American Mortgage Giants Fannie Mae and Freddie Mac: Ending the Unceasing Conservatorship

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I. INTRODUCTION

Fannie Mae and Freddie Mac (Fannie and Freddie) are notorious for their role in the housing market bust-up that precipitated the Great Recession.[1] The companies were subsequently brought under a form of federal government control called conservatorship, where they remain.[2] This sustained experiment in conservatorship for a pair of companies that have long operated as Government Sponsored Agencies (GSEs) has spawned a sea of reports and analyses that seek to assess the efficacy of this unique model. This Note builds on such scholarship, taking stock of the GSE model in general and Fannie and Freddie in particular with reference to changing political winds and recent court holdings. Not only did a Republican succeed a Democratic president who was in office for the majority of the conservatorship, but that Republican president also appointed three Supreme Court Justices and the head of the Federal Housing Finance Administration (FHFA). Additionally, when this Note was written, *Collins v. Mnuchin* was pending in the Supreme Court.[3] Even after the Supreme Court released their opinion, Fannie and Freddie will still be affected by litigation. This Note proceeds by giving a brief overview of the GSE's background, analyzing their current state of affairs, and making a two-part recommendation on how to proceed. The recommendation section also considers possible outcomes surrounding the Supreme Court's remanded portion of *Collins v. Yellen*.[4]

The business reporter Bethany McLean argues that Fannie and Freddie enjoy the "worst of both worlds" as a result of their conservatorship. They are "too political to be financially secure, but too financially insecure to accomplish their political mission. They have become a deficit-reduction device for the federal government."[5] This begs the question, what in Fannie's and Freddie's past led to their current state, and where do they go from here? In light of the previously mentioned changes in circumstance since a majority of papers have been written, this Note serves as a meta-analysis of previous works and builds on previous publications to account for new events. Most notably, the new Trump administration and the Supreme Court case of *Collins v. Mnuchin*.[6]

II. FANNIE MAE AND FREDDIE MAC BACKGROUND

The story of Fannie Mae (Fannie) and Freddie Mac (Freddie) is a story, as Mervyn King puts it, of how the United States chose to socialize the market for mortgages while

1. *See* Steven A. Holmes, *Fannie Mae Eases Credit to Aid Mortgage Lending*, N.Y. TIMES (Sept. 30, 1999), https://www.nytimes.com/1999/09/30/business/fannie-mae-eases-credit-to-aid-mortgage-lending.html [https://perma.cc/2QXQ-YE86] (reporting on the kinds of easy-credit policies that some blame for the market crash, policies pursued by Fannie and Freddie in the decade preceding the crash).

2. *See* Andrew Ackerman & Brent Kendall, *Biden Administration Removes Fannie, Freddie Overseer After Court Ruling*, WALL ST. J. (June 23, 2021), https://www.wsj.com/articles/supreme-court-issues-mixed-ruling-on-government-seizure-of-fannie-freddie-profits-11624459222 [https://perma.cc/2GJH-C3HX] (reporting on and analyzing recent intrigue regarding whether Fannie and Freddie will return to the private sector).

3. Transcript of Oral Argument, Collins v. Mnuchin, 68 Fed. Law. 76 (Dec. 9, 2020) (No. 19-422), https://www.supremecourt.gov/oral_arguments/audio/2020/19-422 [https://perma.cc/4XW5-K4VA].

4. Collins v. Yellen, 141 S. Ct. 1761 (2021).

5. BETHANY MCLEAN, SHAKY GROUND THE STRANGE SAGA OF THE U.S. MORTGAGE GIANTS 58–59 (2015).

6. Collins v. Mnuchin, 938 F.3d 553, 568 (5th Cir. 2019), *sub nom*. Collins v. Yellen, 141 S. Ct. 1761 (2021).

most countries chose to socialize their health care system.[7] By the beginning of 2008, Fannie and Freddie guaranteed 80% of mortgages issued in the United States.[8] This market power can partly be traced to the belief, proven true by time, that the two GSEs had an implicit guarantee that the government would not let them fail.[9] This helped ensure the safety of their investments in the eyes of investors,[10] a moral hazard dilemma that precipitated the GSEs' current state of limbo.

A. An Origin Story

The origins of Fannie and Freddie take us back to Great Depression-era policy-making.[11] Before 1932, the housing market was primarily funded through private sector investment.[12] The terms of these loans were drastically less appealing than the terms of modern-day loans.[13] Some common features included "high down payments (approximately half the home's purchase price), short maturities (ten years or less), and large balloon payments."[14] High interest rates reflected the main issues with the housing market, such as illiquidity, interest rate risk, and the high risk of default.[15] The reliance on private investment and lack of a national mortgage market also led to large disparities in borrowing costs between different regions.[16] In addition to an already precarious housing market, "the Great Depression would prove traumatic to the nation's housing market."[17] As unemployment rose to 23.6% by 1932, the inability to pay debts also began to rise.[18] By 1933, more than 25% of homeowners defaulted on their mortgage and lost their home to foreclosure.[19] This resulted in banks not having sufficient funds to pay deposits,[20] contributing to the banking crisis by undermining depositor confidence.[21] Starting in 1932, the federal government implemented multiple policies in an attempt to

7. *Supra* note 5, at 9.

8. *Id.* at 35.

9. Katie Pickert, *A Brief History 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/3HKL-MEKW].

10. *See* MCLEAN, *supra* note 5, at 35. (detailing the state of Fannie Mae and Freddie Mac)

11. Jean Folger, *Fannie Mae and Freddie Mac: An Overview*, INVESTOPEDIA, https://www.investopedia.com/articles/economics/08/fannie-mae-freddie-mac-credit-crisis.asp [https://perma.cc/2FHW-PL6S].

12. FED. HOUS. FIN. AGENCY OFF. INSPECTOR GEN., A BRIEF HISTORY OF THE HOUSING GOVERNMENT-SPONSORED ENTERPRISES 1 (2011).

13. Ben S. Bernanke, Chairman, Fed. Rsrv. Bank, Address at the Fed. Rsrv. Bank of Kan. City's Econ. Symp.: Housing, Housing Finance, and Monetary Policy (Aug. 31, 2007), https://www.federalreserve.gov/newsevents/speech/bernanke20070831a.htm [https://perma.cc/Y3YC-ETYV].

14. FED. HOUS. FIN. AGENCY OFF. INSPECTOR GEN., *supra* note 12.

15. Folger, s*upra* note 13.

16. *Id.* (describing variations of up to four percentage points).

17. FED. HOUS. FIN. AGENCY OFF. INSPECTOR GEN., *supra* note 12.

18. *Id.*

19. Erica Santos, *Fannie Mae & Freddie Mac: Release from Conservatorship*, 36 REV. BANKING & FIN. L. 92, 93–94 (2016).

20. *Id.* at 92.

21. *See generally* Gary Richardson, *Banking Panics of 1930-31*, FED. RSRV. (Nov. 22, 2013), https://www.federalreservehistory.org/essays/banking_panics_1930_31 [https://perma.cc/G2B6-NHTB] (describing how financial institutions lacking bank reserves is a contributing factor to the panic during the Banking Crisis).

provide liquidity and stability to the housing market.[22] To better facilitate the post-depression era housing market, the federal government, through an amendment to the National Housing Act, created the Federal National Mortgage Association (more commonly known as Fannie Mae) in 1938.[23] Fannie Mae's original objective was to purchase mortgages insured by the FHA, thus providing liquidity to private lenders who could in turn make more loans.[24] Through a consistent supply of liquidity, Fannie Mae facilitated greater access to mortgages and further reinforced the modern mortgage structure of long terms, fixed rates, and self-amortization.[25] In 1948, Fannie Mae expanded its portfolio to include mortgages that originated under the GI Bill.[26]

After a period of significant growth,[27] the Federal National Mortgage Association Charter Act of 1954 withdrew government support from Fannie Mae and allowed private capital to fund the organization's borrowing, creating a semi-public-private corporation.[28]

B. The Move to a Government Sponsored Enterprise

In 1968, fueled by Fannie's continued growth and the pressure of the Vietnam War on the national budget, President Johnson removed Fannie's debt from the government balance sheet by transitioning Fannie Mae into a GSE through the Housing and Urban Development Act of 1968 (HUD Act).[29] By converting Fannie into a GSE, the government relinquished all ownership of the corporation and in its place instituted a private shareholder-owned company.[30] However, through HUD the government retained regulatory oversight of the corporation.[31] Not only did HUD make structural changes to Fannie, but significant operational changes were made as well. HUD expanded the loans that Fannie could purchase to include non-FHA insured home mortgages.[32] Additionally, the government created a dual mandate for the corporation.[33] Not only was Fannie

22. In 1932, the government created the Federal Home Loan Bank Act, which provided relief to troubled homeowners and lending institutions through a credit reserve system. FED. HOUS. FIN. AGENCY OFF. INSPECTOR GEN., *supra* note 12. In 1933, the Home Owners' Loan Act was signed in to law, which allowed refinancing of mortgages and began the practice of long term, fixed rate, self-amortizing mortgages. *Id.* at 2. In 1934, the National Housing Act was passed. *Id.* The NHA allowed the Federal Housing administration to offer government backed insurance for mortgages that originated from lenders approved by the FHA. *Id.*

23. *Id.* at 2; MCLEAN, *supra* note 5, at 17.

24. FED. HOUS. FIN. AGENCY OFF. INSPECTOR GEN., *supra* note 12, at 2.

25. Jean Folger, *Fannie Mae and Freddie Mac: An Overview*, INVESTOPEDIA, https://www.investopedia.com/articles/economics/08/fannie-mae-freddie-mac-credit-crisis.asp [https://perma.cc/DXE2-JGHP]; Pickert, *supra* note 9 ("[T]he agency helped usher in a new generation of American home ownership, paving the way for banks to loan money to low- and middle-income buyers who otherwise might not have been considered creditworthy").

26. FED. HOUS. FIN. AGENCY OFF. INSPECTOR GEN., *supra* note 12, at 2.

27. *Id.*

28. *Id.* at 2–3; Elyse Boyle, Note, *Eliminating the Risk to Taxpayers: Privatizing Fannie Mae and Freddie Mac*, 43 SUFFOLK UNIV. L. REV. 163, 167 (2009).

29. Boyle, *supra* note 28; Pickert *supra* note 9. A GSE is a corporation that is created by an act of Congress, but privately held, in order to facilitate public financial services by purchasing and guaranteeing loans. Troy Segal, *Government-Sponsored Enterprises (GSE)*, INVESTOPEDIA (Aug. 1, 2020) https://www.investopedia.co m/terms/g/gse.asp [https://perma.cc/4RKZ-FXAJ].

30. FED. HOUS. FIN. AGENCY OFF. INSPECTOR GEN., *supra* note 12, at 2–3.

31. *Id.* at 3.

32. Boyle, *supra* note 28, at 167.

33. *See* FED. HOUS. FIN. AGENCY OFF. INSPECTOR GEN., *supra* note 12, at 3.

responsible for making profits to fulfill its obligation to its shareholders, but HUD required that Fannie devote part of its purchases to low-and moderate-income home mortgages.[34] This dual mandate would become problematic in the future.[35]

C. The Creation of Freddie Mac

In 1970 the government created the Federal Home Loan Mortgage Corporation (Freddie Mac) through the Emergency Home Finance Act in order to expand the secondary housing market[36] and stop Fannie Mae from becoming a monopoly.[37] Freddie Mac's purpose is to "provide liquidity, stability, and affordability to the mortgage market."[38] Freddie Mac issued the first conventional mortgage-backed security (MBS) in 1971.[39] Freddie Mac tended to focus its business on buying mortgages from thrift institutions[40] and smaller banks that provided more community-based banking services.[41] In 1989, the federal government reorganized Freddie Mac into a GSE like Fannie Mae through the Financial Institutions Reform, Recovery, and Enforcement Act.[42]

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34. *Id.*

35. *See* MCLEAN, *supra* note 5, at 25–33 (charting Fannie's reckless foray into the subprime mortgage market, debt instruments for "people who couldn't afford traditional mortgages").

36. The secondary housing market is the marketplace in which lenders will sell home loans and servicing rights to investors. Julia Kagan & Troy Segal, *Secondary Mortgage Market*, INVESTOPEDIA (Mar. 16, 2020), https://www.investopedia.com/terms/s/secondary_mortgage_market.asp#:~:text=What%20Is%20the%20Secondary%20Mortgage,sold%20between%20lenders%20and%20investors [https://perma.cc/XAG6-PES3]. The secondary market generally works by packaging individual mortgages into bundles called mortgage-backed securities, which are in turn sold to investors such as hedge funds, insurance companies, or pension plans. *Id.* The housing market serves the primary mortgage market by freeing up capital for lenders which in turn allows them to service more loans, making credit available to consumers across more geographical locations. *Id.* Thus, solving one of the principal issues of the housing market prior to and throughout the great depression, in which disparities between credit availability and loan terms were varied between geographical locations. Bernanke, *supra* note 13 (describing variations of up to four percentage points).

37. Boyle, *supra* note 28; Santos, *supra* note 19, at 94.

38. *About Fannie Mae and Freddie Mac*, FED. HOUS. FIN. AUTH., https://www.fhfa.gov/about-fannie-mae-freddie-mac [https://perma.cc/Z6WT-A433].

39. FED. HOUSING FIN. AGENCY OFF. INSPECTOR GEN., *supra* note 12, at 3. A mortgage backed security is a financial instrument that allows the originator of loans to sell their loan to an investor, who can bundle a number of home loans and sell an interest in them. The individual who buys an interest in the loan will receive the monthly payments attached to the loan. Julia Kagan, *Mortgage-backed security (MBS)*, INVESTOPEDIA, https://www.investopedia.com/terms/m/mbs.asp [https://perma.cc/M4TK-CJN4].

40. A thrift institution "is a type of financial institution which specializes in offering savings accounts and originating home mortgages for consumers." Julia Kagan, *Thrift Bank*, INVESTOPEDIA (July 31, 2020), https://www.investopedia.com/terms/t/thriftbank.asp [https://perma.cc/5TMX-6GCJ]. Thrift institutions are commonly called savings and loan associations. *Id.* Apart from their separate regulatory requirements, thrift institutions differ from commercial banks by the customers they serve. Thrift institutions are focused on individual consumers while commercial banks, in the traditional meaning of the term, tend to serve businesses. Claes Bell, *Thrifts vs. Banks: What's the difference*, BANKRATE (Aug. 15, 2016), https://www.bankrate.com/banking/thrifts-vs-traditional-banks-whats-the-difference/ [https://perma.cc/J226NPJP]. U.S. law requires that at least 65% of a Thrift Institution's lending portfolio be based on consumer loans. *Id.*

41. Folger, *supra* note 11.

42. FED. HOUSING FIN. AGENCY OFF. INSPECTOR GEN., *supra* note 12, at 4.

D. The Lead up to the Great Recession

Throughout most of the 1970s–1990s, the two GSEs conducted their business as usual. However, in 1992, fueled by the fear that Fannie and Freddie were only focused on making money for shareholders rather than making mortgages affordable to Americans, Congress enacted the Federal Housing Enterprises Financial Safety and Soundness Act of 1992.[43] The Act established a new regulatory agency within HUD called the Office of Federal Housing Enterprise Oversight (OFHEO), which was tasked with conducting "safety and soundness examinations of Fannie Mae and Freddie Mac . . . ."[44] Along with creating the OFHEO, the Act created an affirmative obligation for Fannie and Freddie to facilitate housing for low-and middle-income earners by purchasing a number of their mortgages each year.[45] This mandate was part of a broader policy: the so-called "ownership society," where easy credit would usher an ever-greater circle of Americans into the asset-owning Capitalist class.[46]

The increased political pressure began an era of looser standards for the two GSEs.[47] Despite venturing into purchasing more risky mortgages, the investors purchasing the MBSs from Fannie and Freddie were not overly concerned with the risk because Fannie and Freddie had a "gold-plated guarantee" on their securities.[48] This guarantee ensured that investors would get paid the principal and interest on their investments if the homeowners were unable to make their mortgage payments.[49] Accompanying the "gold-plated guarantee" was the implicit guarantee that the government would not let their GSEs fail should financial difficulties arise.[50] The implicit guarantee served to facilitate world-wide investments into the housing market, but it also handcuffed the federal government when financial difficulties inevitably arose.[51]

E. The Great Recession Fallout

While many individuals will inevitably remember September 15th, 2008—the day Lehman Brothers filed for bankruptcy—as the start of the Great Recession, the issues that resulted in the conservatorship of Fannie and Freddie began much earlier.[52] Starting in the 1980s, Congress passed a string of acts that would make subprime lending popular.[53]

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43. *Id.* at 5; Boyle, *supra* note 28, at n.37.

44. FED. HOUSING FIN. AGENCY OFF. INSPECTOR GEN., *supra* note 12, at 5.

45. *Id.* at 5.

46. Boyle, *supra* note 28, at 174. See MCLEAN, *supra* note 5, at 84 (explication briefly on how Fannie fit into this "ownership society" during the administrations of Bill Clinton and George W. Bush).

47. *Id.* at 173–75.

48. MCLEAN, *supra* note 5, at 20.

49. *Id.*

50. *Id.*

51. *See* Boyle, *supra* note 28, at 175 ("For years, many predicted that the federal government would not allow these GSEs to fail because of their size and status, even though no statute mandated that the federal government guarantee the firms' obligations.").

52. Renae Merle, *A Guide to the Financial Crisis – 10 Years Later*, WASH. POST (Sept. 10, 2018, 12:47 PM), https://www.washingtonpost.com/business/economy/a-guide-to-the-financial-crisis--10-years-later/2018/09/10/114b76ba-af10-11e8-a20b-5f4f84429666_story.html [https://perma.cc/VE3Z-SCDA]; *See* MCLEAN, *supra* note 5, at 25–33 (reporting on Fannie's aggressive shift into the subprime mortgage market).

53. *See* Souphala Chomsisenghet & Anthony Pennington-Cross, *The Evolution of the Subprime Mortgage Market*, 88 FED. RSRV. BANK ST. LOUIS REV. 31, 38 (2006), https://files.stlouisfed.org/files/htdocs/publications/review/06/01/ChomPennCross.pdf [https://perma.cc/44Y3-RZ2P] (enumerating the laws that "opened

Throughout the late 1990s and early 2000s, subprime lenders would bundle their subprime loans as MBSs, pay a credit rating agency to assign a risk rating to the security, and sell it to Wall Street.[54] In 2001, the Basel Committee had determined that these so-called private-label securities, assigned the highest possible ratings by the rating agencies despite their fundamental riskiness, were just as financially sound as the securities released by the GSEs.[55] The increase of "GSE safe" MBSs in the private market caused Fannie's and Freddie's market share to drop 20% within three years.[56] In a scheme to gain back their market share, the two GSEs began to purchase the highest rated private-label securities from Wall Street.[57] After a seven-year buying spree beginning in 2001, which represented an increase from 3.8% of subprime mortgage issuances to an astonishing peak at 38.9% of subprime issuances, the GSEs purchased a combined $313 billion worth of the private-label securities.[58] The most precarious maneuver in attempting to gain their market share occurred when the GSEs began to guarantee the credit risk on the private-label securities,[59] a horrifying thought considering the moral hazard issues associated with the private lenders paying the rating agencies who are rating their loans.

By 2008, Fannie and Freddie had $5.2 trillion worth of outstanding debt and MBSs and guaranteed 80% of all U.S. home mortgages.[60] Between 2007 and 2008, as home prices began to fall and loans delinquencies began to rise, Fannie and Freddie began to bleed hopelessly from their investments.[61] In fact, in 2008, the GSEs lost $108 billion, which is more "than they had earned in the previous 37 years combined ($95 billion)."[62] Alas, as the economy and the housing market continued to tumble, Fannie and Freddie were determined to be "too big to fail" and the government stepped in to provide them with a lifeline.[63]

F. Conservatorship

In July 2008, Congress enacted the Housing and Economic Recovery Act (HERA)

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the door for the development of the subprime market"). With the passing of the Depository Institutions Deregulation and Monetary Control Act, Alternative Mortgage Transaction Parity Act, and the Tax Reform Act of 1986 Congress made it possible for lenders to charge high interest rates and fees (preempting state usury laws), variable interest rates and balloon payments, and allowed tax deductions on mortgage interest rates but not for interest on consumer loans; thus, incentivizing high-cost mortgage debt over consumer debt. *Id.* at 38.

54. MCLEAN, *supra* note 5, at 26–27.

55. *Id.*

56. *Id.* at 29. The private market volume exceeding the two GSEs can in part be attributed to the documentation standards required by Fannie and Freddie. *See id.* While Fannie and Freddie require less than 90% loan-value-ratio, 40% of one lender's loan did not even verify the income of the borrower. *Id.*

57. MCLEAN, *supra* note 5, at 29.

58. *Id.* at 30; MANUEL ADELINO ET AL., THE EFFECTS OF LARGE INVESTORS ON ASSET QUALITY: EVIDENCE FROM SUBPRIME MORTGAGE SECURITIES 33 (2017), https://www.frbatlanta.org/-/media/documents/research/publications/wp/2014/04a-the-effect-of-large-investors-on-asset-quality-evidence-from-subprime-mortgage-securities-2017-03-23.pdf [https://perma.cc/SM3Y-REDS].

59. MCLEAN, *supra* note 5, at 31.

60. *Id.* at 35.

61. FED. HOUSING FIN. AGENCY OFF. INSPECTOR GEN., *supra* note 12, at 5.

62. Collins v. Mnuchin, 938 F.3d 553, 564 (5th Cir. 2019).

63. Ally Coll Steele, *Fannie, Freddie, and Fairness: Judicial Review of Federal Conservators*, 53 HARV. J. ON LEGIS. 417, 421 (2016).

which established the independent Federal Housing and Finance Agency (FHFA).[64] HERA not only granted the FHFA the authority to regulate and supervise Fannie and Freddie, but also authorized them to place Fannie and Freddie into a conservatorship or receivership.[65] In September 2008, the FHFA exercised its power under 12 U.S.C. § 4617(2) and placed Fannie Mae and Freddie Mac into a conservatorship, which is where they continue to sit as of the date of publication.[66]

The original terms of the conservatorship involved a Preferred Stock Purchase Agreement (PSPA), the terms of which included a capital commitment of $100 billion for each GSE from the Treasury.[67] This capital backing entitled the Treasury to one million shares of senior preferred stock, which required dividend (interest) payments to be paid before any dividend payment was made to the other preferred or common stock shares.[68] The dividend payments are quarterly payments "equal to 10 percent of the liquidation payments," or, in layman's terms, 10% interest on the amount of money Fannie or Freddie borrowed from the $100 billion capital backing.[69] Lastly, the PSPA allows the treasury to purchase up to 79.9% of the common stock.[70] Why 79.9%? Because purchasing any more would result in Fannie and Freddie's debt showing up on the national budget and further bloating the national debt, something that privatizing the GSEs in the 1960s was supposed to avoid.[71]

Starting in 2009, three amendments were made to the stock agreements.[72] The first amendment was passed in May 2009 and doubled the capital commitment for each GSE to $200 billion.[73] The second amendment was added in December 2009 and once again changed the capital backing, but rather than increasing the ceiling, the Treasury agreed to an adjustable amount that would be determined based on quarterly losses of the two GSEs.[74] The third amendment (infamously coined the "net worth sweep" amendment) was made in 2012 in response to Fannie and Freddie partaking in a circular scheme in which they would have to borrow money from the treasury in order to pay their quarterly 10% dividend.[75] The "net worth sweep" replaced the 10% quarterly dividend with a quarterly payment equal to their net worth.[76] As the amount of the quarterly "net worth

64. 12 U.S.C. § 4511(b)(2); *see* Steele, *supra* note 63, 421 (detailing the establishment of the FHFA).

65. 12 U.S.C. § 4617(2); Cont'l W. Ins. Co. v. FHFA, 83 F. Supp. 3d 828, 831 (S.D. Iowa 2015). A conservatorship is analogous to a guardianship, in which a person or institution is appointed to manage the financial affairs of an individual or organization. Will Kenton, *Conservatorship*, INVESTOPEDIA, https://www.investopedia.com/terms/c/conservatorship.asp [https://perma.cc/X58V-AZWG]. A receivership on the other hand is a court appointed individual or institution which takes custodial responsibility for the property rights of another during a transaction, during the winding up process, or during disputes. Ken Philip & Kerin Kaminski, *Receivership: A Value-Adding Tool*, SECURED LENDER, 30, 30 (Jan.–Feb. 2007).

66. Cont'l W. Ins. Co. v. FHFA, 83 F. Supp. 3d 828, 831 (S.D. Iowa 2015).

67. Collins v. Mnuchin, 938 F.3d 553, 567 (5th Cir. 2019).

68. *Id.*

69. *Id.*; MCLEAN, *supra* note 5, at 41.

70. Collins v. Mnuchin, 938 F.3d 553, 567 (5th Cir. 2019).

71. MCLEAN, *supra* note 5, at 41; Pickert, *supra* note 9.

72. Collins v. Mnuchin, 938 F.3d 553, 567 (5th Cir. 2019).

73. *Id.*

74. Perry Capital LLC. v. Mnuchin, 864 F.3d 591, 601 (D.C. Cir. 2017).

75. *Id.*

76. *Id.* at 602. Aside from the issues raised during shareholder litigation below, the timing of the third amendment was precarious because 2012 happened to be the year the housing market stabilized and Fannie and Freddie became profitable again. Steven Davidoff Solomon & David Zaring, *After the Deal: Fannie, Freddie,*

sweep" quickly grew to be larger than the 10% quarterly dividend, preferred and common stock shareholders started to feel as though they were losing money that was rightfully theirs.[77]

G. Shareholder Litigation

Under conservatorship, the Treasury distributed $187 million to the two GSEs and have recouped more than $250 billion in dividend payments.[78] Shareholders, upset with the continued "net worth sweeps" despite all the money having been paid back, have brought lawsuits against the FHFA and the Treasury.[79] A thorough analysis of this issue will take place in Section III(b) of this Note.

H. The Move Out of Conservatorship

After fourteen years in conservatorship, a question looms over the two GSEs like the shadow of an eclipse: what is to be done with Fannie Mae and Freddie Mac? Many options have been presented, ranging from allowing the GSEs to exit conservatorship and then be regulated like public utilities, to privatizing them in an analogous fashion to Sallie Mae, to creating more GSEs to compete with Fannie and Freddie, keeping them in conservatorship, or merely releasing them to the pre-recession status quo.[80]

This note opines on what the best outcome is given the GSEs history, the current litigation, the overall economic impact of COVID-19, and the new administration.

III. AN ANALYSIS OF THE DEFECTS LEADING TO CONSERVATORSHIP AND THE LEGITIMACY OF THE CURRENT SHAREHOLDER DERIVATIVE LITIGATION

A. Moral Hazard and the Governments Implicit Guarantee

A moral hazard occurs when one party takes on more risk knowing that it is protected against an unexpected or adverse outcome by a third party who will incur the cost should the risk have adverse effects.[81] Moral hazards are notorious in the insurance profession,[82] and the housing market was full of moral hazards prior to the Great

and the Financial Crisis Aftermath, 95 B.U. L. REV. 371, 385 (2015).

77. Solomon and Zaring, *supra* note 76.

78. Perry Capital LLC. v. Mnuchin, 864 F.3d 591, 602 (D.C. Cir. 2017).

79. *See id.* at 591; *see* Continental W. Ins. Co. v. FHFA, 83 F.Supp.3d 828, 832 (S.D. Iowa 2015) ("Continental Western also asserts claims for breach of contract, breach of the implied covenant of good faith and fair dealing, and breach of fiduciary duty against FHFA in its role as conservator of the GSEs."); *see* Collins v. Mnuchin 938 F.3d 553, 562–63 (5th Cir. 2019) ("The Shareholders plausibly allege that the Third Amendment exceeded FHFA's conservator powers by transferring Fannie and Freddie's future value to a single shareholder, Treasury.").

80. Santos, *supra* note 19, at 98–100; MICHAEL FRITZ BAIRD, THE FUTURE OF THE FANNIE MAE AND FREDDIE MAC, 19-I (State Bar of Tex. 2020).

81. *Definition of 'Moral Hazard'*, ECON. TIMES, https://economictimes.indiatimes.com/definition/moral-hazard [https://perma.cc/G7JY-P4QW].

82. AGNÉS BÉNASSY-QUÉRÉ ET AL., ECONOMIC POLICY THEORY AND PRACTICE 87 (2010). The perfect example of a moral hazard is the reason why a government should prohibit construction in flood plains or make explicitly clear that no remedy will be available for families that live in one. *Id.* Otherwise, should the government provide displaced families with free insurance or remedies for their losses, there would be an incentive to build in flood plains knowing that the cost of risk rests on someone else. *Id.*

Recession.[83] The moral hazards most applicable to the present case include: the systemic risk posed by large financial institutions, the collateralization of the MBSs, and the willingness of some homeowners to walk away from their mortgage and allow their home to be foreclosed on.[84] As large and influential financial institutions, Fannie and Freddie were able to see their value in the marketplace and hedge their bets that the market would not survive their failure. The collateralization of MBSs allowed banks to increase their risky lending practices; rather than hold on to a bad loan, banks were able to bundle and sell it with "good loans," thus allowing the buyer to bear the risk of a default.[85] Between 2007–2010, approximately 3.8 million homes were foreclosed on.[86]

In order to understand why Fannie and Freddie were a moral hazard problem for U.S. taxpayers and the federal government, it is imperative to address the issue of the implicit guarantee that "existed" or "did not exist" between the government and the two GSEs. The most telling quote of the "implicit guarantee" conundrum was by Hank Paulson, who upon becoming Treasury Secretary stated, "[Fannie and Freddie are a] disaster waiting to happen," sarcastically adding "[t]ry to go around the world and explain to one leader after another what this implicit-not-explicit government guarantee was about."[87] Certain factors lead to the conclusion that an implicit guarantee exists between the government and the GSEs.[88]

1. Time Inconsistency

Time inconsistency is an economic policy theory that analyzes policy decisions through the potential for long-term adverse effects and short-term optimal decisions.[89] Congress has had a poor history of being time inconsistent. It first provided benefits to Fannie Mae in the 1970s and 1980s after suffering insolvency from interest rate risk; such assistance took the form of both tax benefits and regulatory forbearance.[90] Additionally, Congress provided relief when both the Federal Savings and Loan Insurance Corporation and the Farm Credit System needed liquidity and relief.[91] The lack of consistency

83. *See* Paul Kosakowski, *The Fall of the Market in the Fall of 2008*, INVESTOPEDIA, https://www.investopedia.com/articles/economics/09/subprime-market-2008.asp [https://perma.cc/RR59-TF67] (discussing financial institutions extending mortgages to high-risk individuals); *How did Moral hazard contribute to the 2008 Financial Crisis?*, INVESTOPEDIA, https://www.investopedia.com/ask/answers/050515/how-did-moral-hazard-contribute-financial-crisis-2008.asp [https://perma.cc/6N6F-C7HX].

84. *How did Moral hazard contribute to the 2008 Financial Crisis?*, *supra* note 83.

85. *Id.*

86. Sharanda Dharmasankar & Bhash Mazumder, *Have Borrowers Recovered from Foreclosures During the Great Recession?*, 2016 CHI. FED. LETTER (2016), https://www.chicagofed.org/publications/chicago-fed-letter/2016/370 [https://perma.cc/8LBK-9A2M].

87. MCLEAN, *supra* note 5, at 35.

88. *See* David Reiss, *The Federal Government's Implied Guarantee of Fannie Mae and Freddie Mac's Obligations: Uncle Same Will Pick Up the Tab*, 42 GA. L. REV. 1019, 1046 n.124 (2008).

89. AGNES BENASSY-QUERE ET AL., *supra* note 82, at 88–90. Using the same facts as my previous example concerning flood plains, a time inconsistency would be when the government tells individuals that they will not help victims who build their homes in the flood plains, but after the flood occurs, they find it either socially or politically optimal to help the flood victims. *Id.* Over time, this inconsistency breeds credibility issues because regardless of what policymakers say, individuals will simply take the risk expecting the ex-post bailout. *Id.* This shows how time inconsistency issues facilitate moral hazard dilemmas.

90. FED. HOUSING FIN. AGENCY OFF. INSPECTOR GEN., *supra* note 12, at 1.

91. Reiss, *supra* note 88, at 1073–74.

establishes a default presumption that relief will be provided. While it makes sense that Congress would not let a corporation it chartered fall into insolvency and cause a housing market crash of colossal proportions, this time-inconsistency issue applies to non-government entities as well. The 2008 bailouts are evidence of Congress's ex-ante denial of assistance and ex-post big budget bailout.[92]

This moral hazard dilemma and continued time inconsistency is a material issue that needs to be resolved before any meaningful steps can be taken to release Fannie and Freddie from conservatorship. Otherwise, any step to privatize the two GSEs will inherently carry the stain of a government bailout that will be a constant reminder of Congress's continued time inconsistency, and taxpayers will inevitably remain on the hook for the next big crisis.

2. Privileged Status

Fannie Mae and Freddie Mac have received special privileges as compared to other private companies for having been charted as GSEs.[93] The privileged status that accompanied the GSEs shows that a major moral hazard exists within the structure of the GSEs, and barring a major structural change, the moral hazard will continue to exist. What follows is a list of three examples which would arguably pose a sufficient government connection to assume an implicit guarantee exists between Congress and the two GSEs.

First, Fannie Mae and Freddie Mac are required to serve the dual purpose of profiting for shareholders and providing financing to low-and moderate-income families.[94] Because a majority of publicly traded corporations only serve the single mandate of making a profit for the shareholders, the GSEs mandate shows a significant tie to the government.[95] Second, the President of the United States is able to appoint five of eighteen individuals to the Board of Directors.[96] When the Executive has such a direct impact on decision making within the corporation, and in turn, the corporation has such a large economic effect, it is reasonable to assume that the government is backing them and investors can have full faith in the creditworthiness of the institution. Third, other branches of the government are able to treat Fannie Mae and Freddie Mac products as if they were government products.[97] The Treasury is allowed to purchase debt from Fannie and Freddie, and since "[a]ll redemptions, purchases, and sales by the Secretary of the Treasury" are "treated as public debt transactions of the United States," the government is essentially transforming Fannie and Freddie's debt into federal obligations,[98] as well as stating that this product is creditworthy enough to be trusted in the government's coffer.

In addition to the aforementioned privileges, the two GSEs also received federal and state tax breaks, SEC registration and filing exemptions, as well as collateral benefits like lower financing costs because investors perceived the institutions as safe investments,

92. Merle, *supra* note 52.

93. Reiss, *supra* note 91, at 1061–66.

94. Financial Institutions Reform, Recovery and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183 § 731 (1989); MCLEAN, *supra* note 5, at 17.

95. Reiss, *supra* note 91, at 1052–53.

96. *Id.* at 1054.

97. *Id.* at 1058–61. The Treasury is allowed to purchase Fannie and Freddie's debt. *Id.* at 1058–59.

98. *Id.* (quoting 12 U.S.C. § 1455(c)(5)).

thus keeping interest rates low.[99]

B. Shareholder litigation

After the third stock agreement amendment was passed by Congress, shareholders began to file suit against the Treasury for a wide variety of issues ranging from statutory challenges to constitutional challenges of FHFA's structure.[100] *Collins v. Mnuchin* was argued in front of the Supreme Court on December 9, 2019, and the Court announced the ruling on June 23, 2021. The argument focused on the constitutionality of the FHFA's structure and the validity of the Third Amendment to the preferred stock purchase agreement, which took place under the purported unconstitutional structure of the FHFA.[101] The Supreme Court's ruling in *Collins v. Yellen*[102] will undoubtedly have a substantial impact on Fannie Mae's and Freddie Mac's future. The point of the following analysis is to look at what remains after the Supreme Court's ruling to help understand how Fannie's and Freddie's future may be affected by more litigation.

1. The Constitutional Structure Challenge

The Housing and Economic Recovery Act (HERA) created the FHFA to regulate and act as a conservator or receiver for Fannie and Freddie.[103] The FHFA's governing statute provides that the director serves a five-year term, "unless removed before the end of such term for cause by the President."[104] The petitioners in *Collins v. Mnuchin* argue that the "for cause" removal provision along with ancillary structural features within the agency are violating the separation of powers by not allowing the director to be adequately held accountable or controllable to the executive branch.[105] While the goal of an independent agency is to be independent enough to protect long term policy objectives without having to serve at the whim of someone else, the independence cannot be so far removed as to be considered isolated.[106] The President must still be able to fulfill his constitutional obligations of ensuring that the nation's laws are faithfully executed.[107] The application of the "for cause" removal clause to the present case introduced some interesting dynamics, and the GSEs' futures are quite reliant on how future litigation unfolds.

As respondent, the government did not want to argue that the FHFA's structure was constitutional, so an Amicus Curiae was appointed to argue the issue.[108] It is worth

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99. Boyle, *supra* note 28, at 172–73.

100. Collins v. Mnuchin, 938 F.3d 553, 568 (5th Cir. 2019), *aff'd in part, rev'd in part, remanded in part sub nom.* Collins v. Yellen, 141 S. Ct. 1761 (2021); *see* Perry Capital LLC. v. Mnuchin, 864 F.3d 591 (D.C. Cir. 2017); *see* Continental W. Ins. Co. v. FHFA, 83 F. Supp. 3d 828, 838 (S.D. Iowa 2015) (enumerating the claims brought by the plaintiffs).

101. Brief for Petitioner at 1, Collins v. Mnuchin, No. 19-422 (Sep. 16, 2020).

102. Collins v. Yellen, 141 S. Ct. 1761 (2021).

103. Collins v. Mnuchin, 938 F.3d 553, 568 (5th Cir. 2019) *sub nom*. Collins v. Yellen, 141 S. Ct. 1761 (2021).

104. 12 U.S.C.A. § 4512 (Westlaw through Pub. L. No. 102-550).

105. Collins v. Mnuchin, 896 F.3d 640, 659 (5th Cir. 2018), *overruled in part,* 938 F.3d 553 (5th Cir. 2019) (affirmed the decision on the constitutional issue discussed in text).

106. Collins v. Mnuchin, 896 F.3d 640, 659 (5th Cir. 2018).

107. U.S. CONST. art. II § 3.

108. Transcript of Oral Argument at 2, Collins v. Yellen, 141 S. Ct. 1761 (2021) (No. 19-422, No. 19-563),

noting that the government agreed that the petitioner was entitled to relief on the constitutional issue, concurring that the structure of the FHFA when acting under a confirmed director is unconstitutional.[109] However, the facts of the case gave the Court the option of finding the Third Amendment Constitutional, while also determining whether the petitioners were entitled to prospective or retroactive relief.[110]

The petitioners argued that for cause removal provision violates the separation of powers,[111] and since the Third Amendment was adopted and imposed under an unconstitutionally structured agency, the adoption of the Third Amendment should be void *ab initio*.[112] The outcome of this argument would have had substantial implications, not only on Fannie and Freddie, but also other agencies, such as the Social Security Administration and even the Federal Reserve, who are similarly structured.[113] The petitioners' argument seemed to be unaware of the fact that the GSEs needed the financial assistance that came through conservatorship with the FHFA. To argue that the Third Amendment was unconstitutional also means, by implication, that the Second and First amendments were also unconstitutional,[114] thus depriving Fannie and Freddie of any financial assistance through the recession. However, as the petitioner pointed out during oral arguments, certain statute of limitation provisions would prevent some actions from being retroactively found void. Still, the implication is hard to wrap one's head around.[115] The respondent's argument sounds much more practical, while still being supported by law.[116]

The Amicus Curiae, Aaron Nielson, appointed by the Court to argue the constitutionality of the Third Amendment and the structure of the FHFA, made practical and textually supported arguments favoring the government's position that the petitioners are only entitled to prospective relief on their constitutionality argument.[117] When the Third Amendment was adopted, the director of the FHFA was only an acting director, rather than a senate-confirmed director.[118] Arguably, this means that the acting head was not protected from "at will" removal by the president, and as a result, separation of powers was not violated.[119] Furthermore, the FHFA was only one side of the contract to the third amendment.[120] The United States Treasury was the other party to the contract and the recipient of the Net Worth Sweep. The head of the Treasury was and has always been removable at will by the president.[121] Thus, because both parties to the contract

2020 WL 7263248 [hereinafter Transcript of Oral Argument].

109. Reply and Response Brief for the Federal Parties at 23, Collins v. Yellen, 141 S. Ct. 1761 (2021) (No. 19-422, No. 19-563), 2020 WL 6322317.

110. *See generally id.* at 23–31; Transcript of Oral Argument, *supra* note 108, at 39–61.

111. For a more in depth understanding of the separation of powers argument *see* Seila L. LLC v. CFPB, 140 S. Ct. 2183 (2020).

112. Brief of Patrick J. Collins at 62–66, Collins v. Yellen, 141 S. Ct. 1761 (2021) (No. 19-422, No. 19-563), 2020 WL 5731206.

113. *See generally* Transcript of Oral Argument, *supra* note 108, at 41.

114. *Id.* at 36.

115. *See id.* at 84 (responding to Justice Kagan's statistic that 17 million decisions have been made at the Social Security Administration, an agency the petitioner's argument implicates as being unconstitutional).

116. *See* Transcript of Oral Argument, *supra* note 108, at 40 (outlining Respondent's argument).

117. *Id.* at 40–61.

118. Brief for Respondent at 31, Collins v. Mnuchin, No. 19-422 (Oct. 23, 2020).

119. *Id.*

120. Collins v. Mnuchin, 938 F.3d 553, 568 (5th Cir. 2018).

121. HENRY B. HOGUE ET AL., CONG. RSCH. SERV., INDEPENDENCE OF FEDERAL FINANCIAL

were removable at will by the president at the time the third amendment was entered, it is unlikely that the act was a violation of separation of powers.

The Supreme Court affirmed the lower court's decision in part, reversed in part, and remanded in part.[122] Ultimately, the Court determined that the FHFA's removal clause was unconstitutional and must be excised from the statute. This Note will only focus on the Court's holding regarding the Constitutionality of the third amendment and its future implications for Fannie Mae and Freddie Mac.

First, despite the unconstitutionality of the FHFA's structure, the Court held that the shareholders are not entitled to prospective relief on the third amendment issue.[123] After the oral arguments were held, the Treasury and FHFA ratified a fourth amendment to the stock purchase agreement that repealed the third amendment, thus, mooting one of the shareholders' claims.[124] Since the third amendment was no longer causing the shareholders harm, they were not able to seek prospective relief.[125]

Second, the Court determined that the third amendment was not void *ab initio*.[126] The third amendment was implemented under an acting director.[127] An "acting" director is not protected by the "for cause" removal clause.[128] Therefore, if the acting director was constitutionally appointed, the director's actions would not implicate separation of powers concerns because the director would be removable at will by the president.[129] The Court found that there were no concerns with the acting director's appointment and, as a result, the third amendment was constitutionally sound at the time it was implemented, and through the duration of the acting director's tenure.[130] Similarly, the Court decided that any actions taken by appropriately appointed directors and officials concerning the third amendment would not be void or found per se harmful.[131]

Third, the Court remanded the case to the district court to determine whether any harm occurred to the shareholders that warranted retroactive relief.[132] Despite the FHFA having the authority to adopt the third amendment and the directors and head officials being properly appointed, the Court conceded that it was conceivable to imagine a scenario where the FHFA's unconstitutional structure could have harmed the shareholders.[133] On remand, the shareholders will have to show cognizable harm caused by the FHFA's "for cause" clause and a violation of the third amendment to be entitled to retroactive relief.[134]

While the Supreme Court's decision in *Collins v. Yellen* may not have been the blockbuster the shareholders were hoping for, the future path of Fannie and Freddie will

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REGULATORS: STRUCTURE, FUNDING, AND OTHER ISSUES 15–16 (2017), https://sgp.fas.org/crs/misc/R43391.pdf [https://perma.cc/J7UL-QSS6].

122. Collins v. Yellen, 141 S. Ct. 1761 (2021).
123. *Id.* at 1787.
124. *Id.* at 1779–80.
125. *Id.*
126. *Id.* at 1787–88.
127. Collins v. Yellen, 141 S. Ct. 1761, 1788 (2021).
128. *Id.* at 1782–83, 1788.
129. *Id.*
130. *Id.*
131. *Id.* at 1788.
132. *Id.* at 1787–89.
133. Collins v. Yellen, 141 S. Ct. 1761, 1788–89 (2021).
134. *Id.* at 1788.

be influenced by the district court's decision. The two GSEs must have a strong capital backing to operate safely in the economy without direct government involvement. Should the district court determine that retroactive relief is warranted, the money should be retained by Fannie and Freddie rather than being distributed to shareholders. This would allow the two GSEs to accelerate their progress to meet their capital requirement, at which point, they could be transitioned into private ownership.

C. Privatizing the GSEs

A privately held and run Fannie and Freddie with no dual mandate may seem ethereal, but it is a very tangible outcome. On December 19, 2004, the U.S. Treasury completed the privatization of Sallie Mae.[135] In 1996, the SLMA Reorganization Act started the process of reorganizing Sallie Mae into a privately held corporation called SLM Corporation.[136] Despite the process taking eight years, it was completed four years ahead of the September 30, 2008 congressionally-set deadline.[137] Furthermore, the process of transitioning Sallie Mae into a private entity gave Congress a 326-page report titled *Lessons Learned from The Privatization of Sallie Mae* to assist in Fannie and Freddie's transition.

The privatization of Fannie and Freddie may not result in a socially beneficial outcome—remember that part of Fannie and Freddie's mandate for being GSEs is to help facilitate a certain number of mortgages for low- and middle-income homebuyers.[138] When Sallie Mae was privatized, the government's goal of sending people to college was replaced with the for-profit motives of a private corporation.[139] Thus, when under a purely private corporate form, it is likely that the corporation's duty to profit for shareholders will come at the cost of all the low- and middle-income stakeholders in the housing market.

IV. RECOMMENDATION FOR THE FUTURE FANNIE AND FREDDIE

This Note presents two competing recommendations. The first examines a scenario where Fannie and Freddie are privatized.[140] In this scenario, a return to the pre-conservatorship status quo is not sufficient. A move back to the private sector will require a high capital requirement and a removal of all privileges that gave the two GSEs an advantage in the market and contributed to the moral hazard issue.[141] The inclusion of a

135. Press Release, U.S. Dep't of the Treasury, Treasury Announces Successful Privatization of Sallie Mae (Dec. 29, 2019), https://www.treasury.gov/press-center/press-releases/Pages/js2173.aspx [https://perma.cc/4P4R-2G9W].

136. *Id.*

137. *Id.*

138. FED. HOUSING FIN. AGENCY OFF. INSPECTOR GEN., *supra* note 12, at 3.

139. *See* Eric Westervelt, *'I'm a Student-Debt Slave.' How'd We Get Here?*, NPR (July 11, 2016, 7:07 AM), https://www.npr.org/sections/ed/2016/07/11/484364476/im-a-student-debt-slave-howd-we-get-here [https://perma.cc/KN5J-L59F] (interviewing a Center for Investigative Reporting journalist on how the mission of student lending Giant Sallie Mae shifted following privatization: from the modest task of creating a market for student debt issued by the federal government to the "full-service, for profit corporation that really 'verticalized' its involvement I the student loan industry, everything from issuing loans to running collection bureaus.").

140. *Infra* Part IV.B.

141. Boyle, *supra* note 28, at 181–82.

"living will" will also help reduce the risk of moral hazard by showing investors that there is a clear path laid out to receivership if the GSEs fall into dire financial straits again.[142]

The second recommendation involves a scenario where the two GSEs are removed from conservatorship and nationalized.[143] This plan would keep them in their current conservatorship position and allow for the profits of the two GSEs to continue to be swept by the treasury. However, some changes would have to be made to enhance the soundness of the GSEs operation. For example, pausing the current net worth sweeps in order to allow Fannie and Freddie to build a capital buffer that would be efficient at buffering the taxpayers from losses when the mortgage market inevitably experiences trouble once again. Nationalizing Fannie and Freddie would also guarantee that the profit is being socialized along with the risk.[144] With both scenarios presented, the most legally appropriate solution is to privatize the two GSEs in a manner similar to Sallie Mae. However, the most socially optimal outcome would be to keep the two GSEs nationalized. The following sections express the reasoning behind the conclusion, as well as the options needed to alleviate the problems previously discussed.

A. The Capital Requirement

The capital requirement is essential to both scenarios; it serves the function of protection against the need for government bailout and ensures the liquidity of the entities to function even in distressing times.[145] This recommendation takes the position that a capital requirement would benefit Fannie and Freddie, even under a structure where they are nationalized, for two primary reasons. First, despite being nationalized, should the two entities become insolvent, the government would have to step in and provide liquidity using taxpayer money. While this would be easier to do from a mechanistic point of view, the result is still not desirable. Enforcing a capital requirement under a nationalized Fannie and Freddie would help prevent insolvency and the need for government intervention through tax-payer money. Second, maintaining a capital requirement under a nationalized structure would be easier than if the entities were public, because the entities do not have to worry about paying dividends to shareholders, and a high capital requirement may be maintained without worrying about fiduciary duties. Practically speaking, any money in excess of the capital requirement would be swept to the treasury. Under a nationalized structure there is no pressure from

142. *See* Norbert Michel, *Strict Bank-Like Capital Rules Needed for Fannie Mae and Freddie Mac*, HERITAGE FOUND. (Mar. 9, 2020), https://www.heritage.org/markets-and-finance/report/strict-bank-capital-rules-needed-fannie-mae-and-freddie-mac#:~:text=To%20absorb%20losses%2C%20taxpayer%2Dbacked,1%20ratio%20for%20large%20banks [https://perma.cc/ZME7-ZG56] (arguing that the FHFA should hold Fannie and Freddie to higher regulatory capital requirements, deleveraging the GSEs to prevent them from becoming insolvent yet again).

143. *Infra* Part IV.C.

144. Boyle, *supra* note 28, at 180 (stating that the GSEs benefiting from their implicit guarantee and government privileges have been "privatizing profits but socializing risk").

145. James Chen, *Capital Requirements*, INVESTOPEDIA, https://www.investopedia.com/terms/c/capitalrequirement.asp#:~:text=Capital%20requirements%20are%20set%20to,OL)%20while%20still%20honoring%20withdrawals [https://perma.cc/D7G2-9Y8N]. Capital requirements are regulations that require a financial institution to hold a certain amount of their asset level as liquid capital. *Id.* The main function of a capital requirement is to ensure that financial institution's balance sheet is not dominated by assets that increase their risk of default and allow them to honor their obligations even in the time of an operating loss. *Id.*

shareholders to have a lower capital requirement in order to have larger dividend payments. Additionally, Fannie and Freddie's status as a GSE does not warrant a lesser capital requirement based on the illusion that they are regulated with greater ease or under more scrutiny than private financial institutions. Fannie's and Freddie's own history is evidence that GSE regulation is not error free.[146]

What the capital requirement should be depends on many factors and is generally open to much scholarly debate.[147] However, the FHFA's proposed rule that requires the GSEs to hold capital that equates to four percent of their assets is far too little for the importance they have within our economy.[148] For comparison, the largest global systemically important banks (G-SIBs) have a capital requirement ratio that equates to 14.07%.[149] This Note recommends the capital requirement for Fannie and Freddie be at least equal to the G-SIBs, if not more. Fannie and Freddie are immensely important to not only the U.S. economy but also the world economy.[150] Fannie and Freddie have assets that total more than $6 trillion, an amount that equals nearly half the combined total assets of the eight U.S. banks designated as G-SIBs.[151] Additionally, Fannie and Freddie are unique in that all of their assets are concentrated in one asset type, mortgages. The lack of diversification makes them particularly susceptible to incurring devastating losses in connection to a single event, like what we saw happen during the Great Recession.[152]

This Note recommends a capital requirement similar to the Minneapolis Plan to End Too Big to Fail.[153] The Minneapolis Plan requires equity capital to be set at 23.5% which

146. *See* FED. HOUSING FIN. AGENCY OFF. INSPECTOR GEN., *supra* note 12, at 6 (discussing Fannie and Freddie's accounting problems); Santos, *supra* note 19, at 96 (discussing the Fannie Mae accounting scandal in which the entity overstated its profits).

147. *See Minneapolis Fed Releases Final Plan to End Too Big to Fail*, FED. RSRV. BANK OF MINNEAPOLIS (Jan. 10, 2018), https://www.minneapolisfed.org/news-releases/2018/minneapolis-fed-releases-final-plan-to-end-too-big-to-fail [https://perma.cc/6HMS-GSN7] (explaining that leaving capital requirements at current levels leaves taxpayers at risk of future crisis or bailout); *see also New "Too Big to Fail" Capital Requirements for Globally Systemically Important Banks in Switzerland*, FINMA (Oct. 21, 2015) (discussing the need for capital requirements to be increased); Dwight Smith, *The Impact of Dodd-Frank and Capital Requirements on Commercial Lending*, PRAC. GUIDANCE J. (Aug. 3, 2016), https://www.lexisnexis.com/lexis-practical-guidance/the-journal/b/pa/posts/the-impact-of-dodd-frank-and-capital-requirements-on-commercial-lending#:~:text=Title%20I%20of%20Dodd%2DFrank,to%20set%20more%20stringent%20standards [https://perma.cc/2UF3-Q2MW] (noting the use of two types of ratios used commonly for measuring capital adequacy).

148. Katie O'Donnell, *Fannie, Freddie Pose Risk to Financial System, Panel Says in "Historic" Finding*, POLITICO (Sept. 25, 2020, 5:48 PM), https://www.politico.com/news/2020/09/25/fannie-mae-freddie-mac-financial-risk-421814 [https://perma.cc/M4PC-VSAK].

149. Michel, *supra* note 142.

150. *See* MCLEAN, *supra* note 5, at 74–75 ("By 2000 . . . foreigners owned $348 billion in Fannie and Freddie securities; by 2004, they owned $875 billion.").

151. O'Donnell, *supra* note 148. The eight U.S. Based G-SIBs are: JP Morgan Chase, Citigroup, Bank of America, Goldman Sachs, Wells Fargo, Bank of New York Mellon, Morgan Stanley, and State Street. *2019 List of Globally systemically Important Banks (G-SIBS)*, FIN. STABILITY BD. (Nov. 22, 2019), https://www.fsb.org/wp-content/uploads/P221119-1.pdf [https://perma.cc/93B9-CTZB].

152. It is common knowledge in the investing world that spreading out investments into different financial instruments, industries, and categories reduces risk against loss. Nick K. Lioudis, *The Importance of Diversification*, INVESTOPEDIA (Jan. 29, 2021), https://www.investopedia.com/investing/importance-diversification/#:~:text=Diversification%20is%20a%20technique%20that,differently%20to%20the%20same%20event [https://perma.cc/A2WH-LSCF].

153. *See* FED. RSRV. BANK OF MINNEAPOLIS, THE MINNEAPOLIS PLAN TO END TOO BIG TO FAIL 126 (2018), https://www.minneapolisfed.org/policy/endingtbtf/final-proposal [https://perma.cc/2LUB-WMD9]

would equate to a leverage ratio[154] of 15% of the institution's total assets.[155] The use of the leverage ratio helps prevent situations where the risk weights assigned to an asset are too low.[156] This represents a stark deviation from the 4% suggested by the FHFA.[157]

Once a capital rule is accepted, the net worth sweeps that the Third Amendment authorized must be halted in order to allow the two GSEs to build back a strong capital base. On remand, should the district court determine the shareholders suffered harm to warrant retroactive relief, the money should not be diverted directly to shareholders. Rather, the money should be used to fully capitalize the two GSEs appropriately. Rapidly capitalizing on the GSEs will allow them to exit conservatorship without further increasing the costs of their services and much sooner than expected.[158]

It is important to emphasize that the capital requirement will be the same under this recommendation whether the GSEs would return to the private sector or be held and run under the government.

B. Returning to the Private Market

Despite being considered private before the 2008 recession, the two GSEs operated very differently than any other private financial institution. The title of being a GSE came with numerous privileges.[159] Once the capital requirement has been met, the second step of taking the two GSEs private is to reduce their moral hazard as much as possible. This can be accomplished by doing three things. First, take away all privileges from which GSEs benefit. Second, remove all political affiliation from Fannie and Freddie. Lastly, require Fannie and Freddie to create a living will that outlines a plan for receivership should they become insolvent again in the future. By completing each of these three steps the institutions will be adequately informing investors of the risks associated with their investment and neither their stock price nor products will reflect an implicit government guarantee.

(proposing a set of regulatory tweaks aimed at deleveraging financial institutions and limiting the risk posed by an increasingly consolidated national financial industry).

154. A leverage ratio represents the proportion of debt an institution has compared to its equity/capital. *Leverage Ratio*, ECON. HELP, https://www.economicshelp.org/blog/glossary/leverage-ratio/ [https://perma.cc/AV54-GLHQ].

155. FED. RSRV. BANK OF MINNEAPOLIS, *supra* note 153, at 126.

156. *Id.* The use of a leverage ratio would help reduce the consequences of underestimating the risk of the mortgage market and the mislabeled MSBs, because the use of a leverage ratio ensures that all assets are treated as being equally risky. *Id.*

157. Michel, *supra* note 142.

158. *See* Hannah Lang, *Fannie, Freddie will Retain $45B in Capital in First Step Toward Privatization*, AM. BANKER (Sept. 30, 2019, 9:00 AM), https://www.americanbanker.com/news/fannie-mae-freddie-mac-will-retain-45-billion-in-capital-in-first-step-toward-privatization [https://perma.cc/2AKQ-DR6K] (stating that the FHFA Director estimated that it would a decade just to collect the capital needed to exit conservatorship). The FHFA has stated that Fannie and Freddie should hold near $240 billion in capital after returning to being private institutions. Andrew Ackerman, *Fannie and Freddie Should Hold $240 Billion in Capital After Return to Private Hands, FHFA Says*, WALL ST. J. (May 20, 2020, 5:41 PM), https://www.wsj.com/articles/fannie-freddie-should-hold-240-billion-in-capital-after-return-to-private-hands-fhfa-says-11590004840 [https://perma.cc/9GKV-54JF].

159. *See supra* Part III.A.2 (discussing the special privileges Fannie Mae and Freddie Mac have received compared to other private companies due to them being chartered as GSEs).

1. Removing the GSEs Privileges

As GSEs with the goal of helping foster increased homeownership and the mandate of facilitating greater credit for lower-income homebuyers, Fannie and Freddie benefited from many government privileges in the marketplace that other private financial corporations did not have.[160] These privileges included exemption from all federal, state, and local taxes (except for property taxes).[161] Both GSEs' debts are sellable to the Federal Reserve, a privilege generally held only by the United States Treasury.[162] The privilege of being able to sell to the Federal Reserve Bank can have a serious effect of strengthening implicit bias. Section 14(b) of the Federal Reserve Act gives the Federal Reserve Bank the power to "buy and sell in the open market . . . any obligation which is a direct obligation of, or fully guaranteed as to principal and interest by, any agency of the United States."[163] Thus, 12 U.S.C. §355(2) should be read in context to mean that a security issued by Fannie and Freddie is a direct obligation of the United States. Lastly, Fannie and Freddie's securities are characterized as government securities, which exempts them from federal securities regulation. This means that neither GSE has to register or file financial statements with the SEC.[164] Each of these privileges showcases competitive advantages within the marketplace and strengthened connections between the GSEs and the federal government. Ridding the GSEs of the aforementioned privileges will help cut the ties associated with the implicit guarantee and will help transition the GSEs into fully private entities without being as great of a risk to the taxpayers. The political associations embedded in the structure of Fannie and Freddie introduces the next change needed to assure a fully independent Fannie and Freddie.

2. Depoliticizing Fannie and Freddie

Fannie Mae and Freddie Mac are political behemoths.[165] During the flush pre-Recession years, a running quip had it that "scoring an executive post at Fannie Mae is recognized around establishment Washington as the equivalent of winning the lottery."[166] Fannie and Freddie were described as the housing industrial complex[167]—a reference to alliance between politicians, Fannie and Freddie, and other actors who had large stakes in the American Mortgage market.[168] Fannie and Freddie had built such an image that they "faced little organized political opposition," and were so ruthless as to build the reputation of "they will castrate you, decapitate you, tie you up, and throw you in the Potomac."[169] It is easy to understand the lack of oversight and the presence of an implicit guarantee with a reputation of the pedigree Fannie and Freddie had. Furthermore, it makes sense that little to no legislation was passed curtailing their power when so much

160. Boyle, *supra* note 28, at 173.

161. 12 U.S.C. § 1452(e) (2000); Boyle, *supra* note 28, at 173.

162. 12 U.S.C. §347.

163. 12 U.S.C. §355(2); Reiss, *supra* note 88, at n.197.

164. 15 U.S.C. §78c (42) (2000); Boyle, *supra* note 28, at 172, n.68.

165. *See* MCLEAN, *supra* note 5, at 71–75 (detailing the political influence wielded by Fannie and Freddie during what McLean dubs the "Roaring Nineties."); Boyle, *supra* note 28, at 182–83.

166. MCLEAN, *supra* note 165, at 59 (quoting the Washington Monthly).

167. *Id.*

168. *Id.* at 60.

169. *Id.* (quoting Dan Mudd and International Economy, respectively).

time, energy, and political capital was spent on lobbying to prevent the restriction of power.[170] However, for Fannie and Freddie to operate as a private institution in a private market, they need to be cut off from their political ties. They should not have the lobbying force, they cannot be a hiring magnet for powerful Washington insiders, the President of the United States of America should not be able to appoint board members, and the government should not mandate a mission for the institutions to follow.

3. Establishing a Living Will

A living will for financial institutions establishes their contingency plan for if or when the institution becomes financially insolvent and serves to inform regulators how a financial institution can be soundly closed or broken up.[171] However, a living will can serve a practical purpose even when the bank is still solvent. Because the living will requires a complete working plan of how to wind down a bank during insolvency, a living will often requires close review and scrutiny over the structure of the corporation.[172] Thus, upon making a living will, an institution can recognize deficiencies and rework its structure to be more efficient and profitable overall. A downside of the living will is rating agencies are more likely to give the financial institution's products lower ratings as a reflection of their lack of "too big to fail" status and the increased likelihood that they will be allowed to fail.[173] A market correction of this sort should be welcomed rather than criticized in the housing market.

C. Keeping Fannie and Freddie Nationalized

The second option pertaining to Fannie Mae's and Freddie Mac's status is to keep them nationalized. This option has rightly been met with much criticism. However, it is a viable option. The main obstacle associated with nationalizing Fannie and Freddie is the large amount of debt they would bring to the budget deficit (which is one of the primary reasons they were allowed to be private corporations in the first instance).

However, a benefit would be the ability of the government to be more proactive in its housing policies. In addition to funding mortgages for Americans (as has been done), it is also possible for the U.S. government to focus on housing goals that are more environmentally friendly and cost effective.

D. Supreme Court's Ruling in Collins v. Yellen

On June 23, 2021, the Supreme Court released its decision in *Collins v. Yellen*.[174] As many anticipated, the Court determined that the structure of the FHFA is unconstitutional and the "for cause" removal provision must be severed.[175] However, the Court held that the third amendment did not need to be undone in its entirety because it was adopted by a properly appointed acting director who was removable at will by the

170. *See* MCLEAN, *supra* note 5, at 61; Boyle, *supra* note 28, at 182–83.

171. Mark Kolakowski, *Learn About Living Wills for Banks*, BALANCE CAREERS (June 25, 2019), https://www.thebalancecareers.com/living-wills-for-banks-1287171 [https://perma.cc/QXC3-LRTQ].

172. *Id.*

173. *Id.*

174. Collins v. Yellen, 141 S.Ct. 1761 (2021).

175. *Id.* at 1783–84.

president.[176] Also, all other heads of the FHFA during the tenure of the third amendment were properly appointed.[177] For these reasons, the Court determined "there is no reason to regard any of the actions taken by the FHFA in relation to the third amendment as void."[178] The Court, however, did not rule out the possibility of retroactive relief, so the Court remanded the issue of retroactive relief to the district court to find whether the shareholders were in fact harmed.[179] Should the district court determine that the shareholders were harmed, and thus entitled to retroactive relief, the money taken in excess of what the Treasury gave to GSEs in the form of a bailout should not be distributed to the shareholders. Instead, the money should be held by the two GSEs to restore them to an adequate capital backing or be put towards the principal to pay down the Treasury's preferred liquidation preference, which stands at $228.7 billion.[180] Allowing the GSEs to hold the money as capital would immediately decrease the risk carried by taxpayers. However, allocating the money as a payment to the preferred liquidation preference would be a big step towards privatizing Fannie and Freddie, a result that seems ethereal after the last twelve years. Reducing the taxpayer's risk of another bailout should be the first priority of both the GSEs and the FHFA, especially in light of the global pandemic and being on the brink of another economic recession.

V. CONCLUSION

This Note recommends Fannie and Freddie be released from their status under conservatorship to be private corporations in the secondary housing market fueled by private investors. In order to once again move into the private sector, this Note recommends four conditions be met to better protect future taxpayers from another bailout. First, they are to have a capital requirement in accordance with the Minneapolis Plan ending too big to fail. Second, they must institute a living will that their regulator finds sufficient in the case of insolvency. Third, they are going to be cut off from their previous operating privileges as GSEs and compete in the housing market on equal footing with other financial institutions. Fourth, they are to be depoliticized in accordance with Part III(2)(iii). Furthermore, should the district court determine the shareholders are entitled to retroactive relief, and any money that could be returned to Fannie and Freddie should not be used to pay dividends to its shareholders. The excess money should be reinvested into the GSEs to help meet their capital requirement and accelerate their transition into the private marketplace or pay down the preferred liquidation preference in order to begin cutting the ties of conservatorship and follow in the footsteps of Sallie Mae. Taking the aforementioned steps would help protect taxpayers from future bailouts and allow the invisible hand to once again guide the mortgage market. Thus, ending the government's socialization of housing.

176. *Id.* at 1787.

177. *Id.*

178. *Id.*

179. *Id.* at 1788–89.

180. Press Release, U.S. Dep't of the Treasury, Treasury Department and FHFA Amend Terms of Preferred Stock Purchase Agreements for Fannie Mae and Freddie Mac (Jan. 14, 2021), https://home.treasury.gov/news/press-releases/sm1236 [https://perma.cc/D2JW-QUL2].