, *supra* note 5, at xiv.

<sup>164</sup> See Wayne Passmore, Shane M. Sherlund & Gillian Burgess, The Effect of Housing Government-Sponsored Enterprises on Mortgage Rates 3, 30-31 (Fed. Res. Board Fin. & Econ. Discussion Series Working Paper No. 2005-06; 2005), available at <http://www.federalreserve.gov/pubs/feds/2005/200506/200506pap.pdf>.

<sup>165</sup> Passmore, *supra* note 145. Under a midpoint estimate, “shareholders retain roughly 53 percent of the gains ... or about \$79 billion.” *Id.*

<sup>166</sup> 2004 CBO Estimates, *supra* note 148, at 2-3.

<sup>167</sup> See CBO, PUBLIC COSTS AND BENEFITS, *supra* note 5, at xiii, 29-31.

<sup>168</sup> See, e.g., Gary Painter & Christian L. Redfeam, *The Role of Interest Rates in Influencing Long-Run Homeownership Rates*, 25 J. REAL ESTATE FIN. & ECON. 243 (2002).

<sup>169</sup> See, e.g., Alan S. Blinder, Mark J. Flannery, and James D. Kamihachi, The Value of Housing-Related Government Sponsored Enterprises: A Review of a Preliminary Draft Paper (May 17, 2004) (prepared for Fannie), available at <http://www.fanniemae.com/commentary/2004/05172004.jhtml?p=Issues+%26+Commentary>.

the loans.<sup>170</sup> Depository institutions and the federal government (through its FHA and VA guarantee programs) bear more of such credit risk than the GSEs,<sup>171</sup> which have no “edge in identifying good credit risks among borrowers traditionally regarded as poor credit risks.”<sup>172</sup>

### *3. Distorting Effects of GSE Subsidies*

Government subsidies to GSEs distort both financial markets and government policy.

#### *a. Distorting Financial Markets*

Bond-market investors’ perception that the government implicitly backs the GSEs enables the GSEs to borrow enormous sums at interest rates unwarranted by the GSEs’ own financial strength. In addition to relying on the GSEs’ own assets and earning-power, investors also rely on the perceived government backing. Thus government sponsorship attenuates market discipline by GSEs’ creditors: the GSEs can take greater risks—such as relying more heavily on borrowed money, investing in more volatile assets, and mismatching the duration of their assets and liabilities—without correspondingly increasing their borrowing costs.<sup>173</sup>

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<sup>170</sup> See CBO, PUBLIC COSTS AND BENEFITS, *supra* note 5, at xiii, 30.

<sup>171</sup> See Glenn B. Canner & Wayne Passmore, *Credit Risk and the Provision of Mortgages to Lower-Income and Minority Homebuyers*, 81 FED. RESERVE BULL. 989, 1006 (1995).

<sup>172</sup> See CBO, PUBLIC COSTS AND BENEFITS, *supra* note 5, at xiii.

<sup>173</sup> See, e.g., Ron Feldman, *Improving Control over Fannie Mae and Freddie Mac*, in SERVING TWO MASTERS YET OUT OF CONTROL: FANNIE MAE AND FREDDIE MAC 140, 141 (2001).

Government sponsorship operates as an “immensely valuable” government “seal of approval.”<sup>174</sup> It enables Fannie and Freddie to borrow at rates “not available to any fully private firm.”<sup>175</sup> It also renders mortgage-backed securities they guarantee top-grade “without ... the expense of ... the credit enhancements ... required of fully private intermediaries.”<sup>176</sup> The Congressional Budget Office likens the perceived implicit backing to a massive government purchase of nonvoting, no-dividend stock in each GSE, which greatly strengthens the GSE’s creditworthiness. This notional capital-infusion effectively gives the GSE “more capital than any fully private firm would pay to acquire or find cost-effective.”<sup>177</sup> It is also open-ended, in that if the GSE “grows, takes on more risk, or ... repurchas[es] its own stock,” the value of the government’s commitment increases by enough “to ensure that the enterprise retains its super Aaa rating.”<sup>178</sup>

Government sponsorship gives the GSEs enormous advantages in competing with fully private firms. With lower borrowing and operating costs,<sup>179</sup> the GSEs can offer lower prices and better terms. The GSEs have thus grown enormously—at the expense of better-capitalized (and perhaps better-managed) competitors. At one extreme, government sponsorship keeps Farmer Mac growing despite tepid market demand for its basic products.<sup>180</sup> At the other extreme, “unsubsidized firms cannot compete directly with

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<sup>174</sup> CBO, PUBLIC COSTS AND BENEFITS, *supra* note 5, at 10.

<sup>175</sup> *Id.*

<sup>176</sup> *Id.* Such credit enhancements include subordinating at least one class of securities, obtaining a third-party guarantee, and establishing a reserve guaranty fund. *Id.*

<sup>177</sup> *Id.* at 11.

<sup>178</sup> *Id.*

<sup>179</sup> Regulatory and tax exemptions lower GSEs’ operating costs.

<sup>180</sup> *See, e.g., Interest rate farming, supra* note 115, at 10-11.

Fannie Mae and Freddie Mac”<sup>181</sup> as guarantors of mortgage-backed securities. Passmore concludes that Fannie and Freddie’s implicit federal subsidy accounts for “roughly 44 percent to 89 percent of the [two] GSEs’ market value,”<sup>182</sup> and that without government sponsorship, the two GSEs “would be much smaller organizations,” with much smaller portfolios of mortgage-backed securities and only half their debt-to-equity ratios.<sup>183</sup>

Government sponsorship has thus fostered huge artificial growth by a few thinly capitalized firms, and a potentially dangerous concentration of financial risk in those firms. “In essence, the current system depends on [GSE] risk managers ... to do everything just right,” Chairman Alan Greenspan of the Federal Reserve Board declares, “rather than depending on a market-based system supported by the risk assessments and management capabilities of many participants with different views and different strategies for hedging.”<sup>184</sup>

*b. Distorting Government Policy*

Using GSEs rather than traditional government programs can have significant advantages for policymakers who seek additional government action (e.g., to support housing or assist farmers) but cannot obtain the requisite appropriation. GSEs seem to offer something for nothing:<sup>185</sup> the opportunity to obtain practical results—and political

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<sup>181</sup> CBO, PUBLIC COSTS AND BENEFITS, *supra* note 5, at xii.

<sup>182</sup> Passmore, *supra* note 145.

<sup>183</sup> *See id.*

<sup>184</sup> Greenspan, *supra* note 18, at 7 (referring to Fannie and Freddie).

<sup>185</sup> Larry D. Wall, Robert A. Eisenbeis, and W. Scott Frame, *Resolving Large Financial Intermediaries: Banks Versus Housing Enterprises*, J. FIN. STABILITY (forthcoming) [hereinafter Wall, Frame & Eisenbeis] (Dec. 2004 manuscript at 43; on file with author).

advantage—using only imaginary government money. Establishing or expanding GSEs does not affect the government’s reported spending or budget deficit.<sup>186</sup> Thus GSEs need not compete with other government programs for scarce appropriated funds. Indeed, GSEs can (unless their charters provide otherwise) operate in perpetuity without any additional congressional action: they need no annual appropriations and no periodic reauthorization. As they form no part of the government and do not receive explicit cash payments, they tend to receive less exacting scrutiny than conventional government programs. Moreover, a GSE and its shareholders provide a ready-made institutional constituency for perpetuating and expanding the GSE’s programs.<sup>187</sup> These factors make GSE-based programs easier to enact, defend, and expand than traditional government programs that rely on appropriated funds.

GSEs’ public-policy disadvantages mirror their advantages to budget-constrained policymakers. GSEs sidestep important mechanisms of governmental accountability. In needing no appropriation or reauthorization and having no reported budgetary effect, GSEs face less pressure to demonstrate that their subsidies represent the most effective use of the resources in question.<sup>188</sup> This attenuated political accountability helps GSEs’ subsidies

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<sup>186</sup> See, e.g., CBO, PUBLIC COSTS AND BENEFITS, *supra* note 5, at 33. Differences in budget treatment help explain why GSEs (off-budget) have grown rapidly in recent years even as federal lending and loan-guarantee programs (on-budget) have grown only slightly.

<sup>187</sup> See, e.g., Kane, *supra* note 144, at 205-06; Froomkin, *supra* note 4, at 596-97.

<sup>188</sup> See, e.g., Feldman, *supra* note 144, at 140, 142; STANTON, GSES, *supra* note 34, at 95-96.

persist even if poorly targeted toward public purposes, and makes it easier for GSEs to favor their shareholders' interests over their public missions.<sup>189</sup>

The government has difficulty managing its perceived implicit backing of GSEs,<sup>190</sup> and with good reason. By officially denying any such backing, the government tends to reduce the urgency of keeping GSEs financially sound and demanding that they provide adequate public benefits. As Stanton has noted, “the political process does not handle probabilities well,”<sup>191</sup> and the weakness of most GSE financial-soundness regulation exemplifies “the inability of the political process to take modest steps now to improve the government’s ability to deal with the slight but real probability that a GSE could fail at a substantial cost.”<sup>192</sup>

## II. BANKRUPTCY CODE INAPPLICABLE

GSEs can fail, much as other private firms can fail, and the government does not legally guarantee GSEs' obligations. Yet investors' expectation that Congress would rescue GSEs' creditors underscores the importance of having a practical alternative to such a rescue—a workable process for handling a GSE's failure. I will here consider whether the Bankruptcy Code currently provides such a process.

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<sup>189</sup> See, e.g., CBO, PUBLIC COSTS AND BENEFITS, *supra* note 5, at 33; Kane, *supra* note 144, at 205-06.

<sup>190</sup> See, e.g., STANTON, GSES, *supra* note 34, at 46.

<sup>191</sup> *Id.* at 46.

<sup>192</sup> *Id.* at 47.

Most firms, including virtually all ordinary business corporations, can liquidate or reorganize under the Bankruptcy Code.<sup>193</sup> Although Congress has enacted specialized insolvency statutes for each GSE (examined in Part IV), those statutes do not specifically prohibit GSEs from becoming debtors under the Bankruptcy Code. Thus the question arises whether a GSE could liquidate or reorganize under the code.

For an answer we must turn to the Bankruptcy Code itself. The answer hinges on whether a GSE is a federal “instrumentality.” The code permits only a “person” to be a debtor under chapter 7 or 11.<sup>194</sup> “Person,” as defined in the code, “includes individual, partnership, and corporation, but [with exceptions irrelevant here] does not include governmental unit.”<sup>195</sup> “Governmental unit” includes an “instrumentality of the United States.”<sup>196</sup> Accordingly, if a GSE is a federal instrumentality, it is a “governmental unit,” is not a “person,” and cannot be a debtor under chapter 7 or 11.<sup>197</sup>

The code does not define “instrumentality,”<sup>198</sup> and its legislative history sheds scant light on the term.<sup>199</sup> In ascertaining whether GSEs are federal instrumentalities, we must

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<sup>193</sup> See 11 U.S.C. §§ 101(41), 109(a)-(b), (d).

<sup>194</sup> See *id.* § 109(a) (“Notwithstanding any other provision of this section, only a person . . . or a municipality, may be a debtor under this title”). A “municipality”—defined in § 101(40) as a “political subdivision or public agency or instrumentality of a State”—can be a debtor only under chapter 9. See *id.* § 109(b)-(f).

<sup>195</sup> *Id.* § 101(41).

<sup>196</sup> *Id.* § 101(27).

<sup>197</sup> See THOMAS H. STANTON, *A STATE OF RISK* 206 (1991).

<sup>198</sup> See 11 U.S.C. § 101.

<sup>199</sup> The House and Senate committee reports on the Bankruptcy Reform Act of 1978 both state that the Bankruptcy Code “defines ‘governmental unit’ in the broadest sense.” H. Rep. No. 95-595, at 311 (1977); S. Rep. No. 95-989, at 24 (1978). Both reports also indicate that an instrumentality or other governmental unit must “actually [be] carrying out some governmental function.” Thus “governmental unit” does not include entities merely because they owe their existence to governmental action “such as the granting of a charter or a license.” H. Rep. No. 95-595, at 311 (1977); *accord*, S. Rep. No. 95-989, at 24 (1978).

look to other statutes and general principles of law. Congress has, in fact, declared the two agricultural GSEs “federally chartered instrumentalities of the United States,”<sup>200</sup> and implied that the three housing GSEs are also federal instrumentalities.<sup>201</sup> But because these statutes do not conclusively resolve the issue for all five GSEs, I will begin by examining relevant general principles and then turn to the GSE-specific statutes.

An instrumentality, in Stanton’s apt definition, “carries out public purposes without being part of the government.”<sup>202</sup> “In organizational terms the difference between government agencies and instrumentalities ... generally follows the fundamental distinction between public and private sector institutions. The government directly manages a government agency; by contrast the government may merely supervise an instrumentality through regulation and oversight from outside the organization.”<sup>203</sup>

The leading federal instrumentality cases arose from states’ attempts to tax the Second Bank of the United States. Congress had chartered the bank<sup>204</sup>—predominantly owned and controlled by private shareholders<sup>205</sup>—to act as the government’s fiscal agent,

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The requirement of “actually carrying out some governmental function” provides little useful guidance for classifying GSEs, as the courts have held that anything that a constitutionally valid federal instrumentality does is necessarily a governmental function. *See, e.g., Fed. Land Bank of St. Paul v. Bismarck Lumber Co.*, 314 U.S. 95, 102 (1941) (quoted in note 214 *infra*).

<sup>200</sup> *See* note 235 *infra*.

<sup>201</sup> *See* p. 41 *infra*.

<sup>202</sup> STANTON, GSEs, *supra* note 34, at 16. “Federal instrumentalities can be private companies, nonprofit organizations, or parts of state government that carry out public purposes under federal law.” *Id.* at 13.

<sup>203</sup> *Id.* at 17.

<sup>204</sup> Act of Apr. 10, 1816, 3 Stat. 266 (1816).

<sup>205</sup> The federal government contributed one-fifth of the bank’s capital and appointed 5 of the bank’s 25 directors. Act of Apr. 10, 1816, §§ 1, 8, 3 Stat. 266, 266, 269 (1816).

maintain a reliable currency, and conduct a general banking business.<sup>206</sup> Although the Constitution did not specifically authorize Congress to create banks or other corporations,<sup>207</sup> *McCulloch v. Maryland*<sup>208</sup> resoundingly upheld the bank's constitutionality. The Supreme Court reasoned that Congress could incorporate a bank as a means of exercising its express powers to collect taxes, borrow money, regulate commerce, and support an army and navy.<sup>209</sup> "Let the end be legitimate," Chief Justice Marshall declared, "let it be within the scope of the constitution, and all means which are appropriate, which are plainly adapted to that end, which ... consist with the letter and spirit of the constitution, are constitutional."<sup>210</sup> Just as the states had no power to interfere with the federal government's operations, they had "no power, by taxation or otherwise, to retard, impede, burden, or in any manner control, the operations" of such a federal instrumentality.<sup>211</sup> *Osborn v. Bank of the United States*,<sup>212</sup> in striking down another attempt to tax the bank, stressed that the bank was no "mere private corporation, engaged in its own business," but "a public corporation, created for public and national purposes."<sup>213</sup> These public purposes extended to the bank's ordinary banking business as well as its fiscal agency function: the Court held the ordinary business "essential to [the bank's] character, as a machine for the fiscal operations of the government" and thus

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<sup>206</sup> See generally BRAY HAMMOND, *BANKS AND POLITICS IN AMERICA FROM THE REVOLUTION TO THE CIVIL WAR* 230-41 (1991).

<sup>207</sup> See *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316, 407 (1819).

<sup>208</sup> 17 U.S. (4 Wheat.) 316 (1819).

<sup>209</sup> *Id.* at 407.

<sup>210</sup> *Id.* at 421.

<sup>211</sup> *Id.* at 436.

<sup>212</sup> 22 U.S. (9 Wheat.) 738 (1824).

<sup>213</sup> *Id.* at 859-60.

necessarily “as exempt from State control as the actual conveyance of the public money.”<sup>214</sup>

In keeping with *McCulloch* and *Osborn*, courts have classified Fannie,<sup>215</sup> Freddie,<sup>216</sup> the Federal Home Loan Banks,<sup>217</sup> and Farm Credit System institutions<sup>218</sup> as federal instrumentalities. Courts have also classified national banks,<sup>219</sup> federal savings associations,<sup>220</sup> and federal credit unions<sup>221</sup>—which together number more than 8,500 institutions—as federal instrumentalities.<sup>222</sup>

In *T I Federal Credit Union v. DelBonis*,<sup>223</sup> the First Circuit held a federal credit union to be a federal “instrumentality” and thus a “governmental unit” under the

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<sup>214</sup> *Id.* at 867. The Court underscored this point in *Federal Land Bank of St. Paul v. Bismarck Lumber Co.*, 314 U.S. 95 (1941):

The argument that the lending functions of the federal land banks are proprietary rather than governmental misconceives the nature of the federal government with respect to every function which it performs. The federal government is one of delegated powers, and from that it necessarily follows that any constitutional exercise of its delegated powers is governmental. It also follows that, when Congress constitutionally creates a corporation through which the federal government lawfully acts, the activities of such corporation are governmental.

*Id.* at 102 (citations omitted).

<sup>215</sup> *See, e.g.*, *Rust v. Johnson*, 597 F.2d 174, 178 (9th Cir. 1979).

<sup>216</sup> *See, e.g.*, *Mendrala v. Crown Mortgage Co.*, 955 F.2d 1132, 1138-41 (7th Cir. 1992) (holding that Freddie is a federal instrumentality for estoppel purposes but is not a federal agency for purposes of the Federal Tort Claims Act); *but cf., e.g.*, *Am. Bankers Mortgage Corp. v. Fed. Home Loan Mortgage Corp.*, 75 F.3d 1401, 1406-09 (9th Cir. 1996) (holding Fifth Amendment’s due-process clause inapplicable to Freddie).

<sup>217</sup> *See, e.g.*, *Ass’n of Data Processing Serv. Orgs. v. Fed. Home Loan Bank Bd.*, 568 F.2d 478, 480, 484, 486 (6th Cir. 1977); *Fahey v. O’Melveny & Myers*, 200 F.2d 420, 446-47 (9th Cir. 1952).

<sup>218</sup> *See, e.g.*, *Smith v. Kansas City Title & Trust Co.*, 255 U.S. 180, 210-12 (1921); *Fed. Land Bank of St. Paul v. Bismarck Lumber Co.*, 314 U.S. 95, 102-03 (1941).

<sup>219</sup> *See, e.g.*, *Davis v. Elmira Savings Bank*, 161 U.S. 275, 283 (1896); *Marquette Nat’l Bank v. First of Omaha Serv. Corp.*, 439 U.S. 299, 308 (1978).

<sup>220</sup> *See, e.g.*, *United States v. State Tax Comm’n*, 481 F.2d 963, 969 (1st Cir. 1973).

<sup>221</sup> *See, e.g.*, *T I Fed. Credit Union v. DelBonis*, 72 F.3d 921 (1st Cir. 1995); *United States v. Michigan*, 851 F.2d 803, 807 (6th Cir. 1988).

<sup>222</sup> As of Dec. 31, 2003, the United States had 2,001 national banks, 815 federal savings institutions, and 5,776 federal credit unions.

<sup>223</sup> 72 F.3d 921 (1st Cir. 1995).

Bankruptcy Code.<sup>224</sup> The court based its decision on “a combination of statutory interpretation, case law, and consideration of the factors relevant to federal instrumentality determinations.”<sup>225</sup> It found that federal credit unions “perform important governmental functions,” including “mak[ing] credit available to millions of working class Americans” and serving as fiscal agents of the government and depositories of public funds.<sup>226</sup> It held that these functions, together with tax exemption and “extensive government regulation,” provided “compelling indicia of federal instrumentality status.”<sup>227</sup> The court concluded that treating federal credit unions as federal instrumentalities and “governmental units” fit the purpose of the Bankruptcy Code provision in question.<sup>228</sup>

The case for treating GSEs as federal instrumentalities—even without any explicit statute to that effect—is as strong as the case for treating federal credit unions as instrumentalities. Congress established GSEs for purposes as important and as “governmental” as those cited in *TI Federal Credit Union*.<sup>229</sup> These purposes include assisting “the secondary market for residential mortgages (including ... mortgages on housing for low- and moderate-income families ...) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential

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<sup>224</sup> DelBonis, the debtor in a chapter 7 bankruptcy case, had borrowed from the credit union to finance the education of his wife and children. *Id.* at 925. 11 U.S.C. § 523(a)(8) generally precludes discharge of “an educational ... loan made ... by a governmental unit.” If the credit union were a federal instrumentality, and thus a “governmental unit,” DelBonis could receive a discharge from those loans only by coming within an exception in § 523(a)(8). *Id.* at 926-27.

<sup>225</sup> *Id.* at 931.

<sup>226</sup> *Id.* at 932.

<sup>227</sup> *Id.* at 934.

<sup>228</sup> *Id.* at 937. *See* note 199 *supra*.

<sup>229</sup> 72 F.3d 921 at 931-32.

mortgage financing,”<sup>230</sup> “promot[ing] access to mortgage credit throughout the Nation (including central cities, rural areas, and underserved areas),”<sup>231</sup> and “improving the income and well-being of American farmers and ranchers by furnishing sound, adequate, and constructive credit and closely related services.”<sup>232</sup> Like federal credit unions, GSEs enjoy important tax exemptions.<sup>233</sup> GSEs also face government regulation as extensive as that applicable to federal credit unions.<sup>234</sup> Thus the criteria enunciated in *TI Federal Credit Union*, consistent with those in a long line of nonbankruptcy cases, strongly support classifying GSEs as federal instrumentalities for purposes of the Bankruptcy Code.

This conclusion finds further support in statutes declaring or implying that GSEs are federal instrumentalities. Congress has expressly declared Farm Credit System institutions and Farmer Mac “federally chartered instrumentalities of the United States.”<sup>235</sup> This language, added by the Farm Credit Act of 1971,<sup>236</sup> codified the long series of court decisions<sup>237</sup> classifying Farm Credit System institutions as federal instrumentalities.<sup>238</sup>

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<sup>230</sup> 12 U.S.C. § 1716(3) (Fannie), Housing and Community Development Act of 1992, Pub. L. No. 102-550, § 1382(a)(3), 106 Stat. 3672, 4002 (1992) (Freddie).

<sup>231</sup> 12 U.S.C. § 1716(4) (Fannie), Pub. L. No. 102-550, § 1382(a)(4), 106 Stat. at 4002 (Freddie).

<sup>232</sup> 12 U.S.C. § 2001(a) (FCS).

<sup>233</sup> See 12 U.S.C. §§ 1433 (FHLBS), 1452(e) (Freddie), 1723a(c)(2) (Fannie), 2023, 2077, 2098, 2134 (Farm Credit System). Of all five GSEs only Farmer Mac (which Congress has expressly declared a federal instrumentality) has no statutory tax exemption.

<sup>234</sup> Compare 12 C.F.R. pts. 701-60 (regulations governing credit unions) with *id.* pts. 611-30 (Farm Credit System), pt. 650 (Farmer Mac), pts. 915-98 (FHLBS), pts. 1720-77 (Fannie and Freddie’s financial soundness), 24 C.F.R. pt. 81 (Fannie and Freddie’s housing mission).

<sup>235</sup> 12 U.S.C. § 2121 (banks for cooperatives); *accord, id.* §§ 2011(a) (farm credit banks), 2071(a), (b)(7) (production credit associations), 2091(a), (b)(4) (federal land bank associations), 2141(a) (National Bank for Cooperatives), 2211 (farm credit bank service corporation), 2279aa-1(a)(1) (Farmer Mac). See *generally* Director of Revenue v. CoBank ACB, 531 U.S. 316, 318 (2001) (Farm Credit System as federal instrumentality).

<sup>236</sup> Pub. L. No. 92-181, 85 Stat. 583 (1971).

<sup>237</sup> See cases cited in note 218 *supra*.

Statutes applicable to the three housing GSEs imply that those firms are also federal instrumentalities. Fannie and Freddie must “insert appropriate language” in their “obligations and securities ... clearly indicating that such obligations and securities ... do not constitute a debt or obligation of the United States or *any agency or instrumentality thereof other than the Corporation.*”<sup>239</sup> Using “other than the Corporation” after “agency or instrumentality” implies that the GSE is a federal agency or instrumentality. As a GSE is not an “agency,”<sup>240</sup> it presumably is an “instrumentality.” In addition, each Federal Home Loan Bank can accept deposits from “any other Federal Home Loan Bank or other instrumentality of the United States.”<sup>241</sup> Pairing “Federal Home Loan Bank” with “*other instrumentality of the United States*”<sup>242</sup> implies that Federal Home Loan Banks are also federal instrumentalities.

In sum, Congress has expressly declared both agricultural GSEs federal instrumentalities. Congress has implied that the three housing GSEs are also federal instrumentalities, and courts have classified them as such. *TI Federal Credit Union v. DelBonis* dealt specifically with “instrumentality” for purposes of the Bankruptcy Code, holding that federal credit unions are federal instrumentalities and therefore also “governmental units.” The decision followed the general jurisprudence of federal

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<sup>238</sup> According to the House report, “The powers of the federally chartered land banks as *instrumentalities of the United States* are presently scattered through existing law and by this section have been assembled for ease of identification. ... *The basic character, charters, and functions of these banks will not be changed.*” Farm Credit Act of 1971, H. Rep. 92-593 (1971), *reprinted in* 1971 U.S.C.C.A.N. 2091, 2104 (emphasis added).

<sup>239</sup> 12 U.S.C. § 1455(h)(2) (Freddie Mac) (emphasis added); *accord, id.* § 1719(b), (d), (e) (Fannie Mae).

<sup>240</sup> *See* 5 U.S.C. § 105.

<sup>241</sup> 12 U.S.C. § 1431(e)(1).

<sup>242</sup> *Id.* (emphasis added).

instrumentalities flowing from cases like *McCulloch* and *Osborn*, and placed particular weight on public purposes, tax exemption, and extensive federal regulation—indicia also present in the case of GSEs. Accordingly, GSEs are almost certainly federal “instrumentalities” for purposes of the Bankruptcy Code—and thus, as “governmental units,” cannot be debtors under chapter 7 or 11. Attempting to use the Bankruptcy Code to deal with a faltering GSE would, at the very least, involve legal uncertainty so great as to render the attempt likely to do more harm than good.

### III. THE MODEL OF BANK INSOLVENCY LAW

A specialized insolvency regime has long existed for banks, separate from<sup>243</sup> and antedating the Bankruptcy Code and its predecessor.<sup>244</sup> This streamlined, nonjudicial regime has served as a model for GSE insolvency law—just as banking regulation has, more broadly, served as a model for GSE regulation.

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<sup>243</sup> Depository institutions, with only a few narrow exceptions, cannot become debtors under the Bankruptcy Code. *See* 11 U.S.C. § 109(b)(2)-(3), (d).

<sup>244</sup> *See generally* Peter P. Swire, *Bank Insolvency Law Now That It Matters Again*, 42 DUKE L.J. 469, 477-80, 490-93 (1992). The specialized bank insolvency system arose to reduce the external costs of bank failure by expediting a failed bank’s depositors’ access to their money and reducing the potential for contagious bank runs. *See id.* at 492-93. Banks have high ratios of debt to equity, rely heavily on deposits that depositors can withdraw on demand, do not keep enough cash on hand to repay all depositors, and must redeem deposits at par—all of which make banks vulnerable to runs (at least in the absence of credible deposit insurance). *See id.* at 494-95; JONATHAN R. MACEY, GEOFFREY P. MILLER & RICHARD SCOTT CARNELL, *BANKING LAW AND REGULATION* 53-59, 67-68 (3d ed. 2001) [hereinafter MACEY, MILLER & CARNELL].

## A. Banking Law as a Model for GSE Regulation

Banking regulation provides the most important model for GSE financial-soundness regulation.<sup>245</sup> Congress has, for example, drawn on banking law in framing capital,<sup>246</sup> reporting,<sup>247</sup> and prompt corrective action<sup>248</sup> requirements for GSEs and specifying GSE regulators' examination<sup>249</sup> and enforcement<sup>250</sup> powers.

Using banking regulation as a model for GSE regulation makes sense for substantive and institutional reasons. Banks and GSEs are both financial institutions and face common challenges, including managing credit risk and interest-rate risk and operating with higher ratios of debt to equity than most nonfinancial firms. The congressional committees with jurisdiction over banking—the House Committee on Financial Services and the Senate Committee on Banking, Housing, and Urban Affairs—also have jurisdiction over the three

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<sup>245</sup> See, e.g., Froomkin, *supra* note 4, at 620-21; GAO, THE GOVERNMENT'S EXPOSURE TO RISKS, *supra* note 5, at 4-5.

<sup>246</sup> See 12 U.S.C. §§ 1426(a), 2279bb-1, 2279bb-2, 4611, 4612.

<sup>247</sup> See *id.* §§ 1440, 2243(4), 2254(b), 2277a-7(8), 2279aa-11(c), 4501(6), 4513(b)(7), (11), 4514.

<sup>248</sup> Compare *id.* § 1831o (FDIC-insured depository institutions) with *id.* §§ 4613-4618, 4622 (Fannie and Freddie), 2279bb-1 to 2279bb-6 (Farmer Mac); see also *id.* § 1426(h)(3) (FHLBS).

Prompt corrective action subjects a financial institution to progressively more stringent restrictions and requirements as the institution's capital declines below required levels. See generally Richard Scott Carnell, *A Partial Antidote to Perverse Incentives: The FDIC Improvement Act of 1991*, 12 ANN. REV. BANKING L. 317, 327-48 (1993). Under the prompt corrective action system for depository institutions, a bank is "adequately capitalized" if it meets all applicable capital standards (e.g., by having at least a 4% ratio of core capital to total assets), "undercapitalized" if it fails to meet any capital standard, "significantly undercapitalized" if it falls significantly below any capital standard (e.g., 3% of total assets), and "critically undercapitalized" if its tangible equity falls below 2% of total assets. See 12 U.S.C. § 1831o(b)(1), (c)(3); 12 C.F.R. § 6.4. The lower an institution's capital category, the more stringent the applicable safeguards. See 12 U.S.C. § 1831o(d)-(f), (h)-(i). The prompt corrective action regime applicable to Fannie and Freddie has identical names, with different quantitative definitions, for its capital categories. See *id.* § 4614.

<sup>249</sup> See 12 U.S.C. §§ 1440, 2243(2), 2254(a), 2277a-7(8), 2277a-8(b)(1)-(3), 2279aa-11(a)(1)(A), (b), 4501(6), 4513(b)(2), 4517.

<sup>250</sup> Compare *id.* § 1818 (FDIC-insured depository institutions) with *id.* §§ 1422b(a)(5) (FHLBS), 2261-2269, 2273-2275 (FCS), 4631-4641 (Fannie and Freddie).

housing GSEs.<sup>251</sup> Congress responded to the Farm Credit System’s near-failure during the 1980s by transforming the Farm Credit Administration into an arm’s length financial-soundness regulator modeled on federal bank regulators.<sup>252</sup>

Critics of current GSE regulation often point to banking law as substantively superior to GSE statutes—in particular, as striking a better balance between public and private interests.<sup>253</sup> GSE statutes are company-specific: each applies to only one or at most two GSEs.<sup>254</sup> Moreover, each firm “has been treated as a special case and new corporations ... created in an *ad hoc* manner disregarding prior experience.”<sup>255</sup> Banking statutes, by contrast, are largely generic: designed to apply to hundreds or thousands of disparate banks.<sup>256</sup> As Ronald Moe and Thomas Stanton have explained, framing laws generically promotes accountability.<sup>257</sup> Without generic law, the government tends to deal *ad hoc* with “each institution and set of circumstances,”<sup>258</sup> in ways that tend to favor the narrow

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<sup>251</sup> See U.S. HOUSE OF REPS., RULE X, cl. 1(g) in H. DOC. NO. 107-284 (2003); U.S. SENATE, STANDING RULE XXV(d)(1) in S. DOC. NO. 107-1 (2002).

<sup>252</sup> For the Farm Credit Administration’s transformation into an arm’s-length regulator with powers comparable to those of federal bank regulators, see U.S. GEN. ACCOUNTING OFFICE, FARM CREDIT SYSTEM: FARM CREDIT ADMINISTRATION EFFECTIVELY ADDRESSES IDENTIFIED PROBLEMS, GAO/GGD-94-14, at 15, 29-30 (1994).

<sup>253</sup> See, e.g., GAO, THE GOVERNMENT’S EXPOSURE TO RISKS, *supra* note 5, at 95-96, 100-01, 104-05; Richard Scott Carnell, *Federal Deposit Insurance Versus Federal Sponsorship of Fannie Mae and Freddie Mac: The Structure of Subsidy*, in SERVING TWO MASTERS YET OUT OF CONTROL: FANNIE MAE AND FREDDIE MAC (Peter J. Wallison ed. 2001); Thomas H. Stanton, *Federal Supervision of Safety and Soundness of Government-Sponsored Enterprises*, 5 ADMIN. L.J. 395 (1991).

<sup>254</sup> The statutes administered by OFHEO apply to both Fannie and Freddie, as do the housing goals for those enterprises. See 12 U.S.C. §§ 4501-4641. The statutes governing Farmer Mac form part of the Farm Credit Act of 1971, which governs the Farm Credit System. Indeed, the system officially includes Farmer Mac, *see id.* § 2279aa-1(a)(2). But other GSE statutes (such as those cited in notes 7-12 *supra*) apply only to a single, named GSE.

<sup>255</sup> 1 NAT’L ACAD. OF PUB. ADMIN., REPORT ON GOVERNMENT CORPORATIONS 24-25 (1981). Although the statement refers to government corporations, it also holds true for GSEs.

<sup>256</sup> Moreover, banking law took shape during the nineteenth and early twentieth centuries, when banks were small, numerous, and politically vulnerable and legislators felt a strong imperative to protect depositors, even at the expense of banks’ shareholders and managers.

<sup>257</sup> See Moe & Stanton, *supra* note 141, at 324.

<sup>258</sup> *Id.*

interests of the institution’s owners, managers, and clientele. Generic law “can help shift the political debate to questions about whether exceptions to general rules are warranted”—a context less favorable to those interest groups.<sup>259</sup>

The enforcement powers of federal bank regulators and OFHEO help illustrate this dynamic. The most important bank enforcement provisions appear in the Federal Deposit Insurance Act<sup>260</sup> and apply to more than nine thousand depository institutions and their parents, subsidiaries, other affiliates, and insiders.<sup>261</sup> OFHEO’s enforcement powers apply only to Fannie, Freddie, and their insiders.<sup>262</sup> Fannie and Freddie succeeded in keeping OFHEO’s enforcement powers narrower and weaker than those of bank regulators<sup>263</sup>—so much so that Stanton has described OFHEO’s powers as “a sort of parody of the authority of the federal bank regulators.”<sup>264</sup> In any event, when doubts have arisen about the

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<sup>259</sup> *Id.*

<sup>260</sup> 12 U.S.C. § 1818.

<sup>261</sup> *See id.* §§ 1813(c)(2)-(3), (h), (q), (u), (w), 1818 (persons subject to enforcement action), FED. DEPOSIT INS. CORP., ANNUAL REPORT 112 (2003) (as of Dec. 31, 2003, the FDIC insured 9,237 U.S. depository institutions, not counting insured branches of foreign banks).

<sup>262</sup> *See id.* §§ 4631-4641.

<sup>263</sup> For example, bank regulators can issue a cease-and-desist order against any “unsafe and unsound practice.” *See id.* § 1818(b)(1). OFHEO can issue such an order only if the conduct jeopardizes a GSE’s capital, unjustly enriches an insider, or is likely to cause loss or irreparable harm. *See id.* §§ 4631(a), (d)(1), 4632(a), 4636(a). Bank regulators can bar any officer, director, or employee of an FDIC-insured institution from working at that or any other federally insured institution if the individual committed misconduct (e.g., breaking the law) that (1) enriched the individual or caused loss to the institution, and (2) involved personal dishonesty or demonstrated willful or continuing disregard for institution’s safety and soundness. *See id.* § 1818(e)(1), (4), (6), (7). OFHEO has no such authority. *See id.* §§ 4501-4641. Bank regulators can impose civil money penalties of up to \$25,000 per day for lawbreaking that enriches the violator or breaches the violator’s fiduciary duties. *See id.* § 1818(i)(2)(B). OFHEO cannot impose civil money penalties on these grounds. *See id.* § 4636(a). Bank regulators can impose civil money penalties of up to \$1 million per day for (1) knowingly breaking the law or breaching fiduciary duty, and thereby (2) substantially enriching the violator or causing the institution substantial loss. *See id.* § 1818(i)(2)(C). OFHEO cannot impose civil money penalties on these grounds. *See id.* § 4636(a).

<sup>264</sup> Thomas H. Stanton, *Devising an Effective Legal Framework for Supervising the Public Benefits and Public Costs of Government Sponsored Enterprises*, in *FANNIE MAE AND FREDDIE MAE: PUBLIC PURPOSES AND PRIVATE INTERESTS* (Peter J. Wallison ed. 1999).

adequacy of existing GSE regulation, critics, GSE regulators, and Congress have often turned to banking law as a source and standard for reform.<sup>265</sup>

This pattern of using banking law as a model for GSE regulation holds true for GSE insolvency law. Insolvency mechanisms drawn from banking law apply to Fannie, Freddie, the Farm Credit System, and Farmer Mac.<sup>266</sup> Current congressional proposals to strengthen the mechanisms for Fannie and Freddie also draw heavily on bank insolvency law.<sup>267</sup>

## **B. Bank Insolvency Law**

Under the specialized insolvency regime for banks, a failed bank's regulator appoints a receiver or conservator for the bank, *ex parte* and without prior notice, hearing, or judicial approval.<sup>268</sup> Only the regulator can commence this process; creditors play no formal role.<sup>269</sup> A receiver winds up the bank's business, liquidates the bank's affairs, determines the validity of creditors' claims against the bank, and pays creditors—all in a streamlined and almost purely administrative process.<sup>270</sup>

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<sup>265</sup> For example, Congress used banking law as a model for strengthening financial-soundness regulation of the Farm Credit System in 1985 and 1987 and of Fannie and Freddie in 1992. Similarly, in 1987 and 1989 Congress responded to the savings-and-loan debacle by using banking law as a model for strengthening financial-soundness regulation of savings institutions.

<sup>266</sup> See p. 54 *infra*.

<sup>267</sup> See Part VI-A *infra*.

<sup>268</sup> See, e.g., 12 U.S.C. § 191; Swire, *supra* note 244, at 478-79. Nor can a court restrain the regulator from appointing a receiver or conservator. See, e.g., *Am. Bank, N.A. v. Clarke*, 933 F.2d 899 (10th Cir. 1991), *First Fed. Sav. Bank & Trust v. Ryan*, 927 F.2d 1345 (6th Cir. 1991).

<sup>269</sup> See Swire, *supra* note 244, at 493.

<sup>270</sup> *Id.* at 478-79, 492.

The Federal Deposit Insurance Act<sup>271</sup> incorporates this approach—as do other federal bank insolvency statutes<sup>272</sup>—and makes it applicable to any depository institution insured by the Federal Deposit Insurance Corporation (FDIC).<sup>273</sup> The act provides for two types of fiduciaries to take control of troubled banks:<sup>274</sup> conservators and receivers.<sup>275</sup> A receiver sells or liquidates the bank.<sup>276</sup> A conservator operates a bank as a going concern, seeking to rehabilitate the bank or prepare it for orderly sale in receivership, and has no authority to liquidate the bank.<sup>277</sup> The bank as a corporate entity still exists at the end of a conservatorship but not at the end of a receivership.

The process for dealing with a bank failure has three basic steps: first, appointing a receiver for the bank;<sup>278</sup> second, marshaling the bank’s assets—i.e., identifying and collecting on all items of potential value owned by the bank;<sup>279</sup> and third, using the proceeds of those assets to pay valid claims against the bank in the order of priority established by law.<sup>280</sup> In handling the failure, the FDIC can use a wide range of legal

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<sup>271</sup> 12 U.S.C. §§ 1811-1835a.

<sup>272</sup> *See id.* §§ 191-200 (national bank receiver), 201-212 (national bank conservator), 1464(d)(2)-(3) (federal savings association receiver or conservator), 1787 (credit union conservator or “liquidating agent”).

<sup>273</sup> *See id.* §§ 1813(c), 1821, 1822. FDIC-insured depository institutions comprise the bulk of the U.S. banking system.

<sup>274</sup> Although for brevity I will refer here to “banks,” the Federal Deposit Insurance Act applies equally to savings institutions. *See id.* § 1813(c)(1).

<sup>275</sup> *See generally id.* § 1821(c)-(n).

<sup>276</sup> *See id.* § 1821(d)(2)(E). *See generally* FED. DEPOSIT INS. CORP., RESOLUTIONS HANDBOOK ch. 7 (2005) (FDIC’s role as receiver) [hereinafter FDIC RESOLUTIONS HANDBOOK], available at <http://www.fdic.gov/bank/historical/reshandbook>; FED. DEPOSIT INS. CORP., MANAGING THE CRISIS: THE FDIC AND RTC EXPERIENCE, 1980-1994, at 213-22 (1998) (FDIC’s historical experience as receiver) [hereinafter MANAGING THE CRISIS].

<sup>277</sup> *See* 12 U.S.C. § 1821(d)(2)(D).

<sup>278</sup> *See* Part III-B-1 *infra*.

<sup>279</sup> *See* Part III-B-2 *infra*.

<sup>280</sup> *See* Part III-B-3 *infra*.

tools, including tools designed to preserve the failed bank's going-concern value and minimize disruption to the bank's depositors and other customers.<sup>281</sup>

### *1. Appointing Receiver*

The receiver for a bank is normally appointed by the bank's primary regulator, the government agency that issued the bank's charter.<sup>282</sup> If the bank has FDIC insurance, the regulator almost invariably appoints the FDIC as receiver.<sup>283</sup>

Many grounds for receivership (or conservatorship) exist.<sup>284</sup> Some of the more important grounds include (1) illiquidity—i.e., the bank cannot meet its obligations in the normal course of business;<sup>285</sup> (2) balance sheet insolvency—i.e., the bank's liabilities exceed its assets;<sup>286</sup> (3) serious depletion of the bank's capital;<sup>287</sup> (4) failing to submit a capital restoration plan or materially failing to implement such a plan;<sup>288</sup> (5) failing to correct a capital deficiency after having been formally ordered to do so;<sup>289</sup> (6) being in an

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<sup>281</sup> See Part III-B-4 *infra*.

<sup>282</sup> See, e.g., 12 U.S.C. §§ 191 (national banks), 1464(d)(2)(B) (federal savings associations); see also *id.* § 1821(c)(10) (authorizing FDIC to appoint itself conservator or receiver to avoid or reduce loss to deposit insurance fund).

<sup>283</sup> By law the FDIC serves as receiver for all failed national banks and federally chartered savings institutions. See *id.* §§ 191, 1464(d)(2)(E)(ii), 1821(c)(2)(A)(ii). In practice the FDIC also serves as receiver for state-chartered banks and savings institutions.

<sup>284</sup> See *id.* § 1821(c)(5) (setting forth at least fifteen grounds).

<sup>285</sup> *Id.* § 1821(c)(5)(F).

<sup>286</sup> *Id.* § 12 U.S.C. § 1821(c)(5)(A).

<sup>287</sup> See *id.* § 1821(c)(5)(G) (substantially depleting capital with no reasonable prospect of recapitalizing), (K) (undercapitalized with no reasonable prospect of recapitalizing), (L) (critically undercapitalized).

<sup>288</sup> *Id.* § 1821(c)(5)(K)(iii)-(iv).

<sup>289</sup> *Id.* § 1821(c)(5)(K)(ii).

“unsafe or unsound condition to transact business”;<sup>290</sup> (7) substantially dissipating assets or earnings through a violation of law or an unsafe or unsound practice;<sup>291</sup> (8) concealing records or assets or refusing to let authorized examiners inspect records;<sup>292</sup> and (9) willfully violating a cease-and-desist order.<sup>293</sup>

The practice of appointing a receiver (or conservator) without prior notice, hearing, or judicial approval—as expressly authorized by statute<sup>294</sup>—reflects a judgment that the circumstances will often create a need to act swiftly, decisively, and discreetly. By the time a bank enters receivership, it often has scant net worth and dubious prospects, giving its managers incentives to serve their own interests at creditors’ expense and giving its uninsured depositors incentives to run. Both insider misconduct and a run would work against creditors’ collective interest in maximizing the value of the bank’s assets. In upholding the appointment of a conservator without a prior hearing, the Supreme Court declared:

This is a drastic procedure. But the delicate nature of the institution and the impossibility of preserving credit during an investigation has [sic] made it an almost invariable custom to apply supervisory authority in this summary manner. It is a heavy responsibility to be exercised with disinterestedness and restraint, but in the light of the history and customs of banking we cannot say it is unconstitutional.<sup>295</sup>

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<sup>290</sup> *Id.* § 1821(c)(5)(C).

<sup>291</sup> *Id.* § 1821(c)(5)(B); *see also id.* § 1821(c)(5)(H).

<sup>292</sup> *Id.* § 1821(c)(5)(E).

<sup>293</sup> *Id.* § 1821(c)(5)(D).

<sup>294</sup> *See id.* §§ 191, 203(a), 1464(d)(2)(B).

<sup>295</sup> *Fahey v. Mallonee*, 332 U.S. 245, 253-54 (1947); *see also Am. Bank, N.A. v. Clarke*, 933 F.2d 899, 903-04 (10th Cir. 1991).

The bank does have a right to a prompt post-seizure judicial hearing.<sup>296</sup>

## 2. *Marshaling Assets*

In marshaling a failed bank's assets, the receiver identifies all items of any potential value owned by the bank, including loans, leases, securities, insurance claims, other financial or nonfinancial contract rights, buildings, equipment, and current or potential legal claims (e.g., lawsuits against directors and officers for breaching their fiduciary duties).<sup>297</sup> The receiver then works to turn such assets into cash.<sup>298</sup> It can also invalidate pre-receivership transfers made to defraud the bank or its creditors.<sup>299</sup>

The receiver succeeds to all the bank's "rights, titles, powers, and privileges,"<sup>300</sup> and can exercise all the powers of the bank's directors, officers, and shareholders.<sup>301</sup> It can: collect on the bank's assets;<sup>302</sup> transfer loans without the borrowers' consent and deposits without the depositors' consent;<sup>303</sup> terminate burdensome contracts, generally without incurring more than "actual direct compensatory damages" (i.e., no punitive damages, lost profits, or pain and suffering);<sup>304</sup> and merge the bank with another FDIC-insured

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<sup>296</sup> 12 U.S.C. §§ 191, 203(b)(1), 1464(d)(2)(B).

<sup>297</sup> MACEY, MILLER & CARNELL, *supra* note 244, at 747.

<sup>298</sup> *Id.*

<sup>299</sup> 12 U.S.C. § 1821(d)(17).

<sup>300</sup> *Id.* § 1821(d)(2)(A)(i).

<sup>301</sup> *Id.* § 1821(d)(1)(B)(i).

<sup>302</sup> *Id.* § 1821(d)(2)(B)(ii).

<sup>303</sup> *Id.* § 1821(d)(2)(G)(i)(II).

<sup>304</sup> *Id.* § 1821(e).

depository institution.<sup>305</sup> The Federal Deposit Insurance Act generally forbids any court to “take any action ... to restrain or affect the exercise of [the FDIC’s] powers or functions ... as a conservator or a receiver.”<sup>306</sup>

### 3. *Paying Valid Claims in Order of Priority*

The receiver notifies creditors to file proof of their claims against the bank and determines the validity of those claims.<sup>307</sup> The receiver satisfies secured claims—i.e., claims with a perfected security interest (e.g., mortgage or lien) in property of the bank—from the value of that collateral.<sup>308</sup> The receiver pays allowed unsecured claims in the order of priority prescribed by law: (1) administrative expenses of the receivership; (2) deposits, whether insured or uninsured; (3) “general or senior” liabilities—a residual category including liabilities that do not fit the other categories; (4) liabilities subordinated to deposits or general claims; (5) cross-guarantee liability to the FDIC,<sup>309</sup> and (6) shareholders’ claims.<sup>310</sup> In keeping with traditional receivership law, the receiver generally pays all allowed claims within a given priority class before it makes any payment

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<sup>305</sup> *Id.* § 1821(d)(2)(G).

<sup>306</sup> *Id.* § 1821(j); *see also id.* § 1821(d)(5)(E), (13)(C), (D).

<sup>307</sup> *Id.* § 1821(d)(3)-(8). *See generally* Lawrence G. Baxter, *Life in the Administrative Track: Administrative Adjudication of Claims Against Savings Institution Receiverships*, 1988 DUKE L.J. 422 (1988).

<sup>308</sup> If the claim exceeds the value of the collateral, the excess constitutes an unsecured claim. *See id.* § 1821(d)(5)(D)(ii).

<sup>309</sup> If an FDIC-insured bank fails and causes a loss to the FDIC, the FDIC can hold liable for the loss any other FDIC-insured depository institution that controls, is controlled by, or is under common control with the failed bank. 12 U.S.C. § 1815(e). The FDIC in effect has an option to disregard the corporate separateness of affiliated FDIC-insured institutions and treat them as a single economic entity.

<sup>310</sup> *See id.* §§ 1815(e)(2)(C), 1821(d)(11)(A).

on claims in the next lower priority class.<sup>311</sup> Thus general liabilities receive nothing unless all deposits have been paid in full, and shareholders receive nothing unless all other claims have been paid in full. If a given class of claims exceeds the assets available to pay that class, then the claims share pro rata in the available assets.<sup>312</sup> But the FDIC as receiver has leeway to deviate from these priorities as long as each claimant receives no less than it would have received in a straight liquidation.<sup>313</sup>

#### ***4. Resolution Options***

Bank receivership law facilitates rapid action to deal with (or in bank regulatory jargon, “resolve”) a failed or failing bank. The receiver can liquidate the bank’s assets and pay off the bank’s liabilities (a transaction known as a “deposit payoff”); pay a healthy bank to assume the failed bank’s insured deposits (“insured deposit transfer”); or arrange for an acquirer to purchase some or all of the bank’s assets and assume some or all of the bank’s liabilities (“purchase and assumption”).<sup>314</sup> If the receiver plans to sell the bank as a going concern but has not yet found an acquirer, the receiver can form a “bridge bank,”

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<sup>311</sup> *See id.* § 1821(d)(11)(A).

<sup>312</sup> *See* First Empire Bank v. FDIC, 572 F.2d 1361, 1371 (9th Cir. 1978).

<sup>313</sup> 12 U.S.C. § 1821(i).

<sup>314</sup> MACEY, MILLER & CARNELL, *supra* note 244, at 739-43. *See generally* MANAGING THE CRISIS, *supra* note 276, at 65-111 (describing the evolution of the FDIC’s resolution practices).

For simplicity, the above summary largely omits the FDIC’s role as deposit insurer. When the FDIC as insurer pays a failed bank’s insured depositors, it becomes entitled to receive whatever share of the failed bank’s assets would otherwise have gone to those depositors. *See* 12 U.S.C. § 1821(g)(1).

transfer part or all of the failed bank's assets and liabilities to the bridge bank, and have the bridge bank carry on the failed bank's business until an acquirer is found.<sup>315</sup>

The receiver can combine one or more of these resolution options. Thus, for example, the receiver can establish a bridge bank to carry on the failed bank's business and later arrange for an acquirer to purchase the assets and assume the liabilities of the bridge bank. Likewise, after having an acquirer purchase part of the assets and assume part of the liabilities of the failed bank, the receiver can use a payoff to dispose of the remainder. In any event, the receiver can make an immediate partial payment ("modified payoff") to creditors based on an estimate of their claims will ultimately receive from the liquidation.<sup>316</sup>

#### **IV. LEGAL FRAMEWORK FOR GSE INSOLVENCY**

Congress has enacted specialized insolvency statutes for each GSE. Adequate insolvency mechanisms drawn from banking law apply to the Farm Credit System<sup>317</sup> and

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<sup>315</sup> See *id.* § 1821(n); see also *id.* § 1821(d)(2)(F), (m), MACEY, MILLER & CARNELL, *supra* note 244, at 743-44. "A bridge bank is a full-service national bank chartered by the Office of the Comptroller of the Currency and controlled by the FDIC." FDIC RESOLUTIONS HANDBOOK, *supra* note 276, overview. Such a bank "is especially useful ... when the failing bank is large or unusually complex ... or when the bank is in a liquidity crisis." Rosalind L. Bennett, *Failure Resolution and Asset Liquidation: Results of an International Survey of Deposit Insurers*, 14 FDIC BANKING REV. 1, 15 (2001). A bridge bank resembles a purchase-and-assumption transaction (i.e., purchase of assets and assumption of liabilities) "in which the FDIC itself acts temporarily as the acquirer." See *id.* See generally MANAGING THE CRISIS, *supra* note 276, at 172-209 (FDIC's experience using bridge banks).

<sup>316</sup> See 12 U.S.C. § 1821(d)(10).

<sup>317</sup> See Part IV-C *infra*. Most provisions of the key Farm Credit System statute, 12 U.S.C. § 2183(b), have banking law antecedents. The grounds for appointing a conservator or receiver in § 2183(b)(1)-(6) parallel the first six grounds in the Federal Deposit Insurance Act, *id.* § 1821(c)(5)(A)-(F). The appointment procedure and rules for judicial review parallel 12 U.S.C. § 1464(d)(2)(B).

Farmer Mac.<sup>318</sup> A limited conservatorship mechanism, also drawn from banking law, applies to Fannie and Freddie.<sup>319</sup> Each of these mechanisms enables a GSE’s regulator to have a fiduciary take control of the GSE without prior hearing or judicial approval; affords the GSE a post-seizure judicial hearing; vests the fiduciary with all the powers of the GSE and its managers and shareholders; and bars courts from reviewing the fiduciary’s decisions.<sup>320</sup> A receiver for a Farm Credit System institution or Farmer Mac also has explicit authority to liquidate the firm—marshaling the firm’s assets, adjudicating creditors’ claims, and paying valid claims in order of priority.<sup>321</sup> A conservator for Fannie or Freddie, by contrast, has no statutory authority to liquidate the firm.<sup>322</sup> A sui generis one-sentence statute authorizes the Federal Home Bank System’s regulator to liquidate or reorganize any Home Loan Bank.<sup>323</sup>

I will now examine the insolvency statutes for each of the GSEs.<sup>324</sup> In the case of Fannie and Freddie—for which no statutory liquidation or reorganization mechanism exists—I will also consider two fallback options: using statutory conservatorship to effect

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<sup>318</sup> See Part IV-D *infra*. The Farmer Mac statute, 12 U.S.C. § 2279cc, draws on 12 U.S.C. §§ 2183, 4617, 4619, and 4620 (FCS; Fannie and Freddie), themselves drawn from banking law. Two of the statute’s four additional grounds for conservatorship and receivership also have antecedents in banking law. Compare *id.* § 2279cc(b)(2)(A), (C)(i)(II) with *id.* § 1821(c)(5)(F), (L).

<sup>319</sup> See Part IV-A *infra*. Congress drew the grounds for conservatorship, 12 U.S.C. §§ 4617(a), 4619(a)(1), from the Federal Deposit Insurance Act, *see id.* §§ 1821(c)(5)(D)-(G), (L), 1831o(h)(3)(A). The rules for judicial review, *id.* § 4619(b), parallel the Bank Conservation Act, *id.* § 203(b). A conservator’s powers under 12 U.S.C. § 4620 have antecedents in 12 U.S.C. § 1821(d)(1), (2), (11)(A)(i), (12), (17), (e), (i)(3).

<sup>320</sup> See Part IV-A, -C, -D *infra*.

<sup>321</sup> See Part IV-C, -D *infra*.

<sup>322</sup> See Part IV-A *infra*.

<sup>323</sup> See Part IV-B *infra*.

<sup>324</sup> See Part IV-A to -D *infra*.

a liquidation; and using common-law receivership to effect a liquidation or reorganization.<sup>325</sup>

### **A. Fannie Mae and Freddie Mac**

The statutes governing Fannie and Freddie authorize conservatorship but not receivership.<sup>326</sup> They create no means for reorganizing a troubled GSE and do not even specifically authorize liquidating such a firm.<sup>327</sup> Those statutes would provide only modest support for a liquidation and none whatever for a reorganization.

#### ***1. Limits of conservatorship***

The Office of Federal Housing Enterprise Oversight can appoint a conservator for Fannie or Freddie if the GSE has a serious capital deficiency,<sup>328</sup> “is not likely to pay its obligations in the normal course of business,”<sup>329</sup> conceals records or assets or refuses to let authorized examiners inspect records,<sup>330</sup> or willfully violates a cease-and-desist order.<sup>331</sup> After the conservator takes control of the GSE, the GSE’s directors can challenge the

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<sup>325</sup> See Part IV-A-2 *infra*.

<sup>326</sup> See 12 U.S.C. §§ 4616(b)(6), 4617(a)(1), 4619(a)(1).

<sup>327</sup> See *id.*

<sup>328</sup> *Id.* § 4616(b)(6) (significantly undercapitalized GSE), 4619(a)(1)(B)(ii) (GSE has substantially depleted its capital with no likelihood of timely replenishment). In these and other cases (including those referred to in the next two footnotes), OFHEO can appoint a conservator only if it finds that the “alternative remedies available . . . are not satisfactory.” See *id.* §§ 4616(b)(6)(B) (significantly undercapitalized GSE), 4619(a)(1)(A) (other cases). But the law creates a presumption favoring conservatorship if a GSE’s capital falls low enough to render the firm “critically undercapitalized.” See *id.* § 4617(a).

<sup>329</sup> *Id.* § 4619(a)(1)(B)(i).

<sup>330</sup> See *id.* § 4619(a)(1)(B)(iii).

<sup>331</sup> See *id.* § 4619(a)(1)(B)(iv).

appointment in federal district court.<sup>332</sup> They have the burden of proving that the appointment abused OFHEO's discretion or otherwise violated the law.<sup>333</sup>

The conservator generally has “all the powers of the shareholders, directors, and officers of the enterprise under conservatorship and may operate the enterprise in the name of the enterprise.”<sup>334</sup> Thus, if the GSE has sufficiently good prospects, the conservator should be able to recapitalize the firm by selling new shares (e.g., for cash or in voluntary exchange for creditors' claims), even if the new shares massively dilute existing shareholders' ownership.<sup>335</sup> Other statutes empower the conservator to avoid fraudulent security interests,<sup>336</sup> enforce certain types of contracts despite the GSE's conservatorship or insolvency,<sup>337</sup> and obtain stays of pending litigation.<sup>338</sup>

But neither the conservator nor OFHEO has any statutory authority to require creditors to exchange debt for equity or to accept only partial payment of their claims.<sup>339</sup>

This conclusion follows from the terms of the conservator's authority: the statute granting

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<sup>332</sup> *See id.* § 4619(b)(1).

<sup>333</sup> *See id.* § 4619(b)(3).

<sup>334</sup> *Id.* § 4620(a).

<sup>335</sup> Under § 4620(a) the conservator can exercise the shareholders' authority to authorize new shares and the board's authority to issue those shares.

<sup>336</sup> *Id.* § 4620(b). This innocuous-sounding provision typifies the stinginess of OFHEO's statutory conservatorship authority. OFHEO can “avoid any security interest taken by a creditor with the intent to hinder, delay, or defraud” the GSE or its creditors. But that language is conspicuously narrower than comparable provisions of the Bankruptcy Code, *see* 11 U.S.C. §§ 544(b)(1), 548, bank receivership law, *see* 12 U.S.C. § 1821(d)(17)(A), or the Uniform Fraudulent Transfer Act. Thus, for example, that language does not reach other fraudulent transfers of property. *See* 12 U.S.C. § 4620(b). Nor does it make clear whether OFHEO can pursue any broader remedies afforded by state debtor-creditor law.

<sup>337</sup> *Id.* § 4620(d).

<sup>338</sup> *Id.* § 4620(e).

<sup>339</sup> *See id.* §§ 4616(b)(6), 4617(a)(1), 4619(a)(1).

the conservator “the powers of the [GSE’s] shareholders, directors, and officers”<sup>340</sup> and the absence of any statute specifically authorizing the conservator to restructure or impair creditors’ claims. Thus if a GSE’s assets fall short of its liabilities, the conservator lacks statutory power to resolve the shortfall.<sup>341</sup>

The constraints on when OFHEO can appoint a conservator—combined with weak capital requirements,<sup>342</sup> reliance on accounting numbers that may not reflect market value,<sup>343</sup> and OFHEO’s limited enforcement powers<sup>344</sup>—make the limited scope of a conservator’s authority all the more problematic. By the time OFHEO could place a GSE in conservatorship, the firm’s condition may well have deteriorated to the point that a conservator cannot resolve the firm’s problems.<sup>345</sup>

Consider the case of a GSE that has depleted its capital under circumstances that leave investors wary about the reliability of the firm’s accounting and reporting. Even if the firm actually has a slender positive net worth, as well as good earnings prospects, investors cannot be sure that is so. Thus, even if offered 99.9% ownership of the firm,

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<sup>340</sup> *Id.* § 4620(a).

<sup>341</sup> Moreover, the conservatorship statute does not make clear the relative priority of creditors’ claims. The statute accords top priority to the expenses of the conservatorship: “All expenses of a conservatorship pursuant to this section (including compensation pursuant to subsection (f)) shall be paid by the enterprise ... and shall be secured by a lien on the enterprise, which shall have priority over any other lien.” *Id.* § 4620(h). Specifying that “expenses of a conservatorship” may suggest that “expenses of a conservatorship” has a narrow meaning. Thus pre-conservatorship creditors could argue that the term is not so broad as to encompass all business expenses that the GSE incurs while in conservatorship, including interest expense. A different ambiguity arises from the rule that if the conservator makes payments to creditors, “All creditors who are similarly situated shall be treated in a similar manner.” *Id.* § 4620(f). This language suggests pro rata treatment but does not make clear when creditors are “similarly situated,” nor exactly what “in a similar manner” means. *See id.*

<sup>342</sup> *See id.* §§ 4611-4613.

<sup>343</sup> *See id.* §§ 4612, 4613.

<sup>344</sup> *See Part III-A supra.*

<sup>345</sup> *See Wall, Frame & Eisenbeis, supra note 185 (Dec. 2004 manuscript at 34-35, 44).*

investors may not (given the limits of their knowledge) be willing to restore the firm's equity to a level that would meet regulatory capital requirements. The GSE's plight would be even more serious insofar as the market value of its liabilities exceeded the market value of its assets. But the GSE's prospects would become much brighter if OFHEO could appoint a receiver empowered to reorganize the firm. Such a reorganization could convert some debt into equity and make the terms of the remaining debt less onerous. General and senior debtholders might receive restructured debt (e.g., \$98 in new debt for each \$100 in old debt) plus most of the firm's equity, subordinated debtholders might receive equity or nothing (depending on the seriousness of the firm's problems), and the old shareholders might receive nothing. Thus the firm could emerge from receivership with an adequate equity cushion and a less onerous debt burden.

Although Fannie and Freddie continue to portray the conservatorship statute as adequate for dealing with a troubled GSE,<sup>346</sup> OFHEO now acknowledges the statute's inadequacy. In 2003, after considering ways in which Fannie and Freddie could jeopardize the financial system,<sup>347</sup> OFHEO recommended that Congress grant OFHEO receivership authority.<sup>348</sup> Such authority would, according to OFHEO, "provide greater procedural and substantive certainty to a failed Enterprise's creditors, ... ensure greater fairness to all market participants, and ... facilitate the liquidation or merger of a failed Enterprise by clearly authorizing actions relating to outstanding claims that are essential to such

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<sup>346</sup> See pp. 79-82 *infra*.

<sup>347</sup> OFFICE OF FED. HOUS. ENTER. OVERSIGHT, U.S. DEP'T OF HOUS. AND URBAN DEV., SYSTEMIC RISK: FANNIE MAE, FREDDIE MAC, AND THE ROLE OF OFHEO (Feb. 2003) [hereinafter OFHEO SYSTEMIC RISK STUDY].

<sup>348</sup> *Id.* at 3-4, 114.

remedies.”<sup>349</sup> OFHEO has also begun work on a regulation implementing its conservatorship authority.<sup>350</sup>

## ***2. Fallback options***

Fallback options for handling a severely troubled GSE might include a liquidating conservatorship and a common-law receivership.

### *a. Liquidating conservatorship*

The conservatorship statute permits OFHEO to “require a conservator to set aside and make available for payment to creditors any amounts that [OFHEO] determines may safely be used for such purpose.”<sup>351</sup> OFHEO might thus plausibly attempt to use conservatorship to effect a de facto liquidation, letting the conservator (which could be OFHEO itself<sup>352</sup>) make pro rata payments on creditors’ claims until no assets remained and then liquidate the firm. But such an approach would arguably conflict with the congressional decision to deny the conservator explicit liquidating authority<sup>353</sup> and would thus give creditors an opening to mount both legal and political attacks on the legitimacy of the conservator’s action. In any event, pursuing a de facto liquidation would tend to impede using the firm’s going-concern value for the benefit of creditors.

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<sup>349</sup> *Id.* at 114.

<sup>350</sup> *See* Office of Fed. Hous. Enter. Oversight, Semiannual Regulatory Agenda, 69 Fed. Reg. 38,373 (2004).

<sup>351</sup> 12 U.S.C. § 4620(f).

<sup>352</sup> *See id.* § 4619(a)(4)(A).

<sup>353</sup> *See id.* § 4620.

*b. Common-law receivership*

Alternatively, OFHEO could request that a federal district court appoint a receiver for Fannie or Freddie, drawing on the court’s inherent equitable power. Freddie once suggested this possibility, asserting that “a U.S. district court could appoint a receiver for Freddie Mac under common law practice.”<sup>354</sup> During the late nineteenth and early twentieth centuries, before the advent of chapter 11, “equity receivership” was extensively used to reorganize troubled railroads: restructuring the firm’s ownership, rescheduling its debts, and converting some debt to equity.<sup>355</sup> Assuming that the courts’ equitable receivership authority survived the enactment of chapter 11, at least for firms ineligible to become debtors under the Bankruptcy Code, attempting to use that approach to deal with a faltering GSE would be fraught with uncertainty—and great potential for delay and market disruption.<sup>356</sup>

**B. Federal Home Loan Banks**

The Federal Housing Finance Board, which regulates the Federal Home Loan Bank System, has broad statutory authority to liquidate or reorganize a Federal Home Loan Bank:

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<sup>354</sup> GAO, THE GOVERNMENT’S EXPOSURE TO RISKS, *supra* note 5, at 93 n. 5.

<sup>355</sup> See, e.g., DOUGLAS G. BAIRD, ELEMENTS OF BANKRUPTCY 64-68 (3d ed. 2001); DAVID A. SKEEL, JR., DEBT’S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA 57-69 (2001); Stephen J. Lubben, *Railroad Receiverships and Modern Bankruptcy Theory*, 89 Cornell L. Rev. 1420, 1440-52 (2004).

<sup>356</sup> The potential for market disruption would be particularly acute under the sort of scenario considered in Part V *infra*.

Whenever the Board finds that the efficient and economical accomplishment of the purposes of this Act will be aided by such action, and in accordance with such rules, regulations, and orders as the Board may prescribe, any Federal Home Loan Bank may be liquidated or reorganized, and its stock paid off and retired in whole or in part in connection therewith after paying or making provision for the payment of its liabilities.<sup>357</sup>

Pursuant to this statute, the board's predecessor agency abolished and liquidated two Federal Home Loan Banks during the late 1940s,<sup>358</sup> an action that the Ninth Circuit upheld based on the board's sweeping authority over the banks.<sup>359</sup>

The statute provides a notably vague standard for liquidating or reorganizing a bank: "that the efficient and economical accomplishment of the purposes of this Act [i.e., the Federal Home Loan Bank Act] will be aided by such action."<sup>360</sup> No statute or regulation specifies those purposes,<sup>361</sup> and courts have summarized the act's "general purpose"<sup>362</sup> in terms giving no meaningful guidance for liquidation or reorganization decisions.<sup>363</sup> Some members of Congress have criticized regulators' past use of the statute as high-handed.<sup>364</sup>

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<sup>357</sup> 12 U.S.C. § 1446.

<sup>358</sup> See *Fahey v. O'Melveny & Myers*, 200 F.2d 420, 438, 440, 455, 475 (9th Cir. 1952).

<sup>359</sup> *Id.* at 440-47.

<sup>360</sup> See 12 U.S.C. § 1446.

<sup>361</sup> See *id.* §§ 1421-1449, 12 C.F.R. ch. IX.

<sup>362</sup> *Ass'n of Data Processing Serv. Orgs. v. Fed. Home Loan Bank Bd.*, 568 F.2d 478, 486 (6th Cir. 1977).

<sup>363</sup> See *Laurens Fed. Sav. & Loan Ass'n v. S. Carolina Tax Comm'n*, 365 U.S. 517, 522 (1961) (quoted in Part I-C-3 *supra*); *accord*, *Ass'n of Data Processing Serv. Orgs. v. Fed. Home Loan Bank Bd.*, 568 F.2d 478, 486 (6th Cir. 1977). This "general purpose" centered on providing "low-cost, long-term, installment mortgage money." See Part I-C-3 *supra*.

<sup>364</sup> See, e.g., Fed. News Serv., *Transcript of Joint Hearing of the Capital Markets, Insurance and Government Sponsored Enterprises Subcommittee and the Oversight and Investigations Subcommittee of the House Financial Services Committee on the Office of Federal Housing Enterprise Oversight and Federal Housing Finance Board* (July 13, 2004) (statement by Rep. Luis V. Gutierrez).

By prescribing a regulation to implement the liquidation and reorganization statute, the Federal Housing Finance Board could reduce uncertainty about how it would use the statute, provide safeguards against arbitrary action, and strengthen its hand in any litigation with a faltering Home Loan Bank. Such a regulation should, at a minimum, clarify the criteria for initiating liquidations and reorganizations and relate those criteria to relevant purposes of the Federal Home Loan Bank Act. The regulation could specify procedures for initiating and reviewing liquidations and reorganizations. It could also clarify the effect of each bank's joint and several liability for the twelve banks' consolidated obligations,<sup>365</sup> so that problems at any one bank would not raise unwarranted doubts about the soundness of every other bank. Courts would give the regulation *Chevron* deference<sup>366</sup> if "the agency's interpretation of the statute ... is reasonable and consistent with the statute's purpose."<sup>367</sup>

### **C. Farm Credit System**

The Farm Credit Act empowers the Farm Credit Administration Board (or FCA Board) to appoint conservators or receivers for any Farm Credit System institution,

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<sup>365</sup> 12 U.S.C. § 1431(b)-(c). If one bank defaulted on its share of the consolidated obligations, the board would have discretion to require any one of the other eleven banks to pay the full amount in default. *See* 12 C.F.R. § 966.9(d)(1). The potential for such action could raise doubts about each other bank's balance-sheet solvency, even though the other banks' collectively had ample capital to absorb the loss. The banks have voiced concern about the accounting treatment of their joint and several liability, and the Securities and Exchange Commission's staff has responded by indicating "that it would not object to each Bank reflecting on the face of its balance sheet as long-term indebtedness only the amount of Consolidated Obligations for which that Bank has received proceeds and is therefore viewed by the Banks as primarily liable." Alan L. Beller, *The Application of Federal Securities Law Disclosure and Reporting Requirements to Fannie Mae, Freddie Mac and the Federal Home Loan Banks*, Statement Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, Feb. 10, 2004, *available at* <http://www.sec.gov/news/testimony/ts021004alb.htm>.

<sup>366</sup> *Chevron U.S.A. Inc. v. Natural Res. Def. Council*, 467 U.S. 837, 842-45 (1984).

<sup>367</sup> *Indep. Ins. Agents of Am., Inc., v. Hawke*, 341 U.S. App. D.C. 211, 211 F.3d 638, 643 (D.C. Cir. 2000).

specifies the grounds for such appointments, and provides for judicial review.<sup>368</sup> The board can appoint a conservator or receiver for any FCS institution that has obligations exceeding its assets,<sup>369</sup> cannot “timely pay principal or interest” on certain obligations,<sup>370</sup> culpably dissipates its assets or earnings,<sup>371</sup> is in “an unsafe or unsound condition,”<sup>372</sup> conceals records or assets or refuses to let authorized examiners inspect records,<sup>373</sup> or willfully violates a cease-and-desist order.<sup>374</sup> The board can make the appointment “ex parte and without notice,” subject to review on the merits in federal district court.<sup>375</sup>

The FCA Board has used its general rulemaking authority<sup>376</sup> to flesh out this simple statutory framework. Under the board’s regulation,<sup>377</sup> a receiver or conservator automatically has “all rights, privileges, and powers of the [institution’s] board of directors, officers, and employees.”<sup>378</sup> A conservator operates the institution “for the benefit of the [institution’s] creditors and stockholders,”<sup>379</sup> and has “all powers necessary to continue the ongoing operations of the institution, ... conserve and preserve the institution’s assets and property, and otherwise protect the interests of the institution, its

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<sup>368</sup> 12 U.S.C. § 2183(b).

<sup>369</sup> *Id.* § 2183(b)(1).

<sup>370</sup> *Id.* § 2183(b)(6).

<sup>371</sup> *Id.* § 2183(b)(2).

<sup>372</sup> *Id.* § 2183(b)(3).

<sup>373</sup> *See id.* § 2183(b)(5).

<sup>374</sup> *See id.* § 2183(b)(4).

<sup>375</sup> *Id.* § 2183(b).

<sup>376</sup> *See id.* § 2155(a)(9).

<sup>377</sup> 12 C.F.R. §§ 627.2700-627.2790.

<sup>378</sup> *See id.* §§ 627.2720(e), 627.2775(c).

<sup>379</sup> *Id.* § 627.2780(a).

stockholders, and creditors.”<sup>380</sup> The conservator has considerable freedom to take action “appropriate or expedient to the continuing operation of the institution”<sup>381</sup> but cannot wind up and liquidate the institution.<sup>382</sup> A receiver, by contrast, should “wind up the business operations of such institution, collect the debts owed to the institution, liquidate its property and assets, pay its creditors, and distribute the remaining proceeds to stockholders.”<sup>383</sup> The receiver can exercise “all powers necessary to the efficient termination of an institution’s operation.”<sup>384</sup> After deciding whether creditors have substantiated their claims,<sup>385</sup> the receiver pays allowed claims according to priorities prescribed by regulation.<sup>386</sup>

The statute and regulation together provide an adequate legal framework for handling troubled FCS institutions, including power to appoint a conservator or receiver, grounds for such appointments, a process for judicial review, and agency rulemaking authority to fill in the details.

#### **D. Farmer Mac**

A substantively similar legal framework applies to Farmer Mac. The statute provides somewhat more detail,<sup>387</sup> incorporates by reference some provisions of the Farm Credit

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<sup>380</sup> *Id.* § 627.2770(b).

<sup>381</sup> *Id.* § 627.2780(d).

<sup>382</sup> *See id.* § 627.2780(b).

<sup>383</sup> *Id.* § 627.2725(a)(1).

<sup>384</sup> *Id.*; *see also id.* § 627.2725(b) (specific powers of receiver).

<sup>385</sup> *See id.* § 627.2740(b).

<sup>386</sup> *Id.* §§ 627.2740(c) (paying creditors), 627.2745-627.2752 (priorities). The institution’s shareholders receive any assets remaining after the receiver has paid creditors’ claims. *Id.* § 627.2755(b).

System statute and regulation,<sup>388</sup> and generally leaves the Farm Credit Administration Board free to prescribe the details.<sup>389</sup> The board's implementing regulation largely resembles that for the Farm Credit System<sup>390</sup> and—together with the statute—supplies an adequate legal framework.

## **V. CONSEQUENCES OF HAVING INADEQUATE INSOLVENCY MECHANISMS FOR FANNIE MAE AND FREDDIE MAC**

As previously discussed, the current legal mechanisms for dealing with Fannie or Freddie (if the firm became financially troubled) have serious shortcomings.<sup>391</sup> By the time OFHEO can appoint a conservator, the firm's condition may have deteriorated to the point that the conservator cannot save the firm. A conservator cannot effect a reorganization. Uncertainty exists about a conservator's power to effect a de facto liquidation. Even greater uncertainty—with, at the very least, significant potential for delay and market disruption—would attend an attempt to use common-law receivership to liquidate or reorganize a GSE. Nor does the statute make clear the relative priority of creditors' claims.<sup>392</sup>

These weaknesses of current law could have far-reaching practical consequences, to which we now turn. In particular, uncertainty about the priority of claims against a GSE

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<sup>387</sup> See, e.g., 12 U.S.C. § 2279cc(c), (f), (g), (i).

<sup>388</sup> See *id.* § 2279cc(b)(1) (grounds for appointing conservator or receiver), (e) (powers of conservator or receiver).

<sup>389</sup> See *id.* § 2279cc.

<sup>390</sup> Compare 12 C.F.R. §§ 627.2700-627.2790 (FCS) with *id.* §§ 650.50-650.68 (Farmer Mac).

<sup>391</sup> See Part IV-A *supra*.

<sup>392</sup> See note 341 *supra*.

and the process for handling such claims could curtail the GSE's access to credit and reduce the market value and liquidity of claims against the GSE.<sup>393</sup> Under some circumstances a broader impairment of liquidity in financial markets might result.<sup>394</sup> Although such an extreme scenario is unlikely, it is nonetheless plausible—and as OFHEO has observed, “In analyzing how key financial institutions can affect systemic risk, the important issue is not the likelihood of the scenarios examined, but the magnitude of the potential adverse consequences.”<sup>395</sup>

Problems at Fannie or Freddie could cause significant harm to the financial system. Many other financial institutions have large credit exposures to those firms, having purchased their debt securities, relied on their guarantees of mortgage-backed securities, and entered into over-the-counter derivatives contracts with them.<sup>396</sup> Thus Fannie or Freddie's default could affect other financial institutions' solvency and liquidity.<sup>397</sup> “The Enterprises are so large that the direct interdependencies between them and other participants in securities and derivatives markets may exceed those of any other privately owned financial institutions.”<sup>398</sup>

Yet attempts to quantify the systemic effects of default by Fannie or Freddie face three formidable technical obstacles, according to OFHEO: first, lack of adequate data about the direct and indirect interdependencies among financial institutions and financial

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<sup>393</sup> See p. 67 *infra*.

<sup>394</sup> See p. 69 *infra*.

<sup>395</sup> See OFHEO SYSTEMIC RISK STUDY, *supra* note 347, at 93.

<sup>396</sup> See *id.* at 34, 60-66, 77, 100-01.

<sup>397</sup> See *id.* at 31-32, 100-02.

<sup>398</sup> See *id.* at 75.

markets;<sup>399</sup> second, lack of macro-econometric models quantifying how “financial variables such as the supply of credit and interest rates” affect “different types of financial assets and real variables such as output and employment”;<sup>400</sup> and third, “the inherent difficulty in using quantitative techniques to analyze catastrophic events such as ... financial crises,” which occur rarely and “often involve significant departures from recent historical experience.”<sup>401</sup>

To sidestep these obstacles, OFHEO has used “scenario analysis”<sup>402</sup> to explore the possible systemic consequences of problems at Fannie or Freddie. One scenario assumes that “Enterprise A,” a GSE, “unexpectedly incurs large losses,” leaving investors doubtful about the firm’s viability and “uncertain about whether it will default, about the size of any credit losses they may incur, and about the future liquidity of its debt.”<sup>403</sup> Investors respond by selling the firm’s debt and mortgage-backed securities,<sup>404</sup> depressing the price of those securities and prompting “more and more investors [to] try to liquidate their positions before the market becomes illiquid and they can no longer do so.”<sup>405</sup>

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<sup>399</sup> *Id.* at 36, 87.

<sup>400</sup> *Id.* at 87. Such models typically “represent[] the financial sector in a highly aggregated fashion.” *Id.* Thus, for example, “the model the Congressional Budget Office used to estimate the economic effects of the thrift crisis did not have a banking sector.” *Id.* n.317.

<sup>401</sup> *Id.* at 87.

<sup>402</sup> Scenario analysis involves “the construction and elaboration of hypothetical ... scenarios” to gain “insights into the potential functioning” of the financial system and the economy “under specific conditions of extreme stress.” *Id.* at 87-88.

<sup>403</sup> *Id.* at 98.

<sup>404</sup> *Id.*

<sup>405</sup> *Id.* at 99.

OFHEO stresses the pivotal importance of how investors and “the federal government respond to a rapid decline in the liquidity of Enterprise A’s debt” securities and mortgage-backed securities.<sup>406</sup> If investors expect only small credit losses on those securities—or anticipate a governmental rescue—they may buy up such securities “at bargain prices,” stabilizing the price and “bolster[ing] the liquidity of those securities.”<sup>407</sup> If the other GSE in the Fannie-Freddie duo “is financially strong and able to borrow at reasonable rates,” it may rapidly expand its purchases of mortgage-backed securities and thereby “limit damage to the housing sector, mortgage lenders, and other housing finance businesses.”<sup>408</sup> But if the market for Enterprise A’s debt becomes illiquid, Enterprise A may have to stop issuing debt and buying mortgage-backed securities—and investors may question “the liquidity of all depositories [i.e., banks, savings institutions, and credit unions] whose holdings of GSE debt and MBS [i.e., mortgage-backed securities] are large relative to their equity capital.”<sup>409</sup>

“Illiquidity in the market for Enterprise A’s debt and the plunge in the market value of its MBS exacerbate liquidity problems at many banks and thrifts,”<sup>410</sup> according to OFHEO. “Those problems increase the risk of contagious illiquidity spreading through the banking system, the markets for the obligations of other GSEs, and the financial sector as a whole, adversely affecting the U.S. and the global economy.”<sup>411</sup> “[M]any investors

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<sup>406</sup> *Id.*

<sup>407</sup> *Id.*

<sup>408</sup> *Id.*

<sup>409</sup> *Id.* at 100.

<sup>410</sup> *Id.* at 98.

<sup>411</sup> *Id.*

become less willing to hold debt and other fixed-income obligations perceived to pose a significant degree of credit risk and liquidity risk.”<sup>412</sup> “Those developments substantially reduce the desirability of all GSE debt [even debt of healthy GSEs] ... as suitable instruments for use in hedging or as collateral for repurchase agreements, further reducing liquidity in financial markets.”<sup>413</sup> In sum, this scenario “illustrates how heightened uncertainty about the liquidity of the debt of an undercapitalized Enterprise could lead to contagious illiquidity in the market for those securities. Such illiquidity could cause or worsen liquidity or solvency problems at other financial institutions and disrupt the housing markets and the financial system.”<sup>414</sup>

Uncertainty about the priority of claims against a troubled GSE—and the process for handling such claims—could worsen the GSE’s problems and the potential for harm to financial markets. Although the loss rate per dollar of debt or mortgage-backed securities would almost certainly remain low, “the total dollar amount of the Enterprise’s losses could be substantial and distributed unevenly among different classes of investors”<sup>415</sup> (e.g., debt securities, mortgage-backed securities, over-the-counter derivatives, and subordinated debt). Current law leaves investors “uncertain about the potential severity of the losses specific [classes of] investors would incur if [a faltering GSE] defaulted.”<sup>416</sup> Thus investors may fear the worst for each of several classes of unsecured claims against the

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<sup>412</sup> *Id.* at 101.

<sup>413</sup> *Id.* at 102.

<sup>414</sup> *Id.* at 105.

<sup>415</sup> *Id.* at 101.

<sup>416</sup> *Id.* at 100-01.

firm—as though that class would have to bear the entire loss.<sup>417</sup> Such uncertainty—combined with creditors’ more basic uncertainty about the firm’s prospects and the market value of the firm’s assets and liabilities—could further reduce the firm’s access to credit (and hedging devices), the market value and liquidity of claims against the firm, and under extreme circumstances possibly also the liquidity of financial markets.

In analyzing the potential for a GSE’s troubles to harm the financial system and the economy, Larry Wall, Robert Eisenbeis, and Scott Frame of the Federal Reserve Bank of Atlanta contend that GSE regulators should develop and announce a “credible plan” for handling a GSE’s failure.<sup>418</sup> These economists stress the importance of (1) empowering and instructing OFHEO to sell, merge, or otherwise resolve the problems of a faltering GSE while the market value of the firm’s assets still exceeds the market value of its liabilities, (2) authorizing regulators to place a GSE in receivership and create a “bridge”

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<sup>417</sup> For example intended to illustrate OFHEO’s point about the effect of legal uncertainty about the priority of claims, *id.*, consider the case of a hypothetical GSE with \$100 in total assets and \$103 in total liabilities. The firm’s liabilities (all unsecured) consist of \$97 in senior debt, \$1 in subordinated debt, \$3 in derivatives in loss positions, and \$2 in guaranty liability for mortgage-backed securities:

Senior debt	97
Subordinated debt	1
Derivatives in loss positions	3
Guaranty liability for mortgage-backed securities	<u>2</u>
<i>Total Liabilities</i>	103

The firm has guaranteed another \$100 in outstanding mortgage-backed securities. Even if in fact these numbers all accurately market values, the firm’s creditors do not know that with certainty and fear that the firm has overstated its assets and understated its liabilities.

In any event, because the firm’s liabilities exceed its assets, the firm cannot, if liquidated, satisfy all of its creditors’ claims. Holders of subordinated debt will receive nothing, consistent with their agreement to be paid only after the firm has fully paid more senior creditors. See Noel Fahey, Fannie Mae’s Subordinated Debt Program 11 (Apr. 27, 2001), available at [http://www.fanniemae.com/markets/debt/pdf/subordinated\\_debt\\_program.pdf](http://www.fanniemae.com/markets/debt/pdf/subordinated_debt_program.pdf). But the firm’s remaining liabilities (\$102) will still exceed its assets (\$100), raising questions about the treatment of the remaining classes of claims: senior debt, derivatives, and guaranty liability, plus the contingent liability for other outstanding mortgage-backed securities. Insofar as market participants fear that one class will be paid after the others—and thus have to absorb the \$2 loss—the market value and liquidity of that class could suffer accordingly. And such uncertainty could conceivably affect two, three, or all classes of claims.

<sup>418</sup> See Wall, Frame & Eisenbeis, *supra* note 185 (Dec. 2004 manuscript at 27, 44, 49).

firm to carry on the GSE's business, and (3) specifying the order of priority in which to pay a failed GSE's creditors.<sup>419</sup> They note that current legal mechanisms for Fannie and Freddie take "none of these ... steps."<sup>420</sup> Instead, current law keys OFHEO's powers to accounting numbers that may overstate a GSE's assets and thus mask the seriousness of the firm's problems; directs OFHEO to intervene only after a GSE's capital has fallen precipitously low; fails to specify priority among creditors; does not authorize OFHEO to appoint a receiver or organize a bridge firm; and thus would necessitate special congressional legislation to resolve a GSE with assets worth less than its liabilities.<sup>421</sup> Indeed, Congress could face "intense pressure to act quickly" from the troubled GSE's conservator, creditors, and mortgage-market customers and from other GSEs.<sup>422</sup> Wall, Eisenbeis, and Frame accordingly regard current law as "designed ... to create substantial spillover effects and force Congress to mitigate th[os]e problems by providing the creditors of a failed housing enterprise with a bailout."<sup>423</sup>

Similarly, Chairman Greenspan recommends that Congress enact a receivership process for Fannie and Freddie, with a clear set of priorities among creditors.<sup>424</sup> "Congress needs to clarify the circumstances under which a GSE can become insolvent and, in particular, the resultant position—both during and after insolvency—of the investors that

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<sup>419</sup> *See id.* (Dec. 2004 manuscript at 44, 45-46).

<sup>420</sup> *Id.* (Dec. 2004 manuscript at 44).

<sup>421</sup> *Id.* (Dec. 2004 manuscript at 44-45).

<sup>422</sup> *See id.* (Dec. 2004 manuscript at 45).

<sup>423</sup> *Id.* (Dec. 2004 manuscript).

<sup>424</sup> *See* Greenspan, *supra* note 18, at 8, 11.

hold GSE debt.”<sup>425</sup> Greenspan stresses that such a “process must be clear before it is needed,” lest during any crisis “uncertainties about the process” precipitate a congressional rescue.<sup>426</sup> In Greenspan’s view, the current conservatorship mechanism would make it “very difficult” to avoid such a rescue: the conservatorship statute “essentially says, for all practical [purposes], that the Congress will bail out the GSEs in the event of a crisis.”<sup>427</sup> If Congress does not intend to make such a rescue inevitable, Greenspan concludes, it should change the law now.<sup>428</sup>

Enacting explicit, workable liquidation and reorganization mechanisms, together with statutory payment priorities, would have several salutary effects. By reducing the likelihood of Congress rescuing a faltering GSE, these reforms would increase market discipline on the two GSEs, reduce the GSEs’ incentive to take excessive risks, and thus reduce the likelihood of future problems.<sup>429</sup> If problems do arise, the increased market discipline would promote more timely corrective action—again reducing the risk of more

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<sup>425</sup> *Id.* at 8.

<sup>426</sup> *Id.* at 8-9.

<sup>427</sup> Fed. News Serv., Hearing of Senate Committee on Banking, Housing, and Urban Affairs (Feb. 24, 2004).

By contrast, Fannie and Freddie depict conservatorship as adequate for dealing with a troubled GSE, *see* p. 79 *infra*, as does Susan M. Wachter, *see* p. 79 *infra*, a housing finance expert retained by Fannie. Wachter questions whether OFHEO—even with broad receivership authority—could do anything responsive to the type of systemic crisis posed by a GSE’s failure—a crisis with the potential for a “general lack of liquidity to the overall economy. The government entity charged with dealing with such threats is the Federal Reserve Board as the lender of last resort. And it is certainly not clear that OFHEO’s actions ... would be able ... to respond to this concern.” Susan M. Wachter, *Resolving Failed Banks: A Model for the Resolution of Failed GSEs?* 5 (Sept. 23, 2004) (copy on file with author).

<sup>428</sup> *See id.*

<sup>429</sup> *See* N. Gregory Mankiw, Remarks at the Conference of State Bank Supervisors State Banking Summit and Leadership Conference (Nov. 6, 2003), *available at* <http://www.whitehouse.gov/cea/gsemankiwspeechnov62003.html>; Wall, Frame & Eisenbeis, *supra* note 185 (Dec. 2004 manuscript at 2).

serious problems. In sum, the reforms would help move the adjustment process forward, using the possibility of healthy discomfort now to reduce the risk of crippling pain later.

## **VI. CORRECTING THE DEFICIENCIES OF CURRENT LAW**

The deficiencies of current law could be corrected by adopting adequate GSE-specific liquidation and reorganization mechanisms or by authorizing liquidation and reorganization of GSEs under the Bankruptcy Code. I have already outlined the type of regulation that the Federal Housing Finance Board should adopt to implement its statutory authority to liquidate and reorganize Federal Home Loan Banks.<sup>430</sup> Accordingly, I will focus here on Fannie and Freddie.

### **A. Receivership**

After outlining the requisites of a workable receivership regime, I will summarize the receivership proposals made during the 108th Congress (2003-04) and analyze Fannie and Freddie's objections to receivership.

#### ***1. Requisites of a workable receivership regime***

The four GSE insolvency statutes vary greatly in specificity and in the latitude they accord to regulators. The Federal Home Loan Bank Act, the least specific and least restrictive of these statutes, grants the Federal Housing Finance Board plenary authority

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<sup>430</sup> See Part IV-B *supra*.

with no procedural constraints and virtually standardless discretion.<sup>431</sup> No regulator needs such unconstrained power. At the other extreme, the statutes for Fannie and Freddie provide too little power, too late: allowing only conservatorship; delaying the appointment of a conservator until the GSE is likely to be in serious trouble; not specifically authorizing a liquidation, even of a hopelessly insolvent GSE; and providing no support whatever for a reorganization.<sup>432</sup> The statutes governing the two agricultural GSEs occupy a middle ground. Both statutes authorize appointment of a conservator or receiver, specify the grounds for such an appointment, afford judicial review, and allow the board to fill in the details by regulation.<sup>433</sup> The Farmer Mac statute deals, in addition, with conservators' and receivers' powers.<sup>434</sup>

A GSE insolvency statute should, at a minimum, (1) authorize a GSE's regulator to appoint a conservator or receiver through a process permitting timely *ex parte* action; (2) afford the GSE a prompt post-seizure judicial hearing; and (3) allow the regulator to prescribe implementing regulations. Appointment and rulemaking authority supply the basic legal framework for action. An impartial hearing provides due process. A well-designed insolvency statute should also, in my view, (4) specify the grounds for conservatorship and receivership; (5) specify priorities among claims; and (6) authorize receivers to establish bridge institutions<sup>435</sup> and effect reorganizations. Chairman

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<sup>431</sup> See Part IV-B *supra*.

<sup>432</sup> See *id.*

<sup>433</sup> See Part IV-C, -D *supra*.

<sup>434</sup> See Part IV-D *supra*.

<sup>435</sup> See p. 53 *supra*.

Greenspan rightly stresses the importance of “a *clear process sanctioned by the Congress* for placing a GSE in receivership.”<sup>436</sup> Congress needs not only to give the regulator workable tools but to give those tools political legitimacy.

## 2. *Congressional proposals*

Congress could enact workable liquidation and reorganization mechanisms for Fannie and Freddie based on the specialized mechanisms that currently exist for FDIC-insured depository institutions, the Farm Credit System, and Farmer Mac. All three receivership proposals made during the 2003-04 Congress took this approach.

H.R. 2575, introduced in 2003 by Representative Richard H. Baker and twenty other Republican members of the House Committee on Financial Services,<sup>437</sup> would authorize Fannie and Freddie’s regulator to appoint a receiver for a “critically undercapitalized”<sup>438</sup> GSE that fell within criteria prescribed in advance by the regulator.<sup>439</sup> The receiver would liquidate the GSE,<sup>440</sup> and would have both the powers of a GSE conservator and additional powers drawn from the Federal Deposit Insurance Act.<sup>441</sup> The bill relied on the GSE regulator to specify the additional powers by regulation.<sup>442</sup>

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<sup>436</sup> Greenspan, *supra* note 18, at 11 (emphasis added).

<sup>437</sup> Secondary Mortgage Market Enterprises Regulatory Improvement Act, H.R. 2575, 108th Cong. (2003).

<sup>438</sup> *See* note 248 *supra*.

<sup>439</sup> *Id.* § 134.

<sup>440</sup> *See id.*

<sup>441</sup> *Id.*

<sup>442</sup> *See id.* (“such powers with respect to an enterprise, as the Director may by regulation provide, that the Federal Deposit Insurance Corporation has” under 12 U.S.C. § 1821).

Representative Michael G. Oxley, who chairs the Committee on Financial Services, took a similar approach in a draft bill prepared as a substitute for H.R. 2575.<sup>443</sup> As part of an attempt to obtain support from Fannie, Freddie, and the committee's Democratic members, Oxley used the term "enhanced conservator" instead of "receiver,"<sup>444</sup> but his proposal would have provided the same receivership powers as H.R. 2575.<sup>445</sup>

Senator Richard C. Shelby, who chairs the Committee on Banking, Housing, and Urban Affairs, proposed a more comprehensive and detailed receivership framework, also modeled on the Federal Deposit Insurance Act.<sup>446</sup> The bill revises the grounds for conservatorship; authorizes the regulator to appoint a receiver if any of those grounds exist; and empowers the receiver to liquidate the GSE, transfer its assets and liabilities, and organize a successor firm to carry on the GSE's business.<sup>447</sup> The receiver would determine the validity of claims against the GSE and pay valid unsecured claims in the following order of priority: (1) administrative expenses of the receivership; (2) "general or senior" liabilities of the GSE; (3) obligations "subordinated to general creditors"; and (4) shareholders' claims.<sup>448</sup> The Bush Administration "strongly support[ed] the inclusion of

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<sup>443</sup> Amendment in the Nature of a Substitute to H.R. 2575 (Oct. 7, 2003).

<sup>444</sup> *See id.* § 144.

<sup>445</sup> *See id.*

<sup>446</sup> Federal Housing Enterprise Regulatory Reform Act of 2004, 108th Cong. § 144, at 43-108 (Comm. Print, Mar. 30, 2004).

<sup>447</sup> *See id.*

<sup>448</sup> *See id.*

FDIC-like receivership powers,” calling them “crucial” and “a core component of any credible legislative effort to establish a world-class regulatory regime for the GSEs.”<sup>449</sup>

The committee approved the Shelby bill by a twelve-to-nine vote,<sup>450</sup> with an amendment by Senator Robert F. Bennett delaying the effective date of any receivership until forty-five days after Congress received notice of the GSE regulator’s intent to appoint a receiver.<sup>451</sup> During that period Congress would have an opportunity to consider the merits of the proposed receivership and enact a joint resolution blocking it.<sup>452</sup>

In requiring conspicuous advance notice of receivership, imposing a forty-five day delay, and facilitating legislation to block the receivership, the Bennett Amendment starkly contrasts with traditional bank receivership law<sup>453</sup> and the rules governing national banks,<sup>454</sup> federal savings institutions,<sup>455</sup> federally insured credit unions,<sup>456</sup> and the other three GSEs<sup>457</sup>—all of which allow regulators to appoint receivers *ex parte* and without prior notice, hearing, or judicial approval. This well-established approach recognizes the need to act swiftly, decisively, and discreetly.<sup>458</sup> The Bennett Amendment in effect

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<sup>449</sup> Letter from John W. Snow to Richard C. Shelby (Mar. 30, 2004), *available at* <http://www.treas.gov/press/releases/reports/js1281.pdf>.

<sup>450</sup> Rob Blackwell, *Close Panel Vote Said to Kill GSE Bill*, AM. BANKER, Apr. 2, 2004, at 1. Nine of the committee’s ten Democratic members voted against the bill. *See id.*

<sup>451</sup> Sen. Robert F. Bennett, Amendment to Require Congressional Disapproval of the Appointment of a Receiver, at 1 [Apr. 1, 2004] (on file with author) [hereinafter Bennett Amendment].

<sup>452</sup> *See id.* The Bennett Amendment included expedited procedures to facilitate timely action in both congressional houses. *See id.* at 1-6.

<sup>453</sup> Swire, *supra* note 244, at 478-79.

<sup>454</sup> *See* 12 U.S.C. § 191.

<sup>455</sup> *See id.* § 1464(d)(2)(B).

<sup>456</sup> *See id.* § 1787(a)(1), (3).

<sup>457</sup> *See* Part IV-B to -D *supra*.

<sup>458</sup> *See* p. 49 *supra*.

requires the GSE regulator to proclaim to the world that the GSE is no longer viable—and then wait for forty-five days, even as the proclamation crimps the GSE’s access to liquidity, hobbles the GSE’s business operations, and precipitates a crisis.<sup>459</sup> The amendment then sets the stage for a congressional bailout through a “fast-track” process that precludes normal delaying tactics.<sup>460</sup> The amendment could thus serve as an elaborate device for inducing such a bailout.<sup>461</sup> Former senator Phil Gramm branded congressional involvement in the decision to appoint a receiver “a prescription for chaos.”<sup>462</sup> The administration declared that the amendment “significantly weaken[ed] one of the core powers needed for a strong regulator,” “could reinforce a false impression that the American taxpayer provides an implicit guarantee” to Fannie and Freddie, and rendered the bill unacceptable.<sup>463</sup>

### ***3. GSEs’ objections to receivership***

In opposing receivership, Fannie and Freddie argue (1) that conservatorship deals adequately with troubled GSEs; (2) that receivership is inappropriate for GSEs; (3) that bank receivership exists for reasons irrelevant to GSEs; and that enacting receivership

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<sup>459</sup> Cf. OFHEO SYSTEMIC RISK STUDY, *supra* note 347, at 100 (if the market for a troubled GSE’s debt becomes illiquid, the GSE may have to stop issuing debt and buying mortgage-backed securities); Fahey v. Mallonee, *supra* note 295, at 253 (appointing receiver without prior notice and hearing “is a drastic procedure” necessitated by the “delicate nature” of the institution and “the impossibility of preserving credit during an investigation”).

<sup>460</sup> See Bennett Amendment, *supra* note 451, at 1-6.

<sup>461</sup> Like current law as viewed by Wall, Eisenbeis, and Frame, *supra* note 185 (Dec. 2004 manuscript at 45), the amendment would tend to “create substantial spillover effects and force Congress to mitigate th[os]e problems by providing the creditors of a failed housing enterprise with a bailout.”

<sup>462</sup> David Boraks, *Feisty as Ever*, AM. BANKER, Apr. 2, 2004, at 2 (Gramm “called the Democrats’ plan to give Congress the final say on whether a GSE is put into receivership a ‘prescription for chaos’”).

<sup>463</sup> Joint Statement of Treasury Secretary John Snow and Housing and Urban Development Secretary Alphonso Jackson (Apr. 2, 2004), available at <http://www.treas.gov/press/releases/js1294.htm>.

could (4) create harmful uncertainty and make mortgages more costly and less available, (5) unfairly contravene the expectations of GSEs' creditors, and (6) encourage privatizing the GSEs.<sup>464</sup> In addition, some critics attribute the Bush Administration's support for receivership to bad faith and a bias against housing.<sup>465</sup> Thus, for example, Representative Barney Frank calls receivership "an artificial issue created by the administration."<sup>466</sup>

*a. Conservatorship deals adequately with troubled GSEs*

GSEs and their allies portray conservatorship as entirely adequate for dealing with a troubled GSE. Freddie asserts that "current law provides ample conservatorship powers."<sup>467</sup> "The existing arrangement is fine," according to Representative Frank.<sup>468</sup> Susan Wachter, a housing-finance expert who has acted as a consultant to Fannie and Freddie, contends that a troubled GSE "would either be recapitalized through retained earnings or issuance of new preferred or common stock, or would be wound down over time if it were no longer viable. Even if the company were market-value insolvent, it could have significant going-concern value, and hence could potentially attract new equity capital."<sup>469</sup>

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<sup>464</sup> See pp. 79-91 *infra*.

<sup>465</sup> See, e.g., Claudia Hirsch, *US Tsy's Abernathy: Bush Admin to Keep Pushing GSE Refrm—US Rep Frank: GSE's 'Crisis' 'Wholly Manufactured' by Administration*, THE MAIN WIRE (Apr. 21, 2004); *Bush Accused of Bad Faith in Regulating Fannie, Freddie*, NAT. J. CONG. DAILY, Apr. 20, 2004.

<sup>466</sup> See Hirsch, *supra* note 465.

<sup>467</sup> Richard F. Syron, Statement Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs 11 (Feb. 25, 2004), available at <http://banking.senate.gov/files/syron.pdf>.

<sup>468</sup> Hirsch, *supra* note 465.

<sup>469</sup> Wachter, *supra* note 427, at 4.

In asserting that “an insolvent enterprise would either be recapitalized ... or ... wound down over time,” Wachter suggests a smooth, orderly process in which the firm would recapitalize (“through retained earnings or issuance of new ... stock”) if viable and “be wound down over time if ... no longer viable.”<sup>470</sup> This rosy view evidently assumes that (1) market participants remain would willing to refinance the insolvent firm’s maturing obligations and extend whatever additional credit the firm needs to conduct its business—all at rates and on terms favorable enough so that the firm remains viable; (2) the relevant persons, including the conservator and prospective investors, can timely ascertain whether the insolvent firm is viable; (3) OFHEO should be willing to let the firm operate for years with little or no capital while the firm attempts to rebuild capital through retained earnings; (4) even if prospective investors conclude that the insolvent firm is not viable, the process of winding up the firm would remain orderly; and (5) attempting to deal with an insolvent GSE in this manner—without the option of effecting a reorganization (e.g., subordinating, or converting to equity, some portion of creditors’ claims)—would not unacceptably increase the likelihood of a congressional bailout.

All five of these assumptions merit skepticism. First, investors who know or believe that the firm’s assets fall short of its liabilities will extend unsecured credit to the firm only on costly terms (which will tend to undercut the firm’s viability)—or in the expectation of a governmental rescue. Second, if investors have lost confidence in an insolvent GSE’s accounting, they may decline to buy new stock in the firm even though they would

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<sup>470</sup> *See id.*

consider the firm an attractive prospect if they had perfect information about its condition. Moreover, depository institution regulators' record of forbearance from closing insolvent institutions<sup>471</sup> casts doubt on whether OFHEO or a conservator could make better judgments about the GSE's viability than investors can. Third, such forbearance also casts doubt on whether OFHEO should allow the firm to operate for years with little or no capital based on OFHEO's belief that, despite investors' refusal to buy new stock, the firm remains viable.

Fourth, OFHEO has shown “how heightened uncertainty about the liquidity of the debt of an undercapitalized Enterprise could lead to contagious illiquidity in the market for those securities,” which in turn “could cause or worsen liquidity or solvency problems at other financial institutions and disrupt the housing markets and the financial system.”<sup>472</sup> Thus OFHEO points to the possibility that an undercapitalized GSE could have to stop issuing debt—and that the firm's outstanding debt and mortgage-backed securities could become illiquid, and ultimately result in “contagious illiquidity spreading through the banking system, the markets for the obligations of other GSEs, and the financial sector as a whole, adversely affecting the U.S. and the global economy.”<sup>473</sup> Yet Wachter assumes that a GSE in even worse initial financial condition—not merely undercapitalized but insolvent and unviable—could “be wound down over time.”<sup>474</sup>

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<sup>471</sup> See, e.g., NAT'L COMM'N ON FIN. INST. REFORM, RECOVERY AND ENFORCEMENT, ORIGINS AND CAUSES OF THE S&L DEBACLE 32, 35-39, 51-54 (1993).

<sup>472</sup> OFHEO SYSTEMIC RISK STUDY, *supra* note 347, at 105.

<sup>473</sup> *Id.* at 98.

<sup>474</sup> See Wachter, *supra* note 427, at 4.

This brings us to the fifth assumption: that attempting to deal with an insolvent GSE in this manner would not unacceptably increase the likelihood of a congressional bailout. To remain in business, the firm would need to refinance its maturing debt. To keep its borrowing costs manageable—and avoid a protracted lack of equity—the firm might well need to persuade investors to buy additional stock. Each of these steps could prove difficult if investors doubted that the government would rescue the firm.<sup>475</sup> We would be naive to expect (much less base public policy on the assumption) that the firm would necessarily overcome all such challenges. Thus we should recognize the possibility that attempting to deal with an insolvent GSE under current law would “create substantial spillover effects” and precipitate a congressional bailout.<sup>476</sup>

*b. Receivership is inappropriate for GSEs*

Both Fannie and Freddie dismiss receivership as inappropriate for GSEs. Fannie calls conservatorship “the right model for the GSEs,”<sup>477</sup> “appropriately different” from the receivership tools available to bank regulators.<sup>478</sup> In Fannie’s view, the government has a mere “financial stake” in federally insured depository institutions,<sup>479</sup> whereas it has a broader policy stake in using Fannie and Freddie to “mak[e] homeownership more

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<sup>475</sup> Cf. OFHEO SYSTEMIC RISK STUDY, *supra* note 347, at 68. Treasury Secretary Snow has disavowed government backing for GSEs, referring to the “market misperception of an implied guarantee.” Snow, Statement Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, *supra* note 129, at 4. Given this and other indications of diminished political support for such backing, *see, e.g.*, n. 520 *infra*, a troubled GSE may find itself unable to borrow on favorable terms such as those available to Fannie while market-value insolvent during the 1980s, *see* n. 5 *supra*.

<sup>476</sup> Wall, Frame & Eisenbeis, *supra* note 185 (Dec. 2004 manuscript at 46). *See* p. 71 *supra*.

<sup>477</sup> Franklin D. Raines, Statement Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs 13 (Feb. 25, 2004), available at <http://banking.senate.gov/files/ACF21.pdf>.

<sup>478</sup> *See id.* at 10.

<sup>479</sup> *See id.* at 14.

affordable and more available. That is why a conservator is the appropriate tool to deal with a capital inadequacy problem at a GSE. The conservator’s role is to rebuild the capital of the GSE and ensure it remains an ongoing concern.”<sup>480</sup> Freddie emphasizes that receivership—here equated with liquidation<sup>481</sup>—“would have substantial economic, market and public policy consequences” and “threaten the public policy mission of the GSEs.”<sup>482</sup> Hence “[o]nly Congress should decide if there is no longer a need for [a GSE as an] instrument of national policy to support homeownership.”<sup>483</sup>

This objection to receivership assumes that national housing objectives require the preservation of the two GSEs with their liabilities unimpaired and that no reorganized or successor firm could serve as well. Fannie implies that the two GSEs are unique and possibly irreplaceable instruments for “making homeownership more affordable and more available.”<sup>484</sup> This is consistent with the GSEs’ claim to provide public benefits—such as lower interest rates, nationwide credit availability, improved technology, and market stability—worth far more than the subsidies the GSEs receive from the government.<sup>485</sup> Yet credible studies indicate that Fannie and Freddie retain much if not most of their subsidies, reduce borrowers’ interest rates only slightly, and have little effect on home ownership rates.<sup>486</sup> Moreover, many private firms can now replicate the two GSEs’ key

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<sup>480</sup> *Id.*

<sup>481</sup> *See* Syron, *supra* note 467, at 11.

<sup>482</sup> *Id.*

<sup>483</sup> Raines, *supra* note 477, at 14; *see also* Syron, *supra* note 467, at 11 (“Congress reserved to itself the right to appoint a receiver”).

<sup>484</sup> *See* Raines, *supra* note 477, at 14.

<sup>485</sup> *See* p. 27 *supra*.

<sup>486</sup> *See* p. 29 *supra*.

economic function—linking the bond and mortgage markets—and will do so without any subsidy.<sup>487</sup>

Freddie opposes receivership by implying that the two GSEs are “too big to fail.”<sup>488</sup> Freddie calls receivership “an efficient disposition mechanism for thousands of federally insured depository institutions, whose failure would not threaten the stability of and public confidence in the financial system.”<sup>489</sup> In Freddie’s view, however, the “substantial economic, market and public policy consequences” of “liquidat[ing] a GSE” preclude receivership from being a “credible option for dealing with two GSEs.”<sup>490</sup> Thus receivership makes sense for lesser firms but not for Fannie and Freddie.<sup>491</sup> But Freddie errs in suggesting that no middle ground exists between a liquidating receivership and a rescue-oriented conservatorship: receivership need not involve liquidation. Chapter 11 of the Bankruptcy Code enables business corporations to reorganize without liquidating.<sup>492</sup> The Insurers Rehabilitation and Liquidation Model Act provides an analogous process, known as “rehabilitation,” for insurance companies.<sup>493</sup> The FDIC, in transferring some but not all of a failed bank’s assets and liabilities to a successor entity (such as a bridge bank

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<sup>487</sup> See CBO, PUBLIC COSTS AND BENEFITS, *supra* note 5, at xii. See p. 28 *supra*.

<sup>488</sup> Had Freddie expressly declared itself “too big to fail,” the claim might have struck some policymakers as presumptuous—and invited closer scrutiny of Freddie’s size, government benefits, and financial-soundness regulation as well as the legal framework for handling the failure of a GSE. By making the point obliquely, Freddie reduced the risk of an adverse reaction.

<sup>489</sup> Syron, *supra* note 467, at 11.

<sup>490</sup> See *id.* This argument echoes a 1991 Treasury report: “As a practical matter, receivership is not a credible regulatory option for an entity as large as certain GSEs. . . . Nevertheless, given the significance to the economy of a financial failure of the magnitude that a GSE failure would represent, the ability to appoint a conservator may be appropriate.” U.S. DEP’T OF THE TREASURY, REPORT OF THE SECRETARY OF THE TREASURY ON GOVERNMENT-SPONSORED ENTERPRISES 15 (1991).

<sup>491</sup> See *id.*

<sup>492</sup> See 11 U.S.C. §§ 109(d), 1101-1146.

<sup>493</sup> See NAT’L ASS’N OF INS. COMM’RS, INSURERS REHABILITATION AND LIQUIDATION MODEL ACT §§ 16-19 (1999).

or a private purchaser), can also carry out a de facto reorganization.<sup>494</sup> A receiver can keep a firm in operation and tap its going-concern value for the benefit of creditors. (Part VII *infra* considers whether Fannie and Freddie are “too big to fail.”)

*c. Bank receivership exists for reasons irrelevant to GSEs*

Fannie and Freddie suggest that bank receivership exists to protect FDIC-insured depositors, the federal deposit insurance funds, and the taxpayers who stand behind those funds—reasons that, in the GSEs’ view, have no proper relevance to GSEs.<sup>495</sup> Fannie characterizes “FDIC receivership powers” as “designed to protect insured depositors.”<sup>496</sup> Receivership “is critical in the banking system, as a means of protecting the taxpayer from the exposure created by federal deposit insurance,” Fannie contends.<sup>497</sup> “After the secured creditors, insured depositors have the first call on the failed bank’s assets. . . . The receiver is necessary in order to put the FDIC—and thereby the taxpayers—first in line among the creditors of a failed bank.”<sup>498</sup> Similarly, Wachter argues that “bank regulators need receivership powers because in the event of a bank failure, they must protect depositors and the depository [sic] insurance fund.”<sup>499</sup>

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<sup>494</sup> See 12 U.S.C. § 1821(d)(2)(F), (G)(i)(II), (i)(2), (n).

<sup>495</sup> See, e.g., Raines, *supra* note 477, at 13-14; Wachter, *supra* note 427, at 5; see also Syron, *supra* note 467, at 11 (calling receivership “an efficient disposition mechanism for thousands of federally insured depository institutions”).

<sup>496</sup> Raines, *supra* note 477, at 13.

<sup>497</sup> *Id.*

<sup>498</sup> *Id.*

<sup>499</sup> Wachter, *supra* note 427, at 5.

These arguments mischaracterize receivership as a mere adjunct to deposit insurance. On the contrary, receivership long predates deposit insurance.<sup>500</sup> Congress enacted the first national bank receivership statute in 1863,<sup>501</sup> seventy years before federal deposit insurance.<sup>502</sup> Receivership also long predates depositors' statutory priority over other creditors,<sup>503</sup> which Congress enacted only in 1993.<sup>504</sup>

*d. Enacting receivership could create harmful uncertainty and make mortgages more costly and less available*

Fannie and Freddie argue that enacting a receivership statute could create harmful uncertainty and make mortgages more costly and less available. “It is unclear,” Fannie notes, “how ... FDIC receivership powers ... would apply to Fannie Mae’s obligations—our debt, our [mortgage-backed securities], and our guaranty.”<sup>505</sup> By imposing new risks on GSEs’ creditors, a receivership statute “could undermine the pricing of existing obligations and cast uncertainty on how new obligations should be priced. The uncertainty would have a greater price impact on longer-term securities, and poses risks to the 30-year fixed-rate mortgage. The resulting higher debt prices would translate into higher mortgage

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<sup>500</sup> See generally Swire, *supra* note 244, at 478-79, 490-93.

<sup>501</sup> Act of Feb. 25, 1863, ch. 58, § 29, 12 Stat. 665, 673.

<sup>502</sup> Act of June 16, 1933, ch 89, § 8, 48 Stat. 162, 168-80.

<sup>503</sup> 12 U.S.C. § 1821(d)(11)(A). See p. 51 *supra*.

Fannie mischaracterizes the depositor-preference statute as applying only to insured depositors, asserting that “insured depositors have the first call on the failed bank’s assets” and that receivership “is necessary in order to put the FDIC—and thereby the taxpayers—first in line among the creditors of a failed bank,” Raines, *supra* note 477, at 13. In fact, the statute makes no distinction between insured and uninsured depositors: both have priority. See 12 U.S.C. § 1821(d)(11)(A).

<sup>504</sup> Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 3001(a), 107 Stat. 312, 336 (1993).

<sup>505</sup> Raines, *supra* note 477, at 13.

rates for consumers.”<sup>506</sup> Similarly, Freddie warns that “a change to receivership ... could have significant implications on [sic] our ability to support the market for 30-year fixed-rate mortgages.”<sup>507</sup> In opposing receivership, Senator Paul Sarbanes declared, “We are literally playing with dynamite here, and we need to recognize that.”<sup>508</sup>

Any significant legal reform creates some transitional uncertainty. But a properly designed receivership statute would greatly reduce legal uncertainty relating to a troubled GSE. As previously discussed,<sup>509</sup> uncertainty about the priority of claims against a GSE—and the process for handling such claims—could worsen the GSE’s problems and the potential for harm to financial markets and housing finance. Moreover, the GSEs’ arguments underestimate markets’ ability to deal over time with uncertainty. Fannie asserts that a receivership statute “could undermine the pricing of existing obligations and cast uncertainty on how new obligations should be priced,” “pos[ing] risks to the 30-year fixed-rate mortgage.”<sup>510</sup> Yet markets deal regularly with uncertainty about government budget deficits, monetary policy, currency revaluations, macroeconomic growth and recession, war, terrorism, natural disasters, and changing consumer preferences. To take

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<sup>506</sup> *Id.* at 13-14. Fannie stressed these themes in a television advertisement broadcast during the week before the Senate Banking Committee considered the Shelby bill, *supra* note 446:

The commercials, which began running in heavy rotation in the Washington market during the last week of March, feature a minority couple talking over their kitchen table about new congressional regulations for Fannie Mae. “Will that keep us from getting that lower mortgage rate?” the woman asks in the ad. “Some economists say rates may go up,” her partner responds. “But that could mean we won’t be able to afford the new house,” she says. A narrator cuts in to warn Congress against taking the “wrong path” and closing the door of homeownership for millions of Americans.”

*Senate Banking Committee Narrowly Passes GSE Regulatory Reform Bill on 12-9 (Nearly) Party-Line Vote*, THE GSE REP., Apr. 12, 2004, at 5; *see also* Bethany Mclean, *The Fall of Fannie Mae*, FORTUNE, Jan. 10, 2005, at 122.

<sup>507</sup> Syron, *supra* note 467, at 11-12.

<sup>508</sup> Rob Blackwell, *Close Panel Vote Said to Kill GSE Bill*, AM. BANKER, Apr. 2, 2004, at 1.

<sup>509</sup> *See* pp. 69-72 *supra*.

<sup>510</sup> Raines, *supra* note 477, at 13-14.

more specific examples, markets already price the risk that future hurricanes will cause catastrophic losses in Florida<sup>511</sup> or that the Chilean peso will fall relative to the euro. Markets should easily be able to handle transitional legal uncertainty about a receivership statute for two solvent GSEs.

The GSEs' arguments about thirty-year fixed-rate mortgages invite questions about the value of the GSEs' activities. If Fannie and Freddie lower mortgage interest rates only slightly,<sup>512</sup> how great is the risk that a receivership statute would cause "higher mortgage rates for consumers"<sup>513</sup>? If a receivership statute, by increasing Freddie's borrowing costs, "could have significant implications on our ability to support the market for 30-year fixed-rate mortgages,"<sup>514</sup> then in what sense did and does Freddie "support the market"? For its first two decades Freddie securitized mortgages without holding them in its portfolio,<sup>515</sup> and thus had little need for long-term borrowing. Like Fannie, Freddie now borrows large sums to finance an investment portfolio that critics such as Chairman Greenspan say affords little public benefit—even as such portfolios make the GSEs much riskier (and more profitable) than if they acted only as securitizers and guarantors.<sup>516</sup> In any event, homeowners obtained thirty-year fixed-rate mortgages before Freddie amassed an investment portfolio. They obtain such mortgages now in the "jumbo" market, which

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<sup>511</sup> See, e.g., U.S. CONG. BUDGET OFFICE, FEDERAL REINSURANCE FOR DISASTERS 43-47 (2002).

<sup>512</sup> See p. **Error! Bookmark not defined.** *supra*.

<sup>513</sup> Raines, *supra* note 477, at 13-14.

<sup>514</sup> Syron, *supra* note 467, at 11-12.

<sup>515</sup> See p. 17 *supra*.

<sup>516</sup> See Greenspan, *supra* note 18, at 2-7, 9-10.

Fannie and Freddie cannot serve.<sup>517</sup> We can reasonably expect that a receivership statute would not impede homeowners from continuing to obtain such mortgages.

*e. Enacting receivership would unfairly contravene the expectations of GSEs' creditors*

The GSEs complain that receivership would unfairly contravene the expectations of GSEs' creditors. According to Fannie, “enacting a receivership provision unfairly imposes new risks on holders of existing obligations that they could not have anticipated at the time they purchased these obligations.”<sup>518</sup> According to Freddie, receivership “could potentially disrupt the legal obligations and expectations of market participants.”<sup>519</sup> Yet the potential for the government to change the legal framework for Fannie and Freddie—or end their government sponsorship altogether—has existed all along. It forms part of the political risk market participants consider when analyzing GSEs' debt and equity securities.<sup>520</sup> Freddie's own debt agreements foresee the possibility of receivership by defining the events of default to include any judicial or other appointment of a receiver but

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<sup>517</sup> Fannie and Freddie cannot deal in mortgages that exceed the conforming loan limit, 12 U.S.C. §§ 1454(a)(2), 1717(b)(2), a dollar amount adjusted for changes in housing prices. Jumbo mortgages exceed that limit.

<sup>518</sup> Raines, *supra* note 477, at 13.

<sup>519</sup> Syron, *supra* note 467, at 11.

<sup>520</sup> *See, e.g.*, Standard & Poor's, Subordinated Debt Ratings Reflect Unsupported Creditworthiness of Fannie Mae and Freddie Mac (Mar. 2fs6, 2001) (stating that Standard & Poor's rated the GSEs' subordinated debt “from a financial, not a political, perspective, since the potential for payment default is present”), quoted in Fahey, *supra* note 417, at 4.

In May 2004 Standard & Poor's announced that it no longer had “the highest degree of confidence that the government would ensure full and timely payment” on the GSEs' senior unsecured debt securities, and that it had accordingly changed its rating process for GSE securities to place more weight on the GSEs' own financial condition. *See* Standard & Poor's, Fannie Mae and Other GSEs Ratings Affirmed; Outlook Stable (May 6, 2004) (on file with author).

exclude OFHEO's appointment of a conservator.<sup>521</sup> In any event, the GSEs' creditors have no moral (much less legal) right to demand the continuation of the current, inadequate<sup>522</sup> insolvency statutes.

*f. Enacting receivership would encourage privatization*

Opponents characterize receivership as “a stalking horse for privatization.”<sup>523</sup>

Freddie notes that “Many market participants might view a change to receivership as a first step to privatization of the GSEs.”<sup>524</sup> Senator Charles Schumer asserts that the Shelby bill “opens the door to the complete privatization of Fannie and Freddie—the end of GSEs as we know [them].”<sup>525</sup> But enacting adequate insolvency mechanisms for Fannie and Freddie would not remove the two GSEs' government sponsorship or alter their explicit government benefits. Although subject to receivership,<sup>526</sup> the Federal Home Loan Bank System, Farm Credit System, and Farmer Mac remain government-sponsored enterprises.

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<sup>521</sup> See, e.g., Fed. Home Loan Mortgage Corp., Debenture and Medium-Term Note Agreement § 7.01 (Apr. 2, 2004). Under this agreement, an “Event of Default” occurs if:

(iii) a court . . . shall enter a decree or order for relief in respect of Freddie Mac in an involuntary case under any applicable bankruptcy, insolvency or other similar law now or hereafter in effect, or *appoint a receiver, liquidator, assignee, custodian, or sequestrator (or other similar official)* of Freddie Mac or for all or substantially all of its property, or order the winding up or liquidation of its affairs . . . ; or (iv) Freddie Mac shall commence a voluntary case under any applicable bankruptcy, insolvency or other similar law now or hereafter in effect, or shall consent to the entry of an order for relief in an involuntary case under any such law, or shall consent to the *appointment of* or taking possession by *a receiver, liquidator, assignee, trustee, custodian, or sequestrator (or other similar official)* of Freddie Mac or any substantial part of its property. . . .

*Id.* (emphasis added). The agreement specifies that the “appointment of a conservator (or other similar official) by a regulator having jurisdiction over Freddie Mac” does not constitute an event of default. *Id.*

<sup>522</sup> See Parts IV-A-1 and V *supra*.

<sup>523</sup> See, e.g., *Observers Say the Receivership Provision Will Doom the Bill*, THE GSE REP., Mar. 30, 2004, at 11 (attributing that view to Senate Banking Committee Democrats).

<sup>524</sup> Syron, *supra* note 467, at 11.

<sup>525</sup> Rob Blackwell, *Close Panel Vote Said to Kill GSE Bill*, AM. BANKER, Apr. 2, 2004, at 1.

<sup>526</sup> See Part IV-B to -D *supra*.

Conventional lists of GSEs' explicit government benefits do not include exemption from bankruptcy or receivership.<sup>527</sup> Thus removing Fannie and Freddie's government sponsorship would remain a separate decision from enacting receivership.

*g. Conclusion*

Fannie and Freddie's arguments against receivership ignore the shortcomings of the current conservatorship statute<sup>528</sup> and the availability of nonliquidating forms of receivership,<sup>529</sup> misstate bank receivership law,<sup>530</sup> show some lack of candor,<sup>531</sup> and rely heavily on vague, unsubstantiated assertions about the cost and availability of mortgages<sup>532</sup>—assertions at variance with the proliferation of market-based risk-management mechanisms<sup>533</sup> and with mounting evidence that the two GSEs reduce mortgage interest rates only slightly.<sup>534</sup> Considering how prominently receivership figured in the congressional debates of 2004, the GSEs' arguments are strikingly weak.<sup>535</sup>

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<sup>527</sup> See, e.g., CBO, PUBLIC COSTS AND BENEFITS, *supra* note 5, at 10; U.S. DEP'T OF THE TREASURY, GOVERNMENT SPONSORSHIP OF THE FEDERAL NATIONAL MORTGAGE ASSOCIATION AND THE FEDERAL HOME LOAN MORTGAGE CORPORATION 26 (1996); 1990 TREASURY GSE REPORT., *supra* note 131, at 4.

<sup>528</sup> See Parts IV-A-1 and V and pp. 79-82 *supra*.

<sup>529</sup> See p. 84 *supra*.

<sup>530</sup> See p. 85 *supra*.

<sup>531</sup> See p. 90 *supra*. Administration officials reportedly "refer[red] to Fannie's efforts to undermine the receivership provision as 'deceivership.'" Mclean, *supra* note 506.

<sup>532</sup> See p. 87 *supra*.

<sup>533</sup> See p. 88 *supra*.

<sup>534</sup> See Part I-D-2 *supra*.

<sup>535</sup> After the 2004 presidential election, Fannie indicated that it would support GSE regulatory reform legislation but wanted to ensure "that the federal government would give explicit protection to mortgage-backed securities holders if Fannie Mae were ever forced into receivership." See Jeffrey H. Birnbaum, *Fannie Supports New Regulator, But Wants a Say; Company Hopes to Get Its Way on Bill's Details*, WASH. POST, Nov. 26, 2004, at E1 (summarizing remarks by Charles V. Greener, Fannie's senior vice president for Communications).

## B. Bankruptcy Code

As an alternative to enacting a receivership mechanism for Fannie and Freddie, Congress could permit liquidation and reorganization under the Bankruptcy Code. In basic concept this change would involve making Fannie and Freddie “persons” for purposes of the code.<sup>536</sup> Congress would need to decide who could initiate a GSE bankruptcy case. The code allows voluntary petitions by debtors<sup>537</sup> and involuntary petitions by creditors.<sup>538</sup> By contrast, banking law and current GSE insolvency statutes allow only regulators to initiate insolvency proceedings.<sup>539</sup>

## VII. ARE GSEs TOO BIG TO FAIL?

GSEs are often characterized as “too big to fail” in the sense that the federal government would rescue their creditors rather than risk the economic dislocation that might ensue if those creditors were not promptly paid.<sup>540</sup> Although such a “too big to fail” characterization necessarily turns on some notion of systemic risk, its proponents often evince only a sketchy understanding of such risk. We should be wary of conventional

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<sup>536</sup> See p. 35 *supra*. One could, for example, effectuate such a change by specifying that Fannie and Freddie are “persons” under 11 U.S.C. § 101(27).

<sup>537</sup> See 11 U.S.C. § 301.

<sup>538</sup> See *id.* § 303.

<sup>539</sup> See Parts III and IV *supra*.

<sup>540</sup> See, e.g., Paula Dwyer, *Breaking Up Is Good to Do*, BUS. WEEK, Oct. 13, 2003, at 115 (“Fannie and Freddie are clearly too big to fail”).

wisdom to the effect that large financial institutions are intrinsically too big to fail,<sup>541</sup> and should focus, instead, on the ways in which such institutions could pose systemic risk.

Systemic risk is not a force of nature like earthquakes, hurricanes, and tornados. It results from human decisions about how to structure the financial system, what risks to take, and how to respond to problems. As defined by the Treasury Department, “systemic risk” denotes “the possibility of a sudden, usually unexpected, event that disrupts the financial markets, and thus the efficient channeling of resources, quickly enough and on a large enough scale to cause a significant loss to the real economy.”<sup>542</sup> The disruptive event can be (1) a “cascade,” in which the failure of one firm triggers the failure of other firms to which the failed firm owed money;<sup>543</sup> (2) a “contagion,” in which creditors panic and run even on healthy firms because creditors do not have enough timely, accurate information to distinguish healthy firms from unhealthy firms;<sup>544</sup> and (3) an “asset implosion,” a “sudden and sustained drop in asset values.”<sup>545</sup> Other financial institutions do have significant credit exposure to GSEs, particularly the housing GSEs,<sup>546</sup> creating some potential for a cascade. But contagion probably poses the greater risk.<sup>547</sup>

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<sup>541</sup> See, e.g., Lavargna, *supra* note 35, at 192.

<sup>542</sup> ROBERT E. LITAN & JONATHAN RAUCH, U.S. DEP’T OF THE TREASURY, AMERICAN FINANCE FOR THE 21ST CENTURY 98 (1997) [hereinafter AMERICAN FINANCE FOR THE 21ST CENTURY]. For good discussions of systemic risk, see GARY H. STERN & RON J. FELDMAN, TOO BIG TO FAIL: THE HAZARDS OF BANK BAILOUTS (2004); E.P. DAVIS, DEBT, FINANCIAL FRAGILITY, AND SYSTEMIC RISK (1992).

<sup>543</sup> AMERICAN FINANCE FOR THE 21ST CENTURY, *supra* note 542, at 98-99.

<sup>544</sup> *Id.* at 103.

<sup>545</sup> *Id.* at 107.

<sup>546</sup> See p. 66 *supra*.

<sup>547</sup> See p. 69 *supra*.

Investors' expectations play a large role in shaping any governmental decision to treat a financial institution as too big to fail. If investors regard a firm as too big to fail, they will lend to the firm based not just on the firm's own financial strength but on the expectation that the government would rescue the firm if it did encounter financial trouble. Thus investors' perception of the firm as too big to fail weakens market discipline on the firm and enables the firm to grow larger and take greater risks than it otherwise could have. The firm's greater risk-taking increases the probability that the firm will encounter problems. The firm's greater size—and the commensurately greater credit exposure of other financial institutions—increases the potential for the firm's failure to do unacceptable damage to the financial system and elicit a governmental rescue. Thus “too big to fail” treatment has a basic circularity, in which investors' expectations of such treatment help create circumstances that make a governmental rescue more likely.<sup>548</sup>

But the link between investors' expectations and systemic risk also creates opportunities for the government to reduce the potential for such risk (and the pressure for “too big to fail” treatment) by taking timely action to correct “too big to fail” expectations. The FDIC Improvement Act of 1991 (FDICIA)<sup>549</sup> curtailed the FDIC's practice of treating large banks as “too big to fail”: i.e., protecting all depositors regardless of the \$100,000

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<sup>548</sup> If a large firm's troubles coincide with a broader financial crisis, policymakers will face additional pressures to rescue the firm. Upsetting longstanding expectations during a crisis risks creating contagious uncertainty about the government's willingness to meet other important expectations. A crisis is thus a particularly inopportune time for attempting to reeducate market participants about the scope of the government's undertakings. If during good times the government fails to challenge “too big to fail” expectations, it may during a crisis find itself constrained to rescue a GSE against its better judgment.

<sup>549</sup> Pub. L. No. 102-242, 105 Stat. 2236 (1991).

limit on deposit insurance coverage.<sup>550</sup> Under FDICIA’s “least-cost resolution” rule, the FDIC can protect a failed bank’s uninsured depositors only if doing so is the “least costly to the deposit insurance fund of all possible methods” for meeting the FDIC’s obligation to insured depositors.<sup>551</sup> The rule has a narrow, never-used systemic-risk exception.<sup>552</sup> Before FDICIA, the FDIC was draining money from the insurance fund to protect uninsured depositors at banks as small as \$500 million in total assets. But less than one year later, when an \$8.8 billion bank group in the swing state of Texas failed shortly before the 1992 Presidential election, the FDIC did not protect uninsured depositors and financial markets took that action in stride. By giving clear and timely notice of the new policy, Congress had succeeded in changing market participants’ expectations.<sup>553</sup>

Insofar as GSEs can pose systemic risk, policymakers should act now to reduce the potential risk. Thus, for example, if banks’ large holdings of GSE debt securities could create a cascade—in which a GSE’s default would undermine many banks’ solvency—bank regulators should more closely scrutinize banks’ holdings of GSE debt securities. Similarly, if a GSE’s failure could unleash contagion because creditors could

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<sup>550</sup> See generally Carnell, *supra* note 248, at 363-68.

<sup>551</sup> See 12 U.S.C. § 1823(c)(4).

<sup>552</sup> *Id.* § 1823(c)(4)(G).

<sup>553</sup> By engineering a bailout of Long Term Capital Management in 1998, see generally ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT 195-210 (2000), the Federal Reserve Bank of New York squandered some of FDICIA’s hard-won gains. Yet the dramatic change in how the FDIC dealt with failed banks during the early 1990s shows that progress can be made in curtailing too-big-to-fail treatment.

not distinguish healthy from unhealthy financial institutions, policymakers should act now to improve the timeliness and quality of disclosure.<sup>554</sup>

Insofar as GSEs' size contributes to systemic risk, Congress can and should take steps to limit their size—steps that would make sense in any event. Chairman Greenspan has rightly pointed out that the housing GSEs' size and riskiness arise largely from their investment portfolios,<sup>555</sup> which the GSEs fund by issuing debt securities. These portfolios, although highly profitable for the GSEs, offer few public benefits.<sup>556</sup> As Greenspan has declared, “Fannie and Freddie should be encouraged to continue to expand mortgage securitization, keeping mortgage markets deep and liquid while limiting the size of their portfolios.”<sup>557</sup> Requiring orderly shrinkage of those portfolios would diminish reduce the risk that a GSE would fail. By reducing the GSEs' outstanding indebtedness (and the volume of over-the-counter derivatives contracts the GSEs need to hedge their interest-rate risk), such shrinkage would also reduce other financial institutions' credit exposure to the GSEs and thus reduce the potential for systemic risk to arise from a GSE's failure.<sup>558</sup>

Although we cannot banish systemic risk, we need not and should not be complacent about

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<sup>554</sup> For an explanation of how requiring financial institutions to have subordinated debt outstanding can improve disclosure and market discipline, see, e.g., Douglas D. Evanoff & Larry D. Wall, *Reforming Bank Capital Regulation: Using Subordinated Debt to Enhance Market and Supervisory Discipline*, 19 CONTEMP. ECON. POL'Y 444 (2001).

<sup>555</sup> See Greenspan, *supra* note 18, at 9-10.

<sup>556</sup> Greenspan observes:

Deep and liquid markets for mortgages are made using mortgage-backed securities that are held by non-GSE private investors. Fannie's and Freddie's purchases of their own or each other's securities with their debt do not appear needed to supply mortgage market liquidity or to enhance capital markets in the United States.

*Id.* at 10. See also p. 28 *supra*.

<sup>557</sup> See Greenspan, *supra* note 18, at 11.

<sup>558</sup> See *id.* at 10.

it. GSEs' size and importance, far from obviating workable liquidation and reorganization mechanisms, underscores the need for such mechanisms.

### VIII. AMBIGUITY AND INCENTIVE CONFLICTS

GSEs provide a case study in policymakers' use and abuse of ambiguity. Bond-market investors, undeterred by official disclaimers and the lack of any legally enforceable guarantee, expect the federal government to assure full payment of GSEs' obligations.<sup>559</sup> Investors accordingly lend GSEs vast sums at low interest rates—a kind of quasi-governmental funding that circumvents normal mechanisms of governmental accountability, including the budget process, requirements for annual appropriation and periodic reauthorization of government spending, and ordinary political scrutiny of government programs and the government's risk-exposure.<sup>560</sup> Policymakers can use GSEs to promote desired objectives, such as channeling credit to housing and agriculture. Policymakers in effect harness for their own purposes ambiguity about the government's response if a GSE neared default: investors bet on a rescue; government accountability mechanisms assume none would occur. Policymakers acquiesce in the perception of implicit government backing by failing to take stronger measures to disavow such backing.<sup>561</sup>

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<sup>559</sup> See p. 11 *supra*.

<sup>560</sup> See p. 1 and Part I-D-3-b *supra*.

<sup>561</sup> See p. 25 *supra*.

Under some circumstances, policymakers' use of ambiguity may serve the interests of citizens and taxpayers. But not here: ambiguity about the extent of the government's support for GSEs does much to explain the central failures of GSE policy: obtaining insufficient public benefits from the GSEs and providing inadequate safeguards for the government and the financial system. Far from benefiting citizens and taxpayers, ambiguity blunts accountability for the risks and other costs of government sponsorship—thereby promoting complacency about risks and insouciance about the real value of the benefits the GSEs receive.

Although the government makes no explicit cash payments to the GSEs, it lets the GSEs have benefits worth tens of billions of dollars annually.<sup>562</sup> If sold at auction, the right to receive these benefits should command a high price (in the case of the housing GSEs' benefits, perhaps \$100 billion<sup>563</sup>). In forgoing the opportunity to charge the GSEs a fee commensurate with the value of the benefits, the government incurs real costs and provides real subsidies.<sup>564</sup> Yet the GSEs fail to provide commensurate public benefits. The Congressional Budget Office estimates that Fannie and Freddie retain 40 percent of their subsidies;<sup>565</sup> Passmore estimates even greater retention.<sup>566</sup> We have reason to doubt that the housing GSEs significantly lower mortgage interest rates or otherwise significantly

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<sup>562</sup> See p. 26 *supra*.

<sup>563</sup> See p. 26 *supra*.

<sup>564</sup> See p. 27 *supra*.

<sup>565</sup> See p. 29 *supra*.

<sup>566</sup> See p. 29 *supra*.

increase home ownership rates.<sup>567</sup> Nor does the United States still need them to maintain nationwide credit availability, technological progress, and market stability.<sup>568</sup>

In having no reported budgetary effect and needing no appropriation or reauthorization, GSEs sidestep pressure to demonstrate that their subsidies represent the most effective use of the resources in question. This attenuated political accountability helps GSEs' subsidies persist even if poorly targeted toward public purposes and gives the GSEs more leeway to favor their shareholders' interests over their public missions.<sup>569</sup>

Just as ambiguity reduces demands for GSEs to provide adequate public benefits, it also reduces demands to enact adequate safeguards against risks posed by GSEs. The risk of a future GSE bailout has no current budget cost and usually poses minimal current political risk. The absence of a legally enforceable government guarantee serves as an excuse for failing to enact adequate financial-soundness safeguards, including a workable insolvency mechanism for Fannie and Freddie. The reverse side of that ambiguity—investors' expectation of a governmental rescue—actually increases the risk of financial problems by insulating GSEs from market discipline and thus facilitating artificial growth, inadequate capitalization, and other excessive risk-taking by the GSEs.<sup>570</sup>

In sum, by reducing policymakers' accountability for the risks and other costs of GSEs, ambiguity about the extent of government support for GSEs heightens the conflict

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<sup>567</sup> See p. 29 *supra*.

<sup>568</sup> See p. 28 *supra*.

<sup>569</sup> See p. 34 *supra*.

<sup>570</sup> See p. 30 *supra*.

between policymakers' self-interest and their constituents' interests as citizens and taxpayers. Policymakers can take political credit for GSE activities even as they curry favor with GSEs, obtain meager public benefits, and take inadequate precautions against GSE risk.

The lack of adequate insolvency mechanisms for Fannie and Freddie both reinforces investors' perception of implicit government backing and exemplifies the unhealthy political effects of ambiguity. The government sets itself up for (and thus, in a sense, holds itself hostage to) political pressure to bail out a faltering GSE. Yet the absence of any legally enforceable guarantee also attenuates the perceived urgency of enacting adequate insolvency mechanisms.

## **IX. CONCLUSION**

Adequate insolvency mechanisms, drawn from banking law, apply to the Farm Credit System and Farmer Mac. The Federal Housing Finance Board has plenary authority to liquidate or reorganize a Federal Home Loan Bank. But the conservatorship statute for Fannie and Freddie has serious shortcomings. It does not allow a reorganization, nor does it specifically authorize liquidation. By the time OFHEO can place a GSE in conservatorship, the firm's condition may have so deteriorated that the conservator cannot save the firm. Uncertainty exists about a conservator's power to effect a de facto liquidation. Greater uncertainty, with great potential for delay and market disruption, would attend an attempt to use common-law receivership to liquidate or reorganize a GSE.

Nor does any statute specify the relative priority of creditors' claims. If Fannie or Freddie faltered, uncertainty about the priority and process for handling claims could worsen the firm's problems and the potential for harm to financial markets. Such legal uncertainty—combined with creditors' uncertainty about the firm's prospects and the market value of the firm's assets and liabilities—could further reduce the firm's access to credit, the market value and liquidity of claims against the firm, and under extreme circumstances the liquidity of financial markets. Enacting workable liquidation and reorganization mechanisms, including statutory payment priorities, would increase market discipline on the two GSEs and reduce the likelihood of future problems.

A GSE insolvency statute should, at a minimum, (1) authorize a GSE's regulator to appoint a conservator or receiver through a process permitting timely *ex parte* action; (2) afford the GSE a prompt post-seizure judicial hearing; and (3) allow the regulator to prescribe implementing regulations. A well-designed statute should also (4) specify the grounds for conservatorship and receivership; (5) specify priorities among claims; and (6) authorize receivers to establish bridge institutions and effect reorganizations. In prescribing new insolvency mechanisms for Fannie and Freddie, Chairman Shelby's GSE reform proposal met all six of these criteria.<sup>571</sup> But the Bennett Amendment, adopted by the Senate Banking Committee, does much to undercut the Shelby reforms. The amendment would delay any receivership for forty-five days, precipitating a crisis and setting the stage for a congressional bailout.

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<sup>571</sup> See Federal Housing Enterprise Regulatory Reform Act of 2004, *supra* note 446, § 144.

As an alternative to specialized insolvency mechanisms, Congress could remove the current constraints on Fannie and Freddie becoming debtors under the Bankruptcy Code. In so doing it would need to decide who could initiate such a bankruptcy case: the GSE's regulator alone or also the GSE and its creditors.

Ambiguity about the extent of the government's support for GSEs blunts accountability for the risks and other costs of the government's relationship to GSEs. Far from yielding significant benefits for citizens and taxpayers, ambiguity helps explain the central failures of GSE policy: the government's failure to obtain sufficient public benefits from the GSEs and to provide adequate safeguards against risks posed by GSEs. The lack of an adequate insolvency mechanism for Fannie and Freddie exemplifies this failure to provide adequate safeguards.

The lack of such a mechanism also reinforces investors' perception of implicit government backing by giving Congress little practical alternative to rescuing Fannie or Freddie's creditors if the firm were to fail. If one of the other three GSEs failed, the government would have a legally credible option of letting the GSE's creditors incur a loss. No similarly credible option exists in the case of Fannie and Freddie. The lack of such an option gives those firms an augmented perception of implicit backing, as though the government had painted itself into a corner. The lack of such an option also leaves Fannie and Freddie more profitable than if the government expressly guaranteed their debts. Although an express guarantee would reduce borrowing costs, it would almost certainly carry quantitative limits that would curtail the firms' growth. An express

guarantee would also increase pressure to undertake less profitable activities and heighten the risk that Congress would eventually phase out the guarantee.

Regulating Fannie and Freddie but having no adequate receivership mechanism is like investing in an elaborate fire-protection system—complete with firewalls, smoke detectors, heat sensors, alarm bells, and sprinklers—but neglecting to mount a crucial fire door on its hinges. Like fire-safety measures, GSE financial-soundness regulation serves dual purposes. Fire-safety measures protect a building by preventing and extinguishing fires there; they also protect other buildings by inhibiting the spread of fire. Similarly, GSE regulation seeks not only to keep the GSEs themselves safe but to protect the economy from damage that might result from a GSE's failure. Bank regulation serves similar purposes and did so even before federal deposit insurance: seeking both to protect banks' depositors and other creditors and to prevent bank failures from causing broader economic harm. A receivership mechanism, by providing an orderly means for dealing with a failed GSE's obligations, would help limit and contain the harm resulting from a GSE's failure.