VIII. Fannie Mae & Freddie Mac: Release from Conservatorship

A. Introduction

Fannie Mae, the Federal National Mortgage Association, and Freddie Mac, the Federal Loan Mortgage Corporation, are two of America's largest mortgage companies.[1] Fannie Mae was created in 1938 to act as a secondary mortgage facility with the ability to purchase, hold, and sell loans insured by the Federal Housing Administration (FHA).[2] Later, in 1970, Congress passed the Emergency Home Finance Act, which created Freddie Mac in response to the expanding secondary mortgage market and allowed the sister companies to buy and sell mortgages that are not insured or guaranteed by the federal government.[3]

By the 2000s, investors began to lose confidence in the mortgage companies.[4] In 2003, it was disclosed that Fannie Mae and Freddie Mac had used improper accounting methods, misstating earnings by billions of dollars.[5] When the housing prices plummeted in 2007 and 2008, Fannie Mae and Freddie Mac lost billions of dollars.[6] In 2008, the Federal Housing Finance Agency (FHFA) put the mortgage companies into conservatorship.[7]

There is much debate today about whether Fannie Mae and Freddie Mac should be released from conservatorship.[8] Proponents of

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[1] Kate Pickert, *A Brief Hist. of Fannie Mae and Freddie Mac*, TIME (July 14, 2008), http://content.time.com/time/business/article/0,8599,1822766,00.html [https://perma.cc/8GJN-7FYV] ("Fannie Mae and Freddie Mac are America's two largest mortgage companies.").

[2] FED. HOUSING FIN. AGENCY, OFF. OF THE INSPECTOR GEN., A BRIEF HIST. OF THE GOV'T-SPONSORED ENTERPRISES 2 (2011), https://www.fhfaoig.gov/Content/Files/History%20of%20the%20Government%20Sponsored%20Enterprises.pdf [https://perma.cc/CKH9-TP8T] [hereinafter BRIEF HISTORY].

[3] Emergency Home Fin. Act of 1970, Fed. Home Loan Mortgage Corp. Act, Pub. L. No. 91-351, § 301, 84 Stat. 450 (codified as amended at 12 U.S.C. § 1451 (2000)); BRIEF HISTORY, *supra* note 2, at 3.

[4] BRIEF HISTORY, *supra* note 2, at 5.

[5] *Id*. at 5–6.

[6] *Id.* at 5.

[7] *Id*. at 6.

[8] *See generally* Joe Light, *Treasury Dep't: Fannie, Freddie Bailout Wasn't a Loan*, WALL ST. J. (Apr. 21, 2015, 4:50 PM), http://blogs.wsj.com/developments/2015/04/21/treasury-department-fannie-freddie-bailout-wasnt-a-loan/ [https://perma.cc/ES9A-WBD3] (discussing the potential

their release want to end government involvement and believe releasing the mortgage companies will allow them to regain capital and avoid the need for a bailout in the future.[9] Conversely, opponents believe release will eventually lead to another bailout and raise the cost of mortgages.[10] A bill was introduced in May 2016 that outlines a plan to release the mortgage companies and eliminate the government's involvement.[11] Only time will tell whether the bill, or another legislative attempt to release Fannie Mae and Freddie Mac, will ever be adopted.

This article discusses the history of Fannie Mae and Freddie Mac, the fall of these financial companies, the role the financial crisis played in their placement into conservatorship, the opponents and proponents of potentially releasing them, and current legislation that would eventually provide for their release. First, Section B explains the creation of Fannie Mae and Freddie Mac and how legislation has structured their regulation today. Section C then analyzes how Fannie Mae and Freddie Mac's success diminished in the early 2000s. Next, Section D explores how the financial crisis impacted the decision to place Fannie Mae and Freddie Mac into conservatorship in 2008. Section E then examines the opposing views of potentially releasing the mortgage companies from conservatorship. Finally, Section F discusses legislation recently put forth in an effort to create a plan for releasing the mortgage companies from government involvement.

B. The Creation of Fannie Mae and Freddie Mac

During the Great Depression, banks struggled to maintain sufficient cash to repay deposits as borrowers increasingly defaulted on mortgages.[12] The government estimated that of the nation's home

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consequences of recap and release); Douglas Holtz-Eakin, *Fannie, Freddie and an Outbreak of Amnesia*, WALL ST. J. (May 24, 2016), http://www.wsj.com/articles/fannie-freddie-and-an-outbreak-of-amnesia-1464131687 [https://perma.cc/6HPS-9CVT].

[9] *See* John Carney, *The Latest Fannie and Freddie Reform Bill Offers a Bonanza for Hedge Funds*, WALL ST. J.: MONEYBEAT (May 17, 2016, 3:06 PM), http://blogs.wsj.com/moneybeat/2016/05/17/the-latest-fannie-and-freddie-reform-bill-offers-a-bonanza-for-hedge-funds [https://perma.cc/FJF4-KY22].

[10] *See* Light, *supra* note 8.

[11] *See generally* Housing Financial Restructuring Act of 2016, H.R. 4913, 114th Cong. (2016).

[12] Pickert, *supra* note 1.

mortgage debt, 20 percent to 25 percent was in default by 1933.[13] As part of the New Deal in 1934, President Franklin D. Roosevelt and Congress enacted the National Housing Act (NHA).[14] The NHA established the FHA to offer federally-guaranteed insurance for home mortgages to protect approved lenders against losses on such mortgages.[15] Shortly thereafter, Congress passed the National Housing Act Amendments of 1938, which created Fannie Mae.[16] The purpose of Fannie Mae was to "increase affordability and availability of homeownership for low- and moderate-income" families by ensuring a consistent mortgage credit supply.[17] Fannie Mae was initially only authorized to purchase mortgages from private lenders that were insured by the FHA.[18] In 1954, Congress removed federal backings, allowing private capital to create a mixed ownership system.[19] The federal government further adjusted Fannie Mae's ownership structure in 1968 when the Housing and Urban Development Act (HUD) transformed Fannie Mae into a government-sponsored enterprise, allowing the company to be strictly shareholder-owned and giving HUD regulatory authority over the mortgage company.[20]

In 1970, Congress expanded the secondary mortgage market by establishing Freddie Mac as part of the Emergency Home Finance Act of 1970.[21] Freddie Mac's primary purpose was to prevent Fannie Mae from operating as a monopoly.[22] Like its sister company, Freddie Mac was to "provide liquidity, stability, and affordability to the

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13 BRIEF HISTORY, *supra* note 2, at 1.
14 *Id.* at 2.
15 *Id.*
16 *Id.*; Nat'l Housing Act Amendments of 1938, 75 Pub. L. No. 424, 52 Stat. 8.
17 Elyse Boyle, Note, *Eliminating the Risk to Taxpayers: Privatizing Fannie Mae and Freddie Mac*, 43 SUFFOLK U. L. REV. 163, 166 (2009).
18 *Id*.
19 *Id.* at 167; BRIEF HISTORY, *supra* note 2, at 2–3 ("The Federal National Mortgage Association Charter Act of 1954 (Charter Act) transformed Fannie Mae from a government agency into a public-private, mixed ownership corporation.").
20 BRIEF HISTORY, *supra* note 2, at 3; Housing and Urban Development Act of 1968, 90 Pub. L. No. 448, 82 Stat. 476.
21 BRIEF HISTORY, *supra* note 2, at 3.
22 Pickert, *supra* note 1.

mortgage market."[23] In 1989, Freddie Mac was also restructured into a government-sponsored enterprise and made subject to HUD regulation by the Financial Institutions Reform, Recovery and Enforcement Act.[24] The advantages that accompanied becoming a government-sponsored enterprise, and political efforts such as the Clinton Administration's pressure to expand mortgages, contributed to the "unrestrained growth" and continuous increase in profits of both companies for almost two decades.[25]

C. The Fall of Fannie Mae and Freddie Mac

By 2008, Fannie Mae and Freddie Mac become two of America's largest mortgage companies and dominated the mortgage market.[26] The growth of these companies is due in part to the belief that they carried an implicit government guarantee and that "the companies are so large that the government would never allow them to fail."[27] As Fannie Mae and Freddie Mac grew, critics became concerned that Congressional oversight of the companies was insufficient.[28] Accounting scandals bolstered these concerns in 2003.[29] Freddie Mac's CEO, Leland Brendsel, lost his position when he was accused of understating billions of dollars in profits to purport smoother earnings to the public.[30]To meet "Wall Street expectations," Freddie Mac misstated earnings by about $5 billion from 2000 to 2002 in order to "smooth quarterly volatility in earnings."[31] The Office of

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[23] *About Fannie Mae and Freddie Mac*, FED. HOUS. FIN. AUTH., http://www.fhfa.gov/SupervisionRegulation/FannieMaeandFreddieMac/Pages/About-Fannie-Mae---Freddie-Mac.aspx [https://perma.cc/PYX5-Z5J7].

[24] BRIEF HISTORY, *supra* note 2, at 4; Financial Institutions Reform, Recovery and Enforcement Act of 1989, 101 Pub. L. No. 73, 103 Stat. 183.

[25] *See* Boyle, *supra* note 17, at 173.

[26] Pickert, *supra* note 1.

[27] *Id.*

[28] *See* Boyle, *supra* note 17, at 175.

[29] *See* BRIEF HISTORY, *supra* note 2, at 5.

[30] *See* Bethany McLean, *The Fall of Fannie Mae*, FORTUNE MAG. (Jan. 24, 2005), http://archive.fortune.com/magazines/fortune/fortune_archive/2005/01/24/8234040/index.htm [https://perma.cc/M7SK-H3ZV].

[31] *Freddie Mac Settles Accounting-Fraud Charges*, NBC NEWS (Sept. 28, 2007), http://www.nbcnews.com/id/21027918/ns/business-us_business/t/freddie-mac-settles-accounting-fraud-charges/#.V-LJnjuqy8o [https://perma.cc/5ZJE-WDZ2].

Federal Housing Enterprise Oversight (OFHEO), created in 1992, has the authority to conduct examinations to ensure "safety and soundness" of the mortgage companies and take necessary enforcement actions.[32] In a settlement with the OFHEO, Freddie Mac was fined $125 million for deceiving investors about the actual performance, profitability and growth of the company. [33]

In September 2004, shortly after the Freddie Mac matter was settled, a similar accounting scandal was exposed at Fannie Mae.[34] Fannie Mae's CEO, Franklin Raines, was forced to step down after the Securities and Exchange Commission (SEC) determined the company overstated its profits by 40 percent of its earnings since 2001, an estimated $9 billion.[35] During his six years as CEO, Raines earned over $90 million, largely for meeting profit targets.[36] In May 2006 Fannie Mae settled with the OFHEO and the SEC for $400 million, one of the largest penalties ever imposed in an accounting fraud case.[37]

D. The Financial Crisis and Placement into Conservatorship

During the financial crisis in 2007 and 2008, housing prices fell drastically and borrowers increasingly defaulted on their loans.[38] Confidence in the securities markets plummeted as investors lost billions of dollars in securities held by Fannie Mae and Freddie Mac.[39] The two mortgage companies lost billions of dollars and "were running out of money to cover the losses."[40] This loss of funds resulted in drastic decreases in shareholder equity, forcing the mortgage companies to increase their borrowing.[41]

In response, Congress passed the Housing and Economic Recovery Act (HERA) in 2008.[42] HERA was one of the "most sweeping housing reforms in years," essentially guaranteeing

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[32] BRIEF HISTORY, *supra* note 2, at 5.
[33] *Freddie Mac Settles Accounting-Fraud Charges*, *supra* note 31.
[34] *Id*.
[35] McLean, *supra* note 30.
[36] *Id*.
[37] *Freddie Mac Settles Accounting-Fraud Charges, supra* note 31.
[38] BRIEF HISTORY, *supra* note 2, at 5.
[39] Boyle, *supra* note 17, at 172; BRIEF HISTORY, *supra* note 2, at 5.
[40] Boyle, *supra* note 17, at 176; *see* BRIEF HISTORY, *supra* note 2, at 5.
[41] *See* BRIEF HISTORY, *supra* note 2, at 5.
[42] *Id*. at 6.

government backing of Fannie Mae and Freddie Mac.[43] HERA also created the FHFA and granted it regulatory authority over Fannie Mae and Freddie Mac, including the ability to place either company into conservatorship.[44] Conservatorship is "the legal process (for entities that are not eligible for Bankruptcy court reorganization) in which a person or entity is appointed to establish control and oversight of a company to put it in a sound and solvent condition."[45] In September 2008, the FHFA decided the mortgage companies could no longer survive without government intervention and placed both into conservatorship.[46] As part of the conservatorship, the U.S. Department of Treasury (Treasury) agreed to help Fannie Mae and Freddie Mac continue to provide liquidity and stability to the mortgage market by supporting them financially.[47] The Treasury gave the mortgage companies a bailout amounting to $187.5 billion.[48] In exchange for the bailout, the government was given senior preferred stock in the mortgage companies that paid a 10 percent dividend.[49] In 2012, the agreement changed and almost all profits Fannie Mae and Freddie Mac generated went to the Treasury.[50] As of April 2015, the government had received more than $228 billion from Fannie Mae and Freddie Mac, far exceeding the initial bailout of $187.5 billion.[51]

Since being placed into conservatorship, both Fannie Mae and Freddie Mac's investment portfolios have decreased significantly.[52]

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[43] *See* Boyle, *supra* note 17, at 177–78.

[44] Housing and Econ. Recovery Act of 2008, 110 Pub. L. No. 289, 122 Stat. 2654 (codified as amended at 12 U.S.C. § 4617 (2016)) (creating the FHFA and granting it the authority "take such action as may be necessary" to put Freddie Mac "in a sound and solvent condition;" and appropriate to carry Freddie Mac's business and "preserve and conserve the assets and property" of Freddie Mac).

[45] *Glossary*, FED. RES. BANK ST. LOUIS, https://www.stlouisfed.org/financial-crisis/glossary [https://perma.cc/Y2PW-RZYQ].

[46] *FHFA as Conservator of Fannie Mae and Freddie Mac*, FED. HOUS. FIN. AUTH., http://www.fhfa.gov/Conservatorship/pages/history-of-fannie-mae--freddie-conservatorships.aspx [https://perma.cc/UZ7Q-2WDP].

[47] *Id.*

[48] Light, *supra* note 8.

[49] *Id.*

[50] *Id.*

[51] *Id.*

[52] W. SCOTT FRAME ET AL., FED. RESERVE BANK N.Y. STAFF REP., NO. 719, THE RESCUE OF FANNIE MAE AND FREDDIE MAC 6 (2015),

However, they have both seen continued growth in their total market share of mortgages.[53] Together, the companies owned or guaranteed only 7 percent of all "single-family mortgage debt" in 2007.[54] By 2013, this increased to 40 percent.[55]

E. Opposition and Support for Releasing Fannie Mae and Freddie Mac

With the government owning almost 80 percent of the mortgage companies, investors have argued that it is time for Fannie Mae and Freddie Mac to be released from conservatorship.[56] The Treasury has spoken out against a release, warning that if released, mortgage costs for Americans could rise.[57] In addressing concerns that the dividend payments have exceeded the original loan, the Treasury has argued that rescuing the companies was a major risk and the payments are a return for the risk, rather than repayment of the loan.[58] Moreover, the Obama Administration has made it clear that the housing-finance reform is not going to occur anytime soon.[59] Some critics outside of the government even believe it is time to eliminate Fannie Mae and Freddie Mac altogether.[60] The interest in completely abolishing these mortgage companies is rooted in the belief that Fannie Mae and Freddie Mac would have to charge much higher fees in order to accumulate the capital necessary to back the roughly $5 trillion in

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https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr719.pdf [https://perma.cc/978K-A6CH].

[53] *Id*.

[54] *Id*.

[55] *Id*.

[56] Cheyenne Hopkins & Heather Perlberg, *Obama Officials Resist Calls to Release Fannie Mae, Freddie Mac*, BLOOMBERG (Oct. 19, 2015), http://www.bloomberg.com/news/articles/2015-10-20/obama-officials-resist-calls-to-release-fannie-mae-freddie-mac [https://perma.cc/6UFL-KBUG].

[57] *Id*.

[58] *See* Light, *supra* note 8 (quoting a letter Assistant Secretary from Legislative Affairs Randall DeValk wrote, stating that the government "did not make an ordinary loan [but rather it] took on an enormous risk when rescuing the enterprises in the middle of a financial crisis—a risk for which any private investor would have demanded substantial compensation").

[59] *See* Hopkins & Perlberg, *supra* note 56.

[60] *See, e.g.,* Holtz-Eakin, *supra* note 8.

mortgages they currently carry.[61] New competitors would be able to undercut such high costs and Fannie Mae and Freddie Mae would not be able to survive.[62]

Conversely, investors are the biggest advocates of releasing the mortgage companies from conservatorship.[63] They believe the Treasury is illegally taking money from the companies, which is preventing the companies from accumulating capital.[64] Other proponents of releasing Fannie Mae and Freddie Mac include "[a]ffordable-housing advocates, the mortgage industry, homebuilders and realtors."[65] These advocates want to reform the mortgage companies and believe that their release would allow Fannie Mae and Freddie Mac to regain capital and avoid future bailouts.[66] In particular, Congressman Mick Mulvaney, a Republican from South Carolina, believes the first step to reform is eliminating government involvement in the mortgage business.[67] Congressman Mulvaney introduced the Housing Finance Restructuring Act (the Act) earlier this year in efforts to release Fannie Mae and Freddie Mac from conservatorship.[68]

F. The Housing Finance Restructuring Act of 2016

Removing Fannie Mae and Freddie Mac from conservatorship is one of the Act's primary purposes.[69] The bill would require Fannie Mae and Freddie Mac to maintain capital ratios similar to those of other large financial institutions, which would require them to have more cash on hand.[70] In order to accumulate capital, the bill would require the Treasury to eliminate the dividends it receives from the

[61] *See id*. ("But Fannie and Freddie together carry an existing stock of roughly $5 trillion in mortgages, so they would have to charge much higher fees to accumulate capital to back those guarantees successfully.").
[62] *Id*.
[63] *Id*.
[64] *Id*. ("Investors in the GSEs have sued the government, labeling the Treasury action an illegal 'taking' that has prevented Fannie and Freddie from accumulating capital and meriting release from conservatorship.").
[65] *Id*.
[66] *See* Carney, *supra* note 9.
[67] *Id*.
[68] *Id*.
[69] *See id*.
[70] *Id*.

companies to zero and deem the original loan as repaid in full.[71] The plan would restrict the mortgage companies from declaring or paying any dividends to shareholders, including the Treasury, until it becomes "fully capitalized."[72] To be considered fully capitalized, the bill states a company must maintain an amount of total capital "that is equal to or exceeds 10 percent of the risk-weighted assets" of the company, pursuant to the Housing Enterprises Financial Safety and Soundness Act of 1992.[73]

Additionally, the Act would require the FHFA to require Fannie Mae and Freddie Mac to retain net income as capital reserves if at any time they are not fully capitalized.[74] The FHFA would also be responsible for submitting a capital restoration plan to specified congressional committees.[75] If, at any time, Fannie Mae or Freddie Mac are not fully capitalized, the FHFA would be required to update the plan annually and resubmit it along with a progress report to the congressional committees.[76] If either of the mortgage companies attain "an amount of capital that is equal to or exceeds 5 percent of [its] risk-weighted assets," the FHFA would release the company from conservatorship.[77] Overall, the Act would eliminate government involvement and put Fannie Mae and Freddie Mac on a path to be released from conservatorship.[78] This bill has already received the endorsement of various conservative groups.[79] No action has been taken since the Housing Finance Restructuring Act has been introduced and referred to the House Committee on Financial Services.[80]

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[71] Housing Financial Restructuring Act of 2016, H.R. 4913, 114th Cong. (2016).
[72] *Id*.
[73] *Id*.
[74] Cong. Research Comm., *Summary of H.R. 4913: Housing Fin. Restructuring Act of 2016*, GOVTRACK, https://www.govtrack.us/congress/bills/114/hr4913/summary [https://perma.cc/LL5R-2J66].
[75] *Id*.
[76] Housing Financial Restructuring Act of 2016, H.R. 4913, 114th Cong. (2016).
[77] *Id*.
[78] *See generally* Carney, *supra* note 9.
[79] *Id*.
[80] *See* Housing Financial Restructuring Act of 2016, H.R. 4913, 114th Cong. (2016).

G. Conclusion

There are strong advocates on both sides of the debate about whether Fannie Mae and Freddie Mac should be released from conservatorship.[81] Though Congressman Mulvaney introduced the Act, it is unlikely that any major legislative reform will take place before the President-Elect Donald Trump takes office due to the risks of altering the U.S. housing market.[82] However, with the recent election results, it is likely Fannie Mae and Freddie Mac will experience restructuring, as this has been a priority for Republicans.[83] There is speculation that as President, Trump could "open the door" for release of the mortgage companies.[84] This speculation caused a significant rise in the price of Fannie Mae and Freddie Mac shares after the election results.[85] Others believe release will not be immediate, but the President and Congress could "create a path out of conservatorship."[86] As of now, the fates of Fannie Mae and Freddie Mac remain speculation, but Trump will have to release his plan for the mortgage companies in the near future.

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[81] *See generally* Light, *supra* note 8; Holtz-Eakin, *supra* note 8.
[82] Katina Stefanova, *Will FNMA and FMCC Bring Extraordinary Returns to Investors This Summer?*, FORBES (July 26, 2016), http://www.forbes.com/sites/katinastefanova/2016/07/26/will-fnma-and-fmcc-bring-extraordinary-returns-to-investors-this-summer/#761b82711b1a [https://perma.cc/Q8TE-8AKT].
[83] Rick Boucher et al., *Election Results 2016: Preliminary Considerations for the Financial Services Industry*, LEXOLOGY (Nov. 11, 2016), http://www.lexology.com/library/detail.aspx?g=ef88c17b-5d97-4a80-951f-0bd8ed9f9b86 [https://perma.cc/CH34-BV9W].
[84] Matthew Goldstein, *Fannie and Freddie's Status Continues to Provoke Criticisms*, N.Y. TIMES: DEALBOOK (Nov. 14, 2016), http://www.nytimes.com/2016/11/15/business/dealbook/fannie-and-freddies-status-continues-to-provoke-criticisms.html?_r=0 [https://perma.cc/B7N3-6SNR].
[85] Joe Light, *Fannie-Freddie Investors Cheer Trump on Hopes of Policy Changes*, BLOOMBERG (Nov. 9, 2016), http://www.bloomberg.com/news/articles/2016-11-09/fannie-freddie-investors-cheer-trump-on-hopes-of-policy-changes [https://perma.cc/BHS6-EAKK].
[86] *Id.* (quoting President of the National Community Reinvestment Coalition, John Taylor, stating "It's too late to actually do something that would take them out of conservatorship because they haven't allowed them to build capital reserves, but it's not too late to create a path out of conservatorship").
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