

# Handling the Failure of Fannie Mae and Freddie Mac

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In the interest of brevity, this paper omits most footnotes.  
Readers can find citations and additional detail in the article.

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# Handling the Failure of Fannie Mae and Freddie Mac

Fannie Mae and Freddie Mac are privately owned corporations known as government-sponsored enterprises (or GSEs) because of their special ties to the U.S. Government.<sup>1</sup> They are huge and have been growing rapidly. For example, from 1993 through 2003, their combined total liabilities (mostly in the form of debt securities) rose 514%, from \$286 billion to \$1.76 trillion. The two GSEs' expansion has far outstripped inflation and macroeconomic growth. It has also outstripped the applicable legal and regulatory framework.

This paper focuses on a particular weakness in that framework: the lack of an adequate legal mechanism for handling the failure of Fannie or Freddie. The lack of such a mechanism is, I believe, the single most serious weakness in U.S. financial institution law. As a federal instrumentality, a GSE cannot liquidate or reorganize under the Bankruptcy Code. No adequate alternative mechanism exists for Fannie or Freddie. If such a firm became sufficiently troubled, its regulator could have a "conservator" take control of the firm and attempt to restore the firm's financial health. But by then the firm's problems might well have become too severe for the conservator to resolve. The conservatorship statute provides no means for effectuating a reorganization,<sup>2</sup> nor does it expressly authorize a liquidation. Uncertainty about the priority and process for handling claims could worsen the firm's problems and increase the risk of disrupting financial markets and eliciting a costly congressional rescue.

This paper will briefly discuss the meaning of GSEs' government sponsorship (Part I); explain why GSEs cannot liquidate or reorganize under the Bankruptcy Code (II); summarize the specialized insolvency regime for banks and note its importance as a model for GSE insolvency law (III); examine the insolvency mechanism for Fannie and Freddie (IV); explore

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<sup>1</sup> Three other GSEs also exist: the Federal Home Loan Bank System, the Farm Credit System, and the Federal Agricultural Mortgage Corporation (Farmer Mac).

<sup>2</sup> "Reorganization" refers here to modifying creditors' claims, such as by extending repayment, varying other credit terms, or converting some debt to equity. It does not include a "recapitalization," which here denotes raising equity without modifying creditors' claims.

the potential consequences of that mechanism's inadequacy (V); and discuss ways of correcting the deficiencies of that mechanism, including recent congressional proposals to authorize receivership (VI).

## **I. GOVERNMENT-SPONSORED ENTERPRISES**

Federal statutes give GSEs various benefits unavailable to ordinary private firms.<sup>3</sup> These benefits reduce GSEs' expenses. More importantly, the benefits reduce GSEs' borrowing costs by persuading bond-market investors that the government implicitly backs GSEs—and would not let GSEs' creditors go unpaid. Why else, investors might ask, would Congress exempt GSEs and their securities from the federal securities laws? Why else would Congress exempt GSE securities from the usual limits on depository institutions' investments in nongovernmental securities? These and other statutes treat GSE securities as having little or no risk—like U.S. Government securities and unlike even the most highly rated corporate securities. Investors' perception that the government implicitly backs GSEs is the GSEs' most important and most distinctive characteristic. That perception impairs market discipline on the GSEs and helps them grow at the expense of better-capitalized competitors.

The perception persists despite disclaimers of government liability for GSEs' obligations. These disclaimers—ostensibly designed to protect the government—focus on formal, legally enforceable liability, say nothing about implicit backing, and may thus, ironically, reinforce the perception of implicit government backing.

That perception is often mischaracterized as an “implicit government guarantee,” as though the government had already guaranteed GSEs' obligations but not formally expressed that guarantee. Yet from a legal standpoint an implicit financial guarantee is practically a

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<sup>3</sup> These benefits include: granting GSEs federal charters, which can preempt state laws; authorizing the Secretary of the Treasury to extend credit to GSEs; exempting GSEs from most state and local taxes; exempting GSEs from having to register their securities under the Securities Act of 1933 and the Securities Exchange Act of 1934; imposing no limits on federally chartered depository institutions' investments in GSE securities; making GSEs' debt securities and mortgage-backed securities eligible for open-market purchase by the Federal Reserve Banks, eligible collateral for deposits of public funds and for loans from Federal Reserve Banks, and lawful investments for fiduciaries; and permitting GSEs to issue and transfer securities through the Federal Reserve's electronic book-entry system, the system used for issuing and transferring U.S. Treasury securities.

contradiction in terms—akin to a “mental will” (purporting to dispose of one’s property after one’s death) or an “oral traveler’s check.” In fact, “implicit guarantee” refers not to what the government *has done* but to investors’ belief about what the government *would do* if a GSE failed. Using “government guarantee” to describe investors’ behavior tends to bias analysis by insinuating that the government has a moral obligation to honor the supposed guarantee. To avoid such problems, this paper refers to investors’ “perception of implicit backing” and GSEs’ “perceived implicit backing.”

Although the lack of an adequate insolvency mechanism for Fannie and Freddie strongly reinforces the perception of implicit backing, it is distinguishable from that perception. Investors perceive the government as implicitly backing the Farm Credit System and Farmer Mac, even though adequate insolvency mechanisms already exist for both of those enterprises. Investors also perceive implicit government backing of the Federal Home Loan Bank System, even though the system’s regulator has sweeping authority to liquidate or reorganize any Federal Home Loan Bank.

The lack of an adequate insolvency mechanism for Fannie and Freddie could leave Congress little practical alternative to rescuing those firms’ creditors. That lack therefore fortifies the perception of implicit backing and makes it more like an express guarantee. Enacting a workable insolvency mechanism for Fannie and Freddie would treat them more like the other three GSEs. It would reduce pressure for a congressional rescue but would neither preclude such a rescue nor by itself eliminate the perception of implicit backing.

Traditional mechanisms of government accountability, such as budget rules and appropriations requirements, take no official notice of GSEs’ perceived government backing or even of the costs of GSEs’ explicit government benefits. These official blind spots bias government policy towards perpetuating and expanding GSEs, despite good reasons to doubt GSEs’ efficiency as instruments of public policy.

## II. BANKRUPTCY CODE INAPPLICABLE

GSEs can fail, and the government does not legally guarantee GSEs' obligations. Yet investors' expectation that Congress would rescue GSEs' creditors underscores the importance of having a practical alternative to such a rescue—a workable process for handling a GSE's failure. I will here consider whether the Bankruptcy Code currently provides such a process.

Most firms, including virtually all ordinary business corporations, can liquidate or reorganize under the Bankruptcy Code. Although Congress has enacted specialized insolvency statutes for each GSE, those statutes do not specifically prohibit GSEs from becoming debtors under the Bankruptcy Code. Thus the question arises whether a GSE could liquidate or reorganize under the code.

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

The code does not define "instrumentality," and its legislative history sheds scant light on the term. In ascertaining whether GSEs are federal instrumentalities, we must look to other statutes and general principles of law. Congress has, in fact, declared the two agricultural GSEs "federally chartered instrumentalities of the United States," and implied that the three housing GSEs are also federal instrumentalities. But because these statutes do not conclusively resolve the issue for all five GSEs, we will begin by examining relevant general principles and then turn to the GSE-specific statutes.

An instrumentality, in Thomas H. Stanton's apt definition, "carries out public purposes without being part of the government." The leading federal instrumentality cases arose from states' attempts to tax the Second Bank of the United States, a central bank that existed from

1816 until 1836. Congress had chartered the bank—predominantly owned and controlled by private shareholders—to act as the government’s fiscal agent, maintain a reliable currency, and conduct a general banking business. Although the Constitution did not specifically authorize Congress to create banks or other corporations, *McCulloch v. Maryland* (1819) resoundingly upheld the bank’s constitutionality. The Supreme Court reasoned that Congress could incorporate a bank as a means of exercising its express powers to collect taxes, borrow money, regulate commerce, and support an army and navy. Just as the states had no power to interfere with the federal government’s operations, they had “no power, by taxation or otherwise, to retard, impede, burden, or in any manner control, the operations” of such a federal instrumentality. *Osborn v. Bank of the United States* (1824), in striking down another attempt to tax the bank, stressed that the bank was no “mere private corporation, engaged in its own business,” but “a public corporation, created for public and national purposes.” These public purposes extended to the bank’s ordinary banking business as well as its fiscal agency function: the Court held the ordinary business “essential to [the bank’s] character, as a machine for the fiscal operations of the government” and thus necessarily “as exempt from State control as the actual conveyance of the public money.”

In keeping with *McCulloch* and *Osborn*, courts have classified Fannie, Freddie, the Federal Home Loan Banks, and Farm Credit System institutions as federal instrumentalities. Courts have also classified national banks, federal savings associations, and federal credit unions—which together number more than 8,500 institutions—as federal instrumentalities.

*TI Federal Credit Union v. DelBonis* (1st Cir. 1995) held a federal credit union to be a federal “instrumentality” and thus a “governmental unit” under the Bankruptcy Code. The court based its decision on “a combination of statutory interpretation, case law, and consideration of the factors relevant to federal instrumentality determinations.” It found that federal credit unions “perform important governmental functions,” including “mak[ing] credit available to millions of working class Americans” and serving as fiscal agents of the government and depositories of public funds. It held that these functions, together with tax exemption and “extensive government regulation,” provided “compelling indicia of federal

instrumentality status.” The court concluded that treating credit unions as federal instrumentalities and “governmental units” fit the purpose of the Bankruptcy Code provision in question.

The case for treating GSEs as federal instrumentalities—even without any explicit statute to that effect—is as strong as the case for treating federal credit unions as instrumentalities. Congress established GSEs for purposes as important and as “governmental” as those cited in *TI Federal Credit Union*. These purposes include assisting “the secondary market for residential mortgages (including ... mortgages on housing for low- and moderate-income families ...) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing” and “promot[ing] access to mortgage credit throughout the Nation (including central cities, rural areas, and underserved areas).” Like federal credit unions, GSEs enjoy important tax exemptions. GSEs also face government regulation as extensive as that applicable to federal credit unions. Thus the criteria enunciated in *TI Federal Credit Union*, consistent with those in a long line of nonbankruptcy cases, strongly support classifying GSEs as federal instrumentalities for purposes of the Bankruptcy Code.

This conclusion finds further support in statutes declaring or implying that GSEs are federal instrumentalities. Congress has expressly declared Farm Credit System institutions and Farmer Mac “federally chartered instrumentalities of the United States.” Statutes applicable to the three housing GSEs imply that those firms are also federal instrumentalities. For example, Fannie and Freddie must “insert appropriate language” in their “obligations and securities ... clearly indicating that such obligations and securities ... do not constitute a debt or obligation of the United States or *any agency or instrumentality thereof other than the Corporation.*” Using “other than the Corporation” after “agency or instrumentality” implies that the GSE is a federal agency or instrumentality. As a GSE is not an “agency,” it presumably is an “instrumentality.”

In sum, Congress has expressly declared both agricultural GSEs federal instrumentalities. Congress has implied that the three housing GSEs are also federal instrumentalities, and courts have classified them as such. *TI Federal Credit Union v.*

*DelBonis* dealt specifically with “instrumentality” for purposes of the Bankruptcy Code, holding that federal credit unions are federal instrumentalities and therefore also “governmental units.” The decision followed the general jurisprudence of federal instrumentalities flowing from cases like *McCulloch* and *Osborn*, and placed particular weight on public purposes, tax exemption, and extensive federal regulation—indicia also present in the case of GSEs. Accordingly, GSEs are almost certainly federal “instrumentalities” for purposes of the Bankruptcy Code—and thus, as “governmental units,” cannot be debtors under chapter 7 or 11. Attempting to use the Bankruptcy Code to deal with a faltering GSE would, at the very least, involve legal uncertainty so great as to render the attempt likely to do more harm than good.

### **III. THE MODEL OF BANK INSOLVENCY LAW**

A specialized insolvency regime has long existed for banks, separate from and antedating the Bankruptcy Code and its predecessor. This streamlined, nonjudicial regime has served as a model for GSE insolvency law—just as banking regulation has, more broadly, served as a model for GSE regulation.

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

Banking regulation provides the most important model for GSE financial-soundness regulation. Congress has, for example, drawn on banking law in framing capital, reporting, and prompt corrective action requirements for GSEs and specifying GSE regulators’ examination and enforcement powers.

Using banking regulation as a model for GSE regulation makes sense for substantive and institutional reasons. Banks and GSEs are both financial institutions and face common challenges, including managing credit risk and interest-rate risk and operating with higher ratios of debt to equity than most nonfinancial firms. The congressional committees with jurisdiction over banking—the House Committee on Financial Services and the Senate Committee on Banking, Housing, and Urban Affairs—also have jurisdiction over the three

housing GSEs. Congress responded to the Farm Credit System's near-failure during the 1980s by transforming the Farm Credit Administration into an arm's length financial-soundness regulator modeled on federal bank regulators. When doubts have arisen about the adequacy of existing GSE regulation, critics, GSE regulators, and Congress have often turned to banking law as a source and standard for reform.

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

## **B. Bank Insolvency Law**

Under the specialized insolvency regime for banks, a failed bank's regulator appoints a receiver or conservator for the bank, unilaterally and without prior notice, hearing, or judicial approval. Only the regulator can commence this process; creditors play no formal role. A receiver winds up the bank's business, liquidates the bank's affairs, determines the validity of creditors' claims against the bank, and pays creditors—all in a streamlined and almost purely administrative process.

The Federal Deposit Insurance Act incorporates this approach—as do other federal bank insolvency statutes—and makes it applicable to any depository institution insured by the Federal Deposit Insurance Corporation (FDIC). The act provides for two types of fiduciaries to take control of troubled banks: conservators and receivers. A receiver sells or liquidates the bank. A conservator operates a bank as a going concern, seeking to rehabilitate the bank or prepare it for orderly sale in receivership, and has no authority to liquidate the bank. The bank as a corporate entity still exists at the end of a conservatorship but not at the end of a receivership.

The process for dealing with a bank failure has three basic steps: first, appointing a receiver for the bank; second, marshaling the bank's assets—i.e., identifying and collecting on all items of potential value owned by the bank; and third, using the proceeds of those assets to

pay valid claims against the bank in the order of priority established by law. In handling the failure, the FDIC can use a wide range of legal tools, including tools designed to preserve the failed bank's going-concern value and minimize disruption to the bank's depositors and other customers.

### *1. Appointing Receiver*

The receiver for a bank is normally appointed by the bank's primary regulator, the government agency that issued the bank's charter. If the bank has FDIC insurance, the regulator almost invariably appoints the FDIC as receiver. Many grounds for receivership (or conservatorship) exist.<sup>4</sup>

The practice of appointing a receiver (or conservator) without prior notice, hearing, or judicial approval—as expressly authorized by statute—reflects a judgment that the circumstances will often create a need to act swiftly, decisively, and discreetly. By the time a bank enters receivership, it often has scant net worth and dubious prospects, giving its managers incentives to serve their own interests at creditors' expense and giving its uninsured depositors incentives to run. Both insider misconduct and a run would work against creditors' collective interest in maximizing the value of the bank's assets. In upholding the appointment of a conservator without a prior hearing, the Supreme Court declared:

This is a drastic procedure. But the delicate nature of the institution and the impossibility of preserving credit during an investigation has [sic] made it an almost invariable custom to apply supervisory authority in this summary manner. It is a heavy responsibility to be exercised with disinterestedness and restraint, but in the light of the history and customs of banking we cannot say it is unconstitutional.

The bank does have a right to a prompt post-seizure judicial hearing.

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<sup>4</sup> Some of the more important grounds include (1) illiquidity—i.e., the bank cannot meet its obligations in the normal course of business; (2) balance sheet insolvency—i.e., the bank's liabilities exceed its assets; (3) serious depletion of the bank's capital; (4) failing to submit a capital restoration plan or materially failing to implement such a plan; (5) failing to correct a capital deficiency after having been formally ordered to do so; (6) being in an "unsafe or unsound condition to transact business"; (7) substantially dissipating assets or earnings through a violation of law or an unsafe or unsound practice; (8) concealing records or assets or refusing to let authorized examiners inspect records; and (9) willfully violating a cease-and-desist order.

## ***2. Marshaling Assets***

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

The receiver succeeds to all the bank's "rights, titles, powers, and privileges," and can exercise all the powers of the bank's directors, officers, and shareholders. It can: collect on the bank's assets; transfer loans without the borrowers' consent and deposits without the depositors' consent; terminate burdensome contracts; and merge the bank with another FDIC-insured depository institution. The Federal Deposit Insurance Act generally forbids any court to "take any action ... to restrain or affect the exercise of [the FDIC's] powers or functions ... as a conservator or a receiver."

## ***3. Paying Valid Claims in Order of Priority***

The receiver notifies creditors to file proof of their claims against the bank and determines the validity of those claims. The receiver satisfies secured claims—i.e., claims with a perfected security interest (e.g., mortgage or lien) in property of the bank—from the value of that collateral. The receiver pays allowed unsecured claims in the order of priority prescribed by law: (1) administrative expenses of the receivership; (2) deposits, whether insured or uninsured; (3) "general or senior" liabilities—a residual category including liabilities that do not fit the other categories; (4) liabilities subordinated to deposits or general claims; (5) cross-guarantee liability to the FDIC; and (6) shareholders' claims. In keeping with traditional receivership law, the receiver generally pays all allowed claims within a given priority class before it makes any payment on claims in the next lower priority class. Thus general liabilities receive nothing unless all deposits have been paid in full, and shareholders receive nothing unless all other claims have been paid in full. If a given class of claims

exceeds the assets available to pay that class, then the claims share pro rata in the available assets. But the FDIC as receiver has leeway to deviate from these priorities as long as each claimant receives no less than it would have received in a straight liquidation.

#### ***4. Resolution Options***

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

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

#### **IV. LEGAL FRAMEWORK FOR GSE INSOLVENCY**

Congress has enacted specialized insolvency statutes for each GSE. A one-sentence statute grants the Federal Housing Finance Board plenary authority to liquidate or reorganize any Federal Home Loan Bank, with no procedural constraints and virtually standardless discretion. Adequate insolvency mechanisms drawn from banking law apply to the Farm Credit System and Farmer Mac. A limited conservatorship mechanism, also drawn from

banking law, applies to Fannie and Freddie. Each of these mechanisms enables a GSE's regulator to have a fiduciary take control of the GSE without prior hearing or judicial approval; affords the GSE a post-seizure judicial hearing; vests the fiduciary with all the powers of the GSE and its managers and shareholders; and bars courts from reviewing the fiduciary's decisions. A receiver for a Farm Credit System institution or Farmer Mac also has explicit authority to liquidate the firm—marshaling the firm's assets, adjudicating creditors' claims, and paying valid claims in order of priority. A conservator for Fannie or Freddie, by contrast, has no statutory authority to liquidate the firm.

The statutes governing Fannie and Freddie authorize conservatorship but not receivership. They create no means for reorganizing a troubled GSE and do not even specifically authorize liquidating such a firm. Those statutes would provide only modest support for a liquidation and none whatever for a reorganization. Accordingly, after examining those statutes, I will also consider two fallback options: using statutory conservatorship to effect a liquidation; and using common-law receivership to effect a liquidation or reorganization.

### **A. Limits of Conservatorship**

The Office of Federal Housing Enterprise Oversight (OFHEO), which regulates Fannie and Freddie, can appoint a conservator for a GSE that has a serious capital deficiency, "is not likely to pay its obligations in the normal course of business," conceals records or assets or refuses to let authorized examiners inspect records, or willfully violates a cease-and-desist order. After the conservator takes control of the GSE, the GSE's directors can challenge the appointment in federal district court. They have the burden of proving that the appointment abused OFHEO's discretion or otherwise violated the law.

The conservator generally has "all the powers of the shareholders, directors, and officers of the enterprise under conservatorship and may operate the enterprise in the name of the enterprise." Thus, if the GSE has sufficiently good prospects, the conservator should be able to recapitalize the firm by selling new shares (e.g., for cash or in voluntary exchange for

creditors' claims), even if the new shares massively dilute existing shareholders' ownership. Other statutes empower the conservator to avoid fraudulent security interests, enforce certain types of contracts despite the GSE's conservatorship or insolvency, and obtain stays of pending litigation.

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

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

Consider the case of a GSE that has depleted its capital under circumstances that leave investors wary about the reliability of the firm's accounting and reporting. Even if the firm actually has a slender positive net worth, as well as good earnings prospects, investors cannot be sure that is so. Thus, even if offered 99.9% ownership of the firm, investors may not (given the limits of their knowledge) be willing to restore the firm's equity to a level that would meet regulatory capital requirements. The GSE's plight would be even more serious insofar as the market value of its liabilities exceeded the market value of its assets. But the GSE's prospects would become much brighter if OFHEO could appoint a receiver empowered to reorganize the firm. Such a reorganization could convert some debt into equity and make the terms of the remaining debt less onerous. General and senior debtholders might receive restructured debt (e.g., \$98 in new debt for each \$100 in old debt) plus most of the firm's equity, subordinated

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

Although Fannie and Freddie continue to portray the conservatorship statute as adequate for dealing with a troubled GSE, OFHEO acknowledges the statute's inadequacy and recommends that Congress grant OFHEO receivership authority. Such authority would, according to OFHEO, "provide greater procedural and substantive certainty to a failed Enterprise's creditors, ... ensure greater fairness to all market participants, and ... facilitate the liquidation or merger of a failed Enterprise by clearly authorizing actions relating to outstanding claims that are essential to such remedies."

## **B. Fallback Options**

Fallback options for handling a severely troubled GSE might include a liquidating conservatorship and a common-law receivership.

### ***1. Liquidating conservatorship***

The conservatorship statute permits OFHEO to "require a conservator to set aside and make available for payment to creditors any amounts that [OFHEO] determines may safely be used for such purpose." OFHEO might thus plausibly attempt to use conservatorship to effect a de facto liquidation, letting the conservator make pro rata payments on creditors' claims until no assets remained and then liquidate the firm. But such an approach would arguably conflict with the congressional decision to deny the conservator explicit liquidating authority and would thus give creditors an opening to mount both legal and political attacks on the legitimacy of the conservator's action. In any event, pursuing a de facto liquidation would tend to impede using the firm's going-concern value for the benefit of creditors.

## *2. Common-law receivership*

Alternatively, OFHEO could request that a federal district court appoint a receiver for Fannie or Freddie, drawing on the court's inherent equitable power. Freddie once suggested this possibility, asserting that "a U.S. district court could appoint a receiver for Freddie Mac under common law practice." During the late nineteenth and early twentieth centuries, before the advent of chapter 11, "equity receivership" was extensively used to reorganize troubled railroads: restructuring the firm's ownership, rescheduling its debts, and converting some debt to equity. But attempting to use that approach to deal with a faltering GSE would be fraught with uncertainty—and great potential for delay and market disruption.

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

The current legal mechanisms for dealing with Fannie or Freddie (if the firm became financially troubled) have serious shortcomings. By the time OFHEO can appoint a conservator, the firm's condition may have deteriorated to the point that the conservator cannot save the firm. A conservator cannot effect a reorganization. Uncertainty exists about a conservator's power to effect a de facto liquidation. Even greater uncertainty—with, at the very least, significant potential for delay and market disruption—would attend an attempt to use common-law receivership to liquidate or reorganize a GSE. Nor does the statute make clear the relative priority of creditors' claims.

These weaknesses of current law could have far-reaching practical consequences, to which we now turn. In particular, uncertainty about the priority of claims against a GSE and the process for handling such claims could curtail the GSE's access to credit and reduce the market value and liquidity of claims against the GSE. Under some circumstances a broader impairment of liquidity in financial markets might result. Although such an extreme scenario is unlikely, it is nonetheless plausible—and as OFHEO has observed, "In analyzing how key financial institutions can affect systemic risk, the important issue is not the likelihood of the scenarios examined, but the magnitude of the potential adverse consequences."

Problems at Fannie or Freddie could cause significant harm to the financial system. Many other financial institutions have large credit exposures to those firms, having purchased their debt securities, relied on their guarantees of mortgage-backed securities, and entered into over-the-counter derivatives contracts with them. Yet attempts to quantify the systemic effects of default by Fannie or Freddie face formidable technical obstacles. To sidestep these obstacles, OFHEO has used “scenario analysis” to explore the possible systemic consequences of problems at Fannie or Freddie. One scenario assumes that “Enterprise A,” a GSE, “unexpectedly incurs large losses,” leaving investors doubtful about the firm’s viability and “uncertain about whether it will default, about the size of any credit losses they may incur, and about the future liquidity of its debt.” Investors respond by selling the firm’s debt and mortgage-backed securities, depressing the price of those securities and prompting “more and more investors [to] try to liquidate their positions before the market becomes illiquid and they can no longer do so.” Much then depends on how investors and “the federal government respond to a rapid decline in the liquidity of Enterprise A’s debt” securities and mortgage-backed securities.<sup>5</sup> If the market for Enterprise A’s debt becomes illiquid, Enterprise A may have to stop issuing debt and buying mortgage-backed securities—and investors may question “the liquidity of all depositories [i.e., banks, savings institutions, and credit unions] whose holdings of GSE debt and MBS [i.e., mortgage-backed securities] are large relative to their equity capital.”

“Illiquidity in the market for Enterprise A’s debt and the plunge in the market value of its MBS exacerbate liquidity problems at many banks and thrifts,” according to OFHEO. “Those problems increase the risk of contagious illiquidity spreading through the banking system, the markets for the obligations of other GSEs, and the financial sector as a whole, adversely affecting the U.S. and the global economy.” “[M]any investors become less willing to hold debt and other fixed-income obligations perceived to pose a significant degree of credit risk and liquidity risk.” “Those developments substantially reduce the desirability of all GSE

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<sup>5</sup> If investors expect only small credit losses on those securities—or anticipate a governmental rescue—they may, according to OFHEO, buy up such securities “at bargain prices,” stabilizing the price and “bolster[ing] the liquidity of those securities.” If the other GSE in the Fannie-Freddie duo “is financially strong and able to borrow at reasonable rates,” it may rapidly expand its purchases of mortgage-backed securities and thereby “limit damage to the housing sector, mortgage lenders, and other housing finance businesses.”

debt [even debt of healthy GSEs] ... as suitable instruments for use in hedging or as collateral for repurchase agreements, further reducing liquidity in financial markets.” In sum, this scenario “illustrates how heightened uncertainty about the liquidity of the debt of an undercapitalized Enterprise could lead to contagious illiquidity in the market for those securities. Such illiquidity could cause or worsen liquidity or solvency problems at other financial institutions and disrupt the housing markets and the financial system.”

Uncertainty about the priority of claims against a troubled GSE—and the process for handling such claims—could worsen the GSE’s problems and the potential for harm to financial markets. Although the loss rate per dollar of debt or mortgage-backed securities would almost certainly remain low, “the total dollar amount of the Enterprise’s losses could be substantial and distributed unevenly among different classes of investors” (e.g., debt securities, mortgage-backed securities, over-the-counter derivatives, and subordinated debt). Current law leaves investors “uncertain about the potential severity of the losses specific [classes of] investors would incur if [a faltering GSE] defaulted.” Thus investors may fear the worst for each of several classes of unsecured claims against the firm—as though that class would have to bear the entire loss. Such uncertainty—combined with creditors’ more basic uncertainty about the firm’s prospects and the market value of the firm’s assets and liabilities—could further reduce the firm’s access to credit (and hedging devices), the market value and liquidity of claims against the firm, and under extreme circumstances possibly also the liquidity of financial markets.

In analyzing the potential for a GSE’s troubles to harm the financial system and the economy, Larry Wall, Robert Eisenbeis, and Scott Frame contend that GSE regulators should develop and announce a “credible plan” for handling a GSE’s failure. These economists stress the importance of (1) empowering and instructing OFHEO to sell, merge, or otherwise resolve the problems of a faltering GSE while the market value of the firm’s assets still exceeds the market value of its liabilities, (2) authorizing regulators to place a GSE in receivership and create a “bridge” firm to carry on the GSE’s business, and (3) specifying the order of priority in which to pay a failed GSE’s creditors. They note that current legal mechanisms for Fannie and Freddie take “none of these ... steps.” Instead, current law keys OFHEO’s powers to

accounting numbers that may overstate a GSE's assets and thus mask the seriousness of the firm's problems; directs OFHEO to intervene only after a GSE's capital has fallen precipitously low; fails to specify priority among creditors; does not authorize OFHEO to appoint a receiver or organize a bridge firm; and thus would necessitate special congressional legislation to resolve a GSE with assets worth less than its liabilities. Indeed, Congress could face "intense pressure to act quickly" from the troubled GSE's conservator, creditors, and mortgage-market customers and from other GSEs. Wall, Eisenbeis, and Frame accordingly regard current law as "designed ... to create substantial spillover effects and force Congress to mitigate the problems by providing the creditors of a failed housing enterprise with a bailout."

Similarly, Chairman Greenspan recommends that Congress enact a receivership process for Fannie and Freddie, with a clear set of priorities among creditors. "Congress needs to clarify the circumstances under which a GSE can become insolvent and, in particular, the resultant position—both during and after insolvency—of the investors that hold GSE debt." Greenspan stresses that such a "process must be clear before it is needed," lest during any crisis "uncertainties about the process" precipitate a congressional rescue. In Greenspan's view, the current conservatorship mechanism would make it "very difficult" to avoid such a rescue: the conservatorship statute "essentially says, for all practical [purposes], that the Congress will bail out the GSEs in the event of a crisis." If Congress does not intend to make such a rescue inevitable, Greenspan concludes, it should change the law now.

Enacting explicit, workable liquidation and reorganization mechanisms, together with statutory payment priorities, would have several salutary effects. By reducing the likelihood of Congress rescuing a faltering GSE, these reforms would increase market discipline on the two GSEs, reduce the GSEs' incentive to take excessive risks, and thus reduce the likelihood of future problems. If problems do arise, the increased market discipline would promote more timely corrective action—again reducing the risk of more serious problems. In sum, the reforms would help move the adjustment process forward, using the possibility of healthy discomfort now to reduce the risk of crippling pain later.

## VI. CORRECTING THE DEFICIENCIES OF CURRENT LAW

The deficiencies of current law could be corrected by adopting adequate GSE-specific liquidation and reorganization mechanisms or by authorizing liquidation and reorganization of GSEs under the Bankruptcy Code.

### A. Receivership

After outlining the requisites of a workable receivership regime, I will summarize the receivership proposals made during the 108th Congress (2003-04) and analyze Fannie and Freddie's objections to receivership.

#### *1. Requisites of a workable receivership regime*

A GSE insolvency statute should, at a minimum, (1) authorize a GSE's regulator to appoint a conservator or receiver through a process permitting timely unilateral action; (2) afford the GSE a prompt post-seizure judicial hearing; and (3) allow the regulator to prescribe implementing regulations. Appointment and rulemaking authority supply the basic legal framework for action. An impartial hearing provides due process. A well-designed insolvency statute should also, in my view, (4) specify the grounds for conservatorship and receivership; (5) specify priorities among claims; and (6) authorize receivers to establish bridge institutions and effect reorganizations. Chairman Greenspan rightly stresses the importance of "a *clear process sanctioned by the Congress* for placing a GSE in receivership." Congress needs not only to give the regulator workable tools but to give those tools political legitimacy.

#### *2. Congressional proposals*

Congress could enact workable liquidation and reorganization mechanisms for Fannie and Freddie based on the specialized mechanisms that currently exist for FDIC-insured

depository institutions, the Farm Credit System, and Farmer Mac. All three receivership proposals made during the 2003-04 Congress took this approach.

H.R. 2575, introduced in 2003 by Representative Richard H. Baker and twenty other members of the House Committee on Financial Services, would authorize Fannie and Freddie's regulator to appoint a receiver for a "critically undercapitalized" GSE that fell within criteria prescribed in advance by the regulator. The receiver would liquidate the GSE, and would have both the powers of a GSE conservator and additional powers drawn from the Federal Deposit Insurance Act. The bill relied on the GSE regulator to specify the additional powers by regulation.

Representative Michael G. Oxley, who chairs the Committee on Financial Services, took a similar approach in a draft bill prepared as a substitute for H.R. 2575. As part of an attempt to obtain support from Fannie, Freddie, and the committee's Democratic members, Oxley used the term "enhanced conservator" instead of "receiver," but his proposal would have provided the same receivership powers as H.R. 2575.

Senator Richard C. Shelby, who chairs the Committee on Banking, Housing, and Urban Affairs, proposed a more comprehensive and detailed receivership framework, also modeled on the Federal Deposit Insurance Act. The bill revises the grounds for conservatorship; authorizes the regulator to appoint a receiver if any of those grounds exist; and empowers the receiver to liquidate the GSE, transfer its assets and liabilities, and organize a successor firm to carry on the GSE's business. The receiver would determine the validity of claims against the GSE and pay valid unsecured claims in the following order of priority: (1) administrative expenses of the receivership; (2) "general or senior" liabilities of the GSE; (3) obligations "subordinated to general creditors"; and (4) shareholders' claims. The Bush Administration "strongly support[ed] the inclusion of FDIC-like receivership powers," calling them "crucial" and "a core component of any credible legislative effort to establish a world-class regulatory regime for the GSEs."

The committee approved the Shelby bill by a twelve-to-nine vote, with an amendment by Senator Robert F. Bennett delaying the effective date of any receivership until forty-five

days after Congress received notice of the GSE regulator's intent to appoint a receiver. During that period Congress would have an opportunity to consider the merits of the proposed receivership and enact a joint resolution blocking it.

In requiring conspicuous advance notice of receivership, imposing a forty-five day delay, and facilitating legislation to block the receivership, the Bennett Amendment starkly contrasts with traditional bank receivership law and the rules governing national banks, federal savings institutions, federally insured credit unions, and the other three GSEs—all of which allow regulators to appoint receivers unilaterally and without prior notice, hearing, or judicial approval. This well-established approach recognizes the need to act swiftly, decisively, and discreetly. The Bennett Amendment in effect requires the GSE regulator to proclaim to the world that the GSE is no longer viable—and then wait for forty-five days, even as the proclamation crimps the GSE's access to liquidity, hobbles the GSE's business operations, and precipitates a crisis. The amendment then sets the stage for a congressional bailout through a “fast-track” process that precludes normal delaying tactics. The amendment could thus serve as an elaborate device for inducing such a bailout. Former senator Phil Gramm branded congressional involvement in the decision to appoint a receiver “a prescription for chaos.” The administration declared that the amendment “significantly weaken[ed] one of the core powers needed for a strong regulator,” “could reinforce a false impression that the American taxpayer provides an implicit guarantee” to Fannie and Freddie, and rendered the bill unacceptable.

### ***3. GSEs' objections to receivership***

In opposing receivership, Fannie and Freddie argue (1) that conservatorship deals adequately with troubled GSEs; (2) that receivership is inappropriate for GSEs; (3) that bank receivership exists for reasons irrelevant to GSEs; and that enacting receivership could (4) create harmful uncertainty and make mortgages more costly and less available, (5) unfairly contravene the expectations of GSEs' creditors, and (6) encourage privatizing the GSEs. In addition, some critics attribute the Bush Administration's support for receivership to bad faith

and a bias against housing. Thus, for example, Representative Barney Frank calls receivership “an artificial issue created by the administration.”

*a. Conservatorship deals adequately with troubled GSEs*

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

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

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

Fourth, OFHEO has shown “how heightened uncertainty about the liquidity of the debt of an undercapitalized Enterprise could lead to contagious illiquidity in the market for those securities,” which in turn “could cause or worsen liquidity or solvency problems at other financial institutions and disrupt the housing markets and the financial system.” Thus OFHEO points to the possibility that an undercapitalized GSE could have to stop issuing debt—and that the firm's outstanding debt and mortgage-backed securities could become illiquid, and ultimately result in “contagious illiquidity spreading through the banking system, the markets for the obligations of other GSEs, and the financial sector as a whole, adversely affecting the U.S. and the global economy.” Yet Wachter assumes that a GSE in even worse initial financial condition—not merely undercapitalized but insolvent and unviable—could “be wound down over time.”

This brings us to the fifth assumption: that attempting to deal with an insolvent GSE in this manner would not unacceptably increase the likelihood of a congressional bailout. To remain in business, the firm would need to refinance its maturing debt. To keep its borrowing costs manageable—and avoid a protracted lack of equity—the firm might well need to persuade investors to buy additional stock. Each of these steps could prove difficult if investors doubted that the government would rescue the firm. We would be naive to expect (much less base public policy on the assumption) that the firm would necessarily overcome all

such challenges. Thus we should recognize the possibility that attempting to deal with an insolvent GSE under current law would “create substantial spillover effects” and precipitate a congressional bailout.

*b. Receivership is inappropriate for GSEs*

Both Fannie and Freddie dismiss receivership as inappropriate for GSEs. Fannie calls conservatorship “the right model for the GSEs,” “appropriately different” from the receivership tools available to bank regulators. In Fannie’s view, the government has a mere “financial stake” in federally insured depository institutions, whereas it has a broader policy stake in using Fannie and Freddie to “mak[e] homeownership more affordable and more available. That is why a conservator is the appropriate tool to deal with a capital inadequacy problem at a GSE. The conservator’s role is to rebuild the capital of the GSE and ensure it remains an ongoing concern.” Freddie emphasizes that receivership—here equated with liquidation—“would have substantial economic, market and public policy consequences” and “threaten the public policy mission of the GSEs.” Hence “[o]nly Congress should decide if there is no longer a need for [a GSE as an] instrument of national policy to support homeownership.”

This objection to receivership assumes that national housing objectives require the preservation of the two GSEs with their liabilities unimpaired and that no reorganized or successor firm could serve as well. Fannie implies that the two GSEs are unique and possibly irreplaceable instruments for “making homeownership more affordable and more available.” This is consistent with the GSEs’ claim to provide public benefits—such as lower interest rates, nationwide credit availability, improved technology, and market stability—worth far more than the subsidies the GSEs receive from the government. Yet credible recent studies indicate that Fannie and Freddie retain most of their subsidies, reduce borrowers’ interest rates only slightly, and have little effect on home ownership rates. Moreover, many private firms can now replicate the two GSEs’ key economic function—linking the bond and mortgage markets—and will do so without any subsidy.

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

The tables following this page give two examples of how a receiver could reorganize a GSE as a going concern. In Receivership #1 the old GSE has depleted all its capital: marked to market value, its total liabilities equal its total assets. In Receivership #2 the GSE is insolvent: marked to market value, its liabilities exceed its assets. In both cases the receiver transfers the old GSE’s assets and liabilities to a bridge GSE but adjusts unsecured liabilities—i.e., gives those liabilities a “haircut”—in light of the GSE’s condition and the priority of the liabilities.<sup>6</sup>

In Receivership #1, holders of all liabilities except subordinated debt would, for every \$100 of claims against the old GSE, receive \$97.50 in equivalent claims against the bridge GSE (e.g., for every \$100 of senior debt of the old GSE, creditors would receive \$97.50 in senior debt of the new GSE), \$1.01 in new subordinated debt, \$1.01 in new preferred stock,

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<sup>6</sup> For simplicity, the examples involve no secured liabilities and assume that the receivership has no transaction costs. Note that the nature of the haircut varies. Thus in both examples the receiver converts a small portion of senior debt to subordinated debt and equity (reflecting the priority of such debt) but extinguishes the old shareholders’ claims.

and \$0.48 of new common stock. Holders of the old GSE's subordinated debt would receive common stock of the bridge GSE. Holders of the old GSE's stock would receive nothing. The bridge GSE would begin operations with shareholders' equity equal to 2.77% of total assets and subordinated debt equal to 1%—a total capital cushion of 3.77%.

Receivership #2 involves an insolvent GSE and larger haircuts. But again the GSE emerges with a healthy capital cushion (3% in shareholders' equity and another 1% in subordinated debt), ready to continue of business of the old GSE.

*c. Bank receivership exists for reasons irrelevant to GSEs*

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

These arguments mischaracterize receivership as a mere adjunct to deposit insurance. On the contrary, receivership long predates deposit insurance. Congress enacted the first national bank receivership statute in 1863, seventy years before federal deposit insurance. Receivership also long predates depositors' statutory priority over other creditors, which Congress enacted only in 1993.

*d. Enacting receivership could create harmful uncertainty and make mortgages more costly and less available*

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

Any significant legal reform creates some transitional uncertainty. But a properly designed receivership statute would greatly reduce legal uncertainty relating to a troubled GSE. As discussed in Part V, uncertainty about the priority of claims against a GSE—and the process for handling such claims—could worsen the GSE’s problems and the potential for harm to financial markets and housing finance. Moreover, the GSEs’ arguments underestimate markets’ ability to deal over time with uncertainty. Fannie asserts that a receivership statute “could undermine the pricing of existing obligations and cast uncertainty on how new obligations should be priced,” “pos[ing] risks to the 30-year fixed-rate mortgage.” Yet markets deal regularly with uncertainty about government budget deficits, monetary policy, currency revaluations, macroeconomic growth and recession, war, terrorism, natural disasters, and changing consumer preferences. To take more specific examples, markets already price the risk that future hurricanes will cause catastrophic losses in Florida or that the Chilean peso will fall relative to the euro. Markets should easily be able to handle transitional legal uncertainty about a receivership statute for two solvent GSEs.

The GSEs' arguments about thirty-year fixed-rate mortgages invite questions about the value of the GSEs' activities. If Fannie and Freddie lower mortgage interest rates only slightly, how great is the risk that a receivership statute would cause "higher mortgage rates for consumers"? If a receivership statute, by increasing Freddie's borrowing costs, "could have significant implications on our ability to support the market for 30-year fixed-rate mortgages," then in what sense did and does Freddie "support the market"? For its first two decades Freddie securitized mortgages without holding them in its portfolio, and thus had little need for long-term borrowing. Like Fannie, Freddie now borrows large sums to finance an investment portfolio that critics such as Chairman Greenspan say affords little public benefit—even as such portfolios make the GSEs much riskier (and more profitable) than if they acted only as securitizers and guarantors. In any event, homeowners obtained thirty-year fixed-rate mortgages before Freddie amassed an investment portfolio. They obtain such mortgages now in the "jumbo" market, which Fannie and Freddie cannot serve. We can reasonably expect that a receivership statute would not impede homeowners from continuing to obtain such mortgages.

*e. Enacting receivership would unfairly contravene the expectations of GSEs' creditors*

The GSEs complain that receivership would unfairly contravene the expectations of GSEs' creditors. According to Fannie, "enacting a receivership provision unfairly imposes new risks on holders of existing obligations that they could not have anticipated at the time they purchased these obligations." According to Freddie, receivership "could potentially disrupt the legal obligations and expectations of market participants." Yet the potential for the government to change the legal framework for Fannie and Freddie—or end their government sponsorship altogether—has existed all along. It forms part of the political risk market participants consider when analyzing GSEs' debt and equity securities. Freddie's own debt agreements foresee the possibility of receivership by defining the events of default to include any judicial or other appointment of a receiver but exclude OFHEO's appointment of a conservator. In any event, the GSEs' creditors have no moral (much less legal) right to demand the continuation of the current, inadequate insolvency statutes.

*f. Enacting receivership would encourage privatization*

Opponents characterize receivership as “a stalking horse for privatization.” Freddie notes that “Many market participants might view a change to receivership as a first step to privatization of the GSEs.” Senator Charles Schumer asserts that the Shelby bill “opens the door to the complete privatization of Fannie and Freddie—the end of GSEs as we know [them].” But enacting adequate insolvency mechanisms for Fannie and Freddie would not remove the two GSEs’ government sponsorship or alter their explicit government benefits. Although subject to receivership, the Federal Home Loan Bank System, Farm Credit System, and Farmer Mac remain government-sponsored enterprises. Conventional lists of GSEs’ explicit government benefits do not include exemption from bankruptcy or receivership. Thus removing Fannie and Freddie’s government sponsorship would remain a separate decision from enacting receivership.

*g. Conclusion*

Fannie and Freddie’s arguments against receivership ignore the shortcomings of the current conservatorship statute and the availability of nonliquidating forms of receivership, misstate bank receivership law, show some lack of candor, and rely heavily on vague, unsubstantiated assertions about the cost and availability of mortgages—assertions at variance with the proliferation of market-based risk-management mechanisms and with mounting evidence that the two GSEs reduce mortgage interest rates only slightly. Considering how prominently receivership figured in the congressional debates of 2004, the GSEs’ arguments are strikingly weak.

**B. Bankruptcy Code**

As an alternative to enacting a receivership mechanism for Fannie and Freddie, Congress could permit liquidation and reorganization under the Bankruptcy Code. In basic concept this change would involve making Fannie and Freddie “persons” for purposes of the code. Congress would need to decide who could initiate a GSE bankruptcy case. The code allows

voluntary petitions by debtors and involuntary petitions by creditors. By contrast, banking law and current GSE insolvency statutes allow only regulators to initiate insolvency proceedings.

## **IX. CONCLUSION**

The conservatorship statute for Fannie and Freddie has serious shortcomings. It does not allow a reorganization, nor does it specifically authorize liquidation. By the time OFHEO can place a GSE in conservatorship, the firm's condition may have so deteriorated that the conservator cannot save the firm. Uncertainty exists about a conservator's power to effect a de facto liquidation. Greater uncertainty, with great potential for delay and market disruption, would attend an attempt to use common-law receivership to liquidate or reorganize a GSE. Nor does any statute specify the relative priority of creditors' claims. If Fannie or Freddie faltered, uncertainty about the priority and process for handling claims could worsen the firm's problems and the potential for harm to financial markets. Such legal uncertainty—combined with creditors' uncertainty about the firm's prospects and the market value of the firm's assets and liabilities—could further reduce the firm's access to credit, the market value and liquidity of claims against the firm, and under extreme circumstances the liquidity of financial markets. Enacting workable liquidation and reorganization mechanisms, including statutory payment priorities, would increase market discipline on the two GSEs and reduce the likelihood of future problems.

A GSE insolvency statute should, at a minimum, (1) authorize a GSE's regulator to appoint a conservator or receiver through a process permitting timely, unilateral action; (2) afford the GSE a prompt post-seizure judicial hearing; and (3) allow the regulator to prescribe implementing regulations. A well-designed statute should also (4) specify the grounds for conservatorship and receivership; (5) specify priorities among claims; and (6) authorize receivers to establish bridge institutions and effect reorganizations. In prescribing new insolvency mechanisms for Fannie and Freddie, Chairman Shelby's GSE reform proposal met all six of these criteria. But the Bennett Amendment did much to undercut the Shelby reforms. The amendment would delay any receivership for forty-five days, precipitating a crisis and setting the stage for a congressional bailout.

As an alternative to specialized insolvency mechanisms, Congress could remove the current constraints on Fannie and Freddie becoming debtors under the Bankruptcy Code. In so doing it would need to decide who could initiate such a bankruptcy case: the GSE's regulator alone or also the GSE and its creditors.

The lack of an adequate insolvency mechanism for Fannie and Freddie reinforces investors' perception of implicit government backing by leaving Congress little practical alternative to rescuing creditors if the firms failed. If one of the other three GSEs failed, the government would have the legally credible option of letting the insolvency mechanism work and the GSE's creditors incur some loss. No similarly credible option exists in the case of Fannie and Freddie. The lack of such an option gives those firms an augmented perception of implicit backing—as though the government had taken itself hostage for the benefit of Fannie and Freddie's creditors. The lack of such an option also leaves Fannie and Freddie more profitable than if the government expressly guaranteed their debts. Although an express guarantee would reduce borrowing costs, it would almost certainly carry a dollar limit that would curtail the firms' growth. An express guarantee would also increase pressure to undertake less profitable activities and heighten the risk that Congress would eventually phase out the guarantee.

Regulating Fannie and Freddie but having no adequate receivership mechanism is like investing in an elaborate fire-protection system—complete with firewalls, smoke detectors, heat sensors, alarm bells, and sprinklers—but neglecting to mount a crucial fire door on its hinges. Like fire-safety measures, GSE financial-soundness regulation serves dual purposes. Fire-safety measures protect a building by preventing and extinguishing fires there; they also protect other buildings by inhibiting the spread of fire. Similarly, GSE regulation seeks not only to keep the GSEs themselves safe but to protect the economy from damage that might result from a GSE's failure. Bank regulation serves similar purposes and did so even before federal deposit insurance: seeking both to protect banks' depositors and other creditors and to prevent bank failures from causing broader economic harm. A receivership mechanism, by providing an orderly means for dealing with a failed GSE's obligations, would help limit and contain the harm resulting from a GSE's failure.