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Abstract: Fannie Mae and Freddie Mac are huge, fast-growing, highly leveraged, lightly regulated, and susceptible to failure. Prudence calls for having a legal mechanism adequate for handling their failure. Yet no adequate insolvency mechanism currently exists for them. Unlike ordinary business firms, these government-sponsored enterprises (GSEs) cannot liquidate or reorganize under the Bankruptcy Code. If Fannie Mae or Freddie Mac became sufficiently troubled, its regulator could appoint a conservator to take control of the firm and attempt to restore its financial health. But by then the firm's problems could well have become too severe for the conservator to resolve. The conservatorship statute provides no means for effectuating a reorganization and does not expressly authorize a liquidation. Uncertainty about the priority of and process for handling creditors' claims could worsen the firm's problems and increase the risk of disrupting financial markets and eliciting a costly congressional rescue. By enacting a workable insolvency mechanism, Congress could avoid using public money or credit to rescue a troubled GSE's creditors. Congress should specify priorities among creditors' claims, authorize appointment of a receiver, and empower the receiver to reorganize the GSE or establish an interim firm to carry on the GSE's business. Alternatively, Congress could allow GSEs to liquidate or reorganize under the Bankruptcy Code.

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Handling the Failure of a GSE

INTRODUCTION

The Federal National Mortgage Association (Fannie Mae or Fannie)[1] and the Federal Home Loan Mortgage Corporation (Freddie Mac or Freddie)[2] are huge, fast-growing, highly leveraged, lightly regulated, and susceptible to failure.[3] Prudence calls for having a legal mechanism adequate for handling their failure. Yet no adequate insolvency mechanism currently exists for them. Unlike ordinary business firms, they cannot liquidate or reorganize under the Bankruptcy Code.[4] If Fannie or Freddie became sufficiently troubled, its regulator could appoint a "conservator" to take control of the firm and attempt to restore the firm's financial health.[5] But by then the firm's problems could well have become too severe for a conservator to resolve.[6] The conservator would have only limited powers.[7] The conservatorship statute provides no means for effectuating a reorganization[8] (i.e., a modification of creditors' claims[9]) and does not expressly authorize a liquidation.[10] Moreover, uncertainty about the priority of and process for handling creditors' claims against the firm could worsen the firm's problems and increase the risk of disrupting financial markets and eliciting a costly congressional rescue.[11]

Fannie and Freddie are "government-sponsored enterprises" (GSEs): privately owned financial institutions with special ties to the federal government.[12] Together the three largest GSEs—Fannie, Freddie, and the Federal Home Loan Bank System—have become one-third the size of the entire U.S. commercial banking industry.[13] Yet GSEs have

1. 12 U.S.C. §§ 1716, 1717, 1718, 1719, 1723(b), 1723a, 1723c (2000).
2. *Id*. §§ 1451–1459.
3. *See infra* Part I.B, .C, .E.
4. *See infra* Part IV.A.
5. *See infra* Part IV.B.1.
6. *See infra* text accompanying notes 327–30.
7. *See infra* text accompanying notes 319–30.
8. *See infra* text accompanying notes 324–26.
9. A reorganization could modify creditors' claims by, for example, extending repayment, lowering interest rates, varying other credit terms, or converting some debt to equity. As used in this Article, "reorganization" does not include a "recapitalization," which here denotes raising equity without modifying creditors' claims.
10. *See infra* Part IV.B.2.a.
11. *See infra* text accompanying notes 388–96.
12. *See infra* text accompanying notes 20–30.
13. *See* table *infra* p. 574 (showing that Fannie, Freddie, and Federal Home Loan Bank System

received remarkably little scrutiny from legal scholars[14]—far less than banks have. Few law review articles give GSEs any sustained attention.[15] Some articles focus on individual GSEs[16] or very specialized topics.[17] More commonly, scholars briefly discuss GSEs as they relate to some other topic.[18] No law review article deals adequately with GSEs' ambiguous relationship to the government. This scholarly neglect is particularly unfortunate given GSEs' size and importance—and the legal and policy issues posed by the inadequacy of the current regulatory

(FHLBS) together had $2.58 trillion in total assets on Dec. 31, 2003); FED. DEPOSIT INS. CORP., FDIC QUARTERLY BANKING PROFILE, Fourth Quarter 2003, at 6 [hereinafter FDIC BANKING PROFILE 4Q-2003] (showing that commercial banks insured by Federal Deposit Insurance Corporation (FDIC) had $7.60 trillion in total assets).

14. Thomas H. Stanton, a practicing lawyer who teaches public administration at Johns Hopkins University, is the most knowledgeable and prolific writer bringing legal insight to GSE policy issues. *See generally* THOMAS H. STANTON, GOVERNMENT-SPONSORED ENTERPRISES: MERCANTILIST COMPANIES IN THE MODERN WORLD (2002) [hereinafter STANTON, GSES]; THOMAS H. STANTON, A STATE OF RISK: WILL GOVERNMENT-SPONSORED ENTERPRISES BE THE NEXT FINANCIAL CRISIS? (1991) [hereinafter STANTON, A STATE OF RISK].

15. A. Michael Froomkin, *Reinventing the Government Corporation*, 1995 U. ILL. L. REV. 543, deals with GSEs as part of a larger study of government corporations. Bradley K. Krehely, *Government Sponsored Enterprises: A Discussion of the Federal Subsidy of Fannie Mae and Freddie Mac*, 6 N.C. BANKING INST. 519 (2002), focuses on policy issues involving Fannie and Freddie. Carrie Stradley Lavargna, *Government-Sponsored Enterprises Are "Too Big to Fail": Balancing Public and Private Interests*, 44 HASTINGS L.J. 992 (1993), proceeds from the assumption that "[t]hese part-private, part-public institutions are indispensable components of the nation's economy and are 'too big to fail,'" *id*. at 992, and thus does not consider many of the issues discussed in this article.

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

17. *See, e.g.*, Cheryl D. Block, *Congress and Accounting Scandals: Is the Pot Calling the Kettle Black?*, 82 NEB. L. REV. 365, 435–39 (2003) (likening federal government's use of GSEs to Enron's use of special-purpose vehicles); John L. Brown, *Federal Preemption of the State Regulation of Agricultural Credit*, 7 DRAKE J. AGRIC. L. 563, 571–74 (2002) (examining federal preemption of state usury restrictions).

18. *See, e.g.*, Avery Wiener Katz, *An Economic Analysis of the Guaranty Contract*, 66 U. CHI. L. REV. 47, 56–57 (1999) (characterizing implicit government backing of GSEs as type of guarantee relationship); Amy C. Bushaw, *Small Business Loan Pools: Testing the Waters*, 2 J. SMALL & EMERGING BUS. L. 197, 217–19, 252–56 (1998) (explaining how establishing GSE to securitize bank loans to small businesses could improve small businesses' access to credit); Anthony D. Taibi, *Banking, Finance, and Community Economic Empowerment: Structural Economic Theory, Procedural Civil Rights, and Substantive Racial Justice*, 107 HARV. L. REV. 1465, 1530–31 (1994) (noting that proposed community development financial institutions fund would be government agency, not GSE).

structure.[19]

This Article aims to help fill that gap. Part I introduces the five GSEs and sketches their business activities and financial importance. It explains how their government sponsorship impairs market discipline, enriches shareholders, and promotes artificial growth and excessive risk-taking. It also argues that the government, by timely adopting workable insolvency mechanisms, could avoid using public money or credit to rescue an insolvent GSE's creditors. Part II examines the political economy of GSEs and explains how ambiguity about government backing of GSEs both blunts accountability for the risks and other costs of government sponsorship and helps account for the central failures of GSE policy. These failures include applying inadequate financial-safety rules to GSEs (e.g., weak capital requirements and no adequate insolvency mechanism for Fannie and Freddie) and not demanding adequate public benefits from GSEs. Part III draws on bank insolvency law—the principal model for the specialized insolvency regimes for Fannie, Freddie, and other GSEs—to develop criteria for assessing the adequacy of GSE insolvency regimes, which follow bank insolvency law only imperfectly. Part IV examines GSE insolvency regimes and concludes that the regime for Fannie and Freddie has grave deficiencies and that the regimes for the other three GSEs need improvement. Part V explores the potential practical consequences of these deficiencies. Part VI sets forth criteria for correcting the deficiencies of current law,

19. Since 1999 I have repeatedly stressed the importance of having adequate insolvency mechanisms for GSEs. *See, e.g.*, Richard S. Carnell, Improving the Regulation of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks: Statement Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs 8–9, 15 (Feb. 10, 2004) [hereinafter Carnell, 2004 Senate Testimony], http://banking.senate.gov/_files/carnell.pdf (noting that, unlike business corporations or FDIC-insured depository institutions, Fannie and Freddie face no credible, workable insolvency mechanism and that lack of such mechanism reinforces perception that government implicitly backs Fannie and Freddie; and arguing that Congress should authorize receivership or make Bankruptcy Code apply); *Reforming Fannie Mae and Freddie Mac: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Financial Services*, 107th Cong. 30, 31–32, app. at 135–36, 141 (2001) (statement of Richard S. Carnell) (noting that Fannie and Freddie, unlike FDIC-insured depository institutions, face no credible, workable receivership mechanism and that lack of such mechanism reinforces perception that government implicitly backs Fannie and Freddie); Richard Scott Carnell, *Federal Deposit Insurance and Federal Sponsorship of Fannie Mae and Freddie Mac: The Structure of Subsidy*, *in* SERVING TWO MASTERS YET OUT OF CONTROL: FANNIE MAE AND FREDDIE MAC 56, 64–66 (Peter J. Wallison ed., 2001) [hereinafter SERVING TWO MASTERS YET OUT OF CONTROL] (same); Richard S. Carnell, *Federal Deposit Insurance and Federal Sponsorship of Fannie Mae and Freddie Mac: The Structure of Subsidy*, *in* 2 PUBLIC PURPOSES AND PRIVATE INTERESTS: FANNIE MAE AND FREDDIE MAC 71, 78–79 (Peter J. Wallison ed., 1999) (same). This Article sets forth more fully the legal and policy rationales for this position.

explains how a troubled GSE could be reorganized, analyzes recent congressional reform proposals, and considers GSEs' objections to receivership. Part VII concludes that Congress should act now to provide a receivership mechanism for Fannie and Freddie and broaden the authority of receivers for Farm Credit System institutions and Farmer Mac.

I. BACKGROUND

GSEs are specialized, privately owned, federally chartered financial institutions. Bond-market investors infer from the GSEs' federal ties that the government implicitly backs the GSEs. This perception of government backing reduces the GSEs' borrowing costs and impairs market discipline on the GSEs, enabling the GSEs to grow larger and take greater risks than they could as fully private firms. The GSEs do not provide public benefits commensurate with the subsidies they receive from their government sponsorship. Moreover, despite government financial-soundness regulation, the GSEs remain vulnerable to failure.

This Part defines "government-sponsored enterprise," introduces the GSEs and their businesses, and notes the GSEs' rapid growth and financial importance. It examines the consequences of government sponsorship, including reduced market discipline, higher return for shareholders, extraordinary growth, and increased risk to the financial system. It explains how current GSE financial-soundness regulation fails to provide an adequate substitute for market discipline. Finally, it considers whether the government could avoid rescuing an insolvent GSE's creditors.

A. Defining GSEs

A GSE is a federally chartered, privately owned, privately managed financial institution that has only specialized lending and guarantee powers and that bond-market investors perceive as implicitly backed by the federal government.[20] Several aspects of this definition bear emphasis. First, GSEs have charters granted by or pursuant to an act of

20. This definition broadly accords with definitions used in the Congressional Budget Act, 2 U.S.C. § 622(8) (2000), and by STANTON, GSES, *supra* note 14, at 1–2. *See also* 12 U.S.C. § 2277a-4(a)(4) (2000) (defining GSE, for purposes of Farm Credit System Insurance Corporation premium formula, as "an entity that is chartered by Congress to serve a public purpose and the debt obligations of which are not explicitly guaranteed by the United States").

Congress; ordinary business corporations have state charters.[21] Second, GSEs' private ownership and private management underscore that GSEs form no part of the government, unlike executive departments (e.g., the Department of the Treasury),[22] independent agencies (e.g., the Securities and Exchange Commission),[23] or government corporations (e.g., Amtrak, Ginnie Mae, and the U.S. Postal Service).[24] Thus a GSE cannot exercise sovereign powers[25] and lacks authority to bind the government financially.[26] Third, although GSEs are financial institutions, they have only specialized lending and guarantee powers—powers much narrower than those (for example) of national banks, federal savings associations, and federal credit unions.[27] Fourth, and most importantly, bond-market investors believe that the government implicitly backs each GSE and would not let a GSE's creditors go unpaid.[28] In the words of a prominent financial writer, GSEs "are regarded by most people who lend them money as the government in disguise."[29] This perceived implicit backing is the GSEs' most important and most distinctive characteristic.[30] It

21. *See* Geoffrey P. Miller, *The Future of the Dual Banking System*, 53 BROOK. L. REV. 1, 12 (1987).

22. *See* 5 U.S.C. § 101 (2000) (defining "Executive department"); *id.* § 105 (defining "Executive agency" as an "Executive department, a Government corporation, and an independent establishment").

23. *Id*. § 104 (defining "independent establishment").

24. *Id*. § 103(1) (defining "Government corporation"). For a lucid scholarly analysis of government corporations, with some attention to GSEs, see generally Froomkin, *supra* note 15.

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

25. 2 U.S.C. § 622(8)(B)(i).

26. *Id.* § 622(8)(B)(ii). *See* 6 Op. Off. Legal Counsel 262, 264 (1982) (concluding that "when Congress authorizes a federal agency or officer to incur obligations, those obligations are supported by the full faith and credit of the United States, unless the authorizing statute specifically provides otherwise"); Lebron v. Nat'l R.R. Passenger Corp., 513 U.S. 374, 392 (1995) (referring to "the ordinarily presumed power of Government agencies authorized to incur obligations to pledge the credit of the United States").

27. For examples of the breadth of ordinary depository institutions' powers, see 12 U.S.C. § 1464(b)–(c), (k)–(l), (n) (2000) (federal savings associations); *id.* § 1757 (federal credit unions); OFFICE OF THE COMPTROLLER OF THE CURRENCY, ACTIVITIES PERMISSIBLE FOR A NATIONAL BANK (2003) (national banks).

28. *See infra* Part I.D.2.

29. STIGUM, *supra* note 24, at 358.

30. U.S. CONG. BUDGET OFFICE, ASSESSING THE PUBLIC COSTS AND BENEFITS OF FANNIE MAE AND FREDDIE MAC ix (1996) [hereinafter CBO, PUBLIC COSTS AND BENEFITS].

enables GSEs to borrow vast sums from bond-market investors[31] at interest rates below those available to the most creditworthy fully private firms,[32] even though GSEs have much higher debt-to-equity ratios than those firms.[33] Without the perception of implicit backing, GSEs would be smaller, less heavily indebted, and less likely to endanger the U.S. financial system if they failed. The GSEs' perceived implicit backing plays a major role in shaping both GSEs themselves and the policy concerns they raise.

31. *See* table *infra* p. 574 (showing that GSEs' liabilities totaled $2.58 trillion on Dec. 31, 2003).

32. *See* Wayne Passmore, Shane M. Sherlund & Gillian Burgess, *The Effect of Housing Government-Sponsored Enterprises on Mortgage Rates*, 33 REAL ESTATE ECON. (forthcoming 2005) (manuscript at exhs.3 & 4) (showing that Fannie and Freddie had lower long-term borrowing costs from 1998 through 2003 than non-GSE firms rated AAA or AA); Brent W. Ambrose & Arthur Warga, *Measuring Potential GSE Funding Advantages*, 25 J. REAL ESTATE FIN. & ECON. 129, 146 (2002) (noting that from 1995 through 1999, the three housing GSEs "enjoyed an average advantage of between 25 to 29 basis points over 'AA' banking sector bonds, between 43 and 47 basis points over 'A' rated bonds, and between 76 and 80 basis points for 'BBB' rated banking issues"); CBO, PUBLIC COSTS AND BENEFITS, *supra* note 30, at 10–11 (noting that government sponsorship "transforms the market's view of the credit quality of the housing GSEs and vaults their securities from a rating of A or Aa based on their intrinsic financial condition to super Aaa because the risk of default is seen to be lower than on even the highest-rated fully private securities").

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

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

U.S. GEN. ACCOUNTING OFFICE, GOVERNMENT-SPONSORED ENTERPRISES: THE GOVERNMENT'S EXPOSURE TO RISKS, GAO/GGD-90-97, at 9 (1990) [hereinafter GAO, THE GOVERNMENT'S EXPOSURE TO RISKS].

33. *Compare* table *infra* p. 574 (indicating debt-to-equity ratio of 44:1 for Fannie and 24:1 for Freddie as of Dec. 31, 2003), *with* George G. Kaufman, *Capital in Banking: Past, Present and Future*, 5 J. FIN. SERVS. RES. 385, 387 tbl.2, 390 tbl.3 (1991) (showing capital-to-assets ratios in various industries). The capital-to-assets ratios in Kaufman, *supra*, imply debt-to-equity ratios approximating 4:1 in finance, 3:1 in services, and 1.6:1 in manufacturing (assuming that capital equals equity and that debt equals total assets minus capital).

B. *The Five GSEs*

Five GSEs exist[34]: Fannie Mae,[35] Freddie Mac,[36] the Federal Home Loan Bank System (FHLBS),[37] the Farm Credit System (FCS),[38] and the Federal Agricultural Mortgage Corporation (Farmer Mac).[39] A sixth GSE, the Student Loan Marketing Association (Sallie Mae), dissolved itself in December 2004 after transferring its business to non-GSE affiliates.[40] Fannie, Freddie, and Farmer Mac have shares listed on the

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Fannie and Freddie had lower long-term borrowing costs than AAA-rated General Electric Capital Corporation (GECC) from 1998 through 2003, even though GECC had a much lower debt-to-equity ratio. *See* Passmore, Sherlund & Burgess, *supra* note 32 (manuscript at 17–18, exhs.3 & 4). GECC's year-end debt-to-equity ratio averaged less than 7.4:1 during that period (based on a simple average of the year-end ratios shown in GECC's annual reports) and never exceeded 8.5:1. *See* GEN'L ELEC. CAPITAL CORP., FORM 10-K/A FOR THE FISCAL YEAR ENDED DEC. 31, 2004, at 12 (2005) (showing ratios for 2000–2003); GEN'L ELEC. CAPITAL CORP., FORM 10-K FOR THE FISCAL YEAR ENDED DEC. 31, 2000, at 13 (2001) (showing ratios for 1998–2000).

34. In referring to five GSEs, this article treats the Federal Home Loan Bank System (FHLBS) and Farm Credit System (FCS) each as a single enterprise, treats Farmer Mac as separate from the Farm Credit System, and disregards three pseudo-GSEs: the Financing Corporation, Resolution Funding Corporation, and Financial Assistance Corporation. Although the FHLBS and FCS each comprise multiple institutions, those institutions have joint-and-several liability for the system's consolidated obligations. *See* 12 U.S.C. § 1431(b)–(c) (2000) (FHLBS); *id*. § 2155 (FCS). FCS institutions also have a common insurance fund. *See id*. §§ 2277a-1, 2277a-4, 2277a-9. Farmer Mac, although technically "an institution of the Farm Credit System," *id*. § 2279aa-1(a)(2), is separately owned and economically independent. *See, e.g.*, *id*. § 2279aa-1(a)(3) (specifying that Farmer Mac and FCS are not liable for each other).

During the late 1980s Congress established three pseudo-GSEs designed to avoid the budgetary constraints of the Budget and Emergency Deficit Control Act of 1985, Pub. L. No. 99-177, 99 Stat. 1037. The Financing Corporation, 12 U.S.C. § 1441, and the Resolution Funding Corporation, *id*. § 1441b, facilitated assistance to depositors of failed savings institutions. The Financial Assistance Corporation, *id*. §§ 2278b to 2278b-11, helped rescue the Farm Credit System. Unlike real GSEs, these pseudo-GSEs had no business activities, no opportunity for profit, no voluntary shareholders, and no meaningful managerial discretion; they served merely as vehicles for a budgetary subterfuge. *See* Froomkin, *supra* note 15, at 615 (characterizing those entities as "little more than an accounting trick").

35. 12 U.S.C. §§ 1716–1717, 1718, 1719, 1723(b), 1723a, 1723c.

36. *Id*. §§ 1451–1459.

37. *Id*. §§ 1421–1449.

38. *Id*. §§ 2001–2279g.

39. *Id*. §§ 2279aa-1 to 2279aa-14.

40. Congress chartered Sallie Mae in 1972 to create a secondary market for insured student loans. Education Amendments of 1972, Pub. L. No. 92-318, § 133(a), 86 Stat. 235, 265; H.R. REP. NO. 92-554, at 28–29 (1971), *reprinted in* 1972 U.S.C.C.A.N. 2462, 2489–90. In 1993 Congress curtailed federal student loan guarantees, authorized direct federal loans to students, and began charging Sallie Mae an annual fee. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, §§ 4011–4112, 107 Stat. 312, 341–70. Faced with increased borrowing costs and the loss of its main

New York Stock Exchange.[41] Federal Home Loan Banks and Farm Credit System institutions are cooperatives owned by their member-borrowers.[42]

The following table summarizes the five GSEs' assets, liabilities, guarantees,[43] market capitalization, debt-to-equity ratios, and recent growth:[44]

GOVERNMENT-SPONSORED ENTERPRISES As of Dec. 31, 2003; Billions of Dollars					
	Fannie	**Freddie**	**FHLBS**	**FCS**	**Farmer**
Total Assets	1,010	803	764	104	4.3
Total Liabilities	987	770	727	93	4.1
Outstanding Guarantees	1,300	752	0	0	1.0
Market Capitalization	73	40	n/a	n/a	0.5
Book-Value Shareholders' Equity	22	31	36	7	0.2
Debt-to-Equity Ratio	44	24	20	13	19
Annual Asset Growth Rate, 1993-2003	37%	86%	33%	6%	85%

Market capitalization equals number of outstanding shares multiplied by closing share price
Debt-to-equity ratio equals total liabilities divided by shareholders' equity
Asset growth rate reflects average annual growth in total assets, Dec. 31, 1993-Dec. 31, 2003

As the table indicates, the GSEs differ greatly in size. All but one underwent extraordinary growth during the past decade. The outlier—

business, *see generally* Mark Overend, *The Privatization of Sallie Mae*, *in* SERVING TWO MASTERS YET OUT OF CONTROL, *supra* note 19, at 170 (explaining why government sponsorship had become less desirable), Sallie Mae supported legislation ending its government sponsorship. Student Loan Marketing Association Reorganization Act of 1996, Pub. L. No. 104-208, tit. VI, § 602(a), 110 Stat. 3009, 3009-275 to 3009-290 (codified at 20 U.S.C. § 1087-3 (2000)). Sallie Mae dissolved in December 2004. *See* Dawn Kopecki, *Sallie Mae Completes Privatization 4 Years Early*, WALL ST. J., Dec. 30, 2004, at C3.

41. *See* N.Y. Stock Exchange, Listed Company Directory, http://www.nyse.com/about/listed/lc_F.html?ListedComp=All (last visited July 7, 2005).

42. *See* 12 U.S.C. §§ 1424(a)(1), 1426, 1429, 1430(a) (FHLBS); *id.* § 2154a(c)(1)(D)–(E) (FCS).

43. "Outstanding guarantees" refers to the unpaid principal balance of mortgage-backed securities guaranteed by the GSE and held by someone other than the GSE.

44. Data on total assets, total liabilities, outstanding guarantees, shareholders' equity, and number of shares outstanding are from the following GSE reports: FARM CREDIT SYS., ANNUAL INFORMATION STATEMENT—1996, at 3 (1997); FARM CREDIT SYS., ANNUAL INFORMATION STATEMENT—2003, at F-32 (2004); FARMER MAC, 1996 ANNUAL REPORT 4 (1997); FED. AGRIC. MORTGAGE CORP., 2003 ANNUAL REPORT 9, 52 (1997); FED. HOME LOAN BANK SYS., 1995 FINANCIAL REPORT 5, 20 (1996); FED. HOME LOAN BANK SYS., 2003 FINANCIAL REPORT 20, 38–39 (2004); FED. NAT'L MORTGAGE ASS'N, [1994] INFORMATION STATEMENT, at 15, 39–40 (1995); FED. NAT'L MORTGAGE ASS'N, FORM 10-K FOR THE FISCAL YEAR ENDED DEC. 31, 2003, at 24–25 (2004) [hereinafter FANNIE MAE, 2003 FORM 10-K]; FREDDIE MAC, 1993 ANNUAL REPORT 35 (1994); FREDDIE MAC, 2003 ANNUAL REPORT 29, 69, 176 (2004). Closing share prices are from *NYSE Composite Transactions*, WALL ST. J., Jan. 2, 2004, at C2. Fannie will restate its financial statements, which may change data in the table.

the Farm Credit System—operates under financial-soundness rules modeled on those for commercial banks, rules generally more stringent than those applicable to other GSEs.[45]

1. Fannie Mae and Freddie Mac

Fannie and Freddie help fund residential mortgage loans in two basic ways. The first involves creating and guaranteeing mortgage-backed securities.[46] Fannie and Freddie buy loans originated by banks, savings institutions, and mortgage bankers; put many loans of the same type (e.g., recently originated first mortgages) together in a loan "pool"; and sell investors "mortgage-backed securities" representing interests in that pool.[47] The GSEs receive fees for guaranteeing that holders of mortgage-backed securities will receive timely payments of principal and interest on the securities in the pool.[48] The guarantee entails modest credit risk to the GSEs arising from the possibility that homebuyers will default on their loans and that the value of the property will not cover the balance due on the loans.[49]

Fannie and Freddie also help fund mortgage loans by holding mortgage-backed securities (and to a much lesser extent, mortgages) in their own portfolios. The GSEs borrow money from investors by issuing debt securities (e.g., bonds, notes, and debentures) and use the proceeds to buy their own mortgage-backed securities.[50] This portfolio-investment business generates most of the GSEs' profits: the GSEs borrow money cheaply in the government securities market and invest it at the higher rate available in the mortgage-backed securities market.[51] But these higher profits entail higher risk. Portfolio investment accounts for most of the GSEs' risk exposure.[52] In borrowing vast sums to invest in

45. *See* GAO, THE GOVERNMENT'S EXPOSURE TO RISKS, *supra* note 32, at 98; *see, e.g.*, 12 C.F.R. § 615.5205 (2004) (generally requiring each FCS institution to have permanent capital that equals or exceeds 7% of institution's risk-adjusted asset base).

46. *See generally* 1 TAMAR FRANKEL, SECURITIZATION: STRUCTURED FINANCING, FINANCIAL ASSETS POOLS, AND ASSET-BACKED SECURITIES § 2.5 (1991).

47. *See* Alan Greenspan, Chairman, Federal Reserve Board, Statement Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs 1 n.1 (Feb. 24, 2004), http://banking.senate.gov/_files/ACF1BA.pdf [hereinafter Greenspan, 2004 Senate Testimony].

48. *See* U.S. CONG. BUDGET OFFICE, FEDERAL SUBSIDIES AND THE HOUSING GSES 9 (2001) [hereinafter CBO, FEDERAL SUBSIDIES].

49. CBO, PUBLIC COSTS AND BENEFITS, *supra* note 30, at 5.

50. GAO, THE GOVERNMENT'S EXPOSURE TO RISKS, *supra* note 32, at 20.

51. *See* CBO, FEDERAL SUBSIDIES, *supra* note 48, at 8.

52. *See generally* Alan Greenspan, Chairman, Federal Reserve Board, Government-Sponsored

mortgage-backed securities, the GSEs face interest-rate risk, the risk that a rise in interest rates will reduce the market value of the mortgage-backed securities; prepayment risk, the risk that lower interest rates will prompt borrowers to pay off their loans, shorten the duration of the mortgage-backed securities, and effectively force the GSEs into lower-yielding investments; as well as the credit risk of the mortgages underlying the mortgage-backed securities.[53]

2. *Federal Home Loan Bank System*

The Federal Home Loan Bank System consists of twelve regional Federal Home Loan Banks (FHL Banks).[54] Each FHL Bank, owned by its member commercial banks, savings institutions, and credit unions,[55] has its own management and board of directors.[56] The FHLBS raises money by selling investors debt securities for which the twelve FHL Banks are jointly and severally liable.[57] The FHL Banks loan the proceeds to their member institutions and hold the loans in portfolio.[58] The member institutions, in turn, can lend the money to their own customers. The FHL Banks accept deposits from their member institutions,[59] provide check-clearing and other payment-related services to those institutions,[60] and operate affordable housing programs.[61] Like Fannie and Freddie, they also hold large securities portfolios.[62]

Enterprises: Remarks to the Conference on Housing, Mortgage Finance, and the Macroeconomy, Federal Reserve Bank of Atlanta (May 19, 2005), http://www.federalreserve.gov/BoardDocs/Speeches/2005/20050519/default.htm.

53. *See* GAO, THE GOVERNMENT'S EXPOSURE TO RISKS, *supra* note 32, at 31–32. More specifically, the GSEs' interest-rate risk includes the risk that a rise in interest rates will reduce the market value of GSEs' investments without correspondingly reducing the market value of the liabilities funding those investments. *See generally id.* at 31–33 (summarizing ways in which GSEs face interest-rate risk).

54. *See* 12 U.S.C. § 1423 (2000); 12 C.F.R. pt. 905, app. A (2004).

55. *See* 12 U.S.C. §§ 1424(a)(1), 1426, 1429, 1430(a).

56. *See id*. § 1427(a).

57. *See id*. § 1431(b)–(c); 12 C.F.R. pt. 966. *See generally* David Nickerson & Ronnie J. Phillips, *The Federal Home Loan Bank System and the Farm Credit System: Historic Parallels and Implications for Systemic Risk, in* TOO BIG TO FAIL: POLICIES AND PRACTICES IN GOVERNMENT BAILOUTS 107 (Benton E. Gup ed., 2004) (discussing potentially problematic parallels between FHLBS and FCS, including joint-and-several liability).

58. *See* GAO, THE GOVERNMENT'S EXPOSURE TO RISKS, *supra* note 32, at 22.

59. *See* 12 U.S.C. § 1431(e)(1); 12 C.F.R. § 969.2.

60. *See* 12 U.S.C. § 1431(e)(2); 12 C.F.R. pt. 975.

61. *See* 12 U.S.C. § 1430(i)–(j); 12 C.F.R. pt. 951.

62. *See* 12 U.S.C. § 1431(h); 12 C.F.R. pt. 956.

3. *Farm Credit System*

The Farm Credit System comprises a network of cooperatives that operate as portfolio lenders.[63] It includes ninety-one agricultural credit associations and eleven land credit associations, each owned by its farmer- or rancher-borrowers; five farm credit or agricultural credit banks, each owned by its member associations; and the Federal Farm Credit Banks Funding Corporation, owned by its member banks.[64] That corporation raises money for the credit banks by selling investors debt securities,[65] for which the credit banks are jointly and severally liable.[66] The credit associations borrow from the credit banks and lend to farmers.[67] The Farm Credit System Insurance Corporation guarantees timely payment of FCS obligations.[68]

4. *Farmer Mac*

Farmer Mac purchases loans secured by agricultural land and rural housing and guarantees securities backed by such loans.[69] It also holds a portfolio of mortgaged-backed and other securities.[70] Although originally created strictly as a guarantor, Farmer Mac now derives most of its income from holding loans and securities, including securities unrelated to agriculture.[71]

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63. Unlike the other GSEs, the Farm Credit System originates loans and does not operate in the secondary market.

64. *See* 12 U.S.C. § 2002(a) (defining "Farm Credit System"); *id.* § 2154a(c)(1)(D)–(E) (requiring anyone borrowing from FCS institution to buy institution's shares but allowing only agricultural producers to own voting shares). For the number of FCS institutions of various types, see Farm Credit Administration, FCS Institutions, http://www.fca.gov/FCS-Institutions.htm (last visited July 7, 2005).

65. *See* 12 U.S.C. § 2160(b)(1).

66. *See id*. § 2155.

67. *See* GAO, THE GOVERNMENT'S EXPOSURE TO RISKS, *supra* note 32, at 21–22.

68. *See* 12 U.S.C. § 2277a-1.

69. *See id*. §§ 2279aa-3(a), 2279aa-3(c)(12)–(13), 2279aa-5, 2279aa-6(a).

70. *See id*. §§ 2279aa-3(c)(12), 2279aa-6(e).

71. *See* U.S. GEN. ACCOUNTING OFFICE, GOVERNMENT-SPONSORED ENTERPRISES: FEDERAL OVERSIGHT NEEDED FOR NONMORTGAGE INVESTMENTS, GAO/GGD-98-48, at 29 (1998) [hereinafter GAO, GSES' NONMORTGAGE INVESTMENTS]; *see also id.* at 24 (questioning Farmer Mac's viability without government sponsorship). *See generally Interest Rate Farming*, GRANT'S INT. RATE OBSERVER, July 3, 1998, at 10–11.

C. GSEs' Growth and Financial Importance

Fannie and Freddie are huge. At the end of 2003, they together had $1.81 trillion in total assets and $1.76 trillion in total liabilities.[72] They had also guaranteed $2.05 trillion in outstanding mortgage-backed securities held by other investors.[73] The five GSEs together had $2.68 trillion in total assets and $2.58 trillion in total liabilities.[74] By comparison, the federal government's entire publicly held debt totaled $4.07 trillion,[75] U.S. commercial banks had combined total assets of $7.60 trillion,[76] and U.S. corporate shares had a combined market value of $13.06 trillion.[77]

Fannie and Freddie have grown rapidly since the early 1990s.[78] For example, from 1993 through 2003:[79]

- their combined total assets rose 503%, from $301 billion to $1.81 trillion;[80]
- their combined total liabilities—mostly in the form of debt

72. *See* table *supra* p. 574.

73. *See* table *supra* p. 574. Fannie and Freddie guarantee prompt payment of principal and interest on their mortgage-backed securities. These guarantees create a loss contingency—not included in the GSEs' total liabilities—reflecting the possibility that the GSEs might incur liability on the guarantees. *See* FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 5: ACCOUNTING FOR CONTINGENCIES 4 (1975) (defining "loss contingency").

74. *See* table *supra* p. 574.

75. *See* FIN. MGMT. SERV., U.S. DEP'T OF THE TREASURY, TREASURY BULL., Dec. 2004, at 29 tbl.FD-1.

76. *See* FDIC BANKING PROFILE 4Q-2003, *supra* note 13, at 6.

77. FED. RESERVE BD., FED. RESERVE STATISTICAL RELEASE Z.1, FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES, Fourth Quarter 2003, at 90 tbl.L.213, *available at* http://www.federalreserve.gov/releases/Z1/20040304/z1r-4.pdf.

78. Although Fannie and Freddie's growth has slowed significantly since the end of 2003, each firm has strong profit incentives to resume growth after resolving its accounting problems. *See* Kenneth Posner & David Brown, *Fannie Mae, Freddie Mac, and the Road to Redemption*, MORGAN STANLEY EQUITY RES. N. AM. MORTGAGE FIN., July 6, 2005, at 1, 4 (stating that every year without legislation constraining Fannie and Freddie's growth "means another year where higher returns and faster growth are still legally possible" and would warrant higher valuation of each firm's stock).

79. Most data comparisons in this paragraph compare Dec. 31, 1993, with Dec. 31, 2003. The two exceptions, annual issuance and average daily trading volume, compare the calendar years 1994 and 2003.

80. For 1993 data, see FED. NAT'L MORTGAGE ASS'N, [1994] INFORMATION STATEMENT, at 15, 39–40 (1995); FREDDIE MAC, 1993 ANNUAL REPORT 35 (1994). For 2003 data, see FANNIE MAE, 2003 FORM 10-K, *supra* note 44, at 24–25; FREDDIE MAC, 2003 ANNUAL REPORT 29, 69 (2004).

securities—rose 514%, from $287 billion to $1.76 trillion;[81]

- their total annual issuance of mortgage-backed securities rose 672%, from $248 billion to $1.91 trillion;[82]
- their total outstanding mortgage-backed securities rose 222%, from $936 billion to $3.01 trillion;[83] and
- the total market value of their publicly traded shares rose 321%, from $29 billion to $113 billion.[84]

Fannie and Freddie's growth far outstripped inflation,[85] macroeconomic growth,[86] and the growth of depository institutions (i.e., banks and savings institutions) insured by the Federal Deposit Insurance Corporation (FDIC).[87] The GSEs' combined share of total bond-market debt rose from 15% in 1985 to 27% in 1993 and to 36% in 2003, as shown in the following chart:[88]

81. *See supra* note 80. By contrast, the federal government's publicly held debt increased 25%. *See* Fin. Mgmt. Serv., U.S. Dep't of the Treasury, TREASURY BULL., Dec. 2004, at 29 tbl.FD-1.

82. *See* Bond Mkt. Ass'n, Issuance of Agency Mortgage-Backed Securities, http://www.bondmarkets.com/story.asp?id=297 (last visited July 7, 2005).

83. *See* Bond Mkt. Ass'n, Outstanding Volume of Agency Mortgage-Backed Securities, http://www.bondmarkets.com/story.asp?id=1256 (last visited July 7, 2005).

84. For data on the number of shares outstanding, see FED. NAT'L MORTGAGE ASS'N, [1994] INFORMATION STATEMENT, at 39–40 (1995); FANNIE MAE, 2003 FORM 10-K, *supra* note 44, at 123, 174; FREDDIE MAC, 1993 ANNUAL REPORT 35 (1994). FREDDIE MAC, 2003 ANNUAL REPORT 25 (2004). For data on closing share prices, see *New York Stock Exchange Composite Transactions*, WALL ST. J., Jan. 3, 1994, at 15; *NYSE Composite Transactions*, *supra*, note 44.

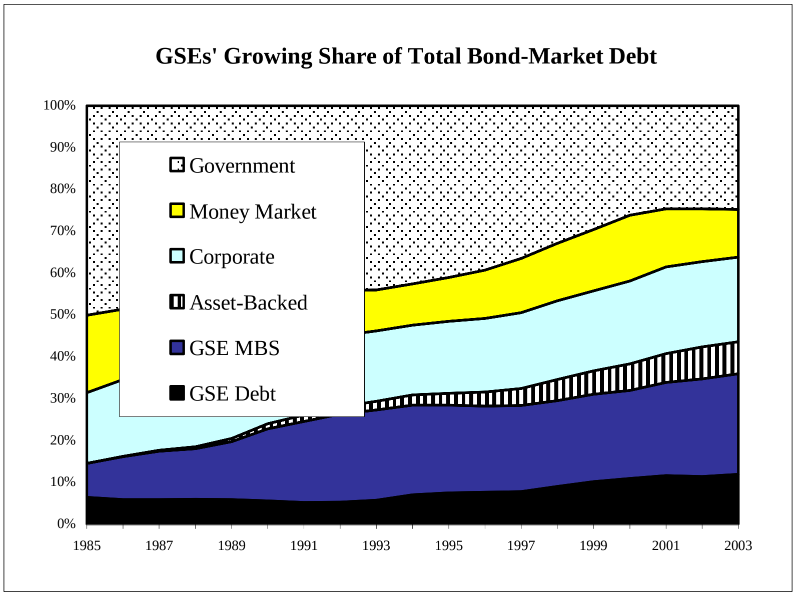
85. The Consumer Price Index for All Urban Consumers, a measure of inflation, increased 26%. *See* Bureau of Labor Statistics, U.S. Dep't of Commerce, Consumer Price Index—All Urban Consumers, http://data.bls.gov (follow "CPI-All Urban Consumers (Current Series), Most Requested Statistics" hyperlink; then select "U.S. All items, 1982-84=100 - CUUR0000SA0").

86. Real gross domestic product, reflecting economic growth, rose 38%; nominal gross domestic product, reflecting both inflation and economic growth, rose 65%. *See* Bureau of Econ. Analysis, U.S. Dep't of Commerce, National Economic Accounts: Current-Dollar and "Real" Gross Domestic Product (June 29, 2005), http://www.bea.doc.gov/bea/dn/gdplev.xls.

87. *See* FED. DEPOSIT INS. CORP., FDIC BANKING PROFILE 4Q-2003, *supra* note 13, at 6.

88. *See* Bond Mkt. Ass'n, Outstanding Level of Public & Private Bond Market Debt, http://www.bondmarkets.com/story.asp?id=323 (last visited July 7, 2005). The chart subdivides bond-market debt into the following components, listed here as each appears from the top to the bottom of the chart: (1) federal, state, and local government securities; (2) money-market instruments; (3) corporate debt securities, excluding GSE debt; (4) asset-backed securities not guaranteed by a GSE; (5) GSE-guaranteed mortgage-backed securities; and (6) GSE debt securities.

The debt securities data in the chart include debt securities issued by Sallie Mae, which remained a GSE until December 2004. *See supra* note 40. But excluding Sallie Mae would not alter the basic trend, as Sallie Mae accounted for only a tiny fraction of all GSE liabilities at the end of 2003. Sallie Mae's non-GSE parent, SLM Corporation (SLM), had $62 million in consolidated total liabilities. SLM CORP., FORM 10-K FOR THE FISCAL YEAR ENDED DEC. 31, 2003, at F-4 (2004). Sallie Mae accounted for less than half of those liabilities. *See id.* at 51 (noting that Sallie had $17 million in



Fannie and Freddie are highly leveraged: they rely heavily on borrowed money. Together they had a debt-to-equity ratio exceeding 32:1,[89] meaning that they had more than $32 in liabilities for each $1 of shareholders' equity. By contrast, FDIC-insured depository institutions, although more heavily leveraged than most firms,[90] had a 10:1 debt-to-equity ratio.[91] Fannie and Freddie's slender equity capital and heavy reliance on debt increase their vulnerability to financial setbacks (e.g., a sharp rise in interest rates would reduce the value of the firms' assets).[92]

D. Consequences of Government Sponsorship

Government sponsorship formally gives GSEs a set of explicit

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short-term and $5 million in long-term managed borrowings). Even if we treated SLM's total liabilities as GSE liabilities, they would amount to only 2.3% of all GSE liabilities ($62 million for SLM divided by $2.60 trillion in total GSE liabilities. *See* table *supra* p. 574).

89. *See* table *supra* p. 574.

90. *See* Kaufman, *supra* note 33, at 387 tbl.2, 390 tbl.3 (showing capital-to-assets ratios in various industries).

91. *See* FDIC BANKING PROFILE 4Q-2003, *supra* note 13, at 5 (dividing total liabilities of $8.25 trillion by equity capital of $831 billion).

92. Other possible risks include mortgage defaults accompanied by a slump in property values, and mismanaged hedging.

benefits, such as a U.S. Treasury line of credit and exemption from most state and local taxation. But the greatest benefit of government sponsorship comes informally, through investors' perception of implicit federal backing. This perception is GSEs' defining characteristic and has major consequences for their borrowing costs, size, profits, and incentives to take risks.

1. GSEs' Explicit Government Benefits

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

- granting GSEs federal charters,[93] which can preempt state laws; [94]
- authorizing the Secretary of the Treasury to extend credit to GSEs;[95]
- exempting GSEs from most state and local taxes;[96]
- exempting GSEs from having to register their securities under the Securities Act of 1933[97] and the Securities Exchange Act of 1934;[98]

93. *See supra* notes 35–39.

94. *See, e.g.*, McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316, 436–37 (1819) (holding unconstitutional state law that impeded federal instrumentality's operations); Fed. Land Bank of St. Paul v. Bismarck Lumber Co., 314 U.S. 95, 102 (1941) (holding that Congress could immunize bank's lending functions from state taxation).

95. 12 U.S.C. § 1431(i) (2000) (FHLBS); *id*. § 1455(c) (Freddie); *id*. § 1719(c) (Fannie); *id*. § 2279aa-13 (Farmer Mac). The Treasury would extend credit to GSEs by purchasing their debt securities.

96. *Id.* § 1433 (FHLBS); *id.*§ 1452(e) (Freddie); *id.* § 1723a(c)(2) (Fannie); *id.* §§ 2023, 2077, 2098, 2134 (Farm Credit System).

97. All five GSEs' securities are exempt from registration under the Securities Act of 1933, 15 U.S.C. §§ 77a–77bbbb (2000). The Act exempts from registration any security "issued or guaranteed . . . by any person . . . supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States." *See id*. § 77c(a)(2). Because GSEs are federal instrumentalities supervised by the federal government, *see infra* Part IV.A, 15 U.S.C. § 77c(a)(2) exempts their securities from registration. In addition, Congress has expressly designated as "exempted securities" securities issued by Fannie and Freddie. *See* 12 U.S.C. § 1455(g) (Freddie); *id*. §§ 1719(d)–(e), 1723c (Fannie).

98. Four of the five GSEs enjoy exemption from the registration and reporting requirements of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78mm. Congress has exempted Fannie and Freddie by designating their securities as "exempted securities," *see supra* note 97. An issuer that has only "exempted securities" outstanding need not register under that Act. *See* 15 U.S.C. § 78*l*(a), (g)(1). An issuer becomes subject to that Act's reporting requirements only if it registers under that Act or the Securities Act of 1933. *See id*. §§ 78m(a), 78o(d).

The Treasury Department has exempted the FHLBS and FCS under 15 U.S.C. §§ 78c(a)(12)(A)(i) (defining "government securities" as "exempted securities"); *id.* § 78c(a)(42)(B) (defining as "government securities" securities "issued . . . by corporations in which the United

- imposing no limits on federally chartered depository institutions' investments in GSE securities;[99]
- making GSEs' debt securities and mortgage-backed securities:
  - eligible for open-market purchase by the Federal Reserve Banks;[100]
  - eligible collateral for deposits of public funds[101] and for loans from Federal Reserve Banks;[102] and
  - lawful investments for fiduciaries;[103] and
- permitting GSEs to issue and transfer securities through the Federal Reserve's electronic book-entry system,[104] the system used for issuing and transferring U.S. Treasury securities.[105]

The government also regulates GSEs,[106] generally has the right to appoint a large minority of GSE directors,[107] and generally requires

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States has a direct or indirect interest and which are designated by the Secretary of the Treasury for exemption as necessary or appropriate in the public interest or for the protection of investors"); *id*. § 78*l*(a) (not requiring registration of "exempted securities").

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

99. 12 U.S.C. §§ 24(Seventh), 2158 (national banks); *id.* § 1464(c)(1)(D)–(F), (M) (federal savings associations); *id*. § 1757(7)(E) (federal credit unions); *see also id*. §§ 335, 2158 (state member banks).

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

100. *Id*. § 355(2) (obligations of "any agency of the United States"); *id*. § 2158 (FCS). 12 U.S.C. § 355(2) authorizes Federal Reserve Banks to purchase obligations of "any agency of the United States," which the Federal Reserve Board construes as including obligations issued or guaranteed by Fannie, Freddie, and the Federal Home Loan Bank System. *See* 12 C.F.R. § 201.108(b)(2), (5), (16) (2004).

101. 12 U.S.C. § 1435 (FHLBS); *id.* § 1452(g) (Freddie); *id*. § 1723c (Fannie); *id*. § 2157 (FCS).

102. *Id*. § 347 (Federal Reserve Banks may make loans secured by obligations "eligible for purchase" under 12 U.S.C. § 355).

103. 15 U.S.C. § 77r-1(a)(1)(D), (2)(D) (Fannie and Freddie); 12 U.S.C. § 1435 (FHLBS); *id*. § 1452(g) (Freddie); *id*. § 1723c (Fannie); *id.* § 2157 (FCS); *id*. § 2279aa-12(c) (Farmer Mac).

104. *See* 12 U.S.C. § 1435 (FHLBS); *id*. § 1452(d) (Freddie); *id*. § 1723a(g) (Fannie); *id*. § 2279aa-3(e) (Farmer); 12 C.F.R. §§ 615.5450(c), 615.5456 (FCS).

105. *See generally* 31 C.F.R. pt. 306 (2003).

106. *See infra* Part I.E.

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

The Bush Administration no longer makes presidential appointments to GSE boards. *Cf*. John W. Snow, Secretary of the Treasury, Statement Before the U.S. Senate Committee on Banking, GSEs to obtain government approval before issuing debt securities.[108]

2. *Investors' Perception of Implicit Government Backing*

Bond-market investors—observing how the government gives GSEs special benefits, uses GSEs to further public purposes, and subjects GSEs to special restrictions and requirements—infer that the government implicitly backs GSEs and would not let their creditors go unpaid.[109] Why else, investors might ask, would Congress exempt GSEs and their securities from the federal securities laws? Why else would Congress exempt GSE securities from the usual limits on depository institutions' investments in nongovernmental securities? These and other statutes treat GSE securities as having little or no risk—like U.S. Government securities and unlike even the most highly rated corporate securities.[110] Thus the Congressional Budget Office (CBO) concluded in 1996 that the federal government sent investors "a strong implication . . . that GSE obligations are safe from the risk of default"—an "assurance . . . conveyed" by statutes repeatedly treating GSEs like

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Housing, and Urban Affairs 3 (Oct. 16, 2003) [hereinafter Snow, 2003 Senate Testimony] http://banking.senate.gov/_files/ACFB2.pdf (declaring the Administration's commitment "to make sure that the directors of publicly-traded corporations like Fannie Mae and Freddie Mac are elected by their shareholders, rather than selected by the President"). The administration has recommended repeal of such appointment authority. *See The Treasury Department's Views on the Regulation of Government Sponsored Enterprises: Hearing Before the H. Comm. on Fin. Servs.*, 108th Cong. 78 (2003) (statement of John W. Snow).

108. Fannie and Freddie need approval from the Secretary of the Treasury. *See* 12 U.S.C. §§ 1455(j), 1719(b). The FHLBS and FCS need approval from their respective regulators. FHL Banks need approval from the Federal Housing Finance Board. *See id*. § 1431(a); 12 C.F.R. § 966.2. Farm Credit Banks need approval from the Farm Credit Administration. *See* 12 C.F.R. § 615(d); *see also* 12 U.S.C. § 2013(10) (authorizing banks to issue debt securities "of such character, terms, conditions, and rates of interest as may be determined as provided for in this Act").

109. STANTON, GSES, *supra* note 14, at 33; *accord* CBO, PUBLIC COSTS AND BENEFITS, *supra* note 30, at 9; U.S. DEP'T OF THE TREASURY, REPORT OF THE SECRETARY OF THE TREASURY ON GOVERNMENT-SPONSORED ENTERPRISES 8 (1990) [hereinafter 1990 TREASURY GSE REPORT].

110. Some statutes overtly equate GSE securities with government securities. The Securities Exchange Act of 1934 defines "government securities" in a way that includes GSE securities. *See* 15 U.S.C. § 78c(a)(42) (2000). GSE charters exempt GSE securities from the securities laws "to the same extent as securities that are direct obligations of . . . the United States." 12 U.S.C. § 1455(g) (Freddie); *accord id*. § 1719(d)–(e), 1723c (Fannie). Statutes also authorize anyone, including a fiduciary, to invest in GSE securities "to the same extent that such person . . . is authorized under any applicable law to . . . invest in obligations issued . . . or guaranteed . . . by the United States." 15 U.S.C. § 77r(a)(1)(D) (Fannie and Freddie); *accord* 12 U.S.C. § 2279aa-12(c)(1) (Farmer Mac).

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

the government and unlike private firms.[111] These statutes "endow[ed] GSE securities with the appearance of being significantly safer than the intrinsic credit quality of the GSE would ordinarily warrant."[112] Thus the CBO, like many financial analysts, regarded investors' perception as entirely reasonable.

The perception of implicit government backing—often mischaracterized as an "implicit government guarantee"[113]—persists despite repeated disclaimers of government liability for GSEs' obligations,[114] disclaimers ostensibly designed to protect the government.[115] These disclaimers say nothing about implicit backing and instead focus on formal, legally enforceable liability. For example, federal statutes require that securities of Fannie, Freddie, and Farmer Mac include "appropriate language . . . clearly indicating" that the securities "are not guaranteed by the United States and do not constitute a debt or obligation of the United States or any agency or instrumentality thereof" other than the GSE in question.[116] This disclaimer merely restates the obvious: that the government has no formal, legally enforceable liability for the GSEs' securities. It does not disclaim implicit backing, nor does it signal that market participants err in perceiving such backing. It thus avoids the real issue: whether the government, although not legally bound to rescue the GSEs, would nonetheless do so (e.g., because it felt a moral obligation for their debts or feared that a GSE's default might damage the nation's financial system). "Indeed, the disclaimer itself hints at a special federal

111. CBO, PUBLIC COSTS AND BENEFITS, *supra* note 30, at 9.

112. *Id.*

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

114. 12 U.S.C. §§ 1435, 1455(h)(2), 1719(b), (d)–(e), 2155(c), 2279aa-12(a)(2), 4501(4), 4503.

115. *See, e.g.*, *id.* § 4503 (proudly captioned "Protection of taxpayers against liability").

116. *Id.* § 1719(b), (d) (Fannie); *accord id.* § 1455(h)(2) (Freddie); *id.* § 1719(e) (Fannie); *id.* § 2279aa-12(a)(2) (Farmer Mac).

relationship; completely private firms do not need to disclaim federal backing because no one believes such backing exists."[117] Thus the disclaimer—in disavowing only formal, legally enforceable liability—may, ironically, reinforce the perception of implicit backing.[118] Other required GSE disclaimers have similar flaws.[119]

3. *Who Benefits from GSEs' Government Subsidies*

In return for large government subsidies, the GSEs claim to provide three key types of public benefits: overcoming defects in credit markets, lowering borrowers' interest rates so as to expand home ownership and support family farms, and stabilizing housing and agricultural credit markets.[120] But the evidence casts doubt on each of these claims. The improvements in credit markets achieved over the past thirty-five years would endure even without GSEs. GSEs do not significantly lower interest rates. Even if they did, lowering interest rates for all or most

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

118. *See* STANTON, GSES, *supra* note 14, at 35.

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

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

120. *See, e.g.*, Susan M. Wachter, Professor, Wharton School, University of Pennsylvania, Statement Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (Feb. 10, 2005), http://banking.senate.gov/_files/wachter.pdf [hereinafter Wachter, 2005 Senate Testimony] (asserting that Fannie and Freddie increase home ownership, both generally and among low-income and minority households, by lowering interest rates and down payments; make possible long-term, fixed-rate, self-amortizing, prepayable mortgages; and stabilize housing markets and national economy by drawing on long-term capital from foreign investors); Richard F. Syron, Chairman and CEO, Freddie Mac, Testimony Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs 3–4 (Apr. 20, 2005), http://banking.senate.gov/_files/ACF879.pdf (asserting that Fannie and Freddie make possible long-term, fixed-rate, prepayable mortgages and stabilize housing markets and national economy).

borrowers would do little to expand home ownership. Moreover, most of the GSEs' lending and guarantee activities offer returns high enough to encourage fully private firms to continue those activities in any event.

Credible studies indicate that the GSEs receive large government subsidies.[121] Wayne Passmore, a Federal Reserve Board economist, estimates that Fannie and Freddie receive an implicit subsidy capitalized at some $122 billion to $182 billion.[122] Using a different methodology,[123] the Congressional Budget Office estimates that the three housing GSEs together receive an implicit annual subsidy of $16.7 billion[124] to $45 billion[125] plus explicit tax and regulatory exemptions worth $1.4 billion annually.[126] Passmore and the CBO "both . . . conclude that the housing GSEs receive large subsidies and

121. For an analysis of the methodological challenges of valuing the subsidies, see Edward J. Kane, *Housing Finance GSEs: Who Gets the Subsidy?* 15 J. FIN. SERVS. RES. 197 (1999), and Ron Feldman, *Estimating and Managing the Federal Subsidy of Fannie Mae and Freddie Mac: Is Either Task Possible?*, 11 J. PUB. BUDGETING, ACCT. & FIN. MGMT. 81 (1999).

122. Wayne Passmore, *The GSE Implicit Subsidy and Value of Government Ambiguity*, 33 J. REAL ESTATE ECON. (forthcoming 2005) (manuscript at 3, on file with author). Under a midpoint estimate, "shareholders retain roughly 53 percent of the gains . . . or about $79 billion." *Id*. Passmore notes that the techniques he and the CBO use actually "understate the value of the implicit subsidy to Fannie Mae and Freddie Mac" by assuming that the GSEs would remain the same size even without their perceived government backing. *See id* (manuscript at 3 n.5). Loss of that perceived backing would increase the GSEs' borrowing costs, make some of the GSEs' investment activities unprofitable, and thus cause the GSEs to shrink. *See id.*

123. Passmore values the benefits as a stock (accumulation). *See id*. (manuscript at 4). The CBO values them as a flow (annual rate). *See* CBO, PUBLIC COSTS AND BENEFITS, *supra* note 30, at 11–16.

124. *See* U.S. CONG. BUDGET OFFICE, UPDATED ESTIMATES OF THE SUBSIDIES TO THE HOUSING GSES 5, 8 (Apr. 8, 2004) [hereinafter 2004 CBO ESTIMATES] (estimating 2003 subsidy at $12.5 billion on debt securities and $9.2 billion on mortgage-backed securities). The CBO offers this explanation of how its estimates differ from Passmore's:

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

Id. at 3.

125. *See id*. at 1 (estimating total 2003 subsidy at $46 billion if GSEs continue to grow); *id.* at 6 (valuing explicit tax and regulatory exemptions at $1.3 billion).

126. *See id.* at 1, 6.

that only a portion of those subsidies reach borrowers," with the rest going to GSEs' shareholders.[127] In any event, the various benefits GSEs derive from their government sponsorship (ranging from tax and regulatory exemptions to reduced borrowing costs) have very real costs to the government if, as is almost certainly the case, both the GSEs and their competitors would be willing to pay for those benefits.[128] "If sold competitively, the benefits the . . . government provides to the . . . GSEs"—including the perception of implicit backing—"would command billions of dollars" annually.[129] Forgoing such revenue involves an opportunity cost just as real as explicit cash payments.[130]

Congress created GSEs to help correct defects of U.S. credit markets. Restrictive bank-branching laws had created regional disparities in the availability of credit.[131] Regulatory limits on bank-deposit interest rates had periodically constricted credit.[132] Banks had regarded housing and agricultural loans as riskier and less profitable than such traditional lines of business as commercial lending and "tended to withdraw from these sectors when the need for funds was the greatest."[133] Other large-scale investors had viewed such loans as too small, illiquid (i.e., difficult to sell quickly at fair market value), labor-intensive to service, unpredictable in prepayment, and potentially difficult to collect.[134] GSEs helped overcome these problems by operating nationwide, offering investors safe, liquid, large-denomination securities, and making housing and agricultural loans "more appealing to lenders by creating efficient secondary markets for resale of the loans."[135]

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.[136] But such a notion strains credulity. Banks

127. *See id*. at 3.

128. *See* CBO, PUBLIC COSTS AND BENEFITS, *supra* note 30, at x, 20.

129. *Id*. at 9.

130. *See id*. at 9, 20.

131. GAO, THE GOVERNMENT'S EXPOSURE TO RISKS, *supra* note 32, at 16; *see* CBO, PUBLIC COSTS AND BENEFITS, *supra* note 30, at 1–2.

132. *See* CBO, PUBLIC COSTS AND BENEFITS, *supra* note 30, at 2.

133. GAO, THE GOVERNMENT'S EXPOSURE TO RISKS, *supra* note 32, at 17.

134. *Id*. at 16–17; Bartke, *Home Financing*, *supra* note 16, at 3–4.

135. GAO, THE GOVERNMENT'S EXPOSURE TO RISKS, *supra* note 32, at 17.

136. *See* CBO, PUBLIC COSTS AND BENEFITS, *supra* note 30, at 26–28, 31 (summarizing Fannie and Freddie's arguments).

can now operate nationwide[137] and pay market interest rates, and they find housing and agricultural lending attractive.[138] Fully private firms routinely securitize loans that once had little or no secondary market, including automobile, credit card, education, and large residential real-estate loans.[139] Ending GSEs' government sponsorship would change none of these realities. Fully private firms would, without any subsidy, maintain "profitable, high-volume links between the bond and mortgage markets."[140]

GSEs stress that they further important public purposes, such as expanding home ownership, by lowering borrowers' interest rates.[141] Yet subsidizing GSEs does not efficiently further such purposes. GSEs are "spongy conduits," retaining much of their government subsidies.[142] Fannie and Freddie have a relatively small effect on mortgage interest rates. A Federal Reserve study concludes that Fannie and Freddie reduce eligible borrowers' interest rates by only about seven basis points (i.e., seven one-hundredths of one percentage point)[143] and retain some $53 billion to $106 billion of a capitalized subsidy estimated at $122 billion to $182 billion.[144] The Congressional Budget Office estimates that Fannie and Freddie lower mortgage interest rates by twenty-five basis points and retain 40% of their government subsidy,[145] and finds the two GSEs an inefficient vehicle for increasing home ownership.[146] Even by their own estimates, the GSEs lower interest rates only slightly (e.g.,

137. *See* 12 U.S.C. § 36(g) (2000) (allowing national banks to establish out-of-state branches); *id.* § 1831u (allowing affiliated banks in different states to merge); *id*. § 1842(d) (allowing bank holding companies to acquire banks in any state).

138. In 2004 Rabobank Group, a Dutch bank, offered to buy Farm Credit Services of America, one of the Farm Credit System's five credit banks. Scott Kilman, *Takeover Battle Erupts in Farm Credit System*, WALL ST. J., Aug. 19, 2004, at A3. The offer underscores fully private firms' willingness to conduct a credit bank's business without government sponsorship.

139. *See* Greenspan, 2004 Senate Testimony, *supra* note 47, at 3. "Securitization" denotes the process of turning loans into securities. *See generally* FRANKEL, *supra* note 46.

140. *See* CBO, PUBLIC COSTS AND BENEFITS, *supra* note 30, at xii. Subsidizing GSEs for their past achievements makes no more sense than subsidizing AT&T now for Alexander Graham Bell's invention of the telephone.

141. *Id.* at 16–18, 20, 25.

142. *Id.* at xiv (stating that Fannie and Freddie absorb "nearly $1 for every $2 delivered").

143. *See* Passmore, Sherlund & Burgess, *supra* note 32 (manuscript at 3, 30–31).

144. Passmore, *supra* note 122 (manuscript at 3). Under a midpoint estimate, "shareholders retain roughly 53 percent of the gains . . . or about $79 billion." *Id.*

145. 2004 CBO ESTIMATES, *supra* note 124, at 2.

146. *See* CBO, PUBLIC COSTS AND BENEFITS, *supra* note 30, at xiii, 29–31.

twenty-five to thirty basis points).[147] Moreover, even significantly lowering interest rates can have surprisingly little effect on long-term home ownership rates.[148] When interest rates fall, housing prices rise—so that lower rates may benefit sellers rather than buyers. Nor do lower interest rates particularly benefit persons for whom low income, imperfect credit history, or lack of savings for a down payment represents the greatest barrier to home ownership. The real constraint on such persons' obtaining mortgage loans is finding primary lenders willing to bear the risk of default on the loans.[149] Depository institutions and the federal government (through its Federal Housing Administration and veterans' loan-guarantee programs) bear more of such credit risk than the GSEs,[150] which have no "edge in identifying good credit risks among borrowers traditionally regarded as poor credit risks."[151] On balance, the GSEs' activities have little effect on home ownership rates.

The GSEs assert that they stabilize markets by buying loans for their own portfolios even when financial stress leaves investors unwilling to buy.[152] Yet the GSEs have failed to show that they behave much differently than other profit-maximizing long-term investors. "Private firms . . . are always willing to buy mortgages at prices that are consistent with their objective of building value for shareholders."[153] According to Federal Reserve economists, Fannie and Freddie's mortgage purchases have "economically and statistically negligible effects on mortgage [interest] rates," whether in good times or bad.[154]

147. *See, e.g.*, ALAN S. BLINDER ET AL., THE VALUE OF HOUSING-RELATED GOVERNMENT SPONSORED ENTERPRISES: A REVIEW OF A PRELIMINARY DRAFT PAPER BY WAYNE PASSMORE 2 (2004) (prepared for Fannie), *available at* http://www.fanniemae.com/commentary/2004/05172004.jhtml?p=Issues+%26+Commentary.

148. *See* Gary Painter & Christian L. Redfearn, *The Role of Interest Rates in Influencing Long-Run Homeownership Rates*, 25 J. REAL ESTATE FIN. & ECON. 243, 260 (2002) (even large changes in interest rates have minimal effects on long-term home ownership rates); Ron J. Feldman, *Mortgage Rates, Homeownership Rates, and Government-Sponsored Enterprises*, *in* FED. RES. BANK MINNEAPOLIS, 2001 ANNUAL REPORT 5 (2002) (same).

149. *See* CBO, PUBLIC COSTS AND BENEFITS, *supra* note 30, at xiii, 30.

150. *See* Glenn B. Canner & Wayne Passmore, *Credit Risk and the Provision of Mortgages to Lower-Income and Minority Homebuyers*, 81 FED. RES. BULL. 989, 1006 (1995).

151. *See* CBO, PUBLIC COSTS AND BENEFITS, *supra* note 30, at xiii.

152. *See, e.g.*, Wachter, 2005 Senate Testimony, *supra* note 120.

153. CBO, PUBLIC COSTS AND BENEFITS, *supra* note 30, at xii.

154. *See* Andreas Lehnert, Wayne Passmore & Shane M. Sherlund, *GSEs, Mortgage Interest Rates, and Secondary Market Activities* 30 (Fed. Res. Bd. Fin. & Econ. Discussion Series Working Paper No. 2005-07, 2005), *available at* http://www.federalreserve.gov/pubs/feds/2005/200507/200507pap.pdf.

Indeed, the two GSEs did "nothing special" during the 1998 financial crisis:[155] their increased purchases "can be explained almost completely by their historical pattern of buying [more] mortgages" when mortgage interest rates are high compared to a risk-free interest rate.[156] As Federal Reserve Chairman Alan Greenspan declares, the GSEs' "huge balance sheets" serve no purpose except to create profits for GSE shareholders by exploiting the GSEs' perceived government backing.[157]

In sum, GSEs provide meager public benefits in return for their government subsidies, and those subsidies go disproportionately to GSE shareholders. GSEs lower mortgage interest rates only slightly. GSEs are an inefficient way of lowering interest rates, and lowering interest rates is an inefficient way of expanding home ownership. Efficient, nationwide secondary markets for home mortgages will continue to thrive even without such subsidies. Financial innovation will proceed even without such subsidies. Most GSE activities are profit-motivated, and (with the exception of amassing large debt-funded investment portfolios) fully private firms would have incentives to continue them.

4. Artificial Growth and Excessive Risk-Taking

Bond-market investors' perception that the government implicitly backs the GSEs enables the GSEs to borrow enormous sums at interest rates unwarranted by the GSEs' own financial strength.[158] In addition to relying on the GSEs' own assets and earning power, investors also rely on the perceived government backing. Thus government sponsorship attenuates market discipline by GSEs' creditors: the GSEs can take greater risks—such as relying more heavily on borrowed money, investing in more volatile assets, and mismatching the duration of their assets and liabilities—without correspondingly increasing their borrowing costs.[159] This encourages GSEs to become artificially large and take excessive risks.

Government sponsorship operates as an "immensely valuable"

155. *Id*. at 22.

156. *Id*.

157. *See* Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, Statement Before U.S. Senate Committee on Banking, Housing, and Urban Affairs 5 (Apr. 6, 2005) [hereinafter Greenspan, 2005 Senate Testimony], *available at* http://banking.senate.gov/_files/ACF1505.pdf.

158. *See supra* note 32 and accompanying text.

159. *See* Ron Feldman, *Improving Control over Fannie Mae and Freddie Mac*, *in* SERVING TWO MASTERS YET OUT OF CONTROL, *supra* note 19, at 140–41.

government "seal of approval."[160] It enables Fannie and Freddie to borrow at rates "not available to any fully private firm."[161] It also renders the mortgage-backed securities they guarantee top-grade "without . . . the expense of . . . the credit enhancements . . . required of fully private intermediaries."[162] The Congressional Budget Office likens the perceived implicit backing to a massive government purchase of nonvoting, no-dividend shares in each GSE, which greatly strengthens the GSE's creditworthiness.[163] This notional capital-infusion effectively gives the GSE "more capital than any fully private firm would pay to acquire or find cost-effective."[164] It is also open-ended in that if the GSE "grows, takes on more risk, or . . . repurchas[es] its own stock," the value of the government's commitment increases by enough "to ensure that the enterprise retains its super Aaa rating."[165]

Government sponsorship gives the GSEs enormous advantages in competing with fully private firms. With lower borrowing and operating costs,[166] the GSEs can offer lower prices and better terms. The GSEs have thus grown enormously—at the expense of better-capitalized (and perhaps better-managed) competitors. Passmore concludes that Fannie and Freddie's implicit federal subsidy accounts for "roughly 44 percent to 89 percent of the [two] GSEs' market value,"[167] and that without government sponsorship, the two GSEs "would be much smaller organizations," with much smaller portfolios of mortgage-backed securities and only half their debt-to-equity ratios.[168] Government sponsorship has thus fostered huge artificial growth by a few thinly capitalized firms and a potentially dangerous concentration of financial risk in those firms. "In essence, the current system depends on [GSE] risk managers . . . to do everything just right," Chairman Greenspan declares, "rather than depending on a market-based system supported by

160. CBO, PUBLIC COSTS AND BENEFITS, *supra* note 30, at 10.

161. *Id*.

162. *Id*. Such credit enhancements include subordinating at least one class of securities, obtaining a third-party guarantee, and establishing a reserve guarantee fund. *Id*.

163. *Id*. at 11.

164. *Id*.

165. *Id*.

166. Regulatory and tax exemptions lower GSEs' operating costs. *See* 2004 CBO ESTIMATES, *supra* note 124, at 6 tbl.2 (valuing housing GSEs' regulatory and tax exemptions at $1.3 billion in 2003).

167. Passmore, *supra* note 122 (manuscript at 3).

168. *See id*. (manuscript at 3–4).

the risk assessments and management capabilities of many participants with different views and different strategies for hedging."[169]

E. Weaknesses of GSE Regulation

Even as the GSEs' perceived government backing inhibits market discipline, GSE regulators' institutional weakness—and GSEs' political clout[170]—impede regulatory discipline. The federal agencies responsible for regulating GSEs are small[171] and hyper-specialized.[172] The Office of Federal Housing Enterprise Oversight (OFHEO) regulates only Fannie and Freddie.[173] The Federal Housing Finance Board regulates only the Federal Home Loan Bank System.[174] The Farm Credit Administration regulates only the Farm Credit System and Farmer Mac.[175]

The structure of these agencies leaves them chronically vulnerable to capture or intimidation by the GSEs. The agencies ordinarily toil in obscurity, closely monitored by the GSEs and their allies but ignored by

169. Greenspan, 2004 Senate Testimony, *supra* note 47, at 7 (referring to Fannie and Freddie).

170. *See, e.g.*, Bara Vaida, *Taking Cover*, 37 NAT'L J. 1610, 1611–13 (2005) (describing power Fannie and Freddie have long exerted); Bethany McLean, *The Fall of Fannie Mae*, FORTUNE, Jan. 24, 2005, at 122, 124, 126, 128 (describing Fannie's power).

171. For example, staffing and budget data underscore the limited resources of the Office of Federal Housing Enterprise Oversight (OFHEO), which oversees Fannie and Freddie. For fiscal year 2003, OFHEO had a $30 million operating budget and the equivalent of 126 full-time employees. *See* OFF. OF FED. HOUS. ENTER. OVERSIGHT, U.S. DEP'T OF HOUS. & URBAN DEV., REPORT TO CONGRESS app. at 3–4 (2004) (Financial Report). Fannie had some 5,000 permanent employees. *See* FANNIE MAE, 2003 FORM 10-K, *supra* note 44, at 17. Fannie had administrative expenses of $1.46 billion during 2003. *Id*. at 37. "Between 1998 and 2004, Fannie Mae and Freddie Mac hired a combined 88 K Street firms, according to the Center for Public Integrity, and employed about a dozen in-house lobbyists . . . ." Vaida, *supra* note 170, at 1612.

Although OFHEO receives no tax money, it must (unlike other GSE regulators, *see* 12 U.S.C. §§ 1422b(c), 2250 (2000), and the federal bank regulators, *see id*. §§ 243, 244, 481, 1467(i)) obtain an annual congressional appropriation for its budget. *See id*. § 4516(a) (empowering OFHEO to collect annual fees from Fannie and Freddie "to the extent provided in appropriation Acts"). Fannie and Freddie have used the appropriations process to pressure OFHEO and limit its resources. *See* Jonathan G.S. Koppell, Op-Ed., *Follow the Loan Money*, N.Y. TIMES, Dec. 26, 2004, § 4, at 9; *see also* McLean, *supra* note 170, at 132 (quoting OFHEO official's statement that unless OFHEO appeased Fannie and Freddie, it would "risk getting reamed in the budget"). For reflections on how dependence on annual appropriations can undercut effective financial regulation, see Joel Seligman, *Self-Funding for the Securities and Exchange Commission*, 28 NOVA L. REV. 233, 233, 246–49, 253–56 (2004).

172. *See, e.g.*, Carnell, 2004 Senate Testimony, *supra* note 19, at 2 (characterizing OFHEO as "a small, hyper-specialized agency . . . with uncertain funding and overly narrow powers").

173. *See* 12 U.S.C. §§ 4502(6), 4513(a).

174. *See id*. § 1422a(a)(3).

175. *See id*. §§ 2243, 2252, 2279aa-1(a)(2).

most others. The policy issues the agencies handle rarely draw public attention. The agencies have no institutional tie to any larger entity with credibility as a financial regulator or policymaker: the Federal Housing Finance Board and Farm Credit Administration are independent agencies;[176] OFHEO forms part of the Department of Housing and Urban Development (HUD).[177] This institutional isolation heightens the challenge of withstanding the GSEs' formidable political clout. Moreover, Fannie and Freddie are relatively homogeneous, as are the twelve Federal Home Loan Banks, which facilitates collective action to pressure regulators.

GSE regulation suffers from substantive as well as institutional weaknesses. These substantive weaknesses reflect the GSEs' political power and the congressional tendency to consider each GSE's regulation ad hoc.[178] For example, at Fannie and Freddie's insistence, Congress denied OFHEO some significant authority possessed by bank regulators, giving OFHEO "a sort of parody of the authority of the federal bank regulators."[179] Although bank regulators have broad authority to prescribe and adjust capital standards,[180] OFHEO faces rigid, detailed constraints on the form and content of capital standards.[181] It also has weaker enforcement authority than bank regulators.[182]

176. *See id*. §§ 1422a(a)(2), 1422b(a) (Federal Housing Finance Board); *id*. § 2241 (Farm Credit Administration).

177. *See id*. § 4511. HUD has little ability to protect OFHEO against pressure from Fannie and Freddie. HUD has an institutional focus on providing housing rather than on financial-soundness regulation. HUD has, moreover, been politically weak and on the defensive for most of the past quarter-century.

178. *See supra* note 166 (GSEs' political power) and *infra* notes 228–29 and accompanying text (ad hoc regulation).

179. *See* Thomas H. Stanton, *Devising an Effective Legal Framework for Supervising the Public Benefits and Public Costs of Government Sponsored Enterprises*, *in* 2 FANNIE MAE AND FREDDIE MAC: PUBLIC PURPOSES AND PRIVATE INTERESTS 29, 39 (Peter J. Wallison ed., 2000) (referring to OFHEO's enforcement authority).

180. *See* 12 U.S.C. §§ 1831o(c)(1), 3907(a).

181. *See id*. §§ 4611–4612.

182. *See* Carnell, 2004 Senate Testimony, *supra* note 19, at 7; U.S. GEN. ACCOUNTING OFFICE, GOVERNMENT-SPONSORED ENTERPRISES: A FRAMEWORK FOR STRENGTHENING GSE GOVERNANCE AND OVERSIGHT, GAO-04-269T, at 16–17 (2004). *Compare* 12 U.S.C. §§ 4631–4636 (OFHEO), *with id*. § 1818 (federal bank regulators).

F. Could the Government Avoid Rescuing an Insolvent GSE's Creditors?

Investors' expectation that the federal government would protect a failed GSE's creditors[183] raises a fundamental question: could the government avoid such a rescue? If as a practical matter the government must assure full payment of all a failed GSE's liabilities, then no insolvency mechanism can be truly workable. Yet good reasons exist for rejecting such fatalism. GSEs' borrowing costs suggest that investors have some doubt about whether the government would assure full payment. GSEs pay interest rates lower than comparable fully private firms[184] but higher than the government itself.[185] The expectation of a government rescue reflects probability, not certainty. GSEs' borrowing costs implicitly recognize the possibility of a delayed or partial rescue or no rescue at all.[186] Similarly, investors recognize that the government might protect some creditors but not others. GSEs pay higher interest rates on subordinated debt[187] than on more senior liabilities.[188] Moreover, even a GSE too large to liquidate need not be too large to reorganize. The government could, for example, create a successor firm to continue the failed GSE's business with a restructured set of liabilities.[189] Finally, the existence and character of GSE insolvency mechanisms—like other aspects of the legal framework for GSEs—affects investors' expectations of a rescue. Workable insolvency mechanisms would tend to increase the credibility of official assertions that the government does not back GSEs.

183. *See supra* Part I.D.2.

184. *See* Ambrose & Warga, *supra* note 32, at 131, 139, 141–42 tbls.7 & 8, 146; Passmore, Sherlund & Burgess, *supra* note 32 (manuscript at exhs.4 & 6).

185. *See* Ambrose & Warga, *supra* note 32, at 136, 137 tbl.6.

186. That possibility represents a type of political risk.

187. A GSE's subordinated debt consists of unsecured debt securities whose holders contractually agree that in any liquidation of the firm they will receive nothing until the firm has fully paid more senior creditors. *See generally* W. Scott Frame & Larry D. Wall, *Fannie Mae's and Freddie Mac's Voluntary Initiatives: Lessons from Banking*, FED. RES. BANK ATLANTA ECON. REV., First Quarter 2002, at 45, 46–50, 52 (discussing Fannie and Freddie's subordinated debt program).

188. *See generally* Michael T. DeStefano et al., *Subordinated Debt Ratings Reflect Unsupported Creditworthiness of Fannie Mae and Freddie Mac*, STANDARD & POOR'S, Mar. 26, 2001 (stating that *Standard & Poor's* rates GSEs' subordinated debt "using the same analytical factors that it uses for [non-GSE] financial institutions"—a standard less favorable than that applied to GSEs' senior debt).

189. *Cf.* 12 U.S.C. § 1821(n) (2000) (authorizing FDIC to form "bridge bank" to continue failed bank's business); *infra* note 284 (discussing bridge banks).

The role of investors' expectations bears emphasis. As previously noted, the expectation of a congressional rescue impairs market discipline on GSEs, enabling GSEs to grow larger and take greater risks than they otherwise could have.[190] Greater risk-taking increases the probability of failure, and greater size increases the potential for a GSE's failure to disrupt the national financial system and economy. Thus investors' expectation of a rescue has a certain circularity: it helps create circumstances that make a rescue more likely.[191]

But the link between investors' expectations and systemic risk also creates opportunities to reduce the potential for such risk (and the pressure for a costly rescue) by taking timely action to correct investors' expectations. In 1991, Congress curtailed the FDIC's practice of treating large banks as "too big to fail" (i.e., protecting all depositors regardless of the $100,000 limit on deposit insurance coverage).[192] It enacted legislation generally allowing the FDIC to protect a failed bank's uninsured depositors only if doing so is the "least costly to the deposit insurance fund of all possible methods" for meeting the FDIC's obligation to insured depositors.[193] The FDIC responded by changing its resolution practices, with no adverse effect on financial markets.[194] By

190. *See supra* notes 159–68 and accompanying text.

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

192. Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), Pub. L. No. 102-242, § 141(a)(1), 105 Stat. 2236, 2273–76 (codified at 12 U.S.C. § 1823(c)(4)); *see generally* Richard Scott Carnell, *A Partial Antidote to Perverse Incentives: The FDIC Improvement Act of 1991*, 12 ANN. REV. BANKING L. 317, 363–68 (1993) (explaining statute and its objectives).

193. *See* 12 U.S.C. § 1823(c)(4).

194. Before FDICIA, the FDIC used the insurance fund to protect uninsured depositors at banks with as little as $500 million in total assets. Less than one year later, when an $8.8 billion bank group in a key state failed shortly before a Presidential election, the FDIC did not protect uninsured depositors. FED. DEPOSIT INS. CORP., MANAGING THE CRISIS: THE FDIC AND RTC EXPERIENCE, 1980–1994, at 180, 578 (1998) [hereinafter FDIC, MANAGING THE CRISIS] (describing how FDIC dealt with banks owned by First City Bancorporation of Texas). Financial markets took the action in stride. *See, e.g.*, Dave Pettit, *Abreast of the Market: Industrials Leap 35.93 to 3262.21 on Hopes of Improving Economy*, WALL ST. J., Nov. 3, 1992, at C2 (reporting market developments without even mentioning FDIC's action). Rating agencies promptly noted the significance of the FDIC's action. *See, e.g.*, *First City Failure Cuts Support for Bank Ratings Derived From Expectation of Regulatory Aid*, FDIC WATCH, Nov. 9, 1992, at 6 (quoting Moody's Investors Service commentary).

giving clear and timely notice of the new policy, Congress had succeeded in changing market participants' expectations.[195] Similarly here, the government can reduce the potential for systemic risk—and the pressure to rescue an insolvent GSE's creditors—by timely adopting workable insolvency mechanisms.

G. Summary

Investors' perception that the government implicitly backs GSEs lets GSEs grow larger and take greater risks than they could as fully private firms. But neither that perception nor government regulation of GSEs' financial soundness would prevent a GSE from failing. Given GSEs' size and financial importance, the possibility of failure underscores the importance of having adequate GSE insolvency mechanisms in place. Yet irresponsible ambiguity about the extent of the government's support for GSEs has facilitated congressional neglect of such mechanisms.

II. IRRESPONSIBLE AMBIGUITY: THE POLITICAL ECONOMY OF GSEs

Ambiguity about whether Congress would rescue a failed GSE's creditors helps produce the central failures of GSE policy: obtaining insufficient public benefits from the GSEs and providing inadequate safeguards for the federal government and the financial system. The ambiguity lets the GSEs and their congressional supporters circumvent normal mechanisms of government accountability. Bond-market investors, undeterred by official disclaimers, expect Congress to assure full payment of GSEs' obligations,[196] enabling GSEs to borrow vast sums at low interest rates.[197] Yet GSEs' borrowing requires no budget authority or periodic reauthorization,[198] does not affect the government's

195. By engineering a rescue of Long Term Capital Management (LTCM) in 1998, the Federal Reserve Bank of New York squandered some of FDICIA's hard-won gains. *See* Craig Furfine, *The Costs and Benefits of Moral Suasion: Evidence from the Rescue of Long-Term Capital Management* 25–27 (Fed. Res. Bank of Chi., Working Paper No. 2001-11), *available at* http://chicagofed.org/publications/workingpapers/papers/wp2002-11.pdf (finding that large, complex banks that were not LTCM creditors had lower borrowing costs after rescue than before). Yet the dramatic change in how the FDIC dealt with failed banks during the early 1990s, *see supra* note 194, shows that progress can be made in curtailing "too big to fail" treatment.

196. *See supra* Part I.D.2.

197. *See supra* note 31 and table p. 574 (GSEs' liabilities).

198. The federal government can spend money only pursuant to congressional appropriation. *See*

reported spending or budget deficit,[199] and sidesteps ordinary political scrutiny of government programs and the government's risk-exposure.[200] Although investors bet on a congressional rescue, fiscal accountability mechanisms assume none would ever occur—creating a blind spot that heightens policymakers' incentive to gain political advantage by perpetuating and expanding GSEs' activities.

Far from benefiting citizens and taxpayers, ambiguity fosters congressional insouciance about the valuable benefits the GSEs receive from the government. Congress neither demands that the GSEs provide public benefits, nor charges the GSEs a fee, commensurate with the value of the benefits the GSEs receive.[201] By avoiding normal government accountability mechanisms, Congress also avoids pressure to demonstrate that the GSEs' subsidies represent the most effective use of the resources in question.[202] This attenuated political accountability helps GSEs' subsidies persist even if poorly targeted toward public purposes and gives the GSEs more leeway to favor their shareholders' interests over their public missions.[203]

Ambiguity also promotes complacency about the risks GSEs pose.

U.S. CONST. art. I, § 9. Government officers and employees can spend money and incur obligations only to the extent authorized by law. *See* 31 U.S.C. § 1341(a) (2000). Rules of the House of Representatives generally prohibit appropriations for expenditures not already authorized by law. *See* U.S. HOUSE OF REPS., RULES OF THE HOUSE OF REPRESENTATIVES, H.R. DOC. NO. 107-284, at Rule XX cl. 2 (2003). A point of order exists in both Houses of Congress against proposed legislation that would exceed applicable budget limits. *See* 2 U.S.C. § 633(f) (2000).

199. *See* Block, *supra* note 17, at 438–39; *see also* 2 U.S.C. § 661c(a) (requiring President's budget to "reflect the costs of direct loan and loan guarantee programs"); *id.* § 655(a) (subjecting budget authority and credit authority to congressional budget process).

200. *See generally* Ron Feldman, *Improving Control over Fannie Mae and Freddie Mac*, *in* SERVING TWO MASTERS YET OUT OF CONTROL, *supra* note 19, at 139–49 (explaining how policymakers designed GSEs to circumvent normal accountability mechanisms applicable to government agencies and business firms).

201. *See supra* Part I.D.3.

202. *See* Ron Feldman, *Improving Control over Fannie Mae and Freddie Mac*, *in* SERVING TWO MASTERS YET OUT OF CONTROL, *supra* note 19, at 143.

203. *See* CBO, PUBLIC COSTS AND BENEFITS, *supra* note 30, at 33–35 (asserting that GSE managers have motive and means to favor shareholders' interests, in part because GSEs need no congressional appropriations); Kane, *supra* note 121, at 205–06 (contending that Fannie and Freddie's "[s]killful lobbying" gives their managers "considerable autonomy" to further shareholders' interests at taxpayers' expense, and identifying "root problem" as "GSE managers' lack of adequate accountability for . . . the taxpayer subsidies their firms receive"); *see also* CBO, PUBLIC COSTS AND BENEFITS, *supra* note 30, at 34 (arguing that Congress controls GSEs less effectively than government agencies because GSEs are harder to monitor, have more scope to exert political influence, and give their managers "incentives . . . more sharply at odds with the public policy goal of maximizing public benefits while minimizing public costs").

The risk of a future GSE bailout has no current budget cost and usually poses minimal current political risk. In not formally backing GSEs,[204] the government reduces the perceived urgency of keeping GSEs financially sound and demanding that they provide adequate public benefits. As Stanton has noted, "the political process does not handle probabilities well,"[205] and the weakness of most GSE financial-soundness regulation exemplifies "the inability of the political process to take modest steps now to improve the government's ability to deal with the slight but real probability that a GSE could fail at a substantial cost."[206] The absence of a legally enforceable government guarantee serves as an excuse for failing to enact adequate financial-soundness safeguards, including a workable insolvency mechanism for Fannie and Freddie. The reverse side of that ambiguity—investors' expectation of a congressional rescue—actually increases the risk of financial problems by insulating GSEs from market discipline and thus facilitating artificial growth, inadequate capitalization, and other excessive risk-taking by the GSEs.[207]

In sum, by reducing policymakers' accountability for the risks and other costs of GSEs, ambiguity about the extent of government support for GSEs heightens the conflict between policymakers' self-interest and their constituents' interests as citizens and taxpayers. Policymakers can take political credit for GSE activities even as they curry favor with GSEs, obtain meager public benefits, and take inadequate precautions against GSE risk. Ambiguity has thus reduced the perceived urgency of enacting adequate insolvency mechanisms for GSEs.

III. BANK INSOLVENCY LAW AS A MODEL FOR GSE INSOLVENCY REGIMES

A specialized insolvency regime has long existed for banks,[208]

204. *See* 12 U.S.C. §§ 1435, 1455(h)(2), 1719(b), (d)–(e), 2155(c), 2279aa-12(a)(2), 4501(4), 4503 (2000) (disclaiming formal, legally enforceable liability).

205. STANTON, GSES, *supra* note 14, at 46.

206. *Id*. at 47.

207. *See supra* Part I.D.4.

208. *See generally* Peter P. Swire, *Bank Insolvency Law Now That It Matters Again*, 42 DUKE L.J. 469, 477–80, 490–95 (1992) (summarizing bank insolvency law, tracing its history, and noting its policy rationale); David A. Skeel, Jr., *The Law and Finance of Bank and Insurance Insolvency Regulation*, 76 TEX. L. REV. 723, 728–30 (1998) (summarizing process for resolving failed banks). Banks have high ratios of debt to equity, invest in assets generally less liquid than their liabilities, rely heavily on deposits that depositors can withdraw on demand, do not keep enough cash on hand to repay all depositors, and must redeem deposits at par—all of which make banks vulnerable to

separate from[209] and antedating the Bankruptcy Code and its predecessor.[210] This streamlined, nonjudicial regime has served as a model for GSE insolvency law—just as banking regulation has, more broadly, served as a model for GSE regulation. Bank insolvency law developed in a world without reliable deposit insurance. It recognized both banks' fragility and their economic importance. A merchant who could not promptly pay his bills "is not ruined at once," a court observed after the Panic of 1907, "and if he should fail the effects are limited to comparatively a few persons."[211] By contrast, if a bank could not meet its obligations, "[i]ts doors are closed, its business is arrested, its affairs go into liquidation, and the mischief takes a wide range."[212] Depositors lost access to their money. Borrowers lost access to credit and might face demands to repay outstanding loans immediately.[213] If one bank's failure sparked contagious runs against other banks, even worse problems ensued: other banks had to "fortify themselves against the uneasiness and even terror of their own depositors" by "call[ing] in their loans and refus[ing] to extend credit."[214] As a result, the court noted, "[c]onfidence is destroyed . . . . Business is brought to a standstill . . . . Property is sacrificed, and disaster spreads from locality to locality."[215] Bank insolvency law arose to reduce these external costs of bank failure by expediting depositors' access to their money and reducing the potential for contagious runs.[216]

Even more so than banks, GSEs rely heavily on borrowed money.[217] Like nineteenth century U.S. banks, GSEs have no federal guarantee and could harm their creditors if they failed. But prompt resolution of

runs in the absence of credible deposit insurance. *See* Swire, *supra*, at 494–95; GEORGE J. BENSTON, ROBERT A. EISENBEIS, PAUL M. HORVITZ, EDWARD J. KANE & GEORGE G. KAUFMAN, PERSPECTIVES ON SAFE & SOUND BANKING 41–45 (1986) [hereinafter PERSPECTIVES ON SAFE & SOUND BANKING]; *see also* Douglas W. Diamond & Philip H. Dybvig, *Bank Runs, Deposit Insurance and Liquidity*, 91 J. POL. ECON. 401, 402–03, 416–18 (1983) (explaining banks' fragility).

209. Depository institutions, with only a few narrow exceptions, cannot become debtors under the Bankruptcy Code. *See* 11 U.S.C. § 109(b)(2)–(3), (d) (2000).

210. *See* Swire, *supra* note 208, at 478–80.

211. Schaake v. Dolley, 118 P. 80, 83 (Kan. 1911).

212. *Id*.

213. *See id*.

214. *Id*.

215. *Id*.

216. Swire, *supra* note 208, at 492–93.

217. *See supra* table p. 574 and text accompanying notes 89–91.

creditors' claims would help contain the harm. This Part explains how banking law has provided a model for GSE regulation and bank insolvency law has provided the main model for GSE insolvency law (albeit a model that GSE insolvency law has followed only imperfectly). This Part concludes that GSE insolvency regimes—insofar as they do not already do so—should follow the example of bank insolvency law by (1) authorizing a GSE's regulator to appoint a conservator or receiver through a process permitting timely ex parte action; (2) specifying the grounds for conservatorship and receivership; (3) affording the GSE a prompt post-seizure judicial hearing; (4) specifying priorities among claims; (5) authorizing receivers to establish bridge enterprises; and (6) authorizing receivers to effect reorganizations.

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

Banking regulation provides the most important model for GSE financial-soundness regulation.[218] Drawing on banking regulation makes sense for substantive and institutional reasons. Banks and GSEs are both financial institutions and face common challenges, including managing credit risk and interest-rate risk[219] and operating with higher ratios of debt to equity than most nonfinancial firms.[220] The congressional committees with jurisdiction over banking—the House Committee on Financial Services and the Senate Committee on Banking, Housing, and Urban Affairs—also have jurisdiction over the three housing GSEs.[221] Accordingly, Congress has drawn on banking law in framing capital,[222] reporting,[223] and prompt corrective action[224] requirements for GSEs and

218. *See, e.g.*, Froomkin, *supra* note 15, at 620–21 (discussing how Congress used bank capital rules as model for GSE capital rules); GAO, THE GOVERNMENT'S EXPOSURE TO RISKS, *supra* note 32, at 4–5, 95 (using bank financial-soundness regulation as standard of reference for GSE financial-soundness regulation).

219. *See* GAO, THE GOVERNMENT'S EXPOSURE TO RISKS, *supra* note 32, at 95.

220. *See* Kaufman, *supra* note 33, at 387 tbl.2 (showing capital-to-assets ratios in various industries); Joseph P.H. Fan, Sheridan Titman & Garry Twite, An International Comparison of Capital Structure and Debt Maturity Choices 41 tbl.2 (June 2003) (unpublished manuscript, on file with author) (showing leverage ratios for firms in various industries).

221. *See* U.S. HOUSE OF REPS., RULES OF THE HOUSE OF REPRESENTATIVES, H.R. DOC. NO. 107-284, at Rule X, cl. 1(g) (2003); U.S. SENATE, SENATE MANUAL, S. DOC. NO. 107-1, at Rule XXV(d)(1) (2002).

222. *See* 12 U.S.C. §§ 1426(a), 2279bb-1, 2279bb-2, 4611, 4612 (2000).

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

224. *Compare id*. § 1831o (FDIC-insured depository institutions), *with id*. §§ 4613–4618, 4622

in specifying GSE regulators' examination[225] and enforcement[226] powers.

Critics of GSE regulation often point to banking law as substantively superior to GSE statutes—in particular, as striking a better balance between public and private interests.[227] GSE statutes are firm-specific: each applies to only one or at most two GSEs.[228] Congress has created GSEs ad hoc, "disregarding prior experience."[229] Banking statutes, by contrast, are largely generic, designed to apply to hundreds or thousands of disparate banks.[230] Framing laws generically promotes

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(Fannie and Freddie), *and id.* §§ 2279bb-1 to 2279bb-6 (Farmer Mac). *See also id*. § 1426(h)(3) (FHLBS).

Prompt corrective action subjects a financial institution to progressively more stringent restrictions and requirements as the institution's capital declines below required levels. *See generally* Carnell, *supra* note 192, at 327–48 (explaining prompt corrective action and its objectives). Under the prompt corrective action system for depository institutions, a bank is "adequately capitalized" if it meets all applicable capital standards (e.g., by having at least a 4% ratio of core capital to total assets), "undercapitalized" if it fails to meet any capital standard, "significantly undercapitalized" if it falls significantly below any capital standard (e.g., 3% of total assets), and "critically undercapitalized" if its tangible equity falls below 2% of total assets. *See* 12 U.S.C. § 1831o(b)(1), (c)(3); 12 C.F.R. § 6.4 (2004). The lower an institution's capital category, the more stringent the applicable safeguards. *See* 12 U.S.C. § 1831o(d)–(f), (h)–(i). The prompt corrective action regime applicable to Fannie and Freddie has identical names, with different quantitative definitions, for its capital categories. *See id*. § 4614.

225. *See* 12 U.S.C. §§ 1440, 2243(2), 2254(a), 2277a-7(8), 2277a-8(b)(1)–(3), 2279aa-11(a)(1)(A), 2279aa-11(b), 4501(6), 4513(b)(2), 4517.

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

227. *See, e.g.*, GAO, THE GOVERNMENT'S EXPOSURE TO RISKS, *supra* note 32, at 97 (calling financial-soundness regulation of Fannie and Freddie "much weaker" than its bank counterpart); Richard Scott Carnell, *Federal Deposit Insurance and Federal Sponsorship of Fannie Mae and Freddie Mac: The Structure of Subsidy*, *in* SERVING TWO MASTERS YET OUT OF CONTROL, *supra* note 19, at 56, 61–62, 64–71 (arguing that government's perceived implicit backing of Fannie and Freddie tends to impart a greater net subsidy than FDIC insurance, partly because GSE regulation has less rigor than bank regulation); Thomas H. Stanton, *Federal Supervision of Safety and Soundness of Government-Sponsored Enterprises*, 5 ADMIN. L.J. 395, 426–35, 440–56 (1991) (advocating that Congress use bank regulation as principal model for strengthening GSE financial-soundness regulation).

228. The statutes administered by OFHEO apply to both Fannie and Freddie, as do the housing goals for those enterprises. *See* 12 U.S.C. §§ 4501–4641. The statutes governing Farmer Mac form part of the Farm Credit Act of 1971, which governs the FCS. Indeed, the FCS officially includes Farmer Mac. *See id*. § 2279aa-1(a)(2). But other GSE statutes (such as those cited *supra* notes 35–39) apply only to a single, named GSE.

229. 1 NAT'L ACAD. OF PUB. ADMIN., REPORT ON GOVERNMENT CORPORATIONS 17 (1981). Although the statement refers to government corporations, it also holds true for GSEs.

230. The Jacksonian free-banking movement, hostile to monopoly and special privilege, helped transform U.S. banking legislation. *See* BRAY HAMMOND, BANKS AND POLITICS IN AMERICA FROM THE REVOLUTION TO THE CIVIL WAR 573, 593 (1985). Chartering a bank had heretofore required

accountability.[231] Without generic law, the government tends to deal ad hoc with "each institution and set of circumstances"[232] in ways that tend to favor the narrow interests of the institution's owners, managers, and clientele. Generic law "can help to shift the political debate to questions about whether exceptions to general rules are warranted"—a context less favorable to those interest groups.[233]

This pattern of using banking law as a model for GSE regulation holds true for GSE insolvency law. Insolvency mechanisms drawn from banking law apply to Fannie, Freddie, the Farm Credit System, and Farmer Mac.[234] Current congressional proposals to strengthen the mechanisms for Fannie and Freddie also draw heavily on bank insolvency law.[235]

B. Bank Insolvency Law: A Synopsis

Under the specialized insolvency regime for banks, a failed bank's regulator appoints a receiver or conservator for the bank, ex parte and without prior notice, hearing, or judicial approval.[236] Only the regulator can commence this process; creditors play no formal role.[237] A receiver winds up the bank's business, liquidates the bank's affairs, determines the validity of creditors' claims against the bank, and pays creditors[238]—

special legislation that named the bank and specified its powers. *See id.* at 572, 593–94. Free-banking legislation, by contrast, relied on an executive-branch official to charter and regulate banks under statutes of general application. *See id.* at 593. Such laws "marked a stage in the evolution of laws from individual and specific enactments into general statutes of uniform and comprehensive nature." *Id.* (referring to 1838 N.Y. statute). Moreover, banking law took shape at a time when banks were small, numerous, and politically vulnerable, federal deposit insurance did not exist, and legislators felt a strong imperative to protect depositors, even at the expense of banks' shareholders and managers.

231. *See* Moe & Stanton, *supra* note 117, at 324.

232. *Id*.

233. *Id*.

234. *See infra* notes 310, 350, 362.

235. *See infra* Part VI.A.2.

236. *See* Swire, *supra* note 208, at 478–79; *see, e.g.*, 12 U.S.C. § 191 (2000) (national bank receiver); *id.* § 1464(d)(2)(A)–(B) (receiver or conservator for FDIC-insured savings institution). Nor can a court restrain the regulator from appointing a receiver or conservator. *See, e.g.*, *id.* § 1464(d)(2)(D) (FDIC-insured savings institution); Am. Bank, N.A. v. Clarke, 933 F.2d 899, 901, 903 (10th Cir. 1991) (national bank); First Fed. Sav. Bank & Trust v. Ryan, 927 F.2d 1345, 1356–58 (6th Cir. 1991) (FDIC-insured savings institution).

237. *See* Swire, *supra* note 208, at 493; Skeel, *supra* note 208, at 723–24, 735. *See generally id.* at 736–39, 744–66, 779–80 (discussing alternatives to regulators' current monopoly on initiating insolvency proceedings).

238. *See* 12 U.S.C. § 1821(d)(2)(E). *See generally* FED. DEPOSIT INS. CORP., RESOLUTIONS

all in a streamlined and almost purely administrative process.[239] A conservator, unlike a receiver,[240] operates a bank as a going concern, seeking to rehabilitate the bank or prepare it for orderly sale in receivership, and has no authority to liquidate the bank.[241] The bank as a corporate entity still exists at the end of a conservatorship but not at the end of a receivership. (Once a bank has failed, regulators would appoint only a receiver; conservatorship has no relevance.) The Federal Deposit Insurance Act[242] incorporates this approach[243]—as do other federal bank insolvency statutes[244]—and makes it applicable to any FDIC-insured depository institution.[245]

The process for dealing with a bank failure has three basic steps: (1) appointing a receiver for the bank; (2) marshaling the bank's assets (i.e., identifying and collecting on all items of potential value owned by the bank); and (3) using the proceeds of those assets to pay valid claims against the bank in the order of priority established by law. In handling the failure, the receiver can use a wide range of legal tools, including tools designed to preserve the failed bank's going-concern value and minimize disruption to the bank's depositors and other customers.

1. Appointing a Receiver

A bank's primary regulator (i.e., the government agency that issued the bank's charter) normally appoints any receiver for the bank.[246] If the

HANDBOOK ch. 7 (2005) (summarizing FDIC's role as receiver) [hereinafter FDIC RESOLUTIONS HANDBOOK], http://www.fdic.gov/bank/historical/reshandbook; FDIC, MANAGING THE CRISIS, *supra* note 194, at 213–22 (summarizing FDIC's historical experience as receiver).

239. *See* Swire, *supra* note 208, at 478–79, 492.

240. "The principal difference between a conservator and receiver is that a conservator may operate and dispose of a bank as a going concern, while a receiver has the power to liquidate and wind up the affairs of an institution." James Madison Ltd. by Hecht v. Ludwig, 82 F.3d 1085, 1090 (D.C. Cir. 1996). A receiver can, however, form a "bridge bank" to carry on a failed bank's business. *See* 12 U.S.C. § 1821(n); *infra* note 284.

241. *See* 12 U.S.C. § 1821(d)(2)(D).

242. *Id*. §§ 1811–1835a.

243. *See id*. § 1821(c)–(n).

244. *See id*. §§ 191–200 (national bank receiver); *id*. §§ 201–212 (national bank conservator); *id*. § 1464(d)(2)–(3) (federal savings association receiver or conservator); *id*. § 1787 (credit union conservator or "liquidating agent").

245. *See id*. §§ 1813(c), 1821, 1822. FDIC-insured depository institutions comprise the bulk of the U.S. banking system. Although for brevity this Article refers to "banks," the Federal Deposit Insurance Act applies equally to savings institutions. *See id*. § 1813(c)(1).

246. *See, e.g.*, *id.* § 191 (national banks); *id*. § 1464(d)(2)(B) (federal savings associations); *see also id*. § 1821(c)(10) (authorizing FDIC to appoint itself conservator or receiver to avoid or reduce

bank has FDIC insurance, the FDIC serves as receiver.[247] Many grounds for receivership (or conservatorship) exist.[248] Some of the more important grounds include (1) illiquidity—i.e., the bank cannot meet its obligations in the normal course of business;[249] (2) balance sheet insolvency—i.e., the bank's liabilities exceed its assets;[250] (3) serious depletion of the bank's capital;[251] (4) failing to submit a capital restoration plan or materially failing to implement such a plan;[252] (5) failing to correct a capital deficiency after having been formally ordered to do so;[253] (6) being in an "unsafe or unsound condition to transact business";[254] (7) substantially dissipating assets or earnings through a violation of law or an unsafe or unsound practice;[255] (8) concealing records or assets or refusing to let authorized examiners inspect records;[256] and (9) willfully violating a cease-and-desist order.[257]

The practice of appointing a receiver (or conservator) without prior notice, hearing, or judicial approval—as expressly authorized by statute[258]—reflects a judgment that the circumstances will often create a need to act swiftly, decisively, and discreetly. By the time a bank enters receivership, it often has scant net worth and dubious prospects, giving its managers incentives to serve their own interests at creditors' expense[259] and giving its uninsured depositors incentives to run.[260] Both

loss to deposit insurance fund).

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

248. *See id*. § 1821(c)(5).

249. *Id*. § 1821(c)(5)(F).

250. *Id*. § 1821(c)(5)(A).

251. *See id*. § 1821(c)(5)(G) (substantially depleting capital with no reasonable prospect of recapitalizing); *id.* § 1821(c)(5)(K) (undercapitalized with no reasonable prospect of recapitalizing); *id.* § 1821(c)(5)(L) (critically undercapitalized).

252. *Id*. § 1821(c)(5)(K)(iii)–(iv).

253. *Id*. § 1821(c)(5)(K)(ii).

254. *Id*. § 1821(c)(5)(C).

255. *Id*. § 1821(c)(5)(B); *see also id*. § 1821(c)(5)(H).

256. *Id*. § 1821(c)(5)(E).

257. *Id*. § 1821(c)(5)(D).

258. *See id*. §§ 191, 203(a), 1464(d)(2)(B).

259. *See* Susan Rose-Ackerman, *Risk Taking and Ruin: Bankruptcy and Investment Choice*, 20 J. LEGAL STUD. 277, 296–97, 306, 309 (1991) (explaining why insolvent or near-insolvent firm's managers have incentives to take risks likely to deepen creditors' losses); DAVID M. KREPS, GAME THEORY AND ECONOMIC MODELING 70 (1990) (explaining how, if both players know "at the start of any round . . . that this is the last" round, then one player has an incentive to exploit the other that

insider misconduct and a run would work against creditors' collective interest in maximizing the value of the bank's assets.[261] The U.S. Supreme Court has accordingly upheld the appointment of a conservator without a prior hearing.[262] "This is a drastic procedure," the Court acknowledged, but had become "an almost invariable custom" because of "the delicate nature of the institution and the impossibility of preserving credit during an investigation."[263] This summary process placed on regulators "a heavy responsibility to be exercised with disinterestedness and restraint," the Court concluded, "but in the light of the history and customs of banking we cannot say it is unconstitutional."[264] The bank does have a right to a prompt post-seizure judicial hearing.[265]

2. *Marshaling Assets*

In marshaling a failed bank's assets, the receiver identifies all items of any potential value owned by the bank, including loans, leases, securities, insurance claims, other financial or nonfinancial contract rights, buildings, equipment, and current or potential legal claims (e.g., lawsuits against directors and officers for breaching their fiduciary duties).[266] The receiver then works to turn such assets into cash.[267] It can also invalidate pre-receivership transfers made to defraud the bank or its creditors.[268]

The receiver succeeds to all the bank's "rights, titles, powers, and

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would not exist if the player expected the game to continue indefinitely).

260. *See* Swire, *supra* note 208, at 495 (explaining uninsured depositors' incentives to run); PERSPECTIVES ON SAFE & SOUND BANKING, *supra* note 208, at 41–42 (same).

261. *See* Swire, *supra* note 208, at 494–95 (explaining how run would work against creditors' collective interest); PERSPECTIVES ON SAFE & SOUND BANKING, *supra* note 208, at 42–45 (same).

262. Fahey v. Mallonee, 332 U.S. 245, 253–54 (1947).

263. *Id.* at 253.

264. *Id.* at 253–54; *accord* First Fed. Sav. Bank & Trust v. Ryan, 927 F.2d 1345, 1357–58 (6th Cir. 1991).

265. 12 U.S.C. § 203(b)(1) (conservator for national bank); *id.* § 1464(d)(2)(B) (receiver or conservator for FDIC-insured savings association); *see* James Madison Ltd. by Hecht v. Ludwig, 82 F.3d 1085, 1094 (D.C. Cir. 1996) (holding that because banking statutes neither require nor preclude judicial hearing on appointment of receiver for national bank, Administrative Procedure Act authorizes such hearing).

266. JONATHAN R. MACEY, GEOFFREY P. MILLER & RICHARD SCOTT CARNELL, BANKING LAW AND REGULATION 747 (3d ed. 2001).

267. *Id.*

268. 12 U.S.C. § 1821(d)(17).

privileges,"[269] and can exercise all the powers of the bank's directors, officers, and shareholders.[270] It can: collect on the bank's assets;[271] transfer loans without the borrowers' consent and deposits without the depositors' consent;[272] terminate burdensome contracts, generally without incurring more than "actual direct compensatory damages" (i.e., no punitive damages or damages for lost profits or pain and suffering);[273] and merge the bank with another FDIC-insured depository institution.[274] The Federal Deposit Insurance Act generally forbids any court to "take any action . . . to restrain or affect the exercise of [the FDIC's] powers or functions . . . as a conservator or a receiver."[275]

3. *Paying Valid Claims in Order of Priority*

The receiver notifies creditors to file proof of their claims against the bank and determines the validity of those claims.[276] The receiver satisfies secured claims—i.e., claims with a perfected security interest (e.g., mortgage or lien) in property of the bank—from the value of that collateral.[277] The receiver pays allowed unsecured claims in the order of priority prescribed by law: (1) administrative expenses of the receivership; (2) deposits, whether insured or uninsured; (3) "general or senior" liabilities—a residual category including liabilities that do not fit the other categories; (4) liabilities subordinated to deposits or general claims; (5) cross-guarantee liability to the FDIC;[278] and (6) shareholders'

269. *Id*. § 1821(d)(2)(A)(i).

270. *Id*. § 1821(d)(2)(B)(i).

271. *Id*. § 1821(d)(2)(B)(ii) (authorizing receiver to "collect all obligations and money due the institution").

272. *Id*. § 1821(d)(2)(G)(i)(II).

273. *Id*. § 1821(e).

274. *Id*. § 1821(d)(2)(G).

275. *Id*. § 1821(j); *see also id*. § 1821(d)(5)(E) (prohibiting judicial review of decision to disallow claim); *id.* § 1821(d)(13)(C) (shielding assets in receiver's possession from attachment and execution); *id.* § 1821(d)(13)(D) (generally withdrawing courts' jurisdiction over claims relating to assets of any depository institution in FDIC receivership or acts or omissions of institution or receiver).

276. *Id*. § 1821(d)(3)–(8).

277. If the claim exceeds the value of the collateral, the excess constitutes an unsecured claim. *Id*. § 1821(d)(5)(D)(ii).

278. If an FDIC-insured bank fails and causes a loss to the FDIC, the FDIC can hold any affiliated FDIC-insured depository institution liable for the loss. *Id.* § 1815(e)(1)(A), (e)(9). The FDIC in effect has an option to disregard the corporate separateness of affiliated FDIC-insured institutions and treat them as a single economic entity.

claims.[279] In keeping with traditional receivership law, the receiver generally pays all allowed claims within a given priority class before it makes any payment on claims in the next lower priority class.[280] Thus general liabilities receive nothing unless all deposits have been paid in full, and shareholders receive nothing unless all other claims have been paid in full. If a given class of claims exceeds the assets available to pay that class, then the claims share pro rata in the available assets.[281] But the FDIC as receiver has leeway to deviate from these priorities as long as each claimant receives no less than it would have received in a straight liquidation.[282]

4. *Resolution Options*

Bank receivership law facilitates rapid action to deal with (or in bank regulatory jargon, "resolve") a failed or failing bank. The receiver can liquidate the bank's assets and pay off the bank's liabilities (a transaction known as a "deposit payoff"); pay a healthy bank to assume the failed bank's insured deposits ("insured deposit transfer"); or arrange for an acquirer to purchase some or all of the bank's assets and assume some or all of the bank's liabilities ("purchase and assumption").[283] If the receiver plans to sell the bank as a going concern but has not yet found an acquirer, the receiver can form a "bridge bank," transfer part or all of the failed bank's assets and liabilities to the bridge bank, and have the bridge bank carry on the failed bank's business until an acquirer is found.[284] In forming a bridge bank with some but not all of the failed

279. *Id*. §§ 1815(e)(2)(C), 1821(d)(11)(A) (listing order of priorities).

280. *Id*. § 1821(d)(11)(A).

281. *See* First Empire Bank v. FDIC, 572 F.2d 1361, 1371 (9th Cir. 1978).

282. 12 U.S.C. § 1821(i)(2).

283. MACEY, MILLER & CARNELL, *supra* note 266, at 739–43. *See generally* FDIC, MANAGING THE CRISIS, *supra* note 194, at 65–111 (describing evolution of FDIC's resolution practices).

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

284. *See* 12 U.S.C. § 1821(n) (authorizing FDIC to form bridge bank); *see also id*. § 1821(d)(2)(F) (authorizing FDIC as receiver to form new depository institutions); *id*. § 1821(m) (authorizing FDIC to form "new bank"). "A bridge bank is a full-service national bank chartered by the Office of the Comptroller of the Currency and controlled by the FDIC." FDIC RESOLUTIONS HANDBOOK, *supra* note 238, ch. 7. Such a bank "is especially useful . . . when the failing bank is large or unusually complex . . . or when the bank is in a liquidity crisis." Rosalind L. Bennett, *Failure Resolution and Asset Liquidation: Results of an International Survey of Deposit Insurers*, 14 FDIC BANKING REV. 1, 15 (2001). A bridge bank resembles a purchase-and-assumption

bank's assets and liabilities, the receiver can in effect reorganize the failed bank.[285]

The receiver can combine one or more of these resolution options. Thus, for example, the receiver can establish a bridge bank to carry on the failed bank's business and later arrange for an acquirer to purchase the assets and assume the liabilities of the bridge bank. Likewise, after having an acquirer purchase part of the assets and assume part of the liabilities of the failed bank, the receiver can use a payoff to dispose of the remainder. In any event, the receiver can make an immediate partial payment ("modified payoff") to creditors based on an estimate of what their claims will ultimately receive from the liquidation.[286]

C. Proposed Criteria for GSE Insolvency Regimes

A GSE insolvency regime should follow the model of bank insolvency law by (1) authorizing a GSE's regulator to appoint a conservator or receiver through a process permitting timely ex parte action, without hearing or judicial approval; (2) specifying the grounds for conservatorship and receivership; (3) affording the GSE a prompt post-seizure judicial hearing; (4) specifying priorities among claims; (5) authorizing receivers to establish bridge enterprises; and (6) authorizing receivers to effect reorganizations. Ex parte appointment of conservators and receivers facilitates swift, decisive, and discreet action to deal with a faltering firm, while a prompt judicial hearing provides due process. Specifying the priority of claims reduces the uncertainty that creditors face. Bridge enterprises and reorganizations can help minimize market-disruption and tap a failed firm's going-concern value for the benefit of creditors.

IV. SPECIALIZED GSE INSOLVENCY REGIMES

This Part begins by explaining why GSEs, unlike most firms, cannot

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transaction (i.e., purchase of assets and assumption of liabilities) "in which the FDIC itself acts temporarily as the acquirer." *See id*. *See generally* FDIC, MANAGING THE CRISIS, *supra* note 194, at 172–209 (describing FDIC's experience using bridge banks).

285. *See* 12 U.S.C. § 1821(d)(2)(F) (2000) (authorizing FDIC as receiver to form bridge bank or similar entity as successor to failed bank); *id*. § 1821(d)(2)(G)(i)(II) (authorizing FDIC to transfer failed bank's assets and liabilities without creditors' consent); *id*. § 1821(i)(2) (specifying that FDIC owes no claimant more than claimant would have received in straight liquidation, which means that FDIC need not necessarily transfer or otherwise satisfy face amount of claim); *id*. § 1821(n) (setting forth rules for bridge banks).

286. *See* 12 U.S.C. § 1821(d)(10).

liquidate or reorganize under the Bankruptcy Code. It will then examine the specialized insolvency regimes Congress has enacted for each GSE, evaluating each regime under the criteria developed in Part III. In the case of Fannie and Freddie, for which no statutory liquidation or reorganization mechanism exists, this Part also considers two potential fallback options: using statutory conservatorship to effect a liquidation, and using common-law receivership to effect a liquidation or reorganization.

A. Bankruptcy Code Is Inapplicable to GSEs

Most firms, including virtually all ordinary business corporations, can liquidate or reorganize under the Bankruptcy Code.[287] Neither the GSEs' charters nor the specialized GSE insolvency statutes specifically prohibit GSEs from doing so. Thus the question arises whether a GSE could liquidate or reorganize under the code.

The answer turns on whether a GSE constitutes a federal "instrumentality" for purposes of the Bankruptcy Code. The code permits only a "person" to be a debtor under chapter 7 or 11.[288] "Person," as defined in the code, "includes individual, partnership, and corporation, but [with exceptions irrelevant here] does not include governmental unit."[289] "Governmental unit" includes an "instrumentality of the United States."[290] Accordingly, if a GSE is a federal instrumentality, it is a "governmental unit," not a "person," and cannot be a debtor under chapter 7 or 11.[291]

The Bankruptcy Code does not define "instrumentality,"[292] and its legislative history sheds scant light on the term.[293] To ascertain whether

287. *See* 11 U.S.C. §§ 101(41), 109(a)–(b), (d) (2000).

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

289. *Id*. § 101(41).

290. *Id*. § 101(27).

291. *See* STANTON, A STATE OF RISK, *supra* note 14, at 206.

292. *See* 11 U.S.C. § 101.

293. The House and Senate committee reports on the Bankruptcy Reform Act of 1978 both state that the Bankruptcy Code "defines 'governmental unit' in the broadest sense." H.R. REP. NO. 95-595, at 311 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6268; S. REP. NO. 95-989, at 24 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5810. Both reports also indicate that an instrumentality or other governmental unit must "actually [be] carrying out some governmental function." H.R REP. NO. 95-595, at 311; S. REP. NO. 95-989, at 24. Thus "governmental unit" does not include entities

GSEs are federal instrumentalities for purposes of the code, we must look to nonbankruptcy statutes and to case law dealing with GSEs and other federally chartered financial institutions. Congress has expressly declared Farm Credit System institutions and Farmer Mac "federally chartered instrumentalities of the United States."[294] Statutes applicable to the three housing GSEs imply that those firms are also federal instrumentalities.[295] Courts have classified Fannie,[296] Freddie,[297] the Federal Home Loan Banks,[298] and FCS institutions[299] as federal

merely because they owe their existence to governmental action "such as the granting of a charter or a license." H.R. REP. NO. 95-595, at 311; S. REP. NO. 95-989, at 24.

The requirement of "actually carrying out some governmental function" provides little useful guidance for classifying GSEs, because the courts have held that anything that a constitutionally valid federal instrumentality does is necessarily a governmental function. In Federal Land Bank of St. Paul v. Bismarck Lumber Co., 314 U.S. 95 (1941), the Supreme Court declared:

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

Id. at 102 (citations omitted).

294. 12 U.S.C. § 2121 (2000) (banks for cooperatives); *accord id*. § 2011(a) (farm credit banks); *id*. § 2071(a), (b)(7) (production credit associations); *id*. § 2091(a), (b)(4) (federal land bank associations); *id*. § 2141(a) (National Bank for Cooperatives); *id*. § 2211 (credit bank service corporation); *id*. § 2279aa-1(a)(1) (Farmer Mac). *See generally* Dir. of Revenue v. CoBank ACB, 531 U.S. 316, 318 (2001) (classifying FCS as federal instrumentality).

295. Fannie and Freddie must "insert appropriate language" in their "obligations and securities . . . clearly indicating that such obligations and securities . . . do not constitute a debt or obligation of the United States or *any* agency or *instrumentality thereof other than the Corporation*." 12 U.S.C. § 1455(h)(2) (Freddie Mac) (emphasis added); *accord id*. § 1719(b), (d), (e) (Fannie Mae). Using "other than the Corporation" after "agency or instrumentality" implies that the GSE is a federal agency or instrumentality. As a GSE is not an "agency," *see* 5 U.S.C. § 105 (2000), it presumably is an "instrumentality." In addition, each FHL Bank can accept deposits from "any *other* Federal Home Loan Bank or other instrumentality of the United States." 12 U.S.C. § 1431(e)(1) (emphasis added). Pairing "Federal Home Loan Bank" with "other instrumentality of the United States" implies that FHL Banks are also federal instrumentalities.

296. *See* Rust v. Johnson, 597 F.2d 174, 178 (9th Cir. 1979).

297. *See* Mendrala v. Crown Mortgage Co., 955 F.2d 1132, 1138–41 (7th Cir. 1992) (classifying Freddie as federal instrumentality for estoppel purposes but not as federal agency for purposes of Federal Tort Claims Act). *But cf., e.g.*, Am. Bankers Mortgage Corp. v. Fed. Home Loan Mortgage Corp., 75 F.3d 1401, 1406–09 (9th Cir. 1996) (holding Fifth Amendment's due-process clause inapplicable to Freddie).

298. *See* Ass'n of Data Processing Serv. Orgs. v. Fed. Home Loan Bank Bd., 568 F.2d 478, 480, 484, 486 (6th Cir. 1977); Fahey v. O'Melveny & Myers, 200 F.2d 420, 446–47 (9th Cir. 1952).

299. *See* Fed. Land Bank of St. Paul v. Bismarck Lumber Co., 314 U.S. 95, 102–03 (1941); Smith v. Kan. City Title & Trust Co., 255 U.S. 180, 198, 210–12 (1921) (holding that Congress properly designated land banks as federal instrumentalities).

instrumentalities. Courts have also classified national banks,[300] federal savings associations,[301] and federal credit unions[302]—together numbering more than 8,000 institutions[303]—as federal instrumentalities. Although these decisions did not involve the "instrumentality" provision of the Bankruptcy Code, they do shed light on the general meaning of federal "instrumentality."

The U.S. Court of Appeals for the First Circuit has specifically held federal credit unions to be federal instrumentalities, and thus also "governmental units," for purposes of the Bankruptcy Code.[304] The case for treating GSEs as federal instrumentalities—even without any explicit statute to that effect—is as strong as the case for treating federal credit unions as instrumentalities: GSEs perform important governmental functions,[305] enjoy significant tax exemptions,[306] and face extensive government regulation.[307] The First Circuit held that these three criteria

300. *See* Davis v. Elmira Sav. Bank, 161 U.S. 275, 283 (1896); Marquette Nat'l Bank v. First of Omaha Serv. Corp., 439 U.S. 299, 308 (1978).

301. *See* United States v. State Tax Comm'n, 481 F.2d 963, 969 (1st Cir. 1973).

302. *See* T I Fed. Credit Union v. DelBonis, 72 F.3d 921, 930–35 (1st Cir. 1995); United States v. Michigan, 851 F.2d 803, 807 (6th Cir. 1988).

303. As of Dec. 31, 2004, the United States had 1,906 national banks, 781 federal savings institutions, and 5,572 federal credit unions. *See* FED. DEPOSIT INS. CORP., FDIC STATISTICS ON BANKING, DEC. 31, 2004, at B-2 tbl.101 (2005), *available at* http://www2.fdic.gov/SDI/SOB (select 2003 "End of Year Publication" for "All FDIC-Insured Institutions"); NAT'L CREDIT UNION ADMIN., 2004 ANNUAL REPORT 100 (2005) (federal credit unions).

304. *See T I Fed. Credit Union*, 72 F.3d at 926–27.

305. Congress established GSEs for purposes as important and as "governmental" as those cited in *T I Fed. Credit Union*. These purposes include assisting "the secondary market for residential mortgages (including . . . mortgages on housing for low- and moderate-income families . . .) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing," 12 U.S.C. § 1716(3) (2000) (Fannie), *accord* Housing and Community Development Act of 1992, Pub. L. No. 102-550, § 1382(a)(3), 106 Stat. 3672, 4002 (Freddie), "promot[ing] access to mortgage credit throughout the Nation (including central cities, rural areas, and underserved areas)," 12 U.S.C. § 1716(4) (Fannie), *accord* Housing and Community Development Act, § 1382(a)(4) (Freddie), and "improving the income and well-being of American farmers and ranchers by furnishing sound, adequate, and constructive credit and closely related services." 12 U.S.C. § 2001(a) (FCS).

306. *See* 12 U.S.C. § 1433 (FHLBS); *id*. § 1452(e) (Freddie); *id*. § 1723a(c)(2) (Fannie); *id*. §§ 2023, 2077, 2098, 2134 (FCS). Of all five GSEs only Farmer Mac, which Congress has expressly declared a federal instrumentality, *see id.* § 2279aa-1(a)(1), has no statutory tax exemption.

307. GSEs also face government regulation as extensive as that applicable to federal credit unions. *Compare* 12 C.F.R. pts. 701–760 (2004) (rules governing credit unions), *with id*. pts. 611–630 (FCS), *and id.* pt. 650 (Farmer Mac), *and id*. pts. 915–998 (FHLBS), *and id*. pts. 1720–1777 (Fannie and Freddie's financial soundness), *and* 24 C.F.R. pt. 81 (2003) (Fannie and Freddie's housing mission).

together provided "compelling indicia of federal instrumentality status."[308] Accordingly, GSEs are almost certainly federal "instrumentalities" for purposes of the Bankruptcy Code—and thus, as "governmental units," cannot become debtors under chapter 7 or 11. Attempting to use the Bankruptcy Code to deal with a faltering GSE would, at the very least, involve legal uncertainty so great as to render the attempt likely to do more harm than good.[309]

B. Fannie Mae and Freddie Mac

Statutes governing Fannie and Freddie authorize conservatorship[310] but not receivership.[311] The statutes provide no means for reorganizing a troubled GSE and do not even specifically authorize liquidating such a firm.[312] Those statutes would furnish only modest support for a liquidation and none whatever for a reorganization.

1. Limits of Conservatorship

The Office of Federal Housing Enterprise Oversight can appoint a conservator for Fannie or Freddie if the GSE has a serious capital deficiency,[313] "is not likely to pay its obligations in the normal course of business,"[314] conceals records or assets or refuses to let authorized examiners inspect records,[315] or willfully violates a cease-and-desist

308. *T I Fed. Credit Union*, 72 F.3d at 934.

309. *See infra* Part V (legal uncertainty under current conservatorship statute for Fannie and Freddie could harm GSEs and financial markets).

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

311. *See id*. §§ 4616(b)(6), 4617(a)(1), 4619(a)(1).

312. *See id*. §§ 4616(b)(6), 4617(a)(1), 4619(a)(1).

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

314. *Id*. § 4619(a)(1)(B)(i).

315. *See id*. § 4619(a)(1)(B)(iii).

order.[316] After the conservator takes control of the GSE, the GSE's directors can challenge the appointment in federal district court.[317] They have the burden of proving that the appointment abused OFHEO's discretion or otherwise violated the law.[318]

The conservator generally has "all the powers of the shareholders, directors, and officers of the enterprise under conservatorship and may operate the enterprise in the name of the enterprise."[319] Thus, if the GSE has sufficiently good prospects, the conservator should be able to recapitalize the firm by selling new shares (e.g., for cash or in voluntary exchange for creditors' claims), even if the new shares massively dilute existing shareholders' ownership.[320] Other statutes empower the conservator to avoid fraudulent security interests,[321] enforce certain types of contracts despite the GSE's conservatorship or insolvency,[322] and obtain stays of pending litigation.[323]

But neither the conservator nor OFHEO has any statutory authority to require creditors to exchange debt for equity or to accept only partial payment of their claims.[324] This conclusion follows from the terms of the conservator's authority: the statute granting the conservator "the powers of the [GSE's] shareholders, directors, and officers"[325] and the absence of any statute specifically authorizing the conservator to restructure or impair creditors' claims. Thus, if a GSE's assets fall short of its liabilities, the conservator lacks statutory power to resolve the

316. *See id.* § 4619(a)(1)(B)(iv).

317. *See id.* § 4619(b)(1).

318. *See id.* § 4619(b)(3).

319. *Id.* § 4620(a).

320. Under § 4620(a) the conservator can exercise the shareholders' authority to authorize new shares and the board's authority to issue those shares. *Id.* § 4620(a).

321. *Id.* § 4620(b). This innocuous-sounding provision typifies the stinginess of OFHEO's statutory conservatorship authority. OFHEO can "avoid any security interest taken by a creditor with the intent to hinder, delay, or defraud" the GSE or its creditors. *Id.* But that language is conspicuously narrower than comparable provisions of the Bankruptcy Code, *see* 11 U.S.C. §§ 544(b)(1), 548 (2000), bank receivership law, *see* 12 U.S.C. § 1821(d)(17)(A), or the Uniform Fraudulent Transfer Act. *See* UNIF. FRAUDULENT TRANSFER ACT §§ 4–5, 7 (1984), 7A, pt. II U.L.A. 301–02, 330, 339–40 (1999). Thus, for example, § 4620(b) does not reach other fraudulent transfers of property. *See* 12 U.S.C. § 4620(b). Nor does it make clear whether OFHEO can pursue any broader remedies afforded by state debtor-creditor law. *See id.*

322. 12 U.S.C. § 4620(d).

323. *Id.* § 4620(e).

324. *See id.* §§ 4616(b)(6), 4617(a)(1), 4619(a)(1).

325. *Id.* § 4620(a).

shortfall.[326]

The constraints on when OFHEO can appoint a conservator—combined with weak capital requirements,[327] reliance on accounting numbers that may not reflect market value,[328] and OFHEO's limited enforcement powers[329]—make the limited scope of a conservator's authority all the more problematic. By the time OFHEO could place a GSE in conservatorship, the firm's condition may well have deteriorated to the point that a conservator cannot resolve the firm's problems.[330]

Consider the case of a GSE that has depleted its capital under circumstances that leave investors wary about the reliability of the firm's accounting and reporting. Even if the firm actually has a slender positive net worth and good earnings prospects, prospective equity investors cannot be sure that is so. Investors may reasonably fear that at market value the firm's liabilities exceed its assets. Thus, even if offered 99.9% ownership of the firm, investors might well (given the limits of their knowledge) balk at restoring the firm's equity to a level that would meet regulatory capital requirements. The GSE's plight would be even worse insofar as its liabilities exceeded its assets.

But a failing GSE's prospects would brighten considerably if OFHEO could appoint a receiver empowered to reorganize the firm. A reorganization could convert some debt into equity and make the terms of the remaining debt less onerous. In such a debt-to-equity conversion, general and senior debtholders might receive restructured debt (e.g., $98 in new debt for each $100 in old debt) plus most of the firm's equity; subordinated debtholders might receive equity or nothing (depending on

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

327. *See id*. §§ 4611–4613.

328. *See id*. §§ 4612–4613.

329. *See* sources cited *supra* note 182.

330. *See* Larry D. Wall, Robert A. Eisenbeis & W. Scott Frame, *Resolving Large Financial Intermediaries: Banks Versus Housing Enterprises*, 1 J. FIN. STABILITY 386, 406–08, 413 (2005).

the seriousness of the firm's problems); and the old shareholders might receive nothing. Thus the firm could emerge from receivership with an adequate equity cushion and a less onerous debt burden.

Although Fannie and Freddie portray the conservatorship statute as adequate for dealing with a troubled GSE,[331] OFHEO now acknowledges the statute's inadequacy. In 2003, after considering ways in which Fannie and Freddie could jeopardize the financial system,[332] OFHEO recommended that Congress grant OFHEO receivership authority.[333] Such authority would, according to OFHEO, "provide greater procedural and substantive certainty to a failed Enterprise's creditors, . . . ensure greater fairness to all market participants, and . . . facilitate the liquidation or merger of a failed Enterprise by clearly authorizing actions relating to outstanding claims that are essential to such remedies."[334]

2. Fallback Options

Fallback options for handling a severely troubled Fannie or Freddie might include a liquidating conservatorship or a common-law receivership.

a. Liquidating Conservatorship

The conservatorship statute permits OFHEO to "require a conservator to set aside and make available for payment to creditors any amounts that [OFHEO] determines may safely be used for such purpose."[335] OFHEO might thus plausibly attempt to use conservatorship to effect a de facto liquidation, letting the conservator (which could be OFHEO itself[336]) make pro rata payments on creditors' claims until no assets

331. *See* Richard F. Syron, Chairman and CEO, Freddie Mac, Statement Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs 11 (Feb. 25, 2004) [hereinafter Syron, 2004 Senate Testimony], *available at* http://banking.senate.gov/_files/syron.pdf; Franklin D. Raines, Chairman and CEO, Fannie Mae, Statement Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs 13 (Feb. 25, 2004), *available at* http://banking.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=93.

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

333. *Id*. at 3–4, 114.

334. *Id*. at 114.

335. 12 U.S.C. § 4620(f) (2000).

336. *See id*. § 4619(a)(4)(A).

remained and then liquidate the firm. But such an approach would arguably conflict with the congressional decision to deny the conservator explicit liquidating authority[337] and would thus give creditors an opening to mount both legal and political attacks on the legitimacy of the conservator's action. In any event, pursuing a de facto liquidation would tend to impede using the firm's going-concern value for the benefit of creditors.

b. Common-Law Receivership

Alternatively, OFHEO could request that a federal district court appoint a receiver for Fannie or Freddie, drawing on the court's inherent equitable power. Freddie once suggested this possibility, asserting that "a U.S. district court could appoint a receiver for Freddie Mac under common law practice."[338] During the late nineteenth and early twentieth centuries, before the advent of chapter 11, "equity receivership" was extensively used to reorganize troubled railroads by restructuring ownership, rescheduling debts, and converting some debt to equity.[339] Assuming that the courts' equitable receivership authority survived the enactment of chapter 11, at least for firms ineligible to become debtors under the Bankruptcy Code, attempting to use that approach to deal with a faltering GSE would be fraught with uncertainty—and with great potential for delay and market disruption.[340]

C. Federal Home Loan Banks

The Federal Housing Finance Board has broad statutory authority to liquidate or reorganize "any Federal Home Loan Bank."[341] The agency can take such action "[w]henever the Board finds that the efficient and economical accomplishment of the purposes of [the Federal Home Loan Bank Act] will be aided by such action."[342] This standard—furthering

337. *See id.* § 4620.

338. GAO, THE GOVERNMENT'S EXPOSURE TO RISKS, *supra* note 32, at 93 n.5.

339. *See* Stephen J. Lubben, *Railroad Receiverships and Modern Bankruptcy Theory*, 89 CORNELL L. REV. 1420, 1440–52 (2004); DOUGLAS G. BAIRD, THE ELEMENTS OF BANKRUPTCY 65–68 (3d ed. 2001); DAVID A. SKEEL, JR., DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA 57–60, 64–68 (2001).

340. The potential for market disruption would be particularly acute under the sort of scenario considered *infra* Part V.

341. *See* 12 U.S.C. § 1446.

342. *See id.* The liquidation or reorganization must follow "such rules, regulations, and orders as the Board may prescribe" and provide for paying the bank's liabilities. *See id.*

"the efficient and economical accomplishment" of the Act's purposes[343]—is extraordinarily vague. No statute or regulation specifies those purposes,[344] and courts have summarized the Act's "general purpose"[345] in terms giving no meaningful guidance for liquidation or reorganization decisions.[346] The Federal Housing Finance Board's predecessor agency used this authority to abolish and liquidate two FHL Banks during the late 1940s.[347] A federal court of appeals upheld that action based on the agency's sweeping authority over the FHL Banks,[348] but at least one current member of Congress has criticized the action as high-handed.[349]

D. Farm Credit System

The Farm Credit Act empowers the Farm Credit Administration Board (FCA Board) to appoint conservators or receivers for any Farm Credit System institution, specifies the grounds for such appointments, and provides for judicial review.[350] The board can appoint a conservator or receiver for any FCS institution that has obligations exceeding its assets,[351] cannot "timely pay principal or interest" on certain obligations,[352] culpably dissipates its assets or earnings,[353] is in "an

343. *See id*.

344. *See id*. §§ 1421–1449; 12 C.F.R. ch. IX (2004).

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

346. *See* Laurens Fed. Sav. & Loan Ass'n v. S.C. Tax Comm'n, 365 U.S. 517, 522 (1961) (summarizing congressional objective as "placing 'long-term funds in the hands of local institutions' in order to alleviate the pressing need of home owners for 'low-cost, long-term, installment mortgage money' and to 'decrease costs of mortgage money' with a 'resulting benefit to home ownership in the form of lower costs and more liberal loans'" (quoting H.R. REP. NO. 72-1418, at 8–10 (1932); S. REP. NO. 72-837, at 9–11 (1932))); *accord Ass'n of Data Processing Serv. Orgs.*, 568 F.2d at 486.

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

348. *Id*. at 440–47.

349. *See Review of the Office of Federal Housing Enterprise Oversight and Federal Housing Finance Board: Joint Hearing Before the Subcomm. on Oversight and Investigations and the Subcomm. on Capital Mkts., Ins. and Gov't Sponsored Enters. of the House Comm. on Fin. Servs.*, 108th Cong. 4–5 (2004) (statement of Rep. Luis V. Gutierrez).

350. 12 U.S.C. § 2183(b) (2000). Most provisions of the key FCS statute, 12 U.S.C. § 2183(b), have banking law antecedents. The grounds for appointing a conservator or receiver in § 2183(b)(1)–(6) parallel the first six grounds in the Federal Deposit Insurance Act, *id*. § 1821(c)(5)(A)–(F). The appointment procedure and rules for judicial review parallel 12 U.S.C. § 1464(d)(2)(B).

351. *Id*. § 2183(b)(1).

352. *Id*. § 2183(b)(6).

unsafe or unsound condition,"[354] conceals records or assets or refuses to let authorized examiners inspect records,[355] or willfully violates a cease-and-desist order.[356] The board can make the appointment "ex parte and without notice," subject to review on the merits in federal district court.[357] In addition, the board can require one credit association to merge with another if the association "has failed to meet its outstanding obligations or failed to conduct its operations in accordance with" the Farm Credit Act.[358]

The FCA Board has used its general rulemaking authority[359] to flesh out this simple statutory framework.[360] The statute and rules together provide a legal framework largely adequate for handling troubled FCS institutions, including power to appoint a conservator or receiver, grounds for such appointments, a process for judicial review, and agency rulemaking authority to fill in the details. But the current framework does not authorize a receiver to reorganize an FCS institution.[361] Thus, for example, the failure of one of the five Farm Credit Banks could

353. *Id*. § 2183(b)(2).

354. *Id*. § 2183(b)(3).

355. *See id*. § 2183(b)(5).

356. *See id*. § 2183(b)(4).

357. *Id*. § 2183(b).

358. *See id*. § 2183(a). To force such a merger, the board needs the concurrence of the association's credit bank. *See id*. For the structure of the FCS, see *supra* Part I.B.3.

359. *See* 12 U.S.C. § 2252(a)(9).

360. Under the board's rules, 12 C.F.R. §§ 627.2700–.2790 (2004), a receiver or conservator automatically has "all rights, privileges, and powers of the [institution's] board of directors, officers, and employees." *See id*. §§ 627.2720(e), .2775(c). A conservator operates the institution "for the benefit of the [institution's] creditors and stockholders," *id*. § 627.2780(a), and has "all powers necessary to continue the ongoing operations of the institution, . . . conserve and preserve the institution's assets and property, and otherwise protect the interests of the institution, its stockholders, and creditors." *Id*. § 627.2770(b). The conservator can take action "appropriate or expedient to the continuing operation of the institution," *id*. § 627.2780(d), but cannot wind up and liquidate the institution. *See id*. § 627.2780(b). A receiver, by contrast, should "wind up the business operations of such institution, collect the debts owed to the institution, liquidate its property and assets, pay its creditors, and distribute the remaining proceeds to stockholders." *Id*. § 627.2725(a)(1). The receiver can exercise "all powers necessary to the efficient termination of an institution's operation." *Id*.; *see also id*. § 627.2725(b) (granting receiver more specific powers). After deciding whether creditors have substantiated their claims, *see id*. § 627.2740(b), the receiver pays allowed claims, *id*. § 627.2740(c) (authorizing payments on creditors' claims), according to priorities prescribed by regulation. *Id*. §§ 627.2745–.2752 (establishing priorities). The institution's shareholders receive any assets remaining after the receiver has paid creditors' claims. *Id*. § 627.2755(b).

361. The board's authority to force a credit association to merge could, however, facilitate a reorganization.

endanger the entire Farm Credit System if it depleted the insurance fund and, through joint-and-several liability, impaired the surviving banks' net worth.

E. Farmer Mac

The insolvency regime for Farmer Mac substantively resembles that for Farm Credit System institutions.[362] The statute provides somewhat more detail,[363] incorporates by reference some provisions of the FCS statute and regulation,[364] and generally leaves the Farm Credit Administration Board free to prescribe the details.[365] The board's implementing rules largely resemble those for the FCS.[366] The statute and rules together supply an adequate legal framework for liquidating Farmer Mac but do not authorize a reorganization.

F. Summary

The four GSE insolvency statutes vary greatly in substance, specificity, and the latitude accorded to regulators. A one-sentence statute grants the Federal Housing Finance Board plenary authority to liquidate or reorganize a Federal Home Loan Bank, with no procedural constraints and virtually standardless discretion. At the other extreme, the statutes for Fannie and Freddie provide too little power, too late: allowing only conservatorship; delaying the appointment of a conservator until the GSE is likely to be in serious trouble; not specifically authorizing a liquidation of even a hopelessly insolvent GSE; and providing no support whatever for a reorganization. The statutes governing Farm Credit System institutions and Farmer Mac

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362. Farmer Mac's creditors, however, lack some protections applicable to FCS institutions' creditors. Farmer Mac has no insurance fund. Because Farmer Mac has no affiliates, a receiver could not merge it into a healthy firm and joint-and-several liability does not apply.

The Farmer Mac insolvency statute, 12 U.S.C. § 2279cc, draws on 12 U.S.C. § 2183 (FCS) and §§ 4617, 4619, and 4620 (Fannie and Freddie), themselves drawn from banking law. Two of the statute's four additional grounds for conservatorship and receivership also have antecedents in banking law. *Compare id*. § 2279cc(b)(2)(A), (b)(2)(C)(i)(II) (inability to pay obligations in normal course of business; critical undercapitalization), *with id*. § 1821(c)(5)(F), (c)(5)(L) (same).

363. *See id*. § 2279cc(c), (f)–(g), (i) (limiting liability, authorizing borrowing, invalidating side agreements, and canceling charter).

364. *See id*. § 2279cc(b)(1), (e) (specifying powers of conservator or receiver, and grounds for appointing conservator or receiver).

365. *See id*. § 2279cc.

366. *Compare* 12 C.F.R. §§ 627.2700–.2790 (2004) (FCS), *with id*. §§ 650.50–.68 (Farmer Mac).

occupy a middle ground. Both statutes authorize appointment of a conservator or receiver, specify the grounds for such an appointment, afford judicial review, and allow the board to fill in the details by regulation. The statutes and implementing rules provide an adequate framework for liquidating a failed firm and for taking control of a troubled firm in an attempt to avert failure. But the current framework does not authorize reorganizing a troubled GSE. Thus if a firm needs a reorganization to survive, current law tends to steer policymakers towards forbearance, liquidation, or a congressional rescue.

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

The current legal mechanisms for dealing with a financially troubled Fannie or Freddie have serious weaknesses,[367] with the potential for far-reaching practical consequences. This Part examines those consequences. In particular, uncertainty about the priority of and process for resolving creditors' claims against Fannie or Freddie could curtail the firm's access to credit and reduce the market value and liquidity of those claims. A broader impairment of liquidity in financial markets might result under some circumstances. Although such an extreme scenario is unlikely, it is nonetheless plausible—and as OFHEO has observed, "[i]n analyzing . . . systemic risk, the important issue is not the likelihood of the scenarios examined, but the magnitude of the potential adverse consequences."[368]

Problems at Fannie or Freddie could cause significant harm to the U.S. financial system. Many other financial institutions have large credit exposures to those firms, having purchased their debt securities, relied on their guarantees of mortgage-backed securities, and entered into over-the-counter derivatives contracts with them.[369] Thus Fannie or Freddie's default could affect other financial institutions' solvency and liquidity.[370] Indeed, "participants in securities and derivatives markets" may have greater direct exposure to Fannie and Freddie than to "any other privately owned financial institutions."[371]

Attempts to quantify the systemic effects of Fannie or Freddie's

367. *See supra* Part IV.B.

368. OFHEO SYSTEMIC RISK STUDY, *supra* note 332, at 93.

369. *See id*. at 34, 60–66, 77, 100–01.

370. *Id*. at 31–32, 100–02.

371. *See id.* at 75.

default face three formidable technical obstacles: (1) lack of adequate data about the direct and indirect interdependencies among financial institutions and financial markets;[372] (2) lack of macro-econometric models quantifying how "financial variables such as the supply of credit and interest rates" affect "different types of financial assets and real variables such as output and employment";[373] and (3) "the inherent difficulty in using quantitative techniques to analyze catastrophic events such as . . . financial crises," which occur rarely and "often involve significant departures from recent historical experience."[374] To sidestep these obstacles, OFHEO has used "scenario analysis"[375] to explore the possible systemic consequences of problems at Fannie or Freddie. This analysis underscores the potential for serious problems at either firm—exacerbated by legal uncertainty related to the conservatorship statute—to cause systemic harm.

In one scenario, Fannie or Freddie—here called "Enterprise A"—"unexpectedly incurs large losses," leaving investors doubtful about the firm's viability and "uncertain about whether it will default, about the size of any credit losses they may incur, and about the future liquidity of its debt."[376] Investors respond by selling the firm's debt and mortgage-backed securities,[377] depressing the price of those securities and prompting even more investors to try to sell those securities "before the market becomes illiquid and they can no longer do so."[378] OFHEO stresses the pivotal importance of how investors and "the federal government respond to a rapid decline in the liquidity of Enterprise A's debt" securities and mortgage-backed securities.[379] If investors expect only small credit losses on those securities—or anticipate a governmental rescue—they may buy up the securities "at bargain prices," stabilizing the price and "bolster[ing] the liquidity of those

372. *Id*. at 36, 87.

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

374. *Id*. at 87.

375. Scenario analysis involves "the construction and elaboration of hypothetical . . . scenarios" to gain "insights into the potential functioning" of the financial system and the economy "under specific conditions of extreme stress." *Id*. at 87–88.

376. *Id*. at 98.

377. *See id*.

378. *Id*. at 99.

379. *Id*.

securities."[380] If the other GSE in the Fannie-Freddie duo "is financially strong and able to borrow at reasonable rates," it may rapidly expand its purchases of mortgage-backed securities and thereby "limit damage to the housing sector, mortgage lenders, and other housing finance businesses."[381] But if the market for Enterprise A's debt becomes illiquid, Enterprise A might have to stop issuing debt and buying mortgage-backed securities—and investors might question the liquidity of all banks, savings institutions, and credit unions "whose holdings of GSE debt and [mortgage-backed securities] are large relative to their equity capital."[382]

"Illiquidity in the market for Enterprise A's debt and the plunge in the market value of its [mortgage-backed securities] exacerbate liquidity problems at many banks and thrifts,"[383] under OFHEO's scenario. "Those problems increase the risk of contagious illiquidity spreading through the banking system, the markets for the obligations of other GSEs, and the financial sector as a whole" and harming the national and international economy.[384] "[M]any investors become less willing to hold debt and other fixed-income obligations perceived to pose a significant degree of credit risk and liquidity risk."[385] "Those developments substantially reduce the desirability" of using even healthy GSEs' debt "in hedging or as collateral for repurchase agreements, further reducing liquidity in financial markets."[386] In sum, this scenario "illustrates how heightened uncertainty about the liquidity" of an undercapitalized GSE's debt "could lead to contagious illiquidity in the market for those securities. Such illiquidity could cause or worsen liquidity or solvency problems at other financial institutions and disrupt the housing markets and the financial system."[387]

Uncertainty about the priority of claims against a troubled GSE—and the process for handling such claims—could worsen the GSE's problems and the potential for harm to financial markets. Although the loss rate per dollar of debt or mortgage-backed securities would almost certainly remain low, "the total dollar amount of the Enterprise's losses could be

380. *Id*.
381. *Id*.
382. *Id*. at 100.
383. *Id*. at 98.
384. *Id*.
385. *Id*. at 101.
386. *Id*. at 102.
387. *Id*. at 105.

substantial and distributed unevenly among different classes of investors"[388] (e.g., holders of debt securities, mortgage-backed securities, over-the-counter derivatives, and subordinated debt). Current law leaves investors "uncertain about the potential severity of the losses specific [classes of] investors would incur if [a faltering GSE] defaulted."[389] Thus investors may fear the worst for each of several classes of unsecured claims against the firm—as though that class alone would have to bear the entire loss.[390] Such uncertainty—combined with creditors' more basic uncertainty about the firm's prospects and the market value of the firm's assets and liabilities—could further reduce the firm's access to credit (and hedging devices), the market value and liquidity of claims against the firm, and under extreme circumstances even the liquidity of financial markets.

Larry D. Wall, Robert A. Eisenbeis, and W. Scott Frame of the Federal Reserve Bank of Atlanta analyze the potential for a faltering GSE to harm the financial system and the economy.[391] They conclude that current law amounts to a recipe for precipitating a congressional bailout of the GSE's creditors.[392] Far from encouraging timely action,

388. *Id*. at 101.

389. *Id*. at 100–01.

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

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

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

In any event, because the firm's liabilities exceed its assets, the firm cannot, if liquidated, satisfy all of its creditors' claims. Holders of subordinated debt will receive nothing, consistent with their agreement to be paid only after the firm has fully paid more senior creditors. But the firm's remaining liabilities ($102) will still exceed its assets ($100), raising questions about the treatment of the remaining classes of claims: senior debt, derivatives, and guarantee liability, plus the contingent liability for other outstanding mortgage-backed securities. Insofar as market participants fear that one class will be paid after the others—and thus have to absorb the $2 loss—the market value and liquidity of that class could suffer accordingly. And such uncertainty could conceivably affect two, three, or all classes of claims.

391. *See* Wall, Eisenbeis & Frame, *supra* note 330, at 408–15.

392. *See id.* at 413–14.

the law ties OFHEO's powers to accounting numbers that may overstate the GSE's assets and thus mask the seriousness of the firm's problems.[393] The law fails, moreover, to specify priority among creditors or authorize OFHEO to appoint a receiver or organize a bridge enterprise—and would thus necessitate special legislation if the GSE had assets worth less than its liabilities.[394] Congress could face "intense pressure to act quickly" from the troubled GSE's conservator, creditors, and mortgage-market customers and from other GSEs.[395] Wall, Eisenbeis, and Frame accordingly regard current law as "designed . . . to create substantial spillover effects and force Congress to mitigate [those] problems" by rescuing the GSE's creditors.[396]

The lack of a credible receivership mechanism reinforces investors' perception of implicit government backing by giving Congress little practical alternative to rescuing an insolvent Fannie or Freddie's creditors. Current law—in failing to authorize receivership and specify priority among creditors[397]—would, Chairman Greenspan observes, make such a rescue "very difficult" to avoid.[398] The conservatorship statute contemplates preserving the GSE as a going concern but, apart from "the symbolic line of credit at the U.S. Treasury, provides no means of financing to do so."[399] Thus the statute, in Greenspan's view, signals that "Congress will bail out the GSEs in the event of a crisis."[400] Having no credible alternative to a rescue augments the perception of

393. *See id*. at 404, 407.

394. *See id*. at 413.

395. *See id*.

396. *Id*. at 413–14.

397. See Greenspan, 2004 Senate Testimony, *supra* note 47, at 8, 11.

398. *Hearing of the Senate Committee on Banking, Housing, and Urban Affairs*, FED. NEWS SERV., Feb. 24, 2004 [hereinafter *Senate Hearing Transcript*].

399. *See* Greenspan, 2005 Senate Testimony, *supra* note 157, at 4.

400. *Senate Hearing Transcript*, *supra* note 398. Thus unless Congress intends to make such a rescue inevitable, Greenspan declares, it should change the law now. *See id*. By contrast, Fannie, Freddie, and their allies depict conservatorship as adequate for dealing with a troubled GSE. *See infra* notes 411–14 and accompanying text. Susan M. Wachter, a housing finance expert retained by Fannie and Freddie, goes further and questions whether OFHEO, even with broad receivership authority, could do anything responsive to the type of systemic crisis posed by a GSE's failure—a crisis with the potential for a "general lack of liquidity to the overall economy. The government entity charged with dealing with such threats is the Federal Reserve Board as the lender of last resort. And it is certainly not clear that OFHEO's actions . . . would be able . . . to respond to this concern." Susan M. Wachter, *Comment on* "Resolving Large Financial Intermediaries: Banks Versus Housing Enterprises" *by Eisenbeis et al.*, 1 J. FIN. STABILITY 447, 449 (2005) [hereinafter Wachter, *Comment on Wall, Eisenbeis & Frame*].

implicit backing for Fannie and Freddie, as though the government had painted itself into a corner.[401]

VI. CORRECTING THE DEFICIENCIES OF CURRENT LAW

An adequate GSE insolvency regime should, as already discussed, (1) authorize a GSE's regulator to appoint a conservator or receiver through a process permitting timely ex parte action; (2) specify the grounds for conservatorship and receivership; (3) afford the GSE a prompt post-seizure judicial hearing; (4) specify priorities among claims; (5) authorize receivers to establish bridge enterprises; and (6) authorize receivers to effect reorganizations.[402] Insofar as current GSE insolvency regimes fall short of meeting this standard, Congress or GSE regulators should correct the deficiencies by following the model of bank insolvency law more closely. Thus Congress should authorize OFHEO to appoint receivers for Fannie and Freddie and empower receivers to establish bridge enterprises and effect reorganizations. The Federal Housing Finance Board should adopt a regulation implementing its statutory authority to liquidate and reorganize Federal Home Loan Banks. Congress or the Farm Credit Administration Board should authorize receivers of Farm Credit System institutions and Farmer Mac to effect reorganizations. As an alternative to correcting the deficiencies of the specialized GSE insolvency regimes, Congress could authorize liquidation and reorganization of GSEs under the Bankruptcy Code.

A. Fannie Mae and Freddie Mac

This Section will begin by discussing the steps Congress should take to fill the gaps in the insolvency regime for Fannie and Freddie. It will then note how Congress is currently considering legislation along these lines. Finally, it will examine the objections Fannie and Freddie have raised against receivership.

401. The lack of a receivership mechanism probably helps make Fannie and Freddie more profitable than if the government expressly guaranteed their debts. Although such a guarantee would reduce the GSEs' borrowing costs, it would require budget authority, have quantitative limits that would curtail the GSEs' growth, and increase political pressure to demonstrate that subsidizing GSEs represents the most effective use of the resources in question.

402. *See supra* Part III.C.

1. Prescriptions for Reform

Current law authorizes OFHEO to appoint a conservator for Fannie and Freddie through a process permitting timely ex parte action, specifies the grounds for conservatorship, and affords the GSE a prompt post-seizure judicial hearing. Congress should take five key steps to strengthen this insolvency regime. First, it should authorize OFHEO to appoint a receiver. Second, it should broaden the current grounds for conservatorship and make them also apply to receivership. Third, it should specify priorities among creditors' claims. Fourth, it should authorize a receiver to establish a bridge enterprise to continue a failed GSE's business. Finally, it should authorize a receiver to reorganize a failed or failing GSE so as to make the GSE viable.

2. Congressional Proposals

Congress is currently considering legislation consistent with these recommendations. After bitter battles over receivership in 2003–2004,[403] the House Committee on Financial Services[404] and the Senate Committee on Banking, Housing, and Urban Affairs[405] have both approved GSE reform bills with receivership provisions drawing extensively on the Federal Deposit Insurance Act.[406] Both bills would revise the grounds for conservatorship; authorize the regulator to appoint a receiver if any of those grounds exist; and empower the receiver to liquidate the GSE, transfer its assets and liabilities, and organize a successor firm to carry on the GSE's business.[407] The receiver would determine the validity of claims against the GSE and pay valid

403. *See, e.g.*, McLean, *supra* note 170, at 134, 136 (describing receivership-related acrimony).

404. *See* Federal Housing Finance Reform Act of 2005, H.R. 1461, 109th Cong. § 142 (2005); H.R. REP. NO. 109–171 pt. 1 (2005).

405. *See* Federal Housing Enterprise Regulatory Reform Act of 2005, 109th Cong. § 144 (Comm. Print, July 22, 2005); Dawn Kopecki, *Committee Passes Tighter Regulation of Fannie, Freddie*, WALL ST. J., July 29, 2005, at A2.

406. *See* H.R. REP. NO. 109–171 pt. 1, at 85 (2005) (stating that bill's "receivership language was modeled after similar provisions in the Federal Deposit Insurance Act that apply to federally insured depositories"); Staff of S. Comm. on Banking, Housing, and Urban Affairs, Section-by-Section Analysis of the Committee Print 9 (July 22, 2005) (on file with author) (describing receiver's powers and responsibilities under section 144 of bill as "substantially similar to those of the Federal Deposit Insurance Corporation").

407. H.R. REP. NO. 109–171 pt. 1, at 41–43, 56–60 (2005); Federal Housing Enterprise Regulatory Reform Act of 2005, 109th Cong. § 144, at 68–77, 144–60 (Comm. Print, July 22, 2005).

unsecured claims in the following order of priority: (1) administrative expenses of the receivership; (2) "general or senior" liabilities of the GSE; (3) obligations "subordinated to general creditors"; and (4) shareholders' claims.[408]

3. GSEs' Objections to Receivership

In opposing receivership, Fannie and Freddie argue that (1) conservatorship deals adequately with troubled GSEs; (2) receivership is inappropriate for GSEs; (3) bank receivership exists for reasons irrelevant to GSEs; and (4) enacting receivership could create harmful uncertainty and make mortgages more costly and less available, unfairly contravene the expectations of GSEs' creditors, and encourage privatizing the GSEs. In addition, some critics attribute the Bush Administration's support for receivership to bad faith and a bias against housing.[409] For example, Representative Barney Frank calls receivership "an artificial issue created by the administration."[410]

a. Conservatorship Deals Adequately With Troubled GSEs

GSEs and their allies portray conservatorship as entirely adequate for dealing with a troubled GSE. Freddie asserts that "current law provides ample conservatorship powers."[411] Representative Frank declares that "[t]he existing arrangement is fine."[412] Susan M. Wachter, a housing-finance expert who has acted as a consultant to Fannie and Freddie, contends that a troubled GSE "would either be recapitalized through retained earnings or issuance of new preferred or common stock, or would be wound down over time if it were no longer viable. Even if the company were market-value insolvent, it could have significant going-concern value, and hence could potentially attract new equity capital."[413]

In asserting that "an insolvent enterprise would either be

408. H.R. REP. NO. 109–171 pt. 1, at 43–47, 48–49, 57 (2005); Federal Housing Enterprise Regulatory Reform Act of 2005, 109th Cong. § 144, at 80–97, 103–05, 142–43 (Comm. Print, July 22, 2005).

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

410. *See* Hirsch, *supra* note 409.

411. Syron, 2004 Senate Testimony, *supra* note 331, at 11.

412. Hirsch, *supra* note 409.

413. Wachter, *Comment on Wall, Eisenbeis & Frame*, *supra* note 400, at 449.

recapitalized . . . or . . . wound down over time," Wachter suggests a smooth, orderly process in which the firm would recapitalize ("through retained earnings or issuance of new . . . stock") if viable and "be wound down over time if . . . no longer viable."[414] This rosy view evidently assumes that (1) market participants would remain willing to refinance the insolvent firm's maturing obligations and extend whatever additional credit the firm needs to conduct its business—all at rates and on terms favorable enough so that the firm remains viable; (2) the relevant persons, including the conservator and prospective investors, could timely ascertain whether the insolvent firm is viable; (3) OFHEO would and should let the firm operate for years with little or no capital while the firm attempts to rebuild capital through retained earnings; (4) even if prospective investors conclude that the insolvent firm is not viable, the process of winding up the firm would remain orderly; and (5) attempting to deal with an insolvent GSE in this manner—without the option of effecting a reorganization (e.g., subordinating or converting to equity some portion of creditors' claims)—would not unacceptably increase the likelihood of a congressional bailout.

All five of these assumptions merit skepticism. First, investors who know or believe that the firm's assets fall short of its liabilities will extend unsecured credit to the firm only on costly terms (which will tend to undercut the firm's viability)—or in the expectation of a governmental rescue. Second, if investors have lost confidence in an insolvent GSE's accounting, they might decline to buy new shares in the firm even though they would consider the firm an attractive prospect if they had perfect information about its condition. Moreover, depository institution regulators' record of forbearance from closing insolvent institutions[415] casts doubt on whether OFHEO or a conservator could make better judgments about the GSE's viability than investors can. Third, such forbearance also casts doubt on whether OFHEO should allow the firm to operate for years with little or no capital based on OFHEO's belief that, despite investors' refusal to buy new shares, the firm remains viable.

Fourth, OFHEO has shown "how heightened uncertainty about the liquidity of the debt of an undercapitalized Enterprise could lead to contagious illiquidity in the market for those securities," which in turn

414. *See id.*

415. *See, e.g.*, NAT'L COMM'N ON FIN. INST. REFORM, RECOVERY AND ENFORCEMENT, ORIGINS AND CAUSES OF THE S&L DEBACLE: A BLUEPRINT FOR REFORM 32, 35–39, 51–54 (1993) (describing role of regulatory forbearance in thrift debacle).

"could cause or worsen liquidity or solvency problems at other financial institutions and disrupt the housing markets and the financial system."[416] Thus OFHEO points to the possibility that an undercapitalized GSE could have to stop issuing debt—and that the firm's outstanding debt and mortgage-backed securities could become illiquid, and ultimately result in "contagious illiquidity spreading through the banking system, the markets for the obligations of other GSEs, and the financial sector as a whole, adversely affecting the U.S. and the global economy."[417] Yet Wachter assumes that a GSE in even worse initial financial condition—not merely undercapitalized but insolvent and unviable—could "be wound down over time."[418]

This brings us to the fifth assumption: that attempting to deal with an insolvent GSE in this manner would not unacceptably increase the likelihood of a congressional bailout. To remain in business, the firm would need to refinance its maturing debt. To keep its borrowing costs manageable—and avoid a protracted lack of equity—the firm might well need to persuade investors to buy additional shares. Each of these steps could prove difficult if investors doubted that the government would rescue the firm.[419] We would be naive to expect (much less base public policy on the assumption) that the firm would necessarily overcome all such challenges. Thus we should recognize the possibility that attempting to deal with an insolvent GSE under current law would "create substantial spillover effects" and precipitate a congressional bailout.[420]

b. Receivership Is Inappropriate for GSEs

Both Fannie and Freddie dismiss receivership as inappropriate for GSEs. Fannie calls conservatorship "the right model for the GSEs,"[421] "appropriately different" from the receivership tools available to bank

416. OFHEO SYSTEMIC RISK STUDY, *supra* note 332, at 105.

417. *Id*. at 98.

418. *See* Wachter, *Comment on Wall, Eisenbeis & Frame*, *supra* note 400, at 449.

419. Treasury Secretary Snow has disavowed government backing for GSEs, referring to the "market misperception of an implied guarantee." Snow, 2003 Senate Testimony, *supra* note 107, at 4. Given this and other indications of diminished political support for such backing, *see* sources cited *infra* note 468, a troubled GSE may find itself unable to borrow on favorable terms such as those available to Fannie while market-value insolvent during the 1980s. *See supra* note 32.

420. Wall, Eisenbeis & Frame, *supra* note 330, at 413–14; *see supra* Part V.

421. Raines, *supra* note 331, at 13.

regulators.[422] In Fannie's view, the government has a mere "financial stake" in federally insured depository institutions,[423] whereas it has a broader policy stake in using Fannie and Freddie to "mak[e] homeownership more affordable and more available. That is why a conservator is the appropriate tool to deal with a capital inadequacy problem at a GSE. The conservator's role is to rebuild the capital of the GSE and ensure it remains an ongoing concern."[424] Freddie emphasizes that receivership—here equated with liquidation[425]—"would have substantial economic, market and public policy consequences" and "threaten the public policy mission of the GSEs."[426] Hence "[o]nly Congress should decide if there is no longer a need for [a GSE as an] instrument of national policy to support homeownership."[427]

This objection to receivership erroneously assumes that national housing objectives require the preservation of the two GSEs with their liabilities unimpaired and that no reorganized or successor firm could serve as well. Fannie implies that the two GSEs are unique and possibly irreplaceable instruments for "making homeownership more affordable and more available."[428] This is consistent with the GSEs' claim to provide public benefits—such as lower interest rates, nationwide credit availability, improved technology, and market stability—worth far more than the subsidies the GSEs receive from the government.[429] Yet credible studies indicate that Fannie and Freddie retain much if not most of their subsidies, reduce borrowers' interest rates only slightly, and have little effect on home ownership rates.[430] Moreover, many private firms can now replicate the two GSEs' key economic function—linking the bond and mortgage markets—and will do so without any subsidy.[431]

Freddie opposes receivership by implying that the two GSEs are "too big to fail."[432] Specifically, Freddie calls receivership "an efficient

422. *See id.* at 10.

423. *See id.* at 14.

424. *Id.*

425. *See* Syron, 2004 Senate Testimony, *supra* note 331, at 11.

426. *Id.*

427. Raines, *supra* note 331, at 14; *see also* Syron, 2004 Senate Testimony, *supra* note 331, at 11 (stating that "Congress reserved to itself the right to appoint a receiver").

428. *See* Raines, *supra* note 331, at 14.

429. *See* CBO, PUBLIC COSTS AND BENEFITS, *supra* note 30, at 20, 25.

430. *See supra* notes 142–47 and accompanying text.

431. *See* CBO, PUBLIC COSTS AND BENEFITS, *supra* note 30, at xii.

432. Had Freddie expressly declared itself "too big to fail," the claim might have struck some policymakers as presumptuous—and invited closer scrutiny of Freddie's size, government benefits,

disposition mechanism for thousands of federally insured depository institutions, whose failure would not threaten the stability of and public confidence in the financial system."[433] But Freddie insists that the "substantial economic, market and public policy consequences" of "liquidat[ing] a GSE" preclude receivership from being a "credible option for dealing with two GSEs."[434] Thus receivership makes sense for lesser firms but not for Fannie and Freddie.[435] But Freddie errs in suggesting that no middle ground exists between a liquidating receivership and a rescue-oriented conservatorship: receivership need not involve liquidation. Chapter 11 of the Bankruptcy Code enables business corporations to reorganize without liquidating.[436] The Insurers Rehabilitation and Liquidation Model Act provides an analogous process, known as "rehabilitation," for insurance companies.[437] The FDIC, in transferring a failed bank's assets and liabilities to a successor entity (such as a bridge bank or a private purchaser), can also carry out a de facto reorganization.[438] A receiver can keep a firm in operation and tap its going-concern value for the benefit of creditors.

c. Bank Receivership Exists for Reasons Irrelevant to GSEs

Fannie and Freddie suggest that bank receivership exists to protect FDIC-insured depositors, the federal deposit insurance funds, and the taxpayers who stand behind those funds—reasons that, in the GSEs'

and financial-soundness regulation as well as the legal framework for handling the failure of a GSE. By making the point obliquely, Freddie reduced the risk of an adverse reaction.

433. Syron, 2004 Senate Testimony, *supra* note 331, at 11.

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

435. *See* Syron, 2004 Senate Testimony, *supra* note 331, at 11.

436. *See* 11 U.S.C. §§ 109(d), 1101–1146 (2000).

437. *See* INSURERS REHAB. & LIQUIDATION MODEL ACT §§ 16–19 (Nat'l Ass'n of Ins. Comm'rs 1999).

438. *See* 12 U.S.C. § 1821(d)(2)(F) (2000) (authorizing FDIC as receiver to form bridge bank or similar entity as successor to failed bank); *id*. § 1821(d)(2)(G)(i)(II) (authorizing FDIC to transfer failed bank's assets and liabilities without creditors' consent); *id*. § 1821(i)(2) (specifying that FDIC owes no claimant more than claimant would have received in straight liquidation, which means that FDIC need not necessarily transfer or otherwise satisfy face amount of claim); *id*. § 1821(n) (setting forth rules for bridge banks).

view, have no proper relevance to GSEs.[439] Fannie characterizes "FDIC receivership powers" as "designed to protect insured depositors."[440] Receivership "is critical in the banking system, as a means of protecting the taxpayer from the exposure created by federal deposit insurance," Fannie contends.[441] "After the secured creditors, insured depositors have the first call on the failed bank's assets . . . . The receiver is necessary in order to put the FDIC—and thereby the taxpayers—first in line among the creditors of a failed bank."[442] Similarly, Wachter argues that "bank regulators need receivership powers because in the event of a bank failure, they must protect depositors and the depository [sic] insurance fund."[443]

These arguments mischaracterize receivership as a mere adjunct to deposit insurance. On the contrary, receivership long predates deposit insurance.[444] Congress enacted the first national bank receivership statute in 1863,[445] seventy years before federal deposit insurance.[446] Receivership also long predates depositors' statutory priority over other creditors,[447] which Congress enacted only in 1993.[448] Receivership existed even before deposit insurance to give depositors and other creditors of a failed bank quick access to their money and thus to reduce the external costs of bank failure (e.g., loss and inconvenience to creditors and damage to the local economy). A workable receivership mechanism for Fannie and Freddie would offer similar benefits.

439. *See* Raines, *supra* note 331, at 13–14; Wachter, *Comment on Wall, Eisenbeis & Frame*, *supra* note 400, at 449; *see also* Syron, 2004 Senate Testimony, *supra* note 331, at 11 (calling receivership "an efficient disposition mechanism for thousands of federally insured depository institutions").

440. Raines, *supra* note 331, at 13.

441. *Id*.

442. *Id*.

443. Wachter, *Comment on Wall, Eisenbeis & Frame*, *supra* note 400, at 449.

444. *See* Swire, *supra* note 208, at 477–79, 490–93.

445. Act of Feb. 25, 1863, ch. 58, § 29, 12 Stat. 665, 673.

446. Act of June 16, 1933, ch 89, § 8, 48 Stat. 162, 168–80.

447. 12 U.S.C. § 1821(d)(11)(A) (2000). *See supra* notes 278–81 and accompanying text.

Fannie mischaracterizes the depositor-preference statute as applying only to insured depositors. Raines, *supra* note 331, at 13. In fact, the statute makes no distinction between insured and uninsured depositors: both have priority. *See* 12 U.S.C. § 1821(d)(11)(A).

448. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 3001(a), 107 Stat. 312, 336.

d. Enacting Receivership Could Create Harmful Uncertainty and Make Mortgages More Costly and Less Available

Fannie and Freddie argue that enacting a receivership statute could create harmful uncertainty and make mortgages more costly and less available. "It is unclear," Fannie notes, "how . . . FDIC receivership powers . . . would apply to Fannie Mae's obligations—our debt, our [mortgage-backed securities], and our guaranty."[449] By imposing new risks on GSEs' creditors, a receivership statute "could undermine the pricing of existing obligations and cast uncertainty on how new obligations should be priced," posing "risks to the 30-year fixed-rate mortgage" and resulting in "higher mortgage rates for consumers."[450] Similarly, Freddie warns that "a change to receivership . . . could have significant implications on [sic] our ability to support the market for 30-year fixed-rate mortgages."[451] In opposing receivership, Senator Paul Sarbanes declared, "We are literally playing with dynamite here, and we need to recognize that."[452]

Any significant legal reform creates some transitional uncertainty, but a properly designed receivership statute would greatly reduce legal uncertainty relating to a troubled GSE. As previously discussed, uncertainty about the priority of claims against a GSE—and the process for handling such claims—could worsen the GSE's problems and the potential for harm to financial markets and housing finance.[453] Moreover, the GSEs' arguments underestimate markets' ability to deal over time with uncertainty. Fannie asserts that a receivership statute "could undermine the pricing of existing obligations and cast uncertainty on how new obligations should be priced, . . . pos[ing] risks to the 30-

449. Raines, *supra* note 331, at 13.

450. *Id*. at 13–14. Fannie stressed these themes in a television advertisement broadcast during the week before the Senate Banking Committee considered Sen. Shelby's draft bill:

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

Senate Banking Committee Narrowly Passes GSE Regulatory Reform Bill on 12-9 (Nearly) Party-Line Vote, GSE REP., Apr. 12, 2004, at 5; *see also* McLean, *supra* note 170, at 136 (describing same advertisement).

451. Syron, 2004 Senate Testimony, *supra* note 331, at 11–12.

452. Rob Blackwell, *Close Panel Vote Said to Kill GSE Bill*, AM. BANKER, Apr. 2, 2004, at 1.

453. *See supra* Part V.

year fixed-rate mortgage."[454] Yet markets deal regularly with uncertainty about government budget deficits, monetary policy, currency revaluations, macroeconomic growth and recession, war, terrorism, natural disasters, and changing consumer preferences. To take more specific examples, markets already price the risk that future hurricanes will cause catastrophic losses in Florida,[455] that cold weather will damage orange trees,[456] and that the Chilean peso will fall relative to the euro.[457] Markets should easily be able to handle transitional legal uncertainty about a receivership statute for two solvent GSEs.

The GSEs' arguments about thirty-year fixed-rate mortgages invite questions about the value of the GSEs' activities. If Fannie and Freddie lower mortgage interest rates only slightly,[458] how great is the risk that a receivership statute would cause "higher mortgage rates for consumers"?[459] If a receivership statute, by increasing Freddie's borrowing costs, "could have significant implications on our ability to support the market for 30-year fixed-rate mortgages,"[460] then in what sense did and does Freddie "support the market"? For its first two decades Freddie securitized mortgages without holding them in its portfolio,[461] and thus had little need for long-term borrowing. Like Fannie, Freddie now borrows large sums to finance an investment portfolio that critics such as Chairman Greenspan say affords little public benefit—even as such portfolios make the GSEs much riskier (and more profitable) than if they acted only as securitizers and guarantors.[462] In any event, homeowners obtained thirty-year fixed-rate mortgages before Freddie amassed a large investment portfolio.[463] They obtain such mortgages now in the "jumbo" market, which Fannie and

454. Raines, *supra* note 331, at 13–14.

455. *See, e.g.*, U.S. CONG. BUDGET OFFICE, FEDERAL REINSURANCE FOR DISASTERS 43–47 (2002).

456. *See* Richard Roll, *Orange Juice and Weather*, 74 AM. ECON. REV. 861, 873 (1984) (concluding that orange-juice futures prices predicted freezing weather in Central Florida even more accurately than the National Weather Service).

457. *See, e.g.*, Markit, http://www.markit.com (select "Market Valuations (Totem)"; then select "Foreign Exchange") (last visited July 19, 2005) (describing firm's services, which include reporting prices of euro-Chilean peso derivatives).

458. *See supra* notes 143–47 and accompanying text.

459. Raines, *supra* note 331, at 13–14.

460. Syron, 2004 Senate Testimony, *supra* note 331, at 11–12.

461. *See* STANTON, GSES, *supra* note 14, at 83.

462. *See* Greenspan, 2004 Senate Testimony, *supra* note 47, at 2–7, 9–10.

463. *See* Greenspan, 2005 Senate Testimony, *supra* note 157, at 6.

Freddie cannot serve.[464] We can reasonably expect that a receivership statute would not impede homeowners from continuing to obtain such mortgages.[465]

e. Enacting Receivership Would Unfairly Contravene the Expectations of GSEs' Creditors

The GSEs complain that receivership would unfairly contravene the expectations of GSEs' creditors. According to Fannie, "enacting a receivership provision unfairly imposes new risks on holders of existing obligations that they could not have anticipated at the time they purchased these obligations."[466] According to Freddie, receivership "could potentially disrupt the legal obligations and expectations of market participants."[467] Yet the potential for the government to change the legal framework for Fannie and Freddie—or end their government sponsorship altogether—has existed all along. It forms part of the political risk market participants consider when analyzing GSEs' debt and equity securities.[468] Freddie's own debt agreements foresee the possibility of receivership by defining the events of default to include any judicial or other appointment of a receiver but exclude OFHEO's appointment of a conservator.[469] In any event, the GSEs' creditors have

464. Fannie and Freddie cannot deal in mortgages that exceed the conforming loan limit, 12 U.S.C. §§ 1454(a)(2), 1717(b)(2) (2000), a dollar amount adjusted for changes in housing prices. Jumbo mortgages, by definition, exceed that limit.

465. *See generally* Posner & Brown, *supra* note 78, at 3 (analyzing Fannie and Freddie's prospects under pending GSE reform legislation and concluding that the two firms' shares "look attractively valued, for anything short of a worst-case scenario for a new [GSE] regulatory regime").

466. Raines, *supra* note 331, at 13.

467. Syron, 2004 Senate Testimony, *supra* note 331, at 11.

468. *See, e.g.*, DeStefano et al., *supra* note 188 (stating that *Standard & Poor's* rated GSEs' subordinated debt "from a financial, not a political, perspective, since the potential for payment default is present").

In May 2004 *Standard & Poor's* announced that it no longer had "the highest degree of confidence that the government would ensure full and timely payment" on the GSEs' senior unsecured debt securities, and that it had accordingly changed its rating process for GSE securities to place more weight on the GSEs' own financial condition. *See* Michael T. DeStefano et al., *Fannie Mae and Other GSEs Ratings Affirmed; Outlook Stable*, STANDARD & POOR'S, May 6, 2004 (on file with author).

469. *See, e.g.*, FED. HOME LOAN MORTGAGE CORP., DEBENTURE AND MEDIUM-TERM NOTE AGREEMENT § 7.01 (Apr. 2, 2004). Under this agreement, an "Event of Default" occurs if:

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

no moral (much less legal) right to demand the continuation of the current, inadequate insolvency statutes.

f. Enacting Receivership Would Encourage Privatization

Opponents characterize receivership as “a stalking horse for privatization.”[470] Freddie notes that “[m]any market participants might view a change to receivership as a first step to privatization of the GSEs.”[471] Senator Charles Schumer asserts that the Shelby bill “opens the door to the complete privatization of Fannie and Freddie—the end of GSEs as we know [them].”[472] But enacting adequate insolvency mechanisms for Fannie and Freddie would not remove the two GSEs’ government sponsorship or alter their explicit government benefits. Investors perceive the government as implicitly backing all GSEs, even those for which receivership mechanisms already exist.[473] Conventional lists of GSEs’ explicit government benefits do not include exemption from bankruptcy or receivership.[474] Thus removing Fannie and Freddie’s government sponsorship would remain a separate decision from enacting receivership.

g. Summary

Fannie and Freddie’s arguments against receivership ignore the

> case under any applicable bankruptcy, insolvency or other similar law now or hereafter in effect, or shall consent to the entry of an order for relief in an involuntary case under any such law, or shall consent to the *appointment of* or taking possession by *a receiver, liquidator, assignee, trustee, custodian, or sequestrator (or other similar official)* of Freddie Mac or any substantial part of its property . . . .

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

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

471. Syron, 2004 Senate Testimony, *supra* note 331, at 11.

472. Blackwell, *supra* note 452.

473. *See supra* Part I.D.2. By leaving Congress little practical alternative to rescuing Fannie or Freddie’s creditors, the lack of an adequate insolvency mechanism fortifies the perception of implicit backing. But enacting such a mechanism would neither preclude such a rescue nor by itself eliminate the perception.

474. *See, e.g.*, CBO, PUBLIC COSTS AND BENEFITS, *supra* note 30, at 10 (not listing exemption from bankruptcy or receivership among GSEs’ characteristics); U.S. DEP’T OF THE TREASURY, GOVERNMENT SPONSORSHIP OF THE FEDERAL NATIONAL MORTGAGE ASSOCIATION AND THE FEDERAL HOME LOAN MORTGAGE CORPORATION 26 (1996) (same); 1990 TREASURY GSE REPORT, *supra* note 109, at 4 (not listing such exemptions among GSEs’ links to government).

shortcomings of the current conservatorship statute[475] and the availability of nonliquidating forms of receivership,[476] misstate bank receivership law,[477] and show some lack of candor.[478] Their arguments also rely heavily on vague, unsubstantiated assertions about the cost and availability of mortgages[479]—assertions at variance with the proliferation of market-based risk-management mechanisms[480] and with mounting evidence that the two GSEs reduce mortgage interest rates only slightly.[481] Considering how prominently receivership figured in the congressional debates of 2004, the GSEs' arguments are strikingly weak.[482]

B. Federal Home Loan Bank System

The Federal Housing Finance Board has sweeping statutory authority to liquidate or reorganize any Federal Home Loan Bank to further the purposes of the Federal Home Loan Bank Act—purposes nowhere specified by statute or regulation.[483] Yet the board has neither issued an implementing regulation nor otherwise indicated (e.g., through guidelines or a policy statement) how it would use its authority.[484] Considerable uncertainty exists about when and how the board would liquidate or reorganize a bank: e.g., under what circumstances the board would act; what standards and process would apply; and how, given the

475. *See supra* Parts IV.B.1, V, and VI.A.3.a.

476. *See supra* text accompanying notes 434–38.

477. *See supra* text accompanying notes 439–48.

478. *See supra* text accompanying notes 439–48, 460–64, and 469. Administration officials reportedly "refer[red] to Fannie's efforts to undermine the receivership provision as 'deceivership.'" McLean, *supra* note 170, at 134.

479. *See supra* text accompanying notes 449–51.

480. *See supra* text accompanying notes 455–57.

481. *See supra* text accompanying notes 142–47.

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

483. *See supra* Part IV.C.

484. *See* 12 C.F.R. ch. IX (2004). Federal Housing Finance Board's rules specify that a Federal Home Loan Bank's capital plan governs its shareholders' rights in any liquidation of the bank, *see id*. §§ 931.5, 933.5(b)(1)(v), but do not otherwise deal with liquidation or reorganization of a Federal Home Loan Bank.

twelve banks' joint-and-several liability for most of their debt securities,[485] the board would apportion responsibility for unsatisfied obligations of the failed bank.[486]

To reduce this uncertainty and make liquidation and reorganization more workable, the Federal Housing Finance Board should prescribe a regulation implementing its statutory authority. The regulation should clarify the substantive criteria for initiating a liquidation or reorganization and relate those criteria to relevant purposes of the Federal Home Loan Bank Act, specify procedures for deciding whether to take such an action, and clarify the operation of joint-and-several liability so that one FHL Bank's problems would not cast unwarranted doubt on every other FHL Bank's soundness. Such a regulation would avoid needless uncertainty about how the board would use its authority, provide safeguards against arbitrary action, and strengthen the board's hand in litigation with a faltering FHL Bank.

C. Farm Credit System

The Farm Credit Act and the Farm Credit Administration Board's rules together provide an adequate legal framework for liquidation but do not authorize reorganization.[487] Congress or the FCA Board should fill this gap by authorizing FCS institutions' receivers to reorganize those institutions. The FCA Board may well be able to fill the gap using its general rulemaking power,[488] under which it has specified receivers' powers[489] and set priorities among creditors.[490] In authorizing

485. 12 U.S.C. § 1431(b)–(c) (2000); *see generally supra* notes 34, 55.

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

487. *See supra* Part IV.D.

488. *See* 12 U.S.C. § 2252(a)(9) (authorizing FCA Board to prescribe rules "necessary or appropriate for carrying out" Farm Credit Act).

489. *See* 12 C.F.R. § 627.2725.

reorganization, the board would, similarly, be delimiting receivers' powers and creditors' rights.

D. Farmer Mac

Farmer Mac's receiver, like a Farm Credit System institution's receiver, currently lacks authority to reorganize the firm.[491] But Congress has expressly empowered the Farm Credit Administration Board to define the receiver's powers and make them "comparable to" the powers of an FCS institution's receiver.[492] Accordingly, if the board can confer reorganization authority on an FCS institution's receiver, it can also confer it on Farmer Mac's receiver.[493]

E. Reducing Potential for Systemic Risk

Curtailing GSEs' investment portfolios and having workable GSE insolvency mechanisms would reduce the potential for GSEs to pose systemic risk. The investment portfolios, although highly profitable,[494] offer negligible public benefits[495] and entail risk: by increasing the GSEs' indebtedness[496] and exposure to changes in interest rates,[497] the portfolios increase the chances of a GSE failing. Shrinking the portfolios would thus make failure less likely. It would also reduce other financial institutions' credit exposure to the GSEs[498] and thus reduce the systemic harm that a GSE's failure could cause.[499]

490. *See id.* §§ 627.2745–.2752.

491. *See supra* Part IV.E.

492. *See* 12 U.S.C. § 2279cc(e) (granting Farmer Mac's receiver "such powers . . . as shall be provided pursuant to regulations adopted by the Farm Credit Administration Board" and specifying that those powers "shall be comparable to the powers" of FCS institution's receiver).

493. *See id.*

494. *See* Greenspan, 2005 Senate Testimony, *supra* note 157, at 3, 5; GAO, GSES' NONMORTGAGE INVESTMENTS, *supra* note 71, at 5, 24, 29–30 (1998).

495. See *supra* notes 141–56 and accompanying text.

496. The GSEs fund their investment portfolios almost entirely with borrowed money. *See* John W. Snow, Secretary of the Treasury, Statement Before U.S. Senate Committee on Banking, Housing, and Urban Affairs 4 (Apr. 7, 2005), *available at* http://banking.senate.gov/_files/snowe.pdf.

497. *See* Greenspan, 2004 Senate Testimony, *supra* note 47, at 9–10.

498. Owning a GSE's debt securities exposes other financial institutions to the risk of default by the GSE. Over-the-counter derivatives contracts, which GSEs use to hedge their exposure to interest-rate risk, expose counterparty financial institutions to the risk of a GSE default. *See* OFHEO SYSTEMIC RISK STUDY, *supra* note 332, at 34, 65–66.

499. *See* Greenspan, 2004 Senate Testimony, *supra* note 47, at 10.

Workable GSE insolvency mechanisms could further reduce the potential for systemic risk. By reducing pressure for Congress to rescue a faltering GSE, such mechanisms would tend to increase market discipline on GSEs, reduce GSEs' incentive to take unsound risks, and thus reduce the likelihood of future problems.[500] If problems do arise, the increased market discipline (e.g., through higher borrowing costs) would encourage more timely corrective action. GSEs' size and importance, far from obviating workable insolvency mechanisms, underscore the value of having such mechanisms.

F. Using Bankruptcy Code as an Alternative to Receivership

As an alternative to filling gaps under the current GSE insolvency regimes, Congress could permit liquidation and reorganization under the Bankruptcy Code. In basic concept this change would involve making GSEs "persons" for purposes of the code.[501] Congress would need to decide who could initiate a GSE bankruptcy case. The code allows voluntary petitions by debtors[502] and involuntary petitions by creditors.[503] By contrast, banking law and current GSE insolvency statutes allow only regulators to initiate insolvency proceedings.[504]

Although applying the Bankruptcy Code to GSEs can work as a legal matter, using specialized insolvency regimes based on bank insolvency law has potential advantages. The congressional committees responsible for GSEs generally lack familiarity with the Bankruptcy Code, whereas they tend to have confidence in the FDIC. Having regulators rather than creditors initiate insolvency proceedings offers some reassurance to members of Congress skeptical about receivership. Handling insolvency administratively, rather than judicially, can facilitate preparation and planning. Other things being equal, an administrative agency can probably do a better job than a court of planning how to handle the possibility of a big, one-time insolvency case. Moreover, keying insolvency to bank-type criteria will tend to produce action sooner than

500. *See* N. Gregory Mankiw, Chairman, Council of Economic Advisors, Remarks at the Conference of State Bank Supervisors State Banking Summit and Leadership Conference (Nov. 6, 2003), http://www.whitehouse.gov/cea/gsemankiw_speech_nov_6_2003.html; Wall, Eisenbeis & Frame, *supra* note 330, at 387.

501. *See supra* notes 287–91. One could, for example, effectuate such a change by specifying that Fannie and Freddie are "persons" under 11 U.S.C. § 101(27) (2000).

502. *See* 11 U.S.C. § 301.

503. *See id*. § 303(a).

504. *See supra* Parts III, IV.

waiting for the firm to default on its debts—the basic standard for a firm's creditors to commence an involuntary bankruptcy case. On balance, I would prefer to rely on specialized insolvency regimes rather than the Bankruptcy Code.

CONCLUSION

The current insolvency statute for Fannie and Freddie has grave deficiencies, with potentially serious consequences for the U.S. financial system. It does not allow a reorganization, nor does it specifically authorize liquidation. By the time OFHEO can place a GSE in conservatorship, the firm's condition might have so deteriorated that the conservator cannot save the firm. If Fannie or Freddie faltered, uncertainty about priority of and process for handling claims could worsen the firm's problems and the potential for harm to financial markets. Such legal uncertainty—combined with creditors' uncertainty about the firm's prospects and the market value of the firm's assets and liabilities—could further reduce the firm's access to credit, the market value and liquidity of claims against the firm, and under extreme circumstances the liquidity of financial markets. Congress should act now to authorize OFHEO to appoint a receiver for Fannie and Freddie under appropriate circumstances, specify priorities among creditors' claims, and authorize a receiver to establish bridge enterprises and effect reorganizations. Such reforms would increase market discipline on the two GSEs and reduce the likelihood of future problems. The insolvency regimes for the other three GSEs also warrant improvement, notably by letting agricultural GSEs' receivers effect reorganizations. As an alternative to specialized insolvency mechanisms, Congress could remove the current constraints on GSEs becoming debtors under the Bankruptcy Code.

Ambiguity about the extent of the government's support for GSEs blunts accountability for the risks and other costs of the government's relationship to GSEs. Far from yielding significant benefits for citizens and taxpayers, ambiguity helps explain the central failures of GSE policy: the government's failure to obtain sufficient public benefits from the GSEs and to provide adequate safeguards against risks posed by GSEs. Having no adequate insolvency mechanism for Fannie and Freddie exemplifies this failure to provide adequate safeguards.

The lack of such a mechanism also reinforces investors' perception of implicit government backing by giving Congress little practical alternative to rescuing Fannie or Freddie's creditors if the firm were to fail. If one of the other three GSEs failed, the government would have a legally credible option of letting the GSE's creditors incur a loss. No similarly credible option exists in the case of Fannie and Freddie. The lack of such an option augments the perception of implicit backing, as though the government had painted itself into a corner. The lack of such an option probably also leaves Fannie and Freddie more profitable than if the government expressly guaranteed their debts. Although an express guarantee would reduce the firms' borrowing costs, it would require appropriations, have quantitative limits that would curtail the firms' growth, and increase political pressure to demonstrate that subsidizing GSEs represents the most effective use of the resources in question.

Regulating Fannie and Freddie but having no adequate insolvency mechanism resembles investing in an elaborate fire-protection system—complete with firewalls, smoke detectors, heat sensors, alarm bells, and sprinklers—but neglecting to mount a crucial fire door on its hinges. Like fire-safety measures, GSE financial-soundness regulation serves dual purposes. Fire-safety measures protect a building by preventing and extinguishing fires there; they also protect other buildings by inhibiting the spread of fire. Similarly, GSE regulation seeks not only to keep the GSEs themselves safe but to protect the economy from damage that might result from a GSE's failure. A receivership mechanism, by providing an orderly means for dealing with a failed GSE's obligations, would help limit and contain the harm resulting from a GSE's failure.