



## Revoke All Perpetual GSE Charters

By Alex J. Pollock

*Today's government-sponsored enterprises (GSEs), including Fannie Mae, Freddie Mac, and the Federal Home Loan Banks, have perpetual charters. A better idea, common in financial history, is for GSEs to have limited-life charters. GSE charters that periodically expire and need reauthorization give taxpayers the chance to reconsider the contingent liability GSEs represent, offer the government an opportunity to cut a new deal, and place reformers in a much stronger position. The conditions which give rise to the creation of a particular GSE are likely to change dramatically over a few decades, so no GSE should ever be granted a perpetual charter. The GSE reform legislation now being considered by Congress should be amended to revoke the GSEs' perpetual charters and replace them with limited-life charters.*

Government-sponsored enterprises (GSEs) have special charters that are acts of Congress. These charters grant them privileges and confer upon their shareholders enormous economic benefits. As Andrew Jackson wrote, "Every monopoly and all exclusive privileges are granted at the expense of the public."<sup>1</sup> How long should these privileges last?

All current American GSEs, including Fannie Mae, Freddie Mac, and the Federal Home Loan Banks, have perpetual charters. This is a mistake. Going back to 1694 and the chartering of the Bank of England, which in its origin was an archetypical GSE, history teaches an essential lesson: GSEs, if they are created at all, should always have limited-life charters and should never be granted perpetual ones.

A charter that expires and requires reauthorization gives society a chance to reconsider whether the grant of special privileges is still warranted. Every GSE creates contingent liabilities for taxpayers. Do the taxpayers think the GSE is still worth it? Every GSE represents some kind of arrangement with the government. Maybe the respective benefits and costs have become skewed

and need to be restructured. A limited-life charter gives the government a chance to cut a new deal.

Moreover, GSEs often grow in unintended ways, developing political and economic power, reaping monopoly (or duopoly) profits, and creating market distortions. Limited-life charters put reformers in a much stronger position as the expiration date approaches. For if the GSEs block all legislative action to refine their charters, they cannot continue to operate once they reach the expiration of their charters. At that point, if no action is taken, they become private entities, or they die.

For more than two centuries after the deal that created the Bank of England, politicians who established and sometimes ended GSEs understood the advantages of the limited-life charter. This includes over 120 years of financial history in the United States, from the First Bank of the United States to the Federal Reserve Act. Those politicians who have more recently granted perpetual GSE charters have caused serious problems for their successors.

The substantial difficulty involved in moving legislation to reform the regulation of Fannie Mae and Freddie Mac provides the most recent evidence. In spite of the opportunity presented by their acutely embarrassing accounting scandals costing many billions of dollars and the missteps

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that caused both of their top managements to be forced out, legislative action may end up stalemated. By contrast, the Enron and WorldCom scandals rapidly resulted in the harsh Sarbanes-Oxley Act.

Think how different the situation would be if Fannie and Freddie, following the American historical tradition, had been given twenty-year charters. Fannie's current charter dates from 1968. Assuming it had been renewed in 1988, it would have expired again in 2008. Freddie's current charter dates from 1989 so would be expiring in 2009. If these GSEs were contemplating charter expiration and potential automatic privatization in just three or four years—a heartbeat in historical time—the negotiations over GSE regulation reform would have an altogether different tone, and the chance to enact meaningful reform would have been greatly enhanced.

### Special Circumstances

Each GSE is created in the particular circumstances of some historical moment, with the GSE as an answer—real or perceived—to specific economic and political issues of the time.

Such was the case for the Federal Home Loan Banks (FHLBs), which were chartered under the sponsorship of Herbert Hoover in 1932. In the midst of the vast economic and financial collapse, mortgage loans had become illiquid, or “frozen,” in the terminology of the day. The principal mortgage lenders—who were small, local, mutual savings and loan associations—often could not honor requests for savings withdrawals because they had no cash. So the savings accounts were frozen as well. In these circumstances, it was probably reasonable, at least as a temporary measure, to try using a GSE to re-liquify mortgages and the related savings.

Later in the 1930s, mortgage lending was still a problem, so the Roosevelt administration decided to have the government insure mortgages through the then-new Federal Housing Administration (FHA). The idea was that investors would be willing to buy mortgages based on the government's insurance coverage, but the results fell short of expectations. So Fannie Mae was chartered, originally as a subsidiary of the Reconstruction Finance Corporation,

with the sole purpose of using government funds to buy FHA loans and hold them in portfolio. You could make a reasonable argument that, at least as a temporary measure, it was worth a try.

Fannie's charter was redone in 1968, during the Johnson administration, in order to move its borrowings off the federal budget and hold down the reported deficit. The motivation was clear, anyway.

Special circumstances surrounded Freddie Mac's creation too. In 1970, the government was engaged in setting ceilings on the interest rates that could be paid on deposits, through the then-famous Regulation Q. Through this federal regulation, the government practiced nationwide price fixing in the deposit market, so that financial institutions could not compete by offering interest rates that were “too high.” When market interest rates went above the regulatory ceilings, as they did with increasing frequency beginning in the mid-1960s—surprise!—savers withdrew deposits from savings and loan associations (still the predominant mortgage lenders). There were insufficient funds to meet mortgage demand, and mortgages were rationed. This was considered an emergency in housing finance, so to correct for one government intervention, a second intervention in the form of a GSE seemed necessary. A related idea, and not a bad one, was to introduce securitization of conforming mortgages.

In 1989, Freddie, in a brilliant political maneuver, slipped a much more favorable charter into the thrift bailout legislation when all eyes were on the savings and loan industry collapse and its associated scandals.

Every GSE gets special benefits, privileges, and economic advantages for its shareholders because it addresses problems politicians are facing at the time. Every GSE represents a deal with the government, which is willing to create contingent taxpayer liability in the context of specific historical circumstances. It would be astonishing if these circumstances did not dramatically change in the course of several decades, making the original deal passé, if not completely irrelevant. Moreover, not only do circumstances necessarily alter, but GSEs themselves also develop in ways never intended or foreseen by their designers.

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There needs to be a required point of reconsideration that stalemate and blocking tactics cannot avoid: a charter expiration date. This required recalibration simply makes good sense for the taxpayers, who are on the hook, and for the government, which is party to the deal, so that they can observe how much things have changed and adjust accordingly. With limited-life charters, the question can—indeed must—be posed: “Okay, what should the arrangement be now?”

## The Situation Today

None of the circumstances which prompted the creation of America’s current GSEs still exists. The assumptions behind their deals with the government have changed beyond all recognition.

In the case of the Federal Home Loan Banks, savings and loan associations are no longer the principal providers of mortgages. Both mortgages and savings instruments are now extremely liquid and traded in active, internationalized markets. Small savings and loan associations in particular represent a minor part of the housing finance market. The principal customers of the FHLBs are giant interstate banks—the exact opposite of the original intended customers, the local mutual thrifts of the 1930s.

Fannie Mae not only no longer buys FHA loans but is also a principal competitor of the FHA. This causes the FHA to suffer severe adverse selection, since Fannie takes the better credits and the riskier loans flow to the FHA, thus contributing to its daunting mortgage loan delinquency ratios. Although its luster has dimmed recently, Fannie became a feared and intimidating political powerhouse—certainly not part of the original intent.

As for Freddie Mac, Regulation Q is long dead and there is no more rationing of mortgage credit—indeed, the problem now is excess mortgage credit fueling house price inflation. Securitization of mortgages is well established, and advanced financial technologies are firmly institutionalized.

None of the problems to which GSEs were considered solutions were permanent problems—and none warranted a perpetual charter.

## The Lessons of History

Let us turn to the history of the better choice, the limited-life charter.

*The Bank of England.*<sup>2</sup> Parliament granted the first charter of the Bank of England on July 27, 1694, in the Continuance of the Bank of England Act. The government was desperately short of money as a result of King William’s wars, and the government’s arrangement with the new private investor-owned GSE was straightforward. The bank would get special banking privileges; in return, it would lend its entire capital to the government by buying government bonds to finance the war against France.

The charter was known to be favorable to the bank at the time, which reflected the exigencies of war finance. A charter life of two years was proposed at one point, but negotiators finally settled on a seventeen-year charter, with the government able to end the charter upon one year’s notice beginning in 1710.

The bank was rechartered early in 1697, with the government again in pressing need of money. The loans to the government grew larger, and Parliament sweetened the charter. This was the first of nine recharterings, which usually occurred in exchange for additional loans, and sometimes grants, to help the government. The nature of the deals between the GSE and the government was clear. For example, the 1742 renewal act of Parliament was called—with remarkable candor—“An Act for Establishing an Agreement with the Governor and Company of the Bank of England for the Sum of £1,600,000 towards the Supply for the Service for the Year.”

The essence of the rechartering process has been instructively summarized as follows:

Recharters were crucial aspects of the contract between the Bank and the government. . . . We conceive of Bank of England charters as mutually beneficial exchanges between the government and the Bank’s private owners (shareholders) designed to ensure . . . that both parties lived up to the agreement in the face of changing circumstances. A single permanent contract could not be written to cover all future contingencies, nor could it prevent either party from acting opportunistically ex post. . . . The rechartering process allowed the government and the Bank to adjust to changing economic and political conditions.<sup>3</sup>

The charter of the Bank of England was renewed, subject to various negotiations, nine times between 1697 and 1844—the last time for a minimum ten-year period. In the course of this development, Sir John H. Clapham

remarked, “By habit, not by law, the Bank of England had become bank to the state.”<sup>4</sup>

The government had the right to terminate the charter any time beginning in 1855, but chose not to act until 1946. Then the Bank of England was nationalized, its private stockholders were compensated, and it ceased to exist as a GSE.

*The First Bank of the United States.*<sup>5</sup> Alexander Hamilton favored the idea of government-sponsored enterprises. As secretary of the treasury, he proposed a national bank on the model of the Bank of England—one that was connected to the government but privately owned and managed, because “the keen, steady . . . sense of their own interest as proprietors . . . is the only security that can always be relied upon.”<sup>6</sup> After a debate between Hamilton and Thomas Jefferson over the constitutionality of a national bank, George Washington agreed to the plan, and America’s first GSE was chartered in 1791.

It was given a twenty-year charter.

The subsequent history clearly shows the power of a limited-life charter to force reconsideration of a GSE. When the charter expired in 1811, Congress voted not to renew it, and the first American GSE simply closed down.

*The Second Bank of the United States.*<sup>7</sup> With James Madison as president, Congress created the next GSE, the Second Bank of the United States, in 1816. Indicating its government sponsorship, five of its directors were appointed by President Madison, while the others were elected by the shareholders.

The charter lasted for twenty years, expiring in 1836.

The dispute over whether this charter should be renewed is known as the famous “Bank War” between Andrew Jackson and Nicholas Biddle, president of the bank. Congress passed an act to recharter the bank in 1832. Jackson vetoed it, accompanying his veto with a message of striking intellectual clarity and rhetorical vigor, which stands as a timeless critique of GSEs. Jackson observed:

The powers, privileges and favors bestowed in the original charter operate as a gratuity to the stockholders.

If the government sell monopolies and exclusive privileges, then they should at least exact for them as much as they are worth in the open market.

Admit that the bank ought to be perpetual, and as a consequence the present stockholders will be established as a privileged order, clothed both with great political power and enjoying immense pecuniary advantages from their connection with the government.

If we can not at once make our government what it ought to be, we can at least take a stand against grants of monopolies and exclusive privileges.<sup>8</sup>

Jackson’s veto stood. In 1836 the Second Bank of the United States ceased to exist as a GSE and became a private sector bank.

*U.S. National Banks.*<sup>9</sup> The chartering of U.S. national banks under the original National Banking Acts of 1863 and 1864 strongly resembled the GSE arrangement that first created the Bank of England. It was the middle of the Civil War, when there was a pressing need for war financing. The new GSEs were given a valuable privilege—the ability as privately owned banking companies to print money in the form of their own circulating bank notes—but in exchange, they had to lend an equivalent amount to the government by buying its bonds. This is what the Federal Reserve Banks do today.

All national banks originally had twenty-year charters.

These charters were renewed until the 1920s, when the national banks mounted a lobbying campaign to obtain perpetual charters instead. Their campaign was ultimately successful, and the McFadden Act of 1927 converted all national bank operations to perpetual charters.

By this time, however, the Federal Reserve was well established, and its authority to issue money was superceding that of the national banks. In the 1930s, the power of national banks to issue circulating bank notes was terminated, thus making obsolete the original GSE charter deal with the government. So as their charters became perpetual, the national banks also ceased to be GSEs.

*The Federal Reserve Banks.*<sup>10</sup> The authors of the Federal Reserve Act of 1913 were keenly aware of banking history and in particular of the war over the charter of the Second Bank of the United States. The Federal Reserve Banks they created were very closely tied to the government but were also corporations with stockholders (the participating commercial banks). Uncertainty over how these relationships would work prompted Congress to

give the original Federal Reserve Banks twenty-year charters, running from 1914 to 1934.

An interesting historical speculation is what would have happened had the Federal Reserve Bank charters been up for renewal at the bottom of the Great Depression. In the event, however, the same McFadden Act of 1927 also converted the operations of the Federal Reserve Banks to perpetual charters. A contemporary commentary argued: "This is the most significant section in the Act. It forever removes the question of charter renewal from the domain of partisan politics and from the danger of bargaining for renewal."<sup>11</sup>

In one sense, this argument was wrong-headed. The question of charter renewal and the bargaining that accompanies it are precisely what should happen with a GSE. However, by then it had become clear that the Federal Reserve was really part of the government and not a GSE like the Second Bank of the United States. Although in the tradition of GSEs, it had proved exceptionally useful in financing the government during the First World War, the formal shareholders in no sense actually owned or controlled the Federal Reserve Banks. Complete control and ownership of the immense residual economic value created by the Federal Reserve's charter monopoly and special privileges belonged, then as now, entirely to the government.

The shift to perpetual charters accompanied the fact that the Federal Reserve Banks had not become GSEs. Unfortunately, the 1927 act seems to have set a precedent for the granting of perpetual charters, which were later inappropriately applied to the GSEs we know today.

### Limited-Life Charters for Today's GSEs

No GSE should have a perpetual charter. All existing perpetual GSE charters should be revoked and replaced by limited-life charters.

The GSE reform legislation now being considered by Congress presents an opportunity to address this fundamental problem. The House of Representatives has passed a GSE reform bill, and the Senate Banking Committee has reported out a bill which is still under discussion. It is not too late to apply the lessons of GSE history. Congress should give Fannie Mae, Freddie Mac, and the Federal Home Loan Banks limited-life charters.

Although hawks on GSE reform would prefer ten-year charters, twenty years, as this historical survey has shown, is the American tradition for GSE charters. This would set the charter expirations for Fannie, Freddie, and the FHLBs in 2025.

Having established the essential principle of limited-life charters in these three cases, it should then be extended to every other existing GSE, such as the Farm Credit Banks, and to any GSEs that may be created in the future.

### Notes

1. Andrew Jackson, message accompanying his veto of an act to re-charter the Second Bank of the United States, 1832, quoted in Richard D. Hoffman, *A Documentary History of the United States* (New York: New American Library, 1999), 109.

2. On the charters of the Bank of England, see Sir John Harold Clapham, *The Bank of England: A History* (Cambridge: Cambridge University Press, 1944), vol. 1 and 2; and J. Lawrence Broz and Richard S. Grossman, "Paying for Privilege: The Political Economy of Bank of England Charters, 1694–1843," *Explorations in Economic History* 41 (2004): 48–72.

3. Broz and Grossman, "Paying for Privilege," 58–60.

4. Sir John Harold Clapham, *The Bank of England: A History*, vol. 1, 101.

5. On the First Bank of the United States, see Bernard Shull, *The Fourth Branch: The Federal Reserve's Unlikely Rise to Power and Influence* (Westport, CT: Praeger, 2005), chap. 2.

6. *Ibid.*, 19.

7. On the Second Bank of the United States, see Shull, *The Fourth Branch*.

8. Andrew Jackson's veto message quoted in Hoffman, *A Documentary History*, 109.

9. On U.S. national bank charters, see H. H. Preston, "The McFadden Banking Act," *The American Economic Review* 17 (1927): 201–218; and Senate Subcommittee of the Committee on Banking and Currency, *Perpetual Charters for National Banks: Hearing on S. 3255, 67th Cong., 2nd session, 1922*, 1–9.

10. On the Federal Reserve Bank charters, see Shull, *The Fourth Branch*; and Allan H. Meltzer, "Lessons from the Early History of the Federal Reserve" (presidential address, International Atlantic Economic Society, Munich, March 17, 2000).

11. Law firm of Kiplinger, Babson and Jacobs, *Analysis of McFadden Act* (Washington, D.C.: Kiplinger, Babson and Jacobs, 1927), 48.