The federal government recently placed Fannie Mae and Freddie Mac, the government-chartered, privately owned mortgage finance companies, in conservatorship. These two massive companies are profit-driven, but as government-sponsored enterprises (GSEs) they also have a government-mandated mission to provide liquidity and stability to the U.S. mortgage market and to achieve certain affordable housing goals. How the two companies should exit their conservatorship has implications that reach throughout the global financial markets and are of key importance to the future of American housing finance policy.

While the American taxpayer will be required to fund a bailout of the two companies that will be measured in the hundreds of billions of dollars, the current state of affairs presents an opportunity to reform the two companies and the manner in which the residential mortgage market is structured. Few scholars, however, have provided a framework in which to conceptualize the possibilities for reform.

This analysis employs regulatory theory to construct such a framework. A critical insight of this body of literature is that regulatory privilege should be presumed to be inconsistent with a competitive market, unless proven otherwise. The federal government’s special treatment of Fannie and Freddie is an extraordinary regulatory privilege in terms of its absolute value, its impact on its competitors, and its cost to the federal government. Regulatory theory thereby clarifies how Fannie and Freddie have relied upon their hybrid public/private structure to obtain and protect economic rents at the expense of taxpayers as well as Fannie and Freddie’s competitors.

Once analyzed in the context of regulatory theory, Fannie and Freddie’s future seems clear. They should be privatized so that they can compete on an even playing field with other financial institutions, and their public functions should be assumed by pure government actors. While this is a radical solution and one that would have been considered politically naive until the recent credit crisis, it is now a serious option that should garner additional attention once its rationale is set forth.
Introduction

As part of its response to the ongoing credit crisis, the federal government recently placed Fannie Mae and Freddie Mac, the government-chartered, privately owned mortgage finance companies, in conservatorship. These two massive companies are profit-driven, but as government-sponsored enterprises (GSEs) they also have a government-mandated mission to provide liquidity and stability to the U.S. mortgage market and to achieve certain affordable housing goals.1 How the two companies should exit their conservatorship is of key importance to the future of federal housing finance policy. Indeed, this question is of pressing importance as the Obama administration has signaled that it would rely heavily on Fannie and Freddie as part of the short-term response to the foreclosure epidemic that has swept across America in the last couple of years.2 Once the acute crisis is dealt with, however, the administration will need to put American housing finance policy on the right track for the long-term health of the system. This will require a framework for analyzing the needs of that system, a framework which this analysis provides.

Fannie and Freddie are extraordinarily large companies: together, they own or guarantee more than 40 percent of all the residential mortgages in the United States.3 This amounts to more than 5.2 trillion dollars in mortgages.4 By statute, Fannie and Freddie’s operations are limited to the “conforming” portion of the mortgage market, which is made up of mortgages that do not exceed an annually adjusted threshold ($417,000 in 2009). The two companies effectively have no competition in the conforming sector of the mortgage market because of advantages granted to them by the federal government in their charters.5 The most significant of these advantages has been the federal government’s implied guarantee of Fannie and Freddie’s debt obligations.6 The implied guarantee allowed Fannie and Freddie to borrow funds more cheaply than its fully private competitors and thereby offer the most attractive pricing in the conforming market.7 As the two companies have grown immense, numerous commentators and government officials called for their reform; Fannie and Freddie’s powerful lobbying forces, however, have kept these reformers mostly at bay.8

As a result, Fannie and Freddie continued to grow at a rapid rate through the early 2000s, until they were each hit by accounting scandals.9 In response to those scandals, Congress and the two companies’ regulators began to take various steps to limit their growth. But once they stabilized in 2007, the current credit crisis commenced and their market share began to increase once again as other lenders could not raise capital to lend to borrowers.10 At first, many commentators believed that Fannie and Freddie would ride the crisis relatively unscathed, but it turned out that they had much more exposure to the problems in the toxic subprime and Alt-A portions of the mortgage market than they had let on in their public disclosures.11

Because of their poor underwriting, the two companies started posting quarterly losses in 2007 that ran into the billions of dollars, with larger losses on the horizon.12 As a result, they were having trouble complying with the capital requirements set by their regulator.13 Their problems began to spiral out of control along with those of the rest of the financial sector until then-secretary of the Treasury Henry M. Paulson, Jr., asked that Congress give the Treasury the authority to take over the two companies if they were not able to meet their financial obligations. With remarkable alacrity, Congress passed the Housing and Economic Recovery Act of 2008 (“the Act”) in the summer of 2008. Soon thereafter Paulson decided that the two companies were flirting with insolvency and placed them in conservatorship, pursuant to the Act.

Although the American taxpayer will likely be required to fund a bailout of the two companies that will be measured in the hundreds of billions of dollars, the current
state of affairs presents an opportunity to reform the two companies and the manner in which the mortgage market is structured. Though the need for reform is evident, few scholars have considered the issue systematically. Scholars have, however, built up a significant base of knowledge about what works well and what does not work well with public/private hybrids like Fannie and Freddie.

Contemporary theories of regulation persuasively argue that special interests work to bend the tools of government to benefit themselves. This analysis, relying on regulatory theory, provides a framework with which to conceptualize the possibilities for reform by viewing Fannie and Freddie as creatures of regulatory privilege. A critical insight of regulatory theory is that regulatory privilege should be presumed to be inconsistent with a competitive market unless proven otherwise. The federal government’s special treatment of Fannie and Freddie is an extraordinary regulatory privilege in terms of its absolute value, its impact on its competitors, and its cost to the federal government. As such, regulatory theory offers a fruitful resource for academics and policymakers considering reform of Fannie and Freddie’s privileged status because it clarifies how Fannie and Freddie have relied upon their hybrid public/private structure to obtain and protect economic rents at the expense of homeowners as well as Fannie and Freddie’s competitors.

Once analyzed in the context of regulatory theory, Fannie and Freddie’s future seems clear. They should be privatized so that they can compete on an even playing field with other financial institutions, and their public functions should be assumed by government actors. While this is a radical solution and one that would have been considered politically naive until the recent credit crisis, it is now a serious option that should garner additional attention once its rationale is set forth.

In an earlier article, I provided a comprehensive analysis of the regulatory privilege that Fannie and Freddie enjoy. This analysis builds on that work to situate that privilege within a broader understanding of regulatory theory and to explain the rare hybrid public/private nature of the privilege that Fannie and Freddie enjoy. In doing so, this analysis argues that the existing regulation of the two companies should be brought in line with our current understanding of how government should be deploying its power in the private sector.

This analysis proceeds as follows. First, I will describe Fannie and Freddie’s role in the secondary market for residential mortgages. After describing what happened to the two companies in the credit crisis that commenced in 2007, I will outline the key provisions of the Housing and Economic Recovery Act of 2008, which authorized the federal government to place Fannie and Freddie in conservatorship.

Next, I will construct a theoretical framework with which to evaluate Fannie and Freddie and will present Fannie and Freddie’s assessment of their own roles in the secondary residential mortgage market. This will include a review of how other scholars have conceptualized the role of Fannie and Freddie in the housing finance market and will evaluate the operation of Fannie and Freddie in the context of six policy goals that derive from contemporary regulatory theory: (1) maintaining competition, (2) efficiently allocating society’s goods and services, (3) promoting innovation, (4) preventing inappropriate wealth transfers, (5) preserving consumer choice, and (6) preventing an overly concentrated economy. I find that Fannie and Freddie come up short under nearly all of these goals.

Based on the conclusion that Fannie and Freddie no longer have a net positive impact, I next argue that the two companies should be privatized. I also argue that the benefits that Fannie and Freddie produce in the residential mortgage market should be maintained through alternative means, including financial regulation, consumer protection legislation, and increased subsidies for affordable housing.
Because of the federal government’s implied guarantee of their debt securities, Fannie and Freddie have been able to profit greatly.

Fannie and Freddie and the Credit Crisis

In this section I begin by explaining what Fannie and Freddie do in the mortgage markets. I then describe how they fared in the credit crisis that commenced in 2007. This brief history opens with the early phase of the credit crisis in which the two companies were perceived as potential white knights, mounting a defense of the distressed secondary mortgage market. I then detail their own troubles that led to the enactment of the Housing and Recovery Act of 2008. The section concludes with the government placing them in conservatorship as the financial condition of the two companies rapidly disintegrated.

Fannie and Freddie’s Business

Fannie and Freddie have two primary lines of business. First, they provide credit guarantees so that groups of residential mortgages can be packaged as residential mortgage-backed securities (RMBS). Second, Fannie and Freddie purchase residential mortgages and related securities with borrowed funds. Because of the federal government’s implied guarantee of their debt securities, Fannie and Freddie have been able to profit greatly from this second line of business. This is because they can make money on the spread between their low cost of funds and what they must pay for the mortgage-related investments in their portfolios.

Fannie and Freddie’s charters restrict the mortgages they may buy. In general, they may only buy mortgages with loan-to-value ratios of 80 percent or less unless the mortgage carries mortgage insurance or other credit support and may not buy mortgages with principal amounts greater than an amount set each year (the 2009 conforming loan limit for a single-family home is $417,000). Loans that Fannie and Freddie can buy are known as “conforming” loans. Loans that exceed the loan amount limit in a given year are known as “jumbo” loans. Most of the remainder of the RMBS market belongs to “private label” firms which securitize jumbo mortgages and subprime mortgages that Fannie and Freddie cannot or choose not to guarantee or purchase for their own portfolio.

Because Fannie and Freddie have so dominated the conforming sector of the mortgage market, they have standardized that sector by promulgating buying guidelines that lenders must follow if they want to sell their mortgages to either of the two companies. Such standardization has led to increases in the liquidity and attractiveness of mortgages as investments to a broad array of investors.

The government-perceived guarantee of Fannie and Freddie’s debt obligations is a regulatory privilege that arose from Congress’s efforts to create a national secondary residential mortgage market. It is that characteristic that allows them to borrow more cheaply than do other financial institutions, which allows them to completely dominate the prime conforming mortgage market. This guarantee also poses the greatest threat to the federal government and the American taxpayer. One must therefore properly account for it in order to understand Fannie and Freddie.

Unlike true monopolists, Fannie and Freddie’s market power is limited by the nature of their competitive advantage: in an otherwise efficient market, the maximum amount that they can retain as economic rent is the spread between the interest rates they must pay and those that their competitors must pay. Nonetheless, Fannie and Freddie share a key characteristic with government-granted monopolies: a legally created and overwhelming competitive advantage in a particular market, which translates into higher prices for consumers than would exist if Fannie and Freddie did not retain a portion of their economic rent for themselves.

Because of their government guarantee, Fannie and Freddie were thought to be well situated when the current credit crisis commenced. As other lenders began to fail and the secondary market for subprime mortgages dried up in 2007, a Citigroup report suggested that Fannie and Freddie could easily ride out the turmoil in the mortgage
markets. Beyond this, some commentators were arguing that Fannie and Freddie would be able to bail out other mortgage market players by buying additional mortgages. At the same time, however, some were raising the alarm that Fannie and Freddie could face some of the same problems that other mortgage lenders had been facing. But this view was overtaken in 2007 by the more dominant one, which saw Fannie and Freddie as saviors of the mortgage markets.

This was a happy development for Fannie and Freddie because it meant that the terms of the debate regarding their appropriate role in the mortgage markets went from one in which the executive branch was beating the drums to limit their growth to one in which politicians and mortgage executives were calling for their role to be significantly expanded. Fannie and Freddie quickly tried to capitalize on this change in their political fortunes, advocating for an increased role in the crisis. At the earliest stage of the credit crisis, the Bush administration continued to oppose an expansion of Fannie and Freddie’s roles. As the crisis progressed, OFHEO began to signal consideration of some expansions in Fannie and Freddie’s role. The Federal Reserve, which had also been calling for limitations on Fannie and Freddie before the credit crisis struck, also began to publicly consider a greater role for the two firms.

The Crisis Deepens

As Fannie and Freddie’s political star began to appear ascendant, troubling accounts of possible losses started to appear: their underwriting models had been too optimistic and had not accounted for the possibility of severe reductions in housing prices across the nation. These fears were confirmed soon thereafter, as Fannie and Freddie began to report very large losses. These losses meant that Fannie and Freddie did not have the capital to expand their role in the mortgage markets and that their political star began its fall once again. The large losses led both companies to seek infusions of fresh capital. By this point, the federal government was now concerned both with Fannie and Freddie’s viability as well as with the health of the overall market. Nonetheless, the federal government was running out of policy responses to the credit crisis, and Fannie and Freddie were seen as some of the few remaining possible agents that could execute federal policy.

By the beginning of 2008, the Bush administration and Congress were seriously considering various initiatives to create more funding for mortgages, a number of which were implemented. As part of the Economic Stimulus Act of 2008, enacted in February 2008, Fannie and Freddie were temporarily allowed to buy or guarantee mortgages with principal amounts as high as $729,750 in order to restore liquidity to at least a portion of the jumbo sector. Fannie and Freddie’s safety and soundness regulator, the Office of Federal Housing Enterprise Oversight, also lifted Fannie and Freddie’s portfolio accounts caps and repeatedly lowered capital requirements to help respond to the housing slump and expand the supply of credit for mortgages.

These steps seemed to have had the intended effect of increasing the supply of credit available for mortgages. Some commentators, however, were still warning that Fannie and Freddie continued to be heavily exposed to losses resulting from the housing slump that they were supposed to be alleviating. The market also began to worry about Fannie and Freddie’s solvency, as the yields on their debt widened by 30 basis points (a basis point is equal to one 100th of a percentage point) to trade at a historically high 40 basis points above LIBOR (London Interbank Offered Rate) in mid-March. By May, more and more parties were concerned about the solvency of the two companies, and Congress and the Bush administration were seriously negotiating an overhaul of Fannie and Freddie’s “safety and soundness” regulator, OFHEO, to increase its ability to oversee and regulate the two companies.

By mid-July, the market’s serious concerns about Fannie and Freddie’s viability were reflected in their stock prices, which were at

Fannie and Freddie’s underwriting models had been too optimistic and had not accounted for the possibility of severe reductions in housing prices.
The Bush administration kept up the pressure to move the bailout plan forward, even in the face of Republican hostility in Congress. The federal government, on the heels of the Bear Stearns bailout, took decisive action to prevent another acute crisis in the financial markets. The Treasury Department announced that it was seeking broad authority from Congress to support Fannie and Freddie through acquisition of its debt and equity securities; at the same time, the Federal Reserve announced that it was authorizing emergency lending to the two companies on the same terms that it has historically lent to its regulated banks and, since the Bear Stearns bailout, to primary dealers. The Bush administration kept up the pressure to move the bailout plan forward, even in the face of Republican hostility in Congress, which was based on opposition to a taxpayer bailout of the two entities. The bailout plan was enacted as part of the Housing and Economic Recovery Act of 2008. While this gave confidence that debt-holders would be bailed out in the case of insolvency, shareholders could not feel the same way, particularly since Fannie and Freddie’s massive portfolios were still in trouble. It also did not offer much confidence to those who had hoped that Fannie and Freddie would continue to support the housing market.


The Housing and Economic Recovery Act of 2008 (the “Act”) was one of the major legislative responses to the credit crisis that had begun in 2007. Among other things, the Act revamped the regulatory oversight for Fannie and Freddie and provided the Treasury with the authority to bail out Fannie and/or Freddie if they faced insolvency. Prior to the passage of the Act, Fannie and Freddie’s “financial safety and soundness” regulator was OFHEO, which was an independent agency located within HUD. OFHEO had limited power over Fannie and Freddie to establish capital standards, conduct financial examinations, determine capital levels, and appoint conservators. Two provisions of the Act are most relevant here; the first strengthened Fannie and Freddie’s “financial safety and soundness” regulation, and the second temporarily increased government support for the two companies.

Improved Financial Safety and Soundness Regulation. The Act replaces OFHEO with a new independent Federal Housing Finance Agency (the “Agency”). The Agency has general regulatory authority over the two companies and the Federal Home Loan Banks. The Agency’s role mirrors that of OFHEO but grants it significantly more power to regulate financial safety and soundness issues. The Agency is intended to be a top-notch financial regulator along the lines of the Federal Deposit Insurance Corporation (FDIC). The Agency is run by a director appointed by the president, with the advice and consent of the Senate. The director’s mandate is to ensure that both entities operate with sufficient capital and internal controls, with a mind toward the public interest, such that Fannie and Freddie accomplish their purpose of providing liquidity to the mortgage markets. The director is assisted in his duties by the Federal Housing Finance Oversight Board, which advises the director about strategies and policies. In addition to the director, the board includes the secretary of the Treasury, the secretary of Housing and Urban Development (HUD), and the chairman of the Securities and Exchange Commission.

Temporary Government Support. The Act temporarily authorizes the secretary of the Treasury to make unlimited equity and debt investments in Fannie and Freddie securities. This appears to be the first time that the Treasury has been authorized to invest
in the equity of privately held companies. That will only be done by mutual agreement between the relevant GSE and the secretary of the Treasury. In order to purchase obligations, an emergency determination must be made by the secretary of the Treasury. This determination must address whether such actions are necessary to provide stability to the financial markets, prevent disruptions in the availability of mortgage finance, and protect the taxpayer.

The director must consult with, and consider the views of, the chairman of the Board of Governors of the Federal Reserve System prior to issuing any proposed or final regulations, orders, and guidelines. Such consultation is limited to the additional authority provided in the Act regarding prudential management and operations standards, safe and sound operations of, and capital requirements and portfolio standards applicable to Fannie and Freddie.

In addition to the two provisions discussed above, the Act has two more that are of some importance here. These two provisions relate to how the two firms seek to expand their market share and how they engage in political horse-trading to achieve their ends, which topics relate to the argument in favor of privatization set forth below. The first provision provides funding for affordable housing through an assessment on Fannie and Freddie. The second provision increases the conforming loan limits. This increase expands the companies' market and increases the availability of mortgage credit during the crisis.

The Act requires that Fannie and Freddie "set aside an amount equal to 4.2 basis points for each dollar of unpaid principal balance of its total new business purchases." When the Act was passed, it was generally agreed that this provision would raise upwards of $500 million each year for affordable housing initiatives.

The Act also raises the conforming loan limits in some areas. Such limits are increased in areas for which 115 percent of the median house price exceeds the conforming loan limits, to the lesser of 150 percent of such loan limit or the amount that is equal to 115 percent of the median house price in such an area. Thus, the 2009 conforming loan limit can be as high as $625,000 for a single family residence in some areas.

**Fannie and Freddie Enter Conservatorship**

Within days of the passage of the Housing and Economic Recovery Act of 2008, Fannie and Freddie faced demands to raise more capital, pressures that they would not be able to meet. Within a few weeks, the markets were expecting the federal government to bail out the two companies. And within a couple of months, Paulson announced that he was placing the two companies in conservatorship because they were not able to raise the capital they needed to continue operating. Throughout the credit crisis, their reported losses have only continued to increase.

One important consequence of conservatorship is its impact on the implied guarantee. Some commentators argue that the implied guarantee is now an explicit one. The government and the market have not yet embraced this view. How the two companies exit their conservatorships will determine the nature of the government guarantee as well.

As the credit crisis unfolds, there is much speculation as to what form Fannie and Freddie should take upon exiting conservatorship once the crisis has passed. In the next section of this analysis, I propose a theoretical framework to help determine the answer to that question.

**Evaluating Fannie and Freddie**

There is very little controversy over the overwhelming benefits that Fannie and Freddie brought to the national mortgage market during the 1970s; indeed, they, along with Ginnie Mae, effectively created the secondary mortgage market. But at least since the early 1990s, there has been much disagreement with Fannie and Freddie’s claims that they continue to provide overwhelming benefits to America’s homeowners.
Instead of borrowing through a GSE, the federal government could act directly at a lower cost to assist favored constituencies like homeowners.

an exploration of the costs that the two companies impose on the American government and on the mortgage markets. I will begin by reviewing how Fannie and Freddie claim to benefit the residential housing finance market and how “independent scholars” evaluate their success at reaching these goals. I will then draw on theories of regulation and monopoly to propose a more comprehensive mode of evaluation which untangles their hybrid public/private structure to demonstrate how that structure gives them extraordinary benefits that undercut competition in the mortgage markets as well as their statutorily mandated public missions.

Fannie and Freddie’s Self-Assessment

Fannie and Freddie set forth four standards by which they believe they should be judged: (1) they lower overall interest rates for homeowners, (2) they offer systemic stability and liquidity to the market, (3) they increase the supply of affordable housing, and (4) they have increased consumer protection in the residential market. I will review evidence for each of these claims in turn. I find that independent research challenges some of these claimed benefits. Moreover, these four standards are ad hoc and fail to account for many other impacts that the two companies have on the housing market.

Lower Overall Interest Rates for Homeowners. Fannie and Freddie claim that they lower interest rates for homeowners. There is nearly universal agreement that this is true. While Fannie and Freddie describe these lower rates as significant, independent scholars describe them as modest.

Various studies have measured the benefit to conforming borrowers as being between 24 and 43 basis points. Assuming an increased 34-point spread (halfway between the two figures) on a $200,000 mortgage, a borrower would pay an additional $57 dollars a month in interest. This figure, while significant for the average American homeowner, is not an extraordinary benefit, particularly for those who can itemize their home mortgage interest deduction to further reduce the after-tax bite of such interest payments.

Moreover, Michael Froomkin, Law Professor at the University of Miami, identifies a hidden cost that the Fannie and Freddie financing model imposes: in many ways the federal government is borrowing at a higher cost than it needs to if it wants to subsidize residential mortgages. Instead of borrowing through a GSE, the federal government could act directly at a lower cost to assist favored constituencies like homeowners. For instance, the federal government could directly provide or guarantee certain kinds of mortgages at a cheaper cost than Fannie and Freddie, much like it directly provides student loans at a cheaper cost than private educational lenders. This hidden cost has come into sharper relief during the current credit crisis, where Fannie and Freddie’s borrowing costs remained for quite some time stubbornly high, even after they entered conservatorship. Thus, the Fannie and Freddie model may not be the most cost-effective means by which the government can achieve the goal of lower interest rates for homeowners.

Systemic Stability and Liquidity. Congress gave Fannie and Freddie the task of providing liquidity and stability to the secondary mortgage markets. In 2003, OFHEO issued a report titled “Systemic Risk: Fannie Mae, Freddie Mac and the Role of OFHEO,” which evaluated their role in the broad financial markets. The report argued that the systemic implications of Fannie or Freddie’s financial difficulties would depend on the circumstances: “Any systemic disruption would likely be minimal as OFHEO took prompt corrective action and other market participants filled the short-term market void. Alternatively, in the unlikely circumstance that an enterprise experienced severe financial difficulties, they could cause disruptions to the housing market and financial system.”

While the secondary mortgage markets generally function well and without liquidity crises, the credit crunch of 2007–09 has provided a rare opportunity to evaluate the impact of Fannie and Freddie on liquidity. At early stages in the crisis, Fannie and Fred-
die promoted themselves as white knights and lobbied for access to a broader swath of the mortgage market in order to stabilize them.\textsuperscript{94} But as the credit crisis developed, it became clear that Fannie and Freddie were subject to the same forces that had led to the insolvency and massive write-downs of private mortgage lenders, until the government stepped in quite forcefully to bolster the government-supported mortgage market.\textsuperscript{95}

In early 2008, the federal government authorized Fannie and Freddie to purchase loans with significantly higher principal amounts in high-cost areas like New York and California, again in order to provide additional liquidity.\textsuperscript{96} But at around the same time, Fannie and Freddie revealed that they faced billions of dollars in losses caused by their poor underwriting.\textsuperscript{97} Fannie Mae issued additional shares to raise billions of dollars of capital to ensure that they complied with the OFHEO capitalization requirements and Freddie Mac planned to do the same.\textsuperscript{98} But, as noted above, Fannie and Freddie ultimately required a bailout in order to prevent a crisis that would have spread far beyond the American residential mortgage market, if left unchecked.\textsuperscript{99} The net effect is that Fannie and Freddie did provide some temporary liquidity and stability, but their long-term impact was very harmful to the broad financial system and will likely cost the American taxpayer tens of billions of dollars.

**Affordable Housing Goals.** The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 established three affordable housing goals for Fannie and Freddie,\textsuperscript{100} those for (1) low- and moderate-income housing; (2) special affordable housing; and (3) central cities, rural areas, and other underserved areas housing.\textsuperscript{101} Pursuant to this statute, HUD is responsible for monitoring, adjusting, and enforcing these housing goals.\textsuperscript{102} These goals represent what should be “the minimum share of housing units financed by a GSE’s mortgage purchases in a particular year.”\textsuperscript{103}

Fannie and Freddie typically meet these goals, although they sometimes may use financing shenanigans (such as buying a portfolio of loans solely to meet affordable housing goals) to do so.\textsuperscript{104} Independent research, however, has challenged whether these goals actually increase the net amount of affordable housing. A number of studies have indicated that Fannie and Freddie actually cannibalize the Federal Housing Administration (FHA) loan market by lending to borrowers who would have otherwise received FHA mortgages.\textsuperscript{105} The U.S. General Accounting Office (GAO) has also questioned whether Fannie and Freddie, notwithstanding their affordable housing mandate, do any more than any other lenders to promote affordable housing.\textsuperscript{106}

**Consumer Protection.** Fannie and Freddie argue that they have helped to standardize the conforming mortgage to the benefit of consumers.\textsuperscript{107} Many observers, including myself, have praised this standardization as a positive, something that on the whole reduces bad options for consumers.\textsuperscript{108} This generally positive development is not without some costs to consumers, however, as it reduces the financing choices available to them. For instance, Fannie and Freddie have effectively banished prepayment penalties from the prime conforming mortgage market, which sounds like a good thing for consumers.\textsuperscript{109} But some consumers might have preferred to take a loan with a prepayment penalty if it meant that the loan would have a lower interest rate.\textsuperscript{110}

Moreover, recent news about Freddie’s role in the subprime and Alt-A markets undercut Fannie and Freddie’s consumer protection argument to some extent.\textsuperscript{111} Apparently, the two firms had a much greater exposure to the disastrous Alt-A (also known as the “liar loan”) subsector than they had previously let on.\textsuperscript{112} In congressional testimony in late 2008, Fannie’s former chief credit officer reported that the two companies “now guarantee or hold 10.5 million nonprime loans worth $1.6 trillion—one in three of all subprime loans, and nearly two in three of all so-called Alt-A loans.”\textsuperscript{113} As these two sectors were rife with predatory lending practices, Fannie and Freddie may be seen as complicit with these practices even though they did not engage in them directly.

Research has challenged whether these goals actually increase the net amount of affordable housing.
Given Fannie and Freddie’s monstrous size and market power, there are no comparable public-private hybrid entities.

Existing Theories of the Government-Sponsored Enterprise

While she was director of the Office of Management and Budget, Alice Rivlin stated that “GSEs were created because wholly private financial institutions were believed to be incapable of providing an adequate supply of loanable funds at all times and to all regions of the nation for specified types of borrowers.” This is certainly the primary reason that Congress employs GSEs, even if, as policy scholar Thomas Stanton notes, “market imperfections are much more difficult to find today” than they were when Fannie and Freddie were created.

Michael Froomkin has suggested four additional reasons behind Congress’s decision to create federal government corporations like Fannie and Freddie: (1) they are believed to be more efficient at achieving market-related goals, (2) they are believed to be more insulated from politics than a division of a large federal agency, (3) they are believed to be effective at delivering targeted subsidies, and (4) they are a useful subterfuge for Congress because their borrowing is typically not counted as part of the federal deficit. As shown here, there is good reason to doubt that the first three reasons are as compelling as Congress would have liked. There is also good reason to believe that Congress was correct regarding the fourth. Rivlin and Froomkin outline the major reasons that Congress creates GSEs, but they do not offer a comprehensive theory of the GSE. Existing efforts to do that are reviewed below.

Finance and economics scholars have proposed a variety of cost/benefit frameworks with which to evaluate Fannie and Freddie, although this is no easy task. These frameworks have often relied on various ad hoc metrics, such as whether Fannie and Freddie actually lower interest rates for homeowners or how much of the Fannie/Freddie subsidy is passed on to homebuyers. There is general agreement that the two companies do lower interest rates to some extent and that they do so by passing a portion of the subsidy that derives from the government’s guarantee of their obligations on to homeowners.

Fannie and Freddie, of course, argue that they still provide an array of benefits, while others vigorously dispute this claim. Fannie and Freddie know that this debate is fundamentally one about their right to exist as GSEs. Their critics, on the other hand, have become increasingly strident in their criticism of the Fannie and Freddie business model as these companies have grown way beyond the expectations of anyone who had studied them in the 1970s and 1980s.

Although this body of literature has provided many insights into Fannie and Freddie, it does not provide an overarching theoretical framework that would help determine their value. Such a framework should describe the ecology of Fannie and Freddie as well as the incentives and structural limitations that drive the development of the two companies. It should also provide guidance as to how they should be treated going forward.

Fannie and Freddie Evaluated through the Lens of Regulatory Theory

Given Fannie and Freddie’s monstrous size and market power, there are no comparable public-private hybrid entities. As products of regulation, however, they fit well within existing theories of regulation. This section evaluates their value as agents of public policy through the lens of regulatory theory.

Two frequently stated objectives of government economic policy are to maintain and encourage competition between firms in order to increase “the material welfare of society” and to maximize consumer welfare “through lower prices, better quality and greater choice.” University of Chicago law professor Cass Sunstein has rightfully noted that many regulatory regimes therefore reflect “a belief that regulatory enactments might simultaneously promote economic productivity and help the disadvantaged.” But Sunstein has also noted that one of the main criticisms of regulation is that it is “only purportedly in the public interest” and that it “turns out on inspection to be interest-group
transfers designed to protect well-organized private groups . . . at the expense of the rest of the citizenry.”126

Indeed, modern theories of regulation stem from the insight that firms attempt to use regulation as a device “to establish or to enhance monopoly power.”127 Assessing the role of regulation in a particular market is necessary to understanding whether that market is functioning competitively and equitably.128 Theories of regulation thus provide a useful framework with which to understand the market in which Fannie and Freddie operate, one that allows us to evaluate whether the companies increase “the material welfare of society” and maximize consumer welfare. This section will analyze Fannie and Freddie as creatures of regulatory privilege within the context of regulatory theory.

The core of Fannie and Freddie’s regulatory privilege is the government’s guarantee of their obligations, which was initially granted to create a national secondary residential mortgage market. This implied guarantee drives any competition from the conforming mortgage market because the two companies can borrow money so much more cheaply than their competitors. This lower cost of funds means that they can out-compete fully private financial institutions in the conforming market, thereby keeping the conforming sector to themselves.129

The government guarantee is a variant on the longstanding government practice of spur- ring private investment in various arenas by granting some privilege or monopoly power to a party that will infuse the activity with needed capital or bring focused attention to it. For example, government-granted monopolies can take the form of a charter granting a monopoly on trade, such as the one granted by Queen Elizabeth I to the English East India Company in 1600 in order to increase English trade with Asian nations.130 They can take the form of a system such as that governing American patents, granting patent-holders the sole right to exploit a patent for a certain period in order to encourage innovation.131 Or they can take the form of a regulated natural monopoly, like a utility company, which is ostensibly regulated not only to protect consumers from monopoly pricing but also to ensure that the company can make a fair return on its investment.132

Unlike true monopolists, Fannie and Freddie are limited by the nature of their competitive advantage: in an otherwise efficient market, the maximum amount that they can retain as economic rent is the spread between the interest rates they must pay and those that their competitors must pay.133 Notwithstanding this cap on profits, Fannie and Freddie share an important characteristic with government-granted monopolies: a legally created and overwhelming competitive funding advantage in a particular market that derives from their special charters. This advantage translates into higher prices for consumers than would exist if Fannie and Freddie did not retain a portion of their economic rent for shareholders and management.

Regulatory theory identifies six goals that are relevant to a study of Fannie and Freddie, including (1) maintaining competition, (2) efficiently allocating society’s goods and services, (3) promoting innovation, (4) preventing inappropriate wealth transfers, (5) preserving consumer choice, and (6) preventing an overly concentrated economy.134 The first three goals relate to economic efficiency.135 The second three goals address additional public policy objectives. As will be seen below, Fannie and Freddie do little to effectuate these goals. Indeed, in some cases they act contrary to them.

Maintaining Competition. Maintaining competition is one of the most important goals of economic regulation.136 But applying this goal to Fannie and Freddie’s activities is a bit difficult as there was no real national mortgage market when they were created. Indeed, they were formed in order create a new product: the fungible mortgage. So, to begin with, there was barely any competition with which Fannie and Freddie could interfere. And now, because of their funding advantage, they have no competitors in the prime conforming market. This state of affairs presents two questions regarding competition in the modern residential mortgage market: should there
Fannie and Freddie are best understood as rent-seekers who expend resources to obtain favorable regulation in order to obtain rents.

be more competition in the conforming mortgage market? And should Fannie and Freddie be allowed to expand the markets in which they compete while maintaining their funding advantage?

As to the first question, it is not controversial to state that competition is considered healthy in almost all markets, except for those that are better suited to natural monopolies like the utilities market. While Fannie and Freddie maintain that they compete with each other, independent commentators describe their behavior more as duopolists than competitors, as discussed above. As to the second question, it again is not controversial to state that introducing subsidized firms like Fannie and Freddie into a generally efficient non-subsidized mortgage market like the jumbo market would distort pricing in that market.

In fact, Fannie and Freddie are entering that jumbo market: the rapidly increasing size of the conforming loan limit, a product of furious lobbying by the two firms, allows Fannie and Freddie to claim more of the overall mortgage market for themselves as opposed to their jumbo-originating competitors. As Fannie and Freddie both operate without competition in the conforming market and expand their markets through political action, they seem to operate contrary to the goal of maintaining competition.

Moreover, if one believes that Fannie and Freddie were primarily created to develop the national mortgage market, then it follows that their government-granted privilege should be revoked after they have completed that task. That is, Fannie and Freddie’s regulatory privilege should be viewed more like the privilege granted to patents, which only allows for a temporary monopoly for the express purpose of encouraging innovation, rather than a natural monopoly like that of a utility company that is typically regulated in perpetuity because it has no potential competition.

Efficiently Allocating Society’s Goods and Services. In a productively efficient system, each unit of a product is produced at the lowest possible cost. If a producer in a competitive market fails to produce its product at the lowest possible cost, it would likely fail. This result would not typically apply to a monopolist because it does not face competition in its market. Monopolists thus typically lack “sufficient incentive to hold production costs at low levels.”

The competitive advantage provided by Fannie and Freddie’s regulatory privilege is limited, as discussed above, by the fact that they would face competition if the price (interest rate and fees) in the conforming market was equal to or higher than the price in the jumbo market. But as long as they keep the price lower than the price in the jumbo market, they are able to extract some economic rent. Thus, they are not efficiently allocating society’s goods and services.

Regulatory privilege imposes certain additional social costs. Its beneficiaries incur costs to retain and expand it, often through campaign contributions, lobbying, and bribery. Such firms are also more likely to dissipate their rents through expenditures like advertising in order to protect their privileged status. Fannie and Freddie are thus best understood as rent-seekers who expend resources to obtain favorable regulation in order to obtain rents.

Promoting Innovation. Recipients of regulatory privilege may have less impetus to innovate because of their competitive advantage. Fannie and Freddie claim, however, that they continue to innovate as the secondary market matures. Indeed, they have executed a number of innovations that allow them to profit from aspects of the mortgage market that had traditionally fallen outside of the scope of their activities. These include, for instance, the development of automated underwriting systems and underwriting guidance systems for third parties. It is no coincidence that these innovations allow the two companies to enter new markets, thereby pushing against the limitations on their expansion into new markets contained in their charters. The Mortgage Banking Association argues that in the area of underwriting technology, Fannie and Freddie have actually squelched the innovations of others, much as Microsoft has squelched its competitors by...
Private-label competitors have innovated at a far greater rate than Fannie and Freddie, introducing a dizzying array of products for consumers to choose from and securities for investors to choose from, although much of that innovation now seems foolish, greedy, and wrongheaded. At a minimum, there is no evidence that Fannie and Freddie innovate more than they would if they faced a marketplace filled with many competitors. That being said, as the subprime crisis unfolds, the once vaunted innovation of private-label lenders has taken on a decidedly morbid pall. Law professors Kathleen Engel and Patricia McCoy argue quite convincingly that the business model of these private-label lenders led directly to much of the abusive lending of the last 10 years. One might argue that this point would decisively go to Fannie and Freddie if they themselves did not invest so heavily in subprime and Alt-A mortgages originated by the very same private-label lenders.

**Preventing Inappropriate Wealth Transfers.** Monopolists are willing to forgo sales for increased profits. Similarly, Fannie and Freddie offering the lowest possible price for mortgages; they do this by retaining a portion of their subsidy instead of passing it on to the borrowers as they would in a perfectly competitive market. This is reflected in the outsized profits that Fannie and Freddie have historically enjoyed as compared to other financial institutions. It may also be reflected in the generous pay packages that management awards itself before turning over the remainder of the economic rent to shareholders. Furthermore, just as monopoly pricing dissuades some buyers who would have purchased a good at a competitive price from doing so at the monopoly price, which is allocatively inefficient, Fannie and Freddie’s retention of a portion of their subsidy keeps some potential borrowers from borrowing.

**Preserving Consumer Choice.** Government regulates businesses that operate in markets that are not fully competitive, in part, to achieve fairness for consumers. Because of their competitive advantage in the conforming loan market, consumers effectively only have the choice of Fannie or Freddie. As noted above, Fannie and Freddie argue convincingly that they have helped to standardize the prime, conforming mortgage to the benefit of consumers.

There is no question that private-label firms would enter the conforming market if they were able to borrow funds at rates comparable to those available to Freddie and Fannie. The pros and cons of those private-label firms have been well documented in the jumbo and subprime markets: they expand consumer choice but often at the expense of the consumer protection inherent in a simple and standardized market place. More competitors would, of course, mean more consumer choice of lenders. It would also likely mean more choice of mortgage products. But in the context of mortgage lending, more consumer choice is a two-edged sword, as the recent implosion of the subprime market attests.

Fannie and Freddie also argue that they implement the government’s policy of increasing homeownership; indeed, Fannie’s slogan is “Our Business is the American Dream.” They claim that they have thereby helped the nation achieve a great increase in the rate of homeownership. This claim is undercut in a variety of ways. First, the credit crunch has made some question whether homeownership is good in and of itself for all households. Second, some scholars argue that America over-invests in housing and that Fannie and Freddie are part of that problem. Third, it is unclear whether they actually help to fund affordable housing for low- and moderate-income homeowners, who should presumably be the main beneficiaries of such a government initiative. Fourth, the amount that the typical homeowner saves because of Fannie and Freddie is relatively modest.

**Preventing an Overly Concentrated Economy.** Regulation may be employed to reduce over-concentrations of market power. Fannie and Freddie argue, however, that their vast size provides stability to the mortgage market. Independent scholars disagree. Recent events disfavor the Fannie/Freddie perspective. Fannie and Freddie each present an over-concentration
of risk that is perhaps unsurpassed by any other private firm operating anywhere in the world. Because the two companies have the identical, undiversified business model, that risk is only magnified. Thus, any substantial operational risk or mistaken hedging strategy at either of those firms poses a systemic risk to the international economy, a risk that has already become a reality.171

Fannie and Freddie do not do well when these six regulatory goals are taken together. As to the three economic efficiency goals, the conforming market is not as competitive or efficient as it would be if there were more competitors.172 There is also no evidence that the market is more innovative than it would be if there were more competitors. Thus, merely on economic efficiency grounds, Fannie and Freddie’s regulatory privilege does not serve the public interest. Nor do Fannie and Freddie do particularly well with the other public policy goals. The two companies engage in rent-seeking, limit consumer choice, and keep other firms from competing with them.

The two areas where Fannie and Freddie seem to offer some clear and significant benefits are (1) providing short-term liquidity and stability to the mortgage market during an acute crisis and (2) in the area of consumer protection, at least in the prime, conforming sector. This second point is underscored by the events leading up to the credit crisis which have demonstrated that too much consumer choice in the mortgage arena can lead to horrible results. If the benefits offered by Fannie and Freddie could be undertaken through alternate means, one might conclude that Fannie and Freddie are not particularly beneficial agents of public policy.

In sum, regulatory theory helps to untangle Fannie and Freddie’s intended market function from their intended public mission and to explain how the two purposes do not work well individually or taken together. Because Fannie and Freddie are creatures of federal regulatory privilege, and not independent firms that are operating in a relatively unregulated market, the federal government has broad latitude in setting new goals for these two firms and modifying the regulatory privileges awarded to them.173

Fannie and Freddie’s GSE Status Should Be Terminated

Identifying the weaknesses of Fannie and Freddie as agents of public policy is very different from identifying what should be done with them. The two companies have two of the most powerful lobbying machines in Washington. Moreover, the nature of Fannie and Freddie’s privileges makes it unlikely that they will be revisited by Congress with any regularity. Because Fannie and Freddie are poor agents of public policy and are political powerhouses with unmatched influence, the two companies should be fully privatized.

Fannie and Freddie Are Political Powerhouses

Jonathan Koppell has thoroughly documented how Fannie and Freddie have been able to exercise unparalleled influence in Washington.174 Mirroring the hybrid analysis presented here, he concludes that it is the combining of elements of public instrumentalities and private companies that gives them the “best of both worlds in terms of the political influence the two companies can marshal.”175 Thus, any policy proposals relating to the two companies must be evaluated in the context of the political environment in which they operate.

Given that Fannie and Freddie have outsized influence in Washington, one must be cautious in recommending half-measures in reaction to their limitations as agents of public policy. Unfortunately, most of the reforms floated in the last few years would seem to fall within this category. They include

- limiting the size of their mortgage portfolios,
- limiting their debt issuance,
- stripping the two companies of some of their unique privileges to signal to the market that the implied guarantee has been weakened,
freezing the conforming loan value to limit the size of mortgages they can buy, thereby limiting their overall size, • requiring them to obtain ratings from rating agencies for their debt issuances that discount the implied guarantee, • imposing user fees, and • strengthening their subordinated debt programs.  

If any of these half-measures were adopted, however, Fannie and Freddie’s lobbying would be sure to undercut them as soon as Congress’s focus moved on to another pressing issue.  

The Government Guarantee Is a Reckless Budgeting Device  
Michael Froomkin, among others, has identified the encouragement of federal budget shenanigans as a hard to quantify “cost” of the Fannie and Freddie hybrid business model. This is because the federal government’s contingent liability for its guarantee of Fannie and Freddie’s obligations is off-budget, allowing Congress to avoid having that liability trigger debt ceiling limits. If off-budget accounting is a bad sign when found in corporations such as Enron, it is at least as bad for the federal government. For, while the federal government was ultimately able to investigate Enron, who will watch the watchers? Indeed, if the federal government had to quantify and account for this contingent liability in its budget, it would most certainly reduce Congress’s ability to increase net spending.  

Fannie and Freddie thus pose four serious budgetary problems. First, the cost of the government’s guarantee is hidden because it is off-budget. Second, the cost of the guarantee is particularly difficult to quantify. Third, the cost of the guarantee is not capped by the federal government, given that the federal government has not imposed any meaningful limits on Fannie and Freddie’s growth. Finally, Fannie and Freddie’s charters and the costs they might pose to the federal government are infrequently revisited by Congress. Indeed, Congress only takes a serious look at them every 10 years or so.  

Washington University law professor Cheryl Block, in her work on the federal tax budget, proposes a set of principles that should guide the budget legislative process. These principles are built on those relied upon by the GAO and are (1) budget formation as a democratic exercise, (2) enforceability, (3) accountability, (4) transparency, and (5) openness and durability. These five principles help to clarify the manner in which the contingent liability of the government’s guarantee should be treated in the federal budget process. The government’s guarantee of Fannie and Freddie’s obligations, when viewed as an item in the legislative budgetary process, fails to abide by any of these principles. Because the government guarantee of Fannie and Freddie’s obligations was effectively created decades ago, it is generally not part of the annual debate surrounding the budget. Because the size of the guarantee is uncapped and contingent, it fails the enforceability and accountability principles: it operates outside of the budget, its cost is hard to estimate, and the trigger for the federal government’s obligation to make good on it is in itself an unexpected event. Similarly, the guarantee, because of its contingent nature, is quite confusing to those outside of the budget process. Finally, it fails to meet the openness and durability principles because it is not typically part of the annual budget deliberations.  

In sum, the budgetary implications of the government’s guarantee provide an additional public policy argument against Fannie and Freddie, one that even on its own weighs heavily against them as agents of public policy.  

Fannie and Freddie Should Be Privatized  
There are four broad positions regarding the appropriate role of Fannie and Freddie in the housing finance market. First, Fannie and Freddie are generally doing the job that they were designed to do, although their powers and that of their regulators should be tweaked. Second, Fannie and Freddie are generally doing their job, but they are retaining too much of the value of the government guarantee for the benefit of shareholders and management
at the expense of their affordable housing goals. Third, Fannie and Freddie should be nationalized because the federal government has taken on most of the risk associated with them already. And finally, Fannie and Freddie pose a systemic risk to the financial system, unfairly benefit from their regulatory privilege, and do not create net benefits for the American people.

This analysis takes the fourth position. In particular, I argue that the government guarantee should be terminated and the two companies should be privatized. Until they entered conservatorship, this position has been considered a political nonstarter, particularly because Fannie and Freddie have many allies in the Republican and Democratic parties. As a result of recent events, it is now one of the options on the table for a post-conservatorship Fannie and Freddie.

One taking the first view—that Fannie and Freddie are generally doing the job that they were designed to do—might argue that “the penetration of competitive markets by laws and regulations is a highly durable and robust intrusion in the U.S. economy . . . [which] is arguably as tightly regulated as the more socialistic economics of Western Europe.” Thus, there is no need to extricate the federal government from its relationship with Fannie and Freddie because the government has similar relationships with many other private companies. Proponents of this view typically recommend the limited reforms outlined above.

Affordable housing providers and advocates often take the second position: Fannie and Freddie are pretty much doing their job of making housing more affordable to Americans, but they are retaining too much of the value of the government guarantee for the benefit of the shareholders and management, at the expense of their affordable-housing goals. Given the shared agenda of Fannie and Freddie on one hand and affordable housing providers and advocates on the other, this position should not come as a surprise to a student of regulation. Thus, these parties favor proposals that redirect some of the excess profits of Fannie and Freddie from their shareholders and management to affordable housing programs.

Indeed, in a plan subsequently suspended by federal conservatorship, Congress had recently implemented an affordable housing fund in which the two firms would deposit upwards of $500 million of their income each year. These monies were to be invested in affordable housing projects throughout the country. Affordable housing advocates saw this as a painless way to dramatically increase the supply of affordable housing. The ongoing bailout of the two companies demonstrates that the initiative was not painless, just pain-deferred.

Fannie and Freddie supported this proposal in exchange for expanding their market. This expansion was implemented by increasing the conforming loan limit in high-cost parts of the country, which allowed the two companies to expand into the bottom part of the jumbo market. It is of note, of course, that Fannie and Freddie’s support for such an extraordinarily costly initiative as the affordable-housing fund came at a low point of their public prestige and was widely seen as a political compromise that brought together a broad set of special interests whose goals are aligned with those of Fannie and Freddie. These interests included affordable-housing advocates, local governments, and the construction industry.

The dynamics of this position are complex. Housing advocates are concerned with the sustained lack of attention that federal and state governments have paid to affordable housing policy and see any dedicated housing dollars as a long overdue priority. Implicit in this view is that the risk of a Fannie and/or Freddie bailout to the typical American taxpayer is worth the benefit of the affordable housing dollars that the affordable housing fund could direct to low- and moderate-income families. The real debate, from this perspective, is how much of the golden egg of the implied subsidy from the federal government (as revealed by Fannie and Freddie’s profits that exceed their industry averages) can be redirected to these affordable housing objectives without killing the Fannie and Freddie geese.

The third position, nationalization, has
only begun to be taken seriously as the Fannie and Freddie bailouts become more and more likely. Indeed, former secretary Paulson has recently raised the idea, one which would seem to be anathema to a fiscal conservative like himself. Paulson proposed merging the two companies with the FHA, a government agency, which already insures certain mortgages. He does note, however, that such a plan would place much of the underwriting in the hands of the government, which is unlikely to do that task well (not that the private sector has done so either in recent years).

As noted above, this analysis advocates for the fourth view: Fannie and Freddie pose a systemic risk to the financial system, unfairly benefit from their regulatory privilege, and do not create meaningful net benefits for the American people. In speaking of regulatory reform, Sunstein notes that a good first step “would be to adopt a presumption in favor of flexible, market-oriented, incentive-based, and decentralized regulatory strategies. Such strategies should be focused on ends . . . rather than on the means of achieving those ends.”

Fannie and Freddie are holdovers from an earlier philosophy of government action, one that has seen its day come and go. Indeed, if one were to create from scratch a new system of federally supported residential mortgage finance, it is quite clear that the model would not be Fannie and Freddie, which are relatively inflexible and centralized solutions to the complex and fluid problems posed by the housing finance market. And while there is an argument to be made that Fannie and Freddie are market-oriented and incentive-based, it is a stronger argument to say that they are beneficiaries of regulatory privilege with incentives that have benefited their management disproportionately.

Privatization is needed to remedy this state of affairs. Theories of regulation and rent-seeking identify erosions of government-granted monopolies over time as part of their natural lifecycle. And, as the credit crisis continues to worsen, more and more previously unthinkable solutions are being taken quite seriously.

Four concrete plans have been recently proposed to fundamentally change Fannie and Freddie’s structure, each involving different degrees of government involvement. First, convert them into cooperatives owned by lenders. Second, break the companies up into a number of smaller companies (or charter a number of similar competitors). Third, leave them intact, but regulate them like public utilities. Fourth, convert them into generic financial holding companies.

The first proposal, converting Fannie and Freddie into cooperatives, has precedent. There are two other privately owned GSEs that are cooperative lenders: the Federal Home Loan Bank System (FHLB System) and the Farm Credit System. Some commentators have called for the FHLB System to take over Fannie and Freddie. This proposal has some initial attraction as it might attenuate the short-term profit-maximizing culture that characterizes publicly traded corporations like Fannie and Freddie. But history does not give comfort that such a GSE structure is superior to that of Fannie and Freddie’s. Indeed, Congress had to bail out the Farm Credit System in 1987. And there are rumblings that the FHLB System may soon face problems similar to those of Fannie and Freddie.

The second proposal, chartering additional housing finance competitors, has some initial attraction. Indeed, one might consider the Federal Deposit Insurance system to be a model of this: numerous recipients of regulatory privilege (access to federally guarantee insurance) who must compete among themselves. If the Fannie/Freddie duopoly could be diluted with enough similar competitors, the amount of economic rent that Fannie and Freddie retain from their government guarantee subsidy should reduce significantly. In addition, one might think that a more competitive market would spread risk among more firms.

On further reflection, however, this proposal also reveals significant flaws. The benefit of GSE competition is less compelling now that we have experienced a bubble where so many financial institutions demonstrated herd-like behavior in their business models.
And, as with the first proposal, the American taxpayer is still left with the contingent liability of the government guarantee.

The third proposal, regulating them like utilities, appears to be favored by Paulson and taken seriously by the likes of Federal Housing Finance Agency director James Lockhart. One worries however, how the common regulatory problem of capture would be avoided here where the two companies to be regulated are so clearly skilled in the art of politics.

The fourth proposal, converting them into generic financial services holding companies along the lines of institutions like Citigroup, J. P. Morgan, and Bank of America, has the attraction of simplicity. It also terminates the contingent liability of the government guarantee and allows the conforming mortgage market to function like other sectors of the overall mortgage market. There is also a precedent for this approach: Sallie Mae was successfully converted from a GSE to a private company. This approach would also send the message that the American mortgage markets have grown up and are now to be integrated with the rest of the financial sector.

This proposal has its own limitations which would have to be addressed if it were to be implemented. First, because Fannie and Freddie can offer at least a short-term stabilizing role in the residential mortgage markets, the federal government would need to implement other policies to take on that role. Possible policy responses to market disruptions could include providing targeted federal mortgage guarantees, authorizing the Treasury to make mortgage-backed securities purchases, and allowing mortgage lenders to access the Federal Reserve’s discount window. Policies like these can ensure that the residential mortgage market function during a panic. Second, homeowners would pay slightly higher interest for conforming mortgages if the two companies were privatized. If Congress determined that this increase was too much, particularly given the current condition of the economy, it could reduce the burden by modifying the deduction for mortgage interest or by providing a tax credit relating to mortgage interest. While such a strategy would decrease federal revenues it would be offset by the liability that Fannie and Freddie impose on the federal government, a liability that is already on its way to costing taxpayers hundreds of billions of dollars as part of the current bailout.

Third, if the federal government wanted to increase funding for affordable housing as contemplated in the Act, it would need to do so through direct expenditures. Again, this direct cost would be offset by terminating the contingent liability of the government guarantee.

Finally, Fannie and Freddie have imposed pro-consumer terms on the prime conforming mortgage market. These must be maintained and built upon through new consumer protection regulation in order to avoid the unpleasant environment of the subprime mortgage market. And, indeed, it is hard to imagine that privatization would be politically feasible if such protections were not built into the privatization proposal.

Notwithstanding these limitations, the full-privatization proposal has the most going for it. It avoids the problem of the government guarantee that remains with the other three proposals. It leaves to the private sector what the private sector is supposed to do best: evaluate risk. And it leaves to the government what it is supposed to do best: protect against systemic risk, and protect consumers and provide affordable housing to those who could not otherwise afford it.

Conclusion

The main problem with GSEs is well documented: they take on a life of their own and can survive well after they have achieved the purposes for which they were created. Alice Rivlin, in her capacity as the director of the Office of Management and Budget, stated that “GSEs should only be created with a clearly articulated ‘exit strategy’ and an express sunset date in their charter.” Unfortunately, this is almost never the case.

The typical result of poor GSE design is that the GSE ends up driving much of the
legislative and regulatory agenda regarding its own fate. Policy scholars Thomas Stanton and Ronald Moe argue that this can lead to “increasing dominance over the governmental process” by GSEs, the inability “of the government to supervise GSE safety and soundness and the government’s resulting financial exposure,” as well as government’s inability “to induce GSEs to serve public purposes that conflict with the interests of shareholders.”

Fannie and Freddie reflect what is worst in GSE design. After fulfilling their purpose of creating a national mortgage market, they have taken on monstrously large lives of their own. In the midst of their bailout, Congress should take the opportunity to convert them to fully private status. Congress should also enact appropriate financial regulation, consumer protection legislation, and affordable housing programs. And Congress should remember the lessons of Fannie and Freddie when it considers using the GSE as a tool of government in the future. It should reflect on the appropriate design for such a hybrid tool, a design informed by a theoretical understanding of the GSE based on regulatory theory and sound federal budget policies.

**Notes**


5. See Reiss, * supra* note 1, at 1033.

6. See generally id. The Housing and Economic Recovery Act of 2008 (“the Act”) appears to have made the implicit guarantee a bit more explicit as it gives the Treasury broad power to assist Fannie and Freddie if one or both were to become insolvent. Pub. L. No. 110-289 (2008), 122 Stat. 2654.

7. See generally Reiss, * supra* note 1, at 1033.

8. See * infra* note 143 and accompanying text.


11. See id.

12. See id.

13. See id.


21. See Eric Bruskin et al., The Nonagency Mortgage Market: Background and Overview, in THE HANDBOOK OF NONAGENCY MORTGAGE-BACKED SECURITIES 6–7 (Frank J. Fabozzi et al. eds., 2d ed. 2000). Jumbo loans (and other loans not purchased by Fannie and Freddie) have bigger spreads than those that are purchased by them because the originators of those loans have higher costs of funds than Fannie and Freddie. Reiss, supra note 1, at 1033.


24. See Reiss, supra note 1, at 1032.


26. James R. Hagerty, Fannie, Freddie Are Said to Suffer in Subprime Mess, WALL ST. J., July 28, 2007, at A3 (reporting that Citigroup indicated that while subprime mortgage bonds held by Fannie and Freddie have fallen in value, the two companies could “easily ride out” the subprime market turmoil).

27. See, e.g., John Authers, The Short View, FIN. TIMES, Aug. 7, 2007, at 15; see James R. Hagerty, Mortgage Crisis Extends its Reach—Fannie, Freddie Regain Dominance as Investors Shrink from Housing, WALL ST. J., Nov. 13, 2007, at A1 (reporting that Fannie and Freddie were continuing to fund mortgages and take on additional risk); Stacy-Marie Ishmael, CIT to Sell Subprime Book to Freddie Mac, FIN. TIMES, Sept. 20, 2007, at 17 (reporting that CIT Group will sell its subprime loan portfolio to Freddie Mac and quit the residential mortgage business).

28. See, e.g., Robert Cyran, False Hopes for Mortgage Leaders, WALL ST. J., Aug. 9, 2007, at C10 (warning that Fannie and Freddie were highly leveraged).

29. See, e.g., James R. Hagerty, Big Fans for Fannie Freddie, WALL ST. J., Aug. 8, 2007, at C1 (noting that Senators Christopher Dodd and Charles Schumer have called for lifting cap on Fannie and Freddie’s portfolios of mortgages and related securities); Angelo R. Mozilo, Calling Fannie and Freddie, WALL ST. J., Dec. 5, 2007, at A24 (CEO of Countrywide Financial Corp. promoting increased role for Fannie and Freddie to temporarily provide support for the housing market); Damian Paletta, Schumers Propose Mortgage Funding Boost, WALL ST. J., Sept. 10, 2007, at A3 (reporting that Senator Schumer plans bill to temporarily loosen constraints on government-sponsored Fannie and Freddie and increase size of mortgages they can purchase in high-cost areas); Damian Paletta, Democrats Propose Mortgage Aid, WALL ST. J., Oct. 4, 2007, at A5 (reporting that House Financial Services committee chair Barney Frank will support temporary increase in portfolios of Freddie Mac and Fannie Mae by 10% for one year in effort to ease credit crunch).

30. See, e.g., Jeremy Grant, Fannie Mae Offer to Ease Subprime Pain Rebuffed by Regulator, FIN. TIMES, Aug. 11, 2007, at 3 (reporting that Fannie CEO unsuccessfully requested that OFHEO increase the cap on its portfolio); see Stacy-Marie Ishmael et al., Freddie Mac Chief Warns of Recession, FIN. TIMES, Sept. 28, 2007, at 27 (reporting Freddie CEO chief remarks regarding how Fannie and Freddie could be used to alleviate the credit crisis); Damian Pal- etta, OFHEO Is Pressured over Mortgages, WALL ST. J., Oct. 24, 2007, at B10 (reporting that OFHEO had received numerous letters from lawmakers and others urging it to allow Fannie and Freddie to increase the size of their portfolios).

31. See, e.g., Jeremy Grant, supra note 30, at 3; Deb-


34. See, e.g., James R. Hagerty, *Fannie, Freddie Feel Default Heat*, WALL ST. J., Nov. 19, 2007, at A14 (reporting that a wave of defaults resulting from fall in home values and sales has hit Fannie and Freddie’s usually more stable borrowers and that the two companies also have significant exposure to subprime loans).

35. See, e.g., James R. Hagerty, *Mortgage Giant Fuels Worries with Steep Loss*, WALL ST. J., Nov. 21, 2007, at A1 (reporting that Freddie Mac had wider-than-expected third-quarter loss of $2.03 billion which follows Fannie Mae’s $1.4 billion loss); see also Reiss, *supra* note 1, at 1031–32 (discussing risks inherent in Fannie/Freddie business model).


39. James R. Hagerty, *More Risk for Fannie, Freddie?*, WALL ST. J., Jan. 25, 2008, at A8 (reporting that Bush administration was considering raising conforming limits); Damian Paletta, *Plains would Boost Funds for Mortgages*, WALL ST. J., Mar. 18, 2008, at A6 (reporting that Bush administration was planning initiatives to create more funding for mortgages by relaxing constraints on Fannie and Freddie); Damian Paletta, *US Boosts Its Role in Mortgages*, WALL ST. J., Mar. 20, 2008, at A3 (reporting that new loosened capital requirements will allow Fannie and Freddie to purchase additional $200 billion of mortgage securities, equivalent to about 10 percent of expected U.S. home-mortgage lending this year).


42. See Michael R. Crittenden, *Some Progress Cited at Fannie and Freddie*, WALL ST. J., Apr. 16, 2008, at A2 (reporting that OFHEO found that Fannie and Freddie helped provide stability and liquidity to U.S. mortgage market in 2007, but also warns of matters requiring attention including Freddie’s internal controls and corporate governance and Fannie’s relatively aggressive strategy for managing risk); James R. Hagerty, *Fannie, Freddie Report Progress in Cutting Some Mortgage Rates*, WALL ST. J., May 23, 2008, at A5 (reporting that Fannie and Freddie executives tell House Financial Services Committee they are bringing down interest rates on some jumbo mortgages); Saskia Scholtes, *Data Show Fannie and Freddie Taking the Wheel in Home Loans*, FIN. TIMES, Apr. 3, 2008, at 19 (reporting that Fannie and Freddie accounted for a record 75 percent of new mortgage financing at the end of 2007 which was twice the share they held at end of 2006).

43. Antony Currie, *Buck Up, Fannie & Freddie*, WALL ST. J., Mar. 14, 2008, at C12 (column warning that...
if housing prices were to fall another 15% in 2008, Fannie and Freddie could find themselves running short of capital; Peter Eavis, How to Value Fannie, Freddie, WALL ST. J., Feb. 29, 2008, at C2 (column warning investors that Freddie increased its leverage in fourth quarter and is more exposed than before to downturns in its business of guaranteeing mortgages and noting that Fannie’s leverage remains at level far above that of other financial institutions); James R. Hagerty, Pressure on Fannie and Freddie, WALL ST. J., Mar. 11, 2008, at A3 (reporting that Fannie and Freddie shares fall on fears that home-mortgage defaults will force companies to raise more capital); David Reilly and Peter Eavis, Will $6 Billion Do for Fannie?, WALL ST. J., May 7, 2008, at C26 (reporting that Fannies will raise six billion dollars through stock sale but warning that this may not be sufficient to shore up its balance sheet while also assisting the liquidity of the housing market); Saskia Scholtes, Freddie Mac Decides against Raising Capital, FIN. TIMES, Mar. 13, 2008, at 42 (reporting that Freddie Mac ruled out any plans to raise new equity capital and rejected mounting speculation that it may not have enough capital to weather the housing slump).

44. Saskia Scholtes, Shock Widening in Spreads of Fannie and Freddie Debt, FIN. TIMES, Mar. 18, 2008, at 25 (noting that, historically, Fannie and Freddie debt has traded from 10 to 20 basis points below LIBOR); see Mark Gongloff, Counting on a Fan, Fred Safety Net, WALL ST. J., May 6, 2008, at C1 (column contending that rise in mortgage delinquencies seems unlikely to reverse as long as home prices keep falling, which means more losses and need for more capital for Fannie and Freddie; cautions that shareholders may not be rescued even if government safety net catches Fannie and Freddie); James R. Hagerty, Mortgage Giants Take Beating on Fears over Loan Defaults, WALL ST. J., July 8, 2008, at A1 (reporting that Fannie and Freddie shares are down because of fears that companies will have to issue billions of dollars in stock).

45. Safety and soundness” regulation refers to government oversight of financial institutions to ensure that they are adequately capitalized given their exposure to risk and given the negative externalities that their failure would cause. See Mark J. Flannery, Supervising Bank Safety and Soundness: Some Open Issues, 92 ECON. R. 83, 86 (2007).

46. Krishna Guha et al., Saviours of the Suburbs: Are US’s Twin Home Loan Titans at Risk? FIN. TIMES, June 4, 2008, at I (noting that Fannie and Freddie’s current performance is making the possibility of a bailout more likely); James R. Hagerty, Fannie, Freddie Called Weak in Capital Base, WALL ST. J., May 17, 2008, at A3 (reporting that OFHEO director James Lockhart charges that Fannie and Freddie are at “point of vulnerability” resulting from a lack of capital); James R. Hagerty, US Mulls Future of Fannie, Freddie, WALL ST. J., July 10, 2008, at A1 (noting that Fannie and Freddie’s recent financial performance has intensified Bush administration talks about possibility of the need for government support of the two entities); Damian Paletta, Senate Strikes Housing Rescue Deal, WALL ST. J., May 20, 2008, at A1 (reporting senators Christopher Dodd and Richard Shelby have completed bipartisan plan that would overhaul supervision of Fannie and Freddie and Bush administration has indicated that this plan was workable).


49. Steven R. Weisman, Plan to Rescue Mortgage Giants Faces Resistance, N.Y. TIMES, July 16, 2008, at A1; see Deborah Solomon, Rescue Plan Is Latest in a Series of Risks Taken on by Taxpayers, WALL ST. J., July 18, 2008, at A10 (noting that the federal government has taken on many contingent liabilities during credit crisis that could result in taxpayers being on the hook for many billions of dollars).


51. Mike Ferullo, Housing Report Says GSE Holdings of Private Securities Pose Substantial Risk, 91 Banking Rep. 142 (July 28, 2008) (reporting that OFHEO stated that Fannie and Freddie subprime and Alt-A holdings continue to pose substantial risks); Mike Ferullo, Fannie, Freddie Report Unexpected Losses, Offer Grim Outlook for Housing Market, 91 Banking Rep. 216 (Aug. 11, 2008) (reporting that Fannie and Freddie had much larger than expected losses for the second quarter of 2008); James R. Hagerty, S&P Cuts Some Ratings on Fannie and Freddie, WALL ST. J., Aug. 12, 2008, at C5 (noting that there is much uncertainty as to whether the federal government would protect holders of preferred stock and subordinated debt even if
they were to back the companies’ senior debt).

52. See Aparajita Saha-Bubna and Prabha Natarajan, Fannie Cuts Support for Mortgage Market, WALL ST. J., Aug. 9, 2008, at B6 (reporting that Fannie Mae disclosed that it would slow its purchases of mortgage-related securities to preserve capital).


55. See §§ 4611–4617, id.; Loretta Nott and Barbara Miles, GSE REGULATORY REFORM: FREQUENTLY ASKED QUESTIONS 5 (CRS Cong. Rep. RS21724, Updated April 27, 2006) (noting that “OFHEO does not have the authority to alter [Fannie and Freddie’s] capital standards, which prevents the enforcement of greater capital requirements when there is an increase in perceived risk due to unsafe or unsound practices”); Reiss, supra note 1, at 1033–36 (reviewing powers of OFHEO).


57. Housing and Economic Recovery Act of 2008 § 1101; see id. § 1301 (abolishing OFHEO); id. § 1311 (abolishing, in addition, Federal Housing Finance Board which regulates Federal Home Loan Banks).


59. U.S.C. § 1312. Until the first director is appointed, the director of OFHEO shall serve as the director of the agency. Id. § 1312(b)(5).


62. Id. The agency also has an inspector general authorized to hire accountants and economists to review the financial health of the two companies. Id. § 1105 (amending section 1317 to Federal Housing Enterprises Financial Safety and Soundness Act of 1992, 12 U.S.C. § 4517). The operating costs of the agency will be borne by annual assessments on Fannie and Freddie that are set by the agency. Id. § 1106. While OFHEO’s funding mechanism was also based on assessments of the two companies, it required Congressional appropriations approval, which made OFHEO more susceptible to political influence. Compare 12 U.S.C. § 4516(f) (2008) with 12 U.S.C. § 4516(f) (2007).


65. Id. § 1144.


67. Housing and Economic Recovery Act of 2008 § 1145. Conservatorship and receivership are quite similar, although a conservatorship is generally preferred where the entity is expected to return to sound and solvent at some point in the future. See, e.g., FDIC, Resolutions Handbook 70–71 (2003), available at http://www.fdic.gov/bank/historical/res handbook/. For an exploration of receivership of large commercial banks as a blueprint for any future resolution of the GSEs, see Robert A. Eisenbeis et al., Resolving Large Financial Intermediaries: Banks versus Housing Enterprises (Federal Reserve Bank of Atlanta Working Paper 2004-23a, 2004). The authors list institutional scale, regulatory relationship with the federal government, federal charters, and exemption from the Bankruptcy Code as common traits shared by both types of entities.


71. Id.


84. See, e.g., STANTON, supra note 23; see also CARNELL, supra note 1, at S87 (2005) (“The GSEs imply that these market improvements depend on GSEs’ continued government sponsorship, as if the old defects would recur if GSEs lost their subsidies”).

85. Fannie and Freddie have funded directly or indirectly most of the research that pertains to them. That research typically supports Fannie and Freddie’s own agendas. In addition, many of the scholars writing about Fannie and Freddie have worked or do work for one of the two companies. Again, much of their research is supportive of the two companies. I use the terms “independent scholars” and “independent research” to distinguish scholar work produced by those without a connection to the two firms as well as research by Fannie- or Freddie-affiliated researchers that does not appear to have a pro–Fannie and Freddie bias.

86. James E. Pearce and James C. Miller III, Revisiting the Net Benefits of Freddie Mac and Fannie Mae 16 (2006). There is a strong argument that the beneficiaries of this reduction in interest rates are not home buyers, but rather developers and home sellers, as the “lower rates attributable to the GSEs’ subsidized borrowing are simply capitalized into the cost of the homes.” Peter J. Wallison and Bert Ely, Nationalizing Mortgage Risk: The Growth of Fannie Mae and Freddie Mac 5–6 (2000).

87. The average existing home cost a bit more than $240,000 in August 2008. National Association of Home Builders website, http://www.nahb.org/ (search for NEWEXISTINGSINGLEFAMILY HOMEPRICESUStruncated.XLS). Assuming a 20 percent down payment, the average mortgage for such a home would be roughly $200,000.


89. See Robert Shireman, What School Loan Scandal? N.Y. TIMES, June 14, 2004, at A19 (“Every independent, apples-to-apples cost comparison—whether by the GAO, by the Congressional Budget Office or by the president’s Office of Management and Budget—has shown that the direct loan program is cheaper” than programs that operate through private lenders).


91. One recent proposal by R. Glenn Hubbard and Christopher Mayer to resolve the credit crisis adopts this position. See Paul Milstein Center for Real Estate at Columbia Business School website, http://www4.gsb.columbia.edu/realestate/research/housingcrisis/mortgagemarket (providing various documents outlining proposal to have government pass on its lower cost of funds to homeowners).


93. OFFEO, SYSTEMIC RISK: FANNIE MAE, FREDDIE MAC AND THE ROLE OF OFFEO 1 (2003); see Paul Kupiec and David Nickerson, Assessing Systemic Risk Exposure from Banks and GSEs under Alternative Ap-
approaches to Capital Regulation, 28 J. REAL EST. FIN. & ECON. 123 (2004) (arguing, in this paper co-authored by a Freddie Mac consultant, that lower capital requirements like those of Fannie and Freddie can reduce systemic risk); Robert Seiler, Fannie Mae and Freddie Mac as Investor-Owned Utilities, 11 J. PUB. BUDGETING ACCT. & FIN. MGMT. 117, 118 (1999) (arguing that, because of implied guaranty, GSEs have "an incentive to increase its risk exposure and leverage in search for higher profits for owners").


95. Ruth Simon, Homeowners’ Refinancing Jumps by Record Pace, WALL ST. J., Dec. 4, 2008, at C1; see also THOMAS STANTON, GOVERNMENT-SPONSORED ENTERPRISES: MERCANTILIST COMPANIES IN THE MODERN WORLD 39 (2002) (noting that GSE specialization "removes a form of diversification that can help an institution absorb financial shocks"). In testimony before the Senate in 2005, then–Federal Reserve chairman Alan Greenspan warned that the GSEs’ large portfolios, far from creating a liquidity buffer against a market crisis as some GSE-insiders argued, were in fact the major source of GSE-related systemic risk. Reform of the Government Sponsored Enterprises before the S. Com. on Banking, Housing and Urban Affairs, 109th Cong. 5-8 (2005) (prepared statement of Alan Greenspan, chairman, Federal Reserve System). Harvard’s Joint Center for Housing Studies argues that the GSEs provided market liquidity through credit crunches in 1998 and 2001. While I acknowledge that the GSEs did provide limited liquidity relief, the center fails to account for the hundreds of billions of dollars that the bailout may ultimately cost as well as the additional systemic risk that the insolvency of the two entities had imposed on the financial system in 2008. JOINT CTR. FOR HOUSING STUDIES OF HARVARD UNIV., MEETING MULTIFAMILY FINANCE NEEDS DURING AND AFTER THE CREDIT CRISIS: A POLICY BRIEF 11–12 (2009) [hereinafter MEETING MULTIFAMILY FINANCE NEEDS DURING AND AFTER THE CREDIT CRISIS] [http://www.jchs.harvard.edu/publications/finance/multifamily_housing_finace_needs.pdf].

96. See note 40 and accompanying text.


98. Hagerty et al., Mortgage Giant Freddie Mac Considers Major Stock Sale—Issue of up to $10 Billion Would Aim to Stave off Rescue Plan, supra note 60 (reporting that by May 2008, “Fannie had raised $7.4 billion of capital by selling common and preferred shares”).

99. See James R. Hagerty et al., U.S. Seizes Mortgage Giants—Government Ousts CEOs of Fannie, Freddie; Promises up to $200 Billion in Capital, supra note 79, at A1 (quoting Treasury Secretary Paulson as stating that “[f]ailure of either of them would cause great turmoil in our financial markets here at home and around the globe”).

100. 12 U.S.C. § 4501 et seq. (2008). These goals would have also been impacted by the Housing and Economic Recovery Act of 2008’s affordable housing fund, if the two companies had not entered conservatorship. See supra notes 60 and 74. FEDERAL NATIONAL MORTGAGE ASSOCIATION, Form 8-K (Nov. 12, 2008), available at http://www.sec.gov/Archives/edgar/data/310522/000129993308005442htm_30041.htm (reporting that the Agency has suspended Fannie’s contributions to affordable housing fund under the Act).

101. 12 U.S.C. §§ 4562–4. The low- and moderate-income housing goal targets “families with incomes at or below the area median income”; the special affordable housing goal targets families at or below 60 percent of area median income as well as low-income families in low-income areas, which are areas at or below 80 percent of area median income; and the underserved areas housing goal targets families “living in low-income census tracts or in low- or middle-income census tracts with high minority populations.” HUD Regulation of Fannie Mae and Freddie Mac, available at http://www.hud.gov/offices/lsg/gse/gse.cfm. [hereinafter HUD Regulation]; see generally 24 C.F.R. §§ 811.13.22 (setting forth Fannie and Freddie’s housing goals).

102. 12 U.S.C. §§ 4561 (adjusting) and 4566 (monitoring and enforcing).

103. HUD Regulation, supra note 101. HUD issued a series of notices and regulations setting these goals for a transition period and beyond. Id.

104. See James R. Hagerty, Fannie, Freddie Face a Tough Plan—Senate Republicans Offer Strong Bill to Strengthen Mortgage Firms’ Oversight, WALL ST. J., Mar. 29, 2004, at A2 (reporting that HUD was investigating transaction between Freddie and Washington Mutual Inc. (WAMu), in which Freddie “bought $6 billion of mortgages on multifamily housing units from WAMu to help Freddie meet its affordable-housing goals for 2003”); John D. McKinnon & John R. Wilke, HUD Says Freddie Double-Counted Some Transactions, WALL ST. J., Oct. 15, 2004, at A2 (reporting that Freddie failed to meet affordable housing goal).

ing research that finds that Fannie and Freddie have responded positively to their affordable housing goals, but finding that those goals and those of FHA “work in opposite directions and can leave credit supply and homeownership unchanged or possibly even reduced”). But see Brent W. Ambrose and Thomas G. Thibodeau, Have the GSEs Affordable Housing Goals Increased the Supply of Mortgage Credit? 34 REGIONAL SCIENCE & URBAN ECON. 263, 263 (2004) (finding that the affordable housing goals “increased the supply of mortgage credit available to low- and moderate-income households, after controlling for other mortgage market factors.”) (both of these authors have received research funding from Fannie Mae); Roberto G. Quercia et al., The Impacts of Affordable Lending Efforts on Homeownership Rates, 12 J. HOUSING ECON. 29 (2003) ( Freddie Mac–funded research finding that GSE activities increase rate of homeownership, particularly among minorities); BRENT AMBROSE ET AL., U.S. DEPT OF HOUSING & URB. DEV. (HUD), AN ANALYSIS OF THE EFFECTS OF THE GSE AFFORDABLE GOALS ON LOW- AND MEDIUM-INCOME FAMILIES 66 (Prepared by The Urban Institute, 2002), available at http://www.huduser.org/Publications/pdf/gsegoals.pdf (finding suggestive evidence that homeownership rates have “increased faster for low- and moderate-income families in areas where the GSEs have relatively large market shares.”) (two of these authors have received research funding from Fannie Mae).

106. Thomas Stanton and Ronald Moe, Government Corporations and Government-Sponsored Enterprises, in The Tools of Government: A Guide to the New Governance 80, 107 n.56 (2002) (Lester M. Salaman, ed., 2002) (citing U.S. General Accounting Office, Federal Housing Enterprises: HUD’s Mission Oversight Needs to Be Strengthened, GAO/GGD 98-173 [1998]); see Richard A. Williams et al., The Effects of the GSEs, CRA, and Institutional Characteristics on Home Mortgage Lending to Underserved Markets, 5 CITYSCAPE (2001), available at http://www.huduser.org/Periodicals/CITYSCPE/VOL5NUM3/williams.pdf (studying the impact of various housing factors in 1990s Indiana, and noting that the GSEs were not leading but mirroring the private market in efforts to provide financing to lower- and moderate-income households); Kirk McClure, The Twin Mandates Given to the GSEs: Which Works Best, Helping Low Income Homebuyers or Helping Underserved Areas? 5 CITYSCAPE (2001), available at http://www.huduser.org/Periodicals/CITYSCPE/VOL5NUM3/mcclure.pdf (finding similar results in the Kansas City area during the 1990s); STANTON, supra note 95, at 81 (“HUD has informed Congress that its analysis of [HMDA data] shows that both GSEs continue to lag the rest of the market in funding affordable housing loans for lower-income families and under-served communities”). In the area of multifamily mortgage finance, the GSEs have not been perceived as leaders either. See Kimberly Burnett and Linda B. Fosburg, Study of the Multifamily Underwriting and the GSEs’ Role in the Multifamily Market: Expanded Version ix (2001) (noting that Fannie and Freddie were not seen as leaders in “affordable segment of multifamily market); but see Edward J. Szymanski and Susan Donahue, Do FHA Multifamily Mortgage Insurance Programs Provide Affordable Housing and Serve Underserved Areas? An Analysis of FHA’s Fiscal Year 1997 Book of Business and Comparison with the GSEs 19-20 (HUD Housing Finance Working Paper Series, HF-008, 1999) (arguing that GSEs provide affordable housing benefits comparable to FHA program).


110. It is a question of policy as to which of these states of affairs is better for consumers and one that will not be reached here. See Lauren E. Willis, Decisionmaking and the Limits of Disclosure: The Problem of Predatory Lending Price, 65 Mo. L. Rev. 707 (2006) (reviewing and critiquing “rational actor” model in context of residential mortgage market consumer).

111. Floyd Norris, Can Lenders Suddenly Tighten Reins?, N.Y. TIMES, Mar. 2, 2007, at C1 (reporting that Freddie Mac announced that it would pull back from the riskier part of the subprime market, which it claimed that it entered in part to meet its affordable housing goals, because it was funding many mortgages that were ultimately defaulting).


115. Stanton, supra note 95, at 10.

116. See Froomkin, supra note 88, at 557–59. The category of federal corporations is broader than the category of GSEs. Because of the requirements of various budget reduction statutes in effect at various times over the last few decades, off-budget activities undertaken by GSEs were popular with Congress. See id. at 559; see also Allen Schick and Felix LoStracco, The Federal Budget: Politics, Policy, Process 146–48 (2000) (describing impact on Congressional behavior of PAYGO rules prescribed by the Budget Enforcement Act of 1990 which requires offsets of the costs imposed by new legislation).

117. See id.


119. See, e.g., Pearce and Miller, supra note 86, at 16 (reviewing various studies that have measured the interest rate reduction to conforming borrowers as being between 24 and 43 basis points); Congressional Budget Office, Assessing the Public Costs and Benefits of Fannie Mae and Freddie Mac (May 1996) (comparing value of Fannie and Freddie credit-enhancement subsidies to benefits passed through to home buyers and finding that Fannie and Freddie retain nearly one-third of that subsidy); see also Anthony B. Sanders, Government Sponsored Agencies: Do the Benefits Outweigh the Costs?, 25 J. REAL. EST. FIN. & ECON. 121 (Sept.–Dec. 2002) (comparing cost of implied guarantee with benefit of reduced mortgage interest rates, without deciding whether the one outweighs the other).

120. Pearce and Miller, supra note 86, at 1 (containing extensive bibliography of cost/benefit studies of Fannie and Freddie). Freddie Mac has funded or otherwise supported a significant amount of research to support its own position. See, e.g., id (study prepared for Freddie Mac); Kupiec and Nickerson, supra note 93, at 123 (study by former Freddie Mac consultant finding that systemic risk might be controlled by lowering capital requirements for housing GSEs); Quercia, et al., supra note 105 (study by authors including at least one Freddie Mac consultant finding that Fannie and Freddie activities increase rate of homeownership, particularly for minorities); Richard Roll, Benefits to Homeowners from Mortgage Portfolios Retained by Fannie Mae and Freddie Mac, 23 J. FIN. SERVICES RES. 29 (2003) (study by Freddie Mac consultant finding that Fannie and Freddie increase liquidity in secondary mortgage market by purchasing their own RMBS); Frank Nothaft, James E. Pearce, and Stevan Stevanovic, Debt Spreads Between GSEs and Other Corporations, 25 J. REAL. EST. FIN. & ECON. 151 (2002) (study by Freddie Mac-affiliated researchers finding that GSE funding advantage in long-term debt is somewhat lower than estimates of other researchers); Robert Van Order, Some Notes of the Effects of Fannie Mae and Freddie Mac on Mortgage Markets, 23 J. REAL. EST. FIN. & ECON. 365 (2001) (Freddie Mac researcher arguing that “Monopoly power provides incentives to take less risk to keep the franchise”).

121. This is true of the work of Stanton, Wallison, and Ely, to name a few. This tendency has also enveloped powerful constituencies within the Democratic and Republican Parties as well as the liberal and conservative media. See, e.g., Editorial, Affordable Housing, N.Y. TIMES, July 1, 2007, at A16 (arguing that only “Hard-line Republicans” oppose compromise on GSE legislation); Editorial, Freddie Guts Frank, WALL ST. J., May 22, 2007, at A14 (arguing that Democratic congressional leaders pretend “to favor reform while letting Fannie and Freddie have their way”); see also Jonathan G. Koppell, The Politics of Quasi-Government 121 (2003) (“Few would have anticipated that Fannie Mae and Freddie Mac would grow into political heavyweights”).

122. Policy scholars Thomas Stanton and Ronald Moe, taking a different tack, have developed a useful framework for evaluating GSEs. They took part in the “Tools of Government Project” which evaluates an array of government tools pursuant to a consistent set of analytic lenses. The “Tools of Government Project” is a useful exercise for comparing
the Boston Tea Party was directed against the tea of
HISTORY 5–6 (1993). As Thomas Stanton has noted,
123. See, e.g., Joseph F. Brodley, The Economic Goals of
Antitrust: Efficiency, Consumer Welfare, and Technologi-
cal Progress Antitrust: Efficiency, Consumer Welfare, and Technologi-
cal Progress 41–43.
126. Stanton and Moe, supra note 106.
and Rowley go on to summarize the major contem-
porary theories of regulation, including economic,
contractual and public choice theories. Id. at 6–15.
For the purposes of this analysis, “regulation the-
ory” refers to the broadly overlapping portions of
these theoretical approaches to regulation that ex-
plain the extent to which regulation actually ben-
fits the regulated entity.
128. See Dennis W. Carlton and Randal C. Picker,
Antitrust and Regulation 51 (NBER Working Paper
srn.com/sol3/papers.cfm?abstract_id=937020
discussing antitrust and regulation as two compli-
mentary aspects of competitive policy).
129. OFHEO, SYSTEMIC RISK: FANNIE MAE, FREDDIE
MAC AND THE ROLE OF OFHEO, supra note 93, at
41–43.
130. Philip Lawson, The East India Company: A
History 5–6 (1993). As Thomas Stanton has noted,
the Boston Tea Party was directed against the tea of
the monopolistic East India Company. STANTON, supra note 95, at 106; see generally BENJAMIN WOODS
132. See Peter Z. Grossman and Daniel H. Cole, eds,
Introduction, in The End of a Natural Monopoly:
Deregulation and Competition in the Electric
133. See stephen g. breyer, Regulation And Its
Reform 18 (1982).
134. See Seiler, supra note 93, at 118 (“Economic
regulation is intended to address problems of mo-
nopoly, extreme concentration in an industry, or
the social or political power of large corporations”); com-
pare Lawrence A. Sullivan and Warren S.
(reviewing these goals in antitrust regulation con-
text).
135. Areeda and Hovenkamp note that “economic
concerns have generally dominated antitrust policy
and trumped competing ‘ populist’ concerns.” Phi-
lip E. Areeda and Herbert Hovenkamp, I Antitrust
Law 98. Areeda and Hovenkamp as well as Judge
Richard Posner are examples of those who fall into
the economic efficiency camp.
136. See generally Hylton, supra note 126, at 1–19.
“Optimal competition,” as an economist would un-
derstand it, exists “when the firms in a market price
their output at marginal costs and costs are mini-
mized by internal efficiency, research, and develop-
ment, attainment of economies of scale or scope.”
Areeda and Hovenkamp, supra note 135, at 4.
137. Robert Seiler and others argue that Fannie and
Freddie have a number of characteristics of duopo-
lists. Seiler, supra note 93, at 125; see Benjamin E.
Her-
malin and Dwight M. Jaffee, The Privatization of Fannie
Mae and Freddie Mac: Implications for Mortgage Industry
Structure, in Studies on Privatizing Fannie Mae and
Freddie Mac 225 (1994) (arguing that there is empir-
ical support for finding that Fannie and Freddie have
opportunities to collude, based on historically high
profits); John L. Goodman, and Wayne S. Passmore,
Market Power and The Pricing of Mortgage Secu-
ritization 2 (1992) (Federal Reserve Board’s Finance
and Economics Discussion Series, Number 187) (not-
ing that conforming market is a classic duopoly); see
also Lawrence White and W. Scott Frame, Fussing and
Fuming over Fannie and Freddie: How Much Smoke, How
Much Fire, 21 n.10 (NYU Stern Working Paper No.
04-27; Federal Reserve Bank of Atlanta Working Pa-
srn.com/abstract=604525 (“The empirical evidence
suggests that Fannie Mae and Freddie Mac do retain
some portion of their federal benefits and hence are
not acting in a perfectly competitive manner”). Fan-

138. See, e.g., supra note 76. Before the credit crisis, they were also becoming formidable competitors in the subprime conforming market, which they had avoided until recently in favor of the prime conforming market. Reiss, supra note 108, at 1033. The regulation of Fannie and Freddie perversely results in “cream-skimming,” a problem that is generally considered to be a rationale for a regulated monopoly, not a result of a regulated monopoly. “Cream-skimming” refers to the practice of only choosing to enter into the lucrative parts of a market. Alfred Kahn, The Economics of Regulation 7 (1988). In order to prevent the other parts of such a market from being underserved, a regulatory scheme might bar competitors intent on cream-skimming from the entire market. The limitations on which loans Fannie and Freddie can buy and guarantee have effectively given them a monopoly over the creamy markets and bar them from entering the skimmed portion of the market.


140. This assumes that there are no easily acceptable substitute products for the monopolist producers. See RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 254–55 (3d ed. 1986).

141. BREYER, supra note 133, at 16; see Froomkin, supra note 88, at 618. See also U.S. Department of the Treasury, REPORT OF THE SEC. OF THE TREASURY ON GOVERNMENT-Sponsored Enterprises 8 (1991) (noting that because of GSEs’ special privileges, they are “effectively insulated from private market discipline”).

142. See, e.g., Seiler, supra note 93, at 132 (citing three studies that support a finding that Fannie and Freddie price “their mortgage guarantee services above competitive levels”). There is also some evidence that Fannie and Freddie engage in price discrimination by setting their mortgage guarantee fees higher for smaller lenders. Id. at 132–33.


144. Cowling and Mueller, supra note 143, at 141. See also NEIL K. KOMESAR, IMPERFECT ALTERNATIVES: CHOOSING INSTITUTIONS IN LAW, ECONOMICS AND PUBLIC POLICY 115–119 (1994) (noting that rent seeking skews distribution of resources toward lobbying efforts); James M. Buchanan, From Private Preferences to Public Philosophy: The Development of Public Choice, in THE ECONOMICS OF POLITICS 1, 13 (1978) (“when politics creates profit opportunities or rents . . . we can expect resource waste in investments to secure the favoured plums”).

145. See ROGER SHERMAN, THE REGULATION OF MONOPOLY 64 (1989) (arguing that government-created monopolies face only a “slight threat” of competition and as a result they may have “no great urge to innovate”). But see Richard A. Posner, Antitrust Law 20 (2d ed. 2001) (“It is an empirical question whether monopoly retards or advances innovation”).

146. See, e.g., Proposals for Improving the Regulation of the Housing Government Sponsored Enterprises: Hearing before the Senate Comm. on Banking, Housing and Urban Affairs 108th Cong. 18 (2004) (statement of Franklin D. Raines, chief executive officer, Fannie Mae), available at http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=d0df394d-a9f7-4642-bf10-7bad6b5e09 (“We work every day to innovate and develop creative ways to bring homeownership opportunities to all corners of the nation”).
Stanton, supra note 95, at 8.

148. See Seiler, supra note 93, at 130 (“The regulated firm may be able to use profits from its regulated markets to fund a policy of predatory pricing in new, unregulated markets. . . . If a regulated product is an input in the production of an unregulated product, a regulated monopolist will also try to control the supply of competitors through its control of the regulated product”). Fannie and Freddie’s incursions into the loan underwriting technology market may, for instance, blur the line between the secondary mortgage market, where they are allowed to operate, and the primary mortgage market, where they are barred from operating. See generally Mortgage Bankers Association, supra note 60, at 4. See also Housing Enterprises: The Roles of Fannie Mae and Freddie Mac in the U.S. Housing System Before the H. Comm. Task Force on Housing and Infrastructure, 106th Cong. 7 (2000) (statement of Thomas J. McCool, director, Financial Institutions and Market Issues, U.S. General Accounting Office (GAO), noting that the GSE’s forays into automated underwriting may signal move to expand into new areas of the mortgage industry), available at http://www.gao.gov/archive/2000/gg00182t.pdf.

149. Mortgage Bankers Association, supra note 60, at 4 (“[T]he GSEs have established a duopoly in loan underwriting technology”); see Jie Gan and Timothy J. Riddiough, Monopoly and Information Advantage in the Residential Mortgage-Market 3 (Review of Financial Studies, forthcoming), available at http://ssrn.com/abstract=962321 (“GSEs effectively lend directly to consumers as an informationally advantaged monopolist”). But even longstanding Fannie/Freddie critic Stanton acknowledges that the two companies “have been among leaders in their segments of the market in adopting new technology-based servicing, loan management, and loan underwriting systems.” Stanton and Moe, supra note 106, at 110.


151. See, e.g., Edmund L. Andrews, Loose Reins on Galloping Loans; Efforts to Regulate Risky Mortgage Innovations Are So Far Ignored, N.Y. TIMES, July 15, 2005, at C1 (describing complex mortgage-backed securities offerings); James R. Hagerty, Mortgage-Bond Pioneer Dislikes What He Sees, WALL ST. J., Feb. 24, 2007, at B1 (describing risky residential mortgage products). As these two representative news articles indicate, this innovation has its downsides, for both consumers and investors, if they do not properly judge the risk posed by such innovations.

152. See Sherman, supra note 145, at 63 (noting that “hordes of potential competitors” can spur management effort more than anything else).


154. Breyer, supra note 133, at 15-16; see Sherman, supra note 145, at 64 (“[T]he monopoly tendency is to set price above marginal cost”).

155. See supra note 119. Profits reported by a monopolist understate the true economic profit to the extent that the firm competes for monopoly power by investing for the purpose of maintaining the monopoly. See Cowling and Mueller, supra note 143, at 150. For a defense of the GSEs’ profit yield against “controversial studies” that link company profits with an implicit subsidy, see Michael Fratantoni and Peter Niculescu, Subsidies in a Context of Efficient Markets: A New Framework for Evaluating the Role of Fannie Mae (SSRN Working Paper Series, 2005), available at http://ssrn.com/abstract=841345. The article argues that the efficiency of financial markets prevents extraordinary profits, as MBS yields will decline by the same amount as debt yields, and any profit is the result of efficiencies of size and expertise in risk management. Its co-author, Peter Niculescu, was an executive vice president at Fannie Mae at the time of its writing.

156. White and Frame, supra note 137, at 21 n.10 (noting the extraordinary profitability of Fannie and Freddie for the years 1998–2002 in which “Fannie Mae earned an average return on equity of 25.4 percent while Freddie Mac earned an average of 24.2 percent. By contrast, the industry return on equity for all FDIC-insured commercial banks for the same five years was around 14 percent”). While they have generally enjoyed high profits, Fannie and Freddie’s large losses in 2008, of course, led to their entering conservatorship.

157. Froomkin, supra note 88, at 547 (“The greatest microeconomic concerns [relating to federal government corporations] are self-dealing, and management or shareholder enjoyment of a publicly created rent, free of charge”). Fannie Mae management, in particular, has awarded itself outsized pay packages in recent years. See, e.g., Editorial, Ill-Gotten Raines, WALL ST. J., Dec. 20, 2006, at A18 (praising OFHEO suit seeking $115 million in restitution of ill-gotten pay from former members of Fannie management). This is not to say that other financial firms do not provide astronomical compensation to their executives, but just to say that Fannie operates in that same league.
disruptions. Our credit risk, interest-rate risk, Freddie Mac states that it is the least likely of large 
regardless of which definition [of systemic risk] to stabilize the financial markets in which it operates 
being a source of systemic risk, Fannie Mae operates 
2001, Fannie Mae asserts far from 

See Breyer, supra note 133, at 20.

See supra text accompanying notes 107–109; see also Fannie Mae, INTRODUCING FANNIE MAE, supra 
notice 107, at 4; Freddie Mac, JUST THE FACTS: HOW WE MAKE HOME POSSIBLE, supra note 107, at 5.

See Reiss, supra note 108, at 1011–12.

See generally Engel and McCoy, Turning a Blind Eye: Wall Street Financing of Predatory Lending, supra note 153.


Compare Benton E. Gup, Are Fannie Mae and Freddie Mac Too Big to Fail? In Too Big to Fail: Policies and Practices in Government Bailouts 315 n.28 (Benton E. Gup ed. 2004) (“In their responses to an OFHEO inquiry for public comments with respect to systemic risk in 2001, Fannie Mae asserts ‘far from being a source of systemic risk, Fannie Mae operates to stabilize the financial markets in which it operates . . . regardless of which definition [of systemic risk] is applied, Fannie Mae does not pose systemic risk.’ Freddie Mac states that it ‘is the least likely of large financial institutions to cause significant financial disruptions. . . . Our credit risk, interest-rate risk, capital management and disclosure practices make Freddie Mac strong and well managed’”) and White and Frame, supra note 137, at 22 n.11 (reviewing literature that suggests “that because of their implicit government guarantees, the companies might also act as a source of strength to financial markets in the face of external shocks”), with Dwight M. Jaffee, Controlling the Interest Rate Risk of Fannie Mae and Freddie Mac I (Networks Financial Institute Policy Brief No. 2006-PB-04 Apr. 2006), available at http://ssrn.com/abstract=923568 (“It is increasingly recognized that the interest rate risk embedded in the F&F retained mortgage portfolios represents a serious threat to the US financial system”). Notwithstanding this dispute, nearly all commentators agree that GSEs are generally successful at making credit more available and more liquid in the particular markets in which they operate. See, e.g., Michael J. Lea, Privatizing a Government-Sponsored Enterprise: Lessons from the Sallie Mae Experience, NETWORKS FIN. INST. 2006-PB-09, at 15 (2006), available at http://ssrn.com/abstract=923461 (“From the perspective of credit availability, the GSE concept has been a major success”).

Reiss, supra note 1, at 1049–51 (discussing risks of Fannie/Freddie business model).

Notwithstanding the fact that Fannie and Freddie do not appear to be particularly efficient, there is a bias in favor of privatizing government functions. See Fromkin, supra note 88, at 547 (“[Federal government corporations] conjure up an image of business efficiency as opposed to the traditional bureaucratic cabinet department. Proponents of small government may welcome the introduction of an element of private control into most realms of public administration as a means of preparing for the privatization of federal functions. Democratic socialists may view wholly or even partly owned government corporations as a means of capturing the rents and profits from public activities or natural monopolies for the benefit of the public fisc”).


See Koppell, supra note 121, at 97–121. See also The Role of Fannie Mae and Freddie Mac in the Financial Crisis before the H. Comm. on Oversight and Gov’t Reform, 110th Cong. 1 n.1 (2008) (providing litany of GSE reform legislation blocked since 2000).

See id. at 102–103.

177. Koppell, supra note 121, at 164 (arguing that use of hybrid entities like Fannie and Freddie lead to government’s loss of control over public policy). Even the Treasury Department has noted that the “problem of avoiding capture appears to be particularly acute in the case of regulation of GSEs.” Stanton, supra note 95, at 44 (quoting 1991 Treasury study). A further challenge the GSEs lobbying arm presents is requiring the untangling of market complexities, and the danger of politicians underestimating how seemingly minor policy changes, often clothed in the guise of serving the GSEs’ public mission, can have drastic ramifications in the financial and mortgage markets. Thomas H. Stanton, The Administrative Conference of the United States: A Resource to Help Policymakers Deal with the Legal Framework of Third Party Government before the Section of Admin. Law, American Ass’n of Law Schools Annual Meeting 6–7 (Jan. 3, 2002), available at http://www.aals.org/am2002/stanton.pdf.

178. See Froomkin, supra note 88, at 618. The federal budget does, in contrast, include corporations owned in whole or in part by the government. Schick and LoStracco, supra note 116, at 42.


180. Cheryl Block, Congress and Accounting Scandals: Is the Pot Calling the Kettle Black? 82 NEB. L. REV. 365, 435–42 (2003–04) (comparing off-budget nature of GSEs to private sector use of special purposes enterprises used by corporations like Enron to keep certain activities off of their financial statements).

181. See Reiss, supra note 1, at 1048 n.132.

182. See id.

183. See id. at 1027–1042.

184. Cheryl Block, Pathologies at the Intersection of the Budget and Tax Legislative Process, 43 B.C. L. Rev. 863, 900–904 (2001–02). While the meaning of some of these principles is clear, a few are not. “Enforceability” refers to mechanisms to enforce budget decisions once they are made. Id. at 901. The government should be “accountable” in two ways for the budget: (1) for the cost of budget items and (2) for the cost of unexpected events. Id. Finally, the phrase “openness and durability” reflects the concern that the budget process be open such that the public can understand and participate in it; and that the process by which the budget is set is reasonably durable so that the public can better understand how it unfolds. Id. at 904. Block has added this last goal to those set forth by the GAO in BUDGET PROCESS: EVOLUTION AND CHALLENGES 12 (1996) (GAO/TAIMD-96-129).


187. See Sam Peltzman, The Economic Theory of Regulation after a Decade of Deregulation, in ECONOMIC REGULATION 123, 135 (2000) (“Compact, well-organized groups will tend to benefit more from regulation than broad, diffuse groups. This probably creates a bias in favor of producer groups, because they are usually well organized relative to all consumers. But the dominant coalition usually also includes subsets of consumers”); Sunstein, supra note 125, at 55 (noting that many regulatory schemes “are designed to redistribute resources from one group to another. Some respond to a widely held or easily defended view that the benefited groups have a legitimate claim to the relevant resources”).

188. Even as persistent a GSE critic as Thomas Stanton sees some merit in this approach. He argues that such a clear cut approach limits the ability of GSEs to manipulate their public giving in order to influence the political process. Stanton and Moe, supra note 106, at 107 (arguing that a potentially effective tool to assure that GSEs serve their public purposes is to “require that a GSE set aside a fixed percentage of its income to serve high-priority public purposes”). Indeed, Congress did just that with the Federal Home Loan Banks in 1989 when it required them to set aside 10 percent of their income each year to reduce the costs of mortgages for underserved borrowers and communities.” Id.
189. See supra note 75.

190. See, e.g., Editorial, Affordable Housing, supra note 121, at A16.

191. See supra note 76.

192. See, e.g., National Housing Trust Fund website, https://www2398.ssldomain.com/nhlfhome/template/page.cfm?id=40 (noting that the affordable housing fund was major victory for affordable housing advocates); Mike Wallace, President Signs Federal Housing Bill (no date), http://www.nclo.org/ARTICLES/articleItems/NCW8408/housingbillsigned.aspx (noting that affordable housing fund paid for by Fannie and Freddie was long-time policy recommendation of National League of Cities); American Institute of Architects, Washington Update: Housing Relief Bill Signed into Law (Aug. 4, 2008), available at http://www.aia.org/newsstr_print.cfm?pagename=angle_newsstr_20080804 (“AIA has supported legislation to create such a fund with its partners in the affordable housing industry”).

193. In a perverse way, it might turn out that the net impact of the guarantee of Fannie and Freddie’s obligations (lower interest rates for homeowners netted from the cost of bailing out Fannie and Freddie) might actually be a progressive wealth transfer, given that roughly two-thirds of Americans are homeowners and the top 20 percent of American households pay roughly two-thirds of all federal taxes. See Harvard Joint Center for Housing Studies, supra note 164, at 7 (noting homeownership rate); CBO, Historical Effective Federal Tax Rates: 1979 to 2004 (Dec. 2006) (noting tax burden). Even if this were true, this was clearly not the intent and would be a horribly indirect way to implement public policy.

194. See Stanton and Moe, supra note 106 (disfavoring comparing operations of the privately owned Fannie Mae to those of the federal government corporation Ginnie Mae); Holman Jenkins, Jr., How to Shake off the Mortgage Mess, Wall St. J., July 30, 2008, at A13 (arguing that Fannie and Freddie should be nationalized and then privatized); see also Wallison, Fannie and Freddie by Twilight, supra note 81, at 4-6 (evaluating possibility of nationalizing the two companies under the act).


196. See id. The Obama administration is signaling that it may be taking this path as well, perhaps as Fannie and Freddie become more enmeshed with the government’s response to the foreclosure crisis. Charles Duhhigg, U.S. Likely to Keep the Reins On 2 Fallen Mortgage Giants, N. Y. Times, Mar. 3, 2009, at A1.

197. See Sunstein, supra note 125, at 84 (“Statutes that amount to private wealth transfers should be understood as failures per se”).

198. Id. at 109.

199. See note 157 (noting OFHEO challenge to $115 million in Fannie Mae executive compensation).

200. Paulson believes that this is the least attractive reform although it is unclear from news reports why this is the case. Hagerty, Paulson: Redo Fannie, Freddie, supra note 195, at A11. Some commentators have pointed out that privatization is not a panacea for all systemic risk in the mortgage market. See, e.g., Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises (2009), supra note 82, (prepared testimony of Dr. Susan M. Wachter, Prof. of Real Estate & Fin., U. Pa.). Professor Wachter notes that taxpayers have been held liable for bailing out private actors as much as GSEs during the recent crisis. Id. at 2. However, in any systemic crisis comparable to the present one, the federal government will necessarily play the role of lender of last resort. Under more common market conditions, privatization is a far superior alternative to private companies extracting monopolistic rents by exploiting a government-granted regulatory privilege.

201. See Gordon Tullock, Rents and Rent-Seeking, in The Political Economy of Rent-Seeking 51, 56 (Charles K. Rowley et al. eds., 1988) (“[M]onopolies “provided by obtaining government action, strenuous lobbying, etc., normally also are eroded over time, partly by political forces and partly by market forces”).


204. Reiss, supra note 1, at 1075–76.

206. Hagerty, Paulson: Redo Fannie, Freddie, supra note 195, at A11 (reporting that Paulson said that a public utility model "could be the best way to resolve the inherent conflict" between public and private missions).


208. Others have advocated this view as well. See White, supra note 166 (proposing that Fannie and Freddie be converted into standard for-profit Delaware corporations). Peter Wallison, Thomas Stanton, and Bert Ely have even drafted proposed legislation to implement it. Peter J. Wallison, Et Al., Privatizing Fannie Mae, Freddie Mac, and the Federal Home Loan Banks (2004). These proposals fail, however, to take into account the benefits that Fannie and Freddie offer and thus do not make allowances for them as this analysis does.

209. Reiss, supra note 1, at 1079–80. And just as the privatization of Sallie Mae required government satisfaction of that GSE's existing debt before releasing the company to the private sector, comparable actions would necessarily be taken for Fannie and Freddie. See Subcomm. on Capital Markets, Insurance and Government-Sponsored Enterprises (2009), supra note 82, at 8 (prepared statement of Lawrence J. White, Prof. of Econ., N.Y.U.) ("The federal government will have to fill the large negative net worth 'holes' of the two companies before privatizing them; but those 'hole-filling' expenditures will be necessary regardless of what happens to the two companies, since the federal government is unlikely to stiff [the GSEs'] creditors").

210. See David Reiss, After Fannie and Freddie, Nat'l L. J., Sept. 19, 2008, at 23 (discussing alternatives to Fannie and Freddie to stabilize mortgages markets). See also Meeting Multifamily Finance Needs During and After the Credit Crisis 14–16 (listing options for maintaining liquidity in face of pending reforms to GSE structure).

211. Hagerty et al., Red Ink Clouds Role of Fannie, Freddie, supra note 80, at A2 (reporting that federal government has made $400 billion available to the two companies).

212. See supra text accompanying notes 79–80.

213. See Forrester, supra note 108 (describing pro-consumer terms in form Fannie/Freddie loan documents); Engel and McCoy, supra note 162, at 2061, 2095 (describing due diligence best practices imposed by Fannie and Freddie).

214. Even if current events shake the faith of even the most ardent free market proponent. See Krishna Guha and Edward Luce, Greenspan Suggests Nationalising Banks, FT.COM, Feb. 18, 2009, available at http://www.ft.com/cms/s/0/e310cbf6-fd4e-11dd-a103-000077b07658.html?nclick_check=1 (quoting Alan Greenspan as saying, "It may be necessary to temporarily nationalize some banks in order to facilitate a swift and orderly restructuring").


216. Stanton and Moe, supra note 106, at 105.
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