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BAILOUTS AND CREDIT CYCLES: FANNIE, FREDDIE, AND THE FARM CREDIT SYSTEM

JULIE ANDERSEN HILL*

In September 2008, the United States government seized mortgage giants Fannie Mae and Freddie Mac. Since that time, the government has pumped $111 billion of new capital into these government-sponsored enterprises. Yet the future of these companies post-bailout is far from clear. As policymakers consider the future of Fannie and Freddie, it is useful to remember that this is not the first significant bailout of a government-sponsored enterprise. The government also rescued the Farm Credit System in the 1980s. This Article examines the historical cycles in which Fannie, Freddie, and the Farm Credit System have funded loans: they fund more loans in good economic times but fund fewer loans in poor economic times. In other words, they fund loans pro-cyclically with business and credit cycles. By repeatedly providing bailouts, however, government officials demonstrate that they want these government-sponsored enterprises to fund loans in a countercyclical manner. This Article considers the advantages and disadvantages of three possible ways to induce countercyclical behavior. It concludes that policymakers should impose countercyclical capital requirements and create an insurance system funded with risk-based premiums to insure the companies' bonds. It further concludes that, even with these measures, occasional government bailouts may be necessary to stimulate lending during severe economic downturns.

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INTRODUCTION

On the morning of September 8, 2008, newspaper headlines around the world announced that the United States Department of the Treasury (Treasury) had taken drastic measures. "U.S. Seizes

Mortgage Giants" screamed the front page of the Wall Street Journal.[1] In London, the Daily Telegraph proclaimed "World's Biggest Mortgage Bail-Out: U.S. Nationalises Home Loan Giants to Fight Credit Crunch."[2] Even in China, the United States' rescue of mortgage giants Fannie Mae (Fannie) and Freddie Mac (Freddie) was front page news.[3] Treasury decided that Fannie and Freddie, two large government-sponsored enterprises[4] (GSEs) that guarantee mortgage-backed securities and buy home mortgages in the secondary market, were at risk of failure.[5] Increasingly, homeowners were defaulting on their mortgages. This, combined with a worldwide credit crunch, spelled deep losses for Fannie and Freddie.[6] The problem was acute because both companies were enormous. Together they owned or guaranteed more than $5 trillion in residential mortgages—more than 40 percent of the residential mortgage market.[7] To avert the potential failure, Treasury and the Federal Housing Finance Agency (Fannie and

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1. James R. Hagerty et al., *U.S. Seizes Mortgage Giants: Government Ousts CEOs of Fannie, Freddie: Promises Up to $200 Billion in Capital*, WALL ST. J., Sept. 8, 2008, at A1.

2. Harry Wallop & James Quinn, *World's Biggest Mortgage Bailout: U.S. Nationalises Home Loan Giants to Fight Credit Crunch*, DAILY TELEGRAPH (London), Sept. 8, 2008, at 1.

3. *See U.S. Gov't Takes Over Fannie, Freddie*, CHINA DAILY, Sept. 8, 2008, at 1, *available at* http://www.chinadaily.com.cn/cndy/2008-09/08/content_7006297.htm.

4. "Broadly defined, a GSE is a corporation chartered by the federal government to achieve public purposes that has nongovernmental status, is excluded from the federal budget, and is exempt from most, if not all, laws and regulations applicable to federal agencies, officers, and employees." CONG. BUDGET OFFICE, CONTROLLING THE RISKS OF GOVERNMENT-SPONSORED ENTERPRISES 2 (1991). *See also* 2 U.S.C. § 622(8) (2006) (defining "government-sponsored enterprise" for federal budgetary purposes).

5. James B. Lockhart, Dir., Fed. Hous. Fin. Agency, Statement Announcing the Conservatorship of Fannie Mae and Freddie Mac (Sept. 7, 2008), *available at* http://www.fhfa.gov/GetFile.aspx?FileID=23 [hereinafter Lockhart Statement]; Henry M. Paulson, Jr., Sec'y, Dep't of Treasury, Statement on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers (Sept. 7, 2008), *available at* http://www.ustreas.gov/press/releases/hp1129.htm [hereinafter Paulson Statement].

6. *See* Lockhart Statement, *supra* note 5, at 1-2.

7. *Oversight Hearing to Examine Recent Treasury and FHFA Actions Regarding the Housing GSEs: Hearing Before the H. Comm. on Fin. Servs.*, 100th Cong. 11 (2008) (testimony of James B. Lockhart, III, Dir., Fed. Hous. Fin. Agency); FED. HOUS. FIN. AGENCY, TOTAL MORTGAGES HELD OR SECURITIZED BY FANNIE MAE AND FREDDIE MAC AS A PERCENTAGE OF RESIDENTIAL MORTGAGE DEBT OUTSTANDING, 1990-2008 (Mar. 12, 2009), *available at* http://www.fhfa.gov/webfiles/1663/ESRMDO1990to2008.xls.

Freddie's regulator)[8] placed both companies in conservatorship.[9] In addition, Treasury entered agreements with Fannie and Freddie stating that it would provide up to $100 billion in capital for each company.[10] At the time of the Fannie/Freddie takeover, Treasury's move was the "most dramatic market intervention in years."[11] However, the conservatorship is far from the final chapter in Fannie's and Freddie's stories. Even as he announced the conservatorship, then-Treasury Secretary Henry Paulson emphasized that "[t]he new Congress and the next Administration must decide what role government in general, and these entities in particular, should play in the housing market."[12]

In considering the future of Fannie and Freddie, it is useful to remember that while their rescue was dramatic, it was not without precedent: the U.S. government had rescued a government-sponsored enterprise before. In 1987, Congress stepped in to prop up the ailing balance sheet of the Farm Credit System,[13] a group of financial cooperatives that lends to farmers.[14] In the 1980s, an agricultural

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8. *See* Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, § 1101, 122 Stat. 2654, 2661 (to be codified at 12 U.S.C. § 4511) (creating the Federal Housing Finance Agency as a new regulator for Fannie and Freddie).

9. *See* Lockhart Statement, *supra* note 5, at 5–6.

10. *See* Fannie Mae Amended and Restated Senior Preferred Stock Purchase Agreement ¶ 2.1, Sept. 26, 2008, *available at* http://www.treasury.gov/press/releases/reports/seniorpreferredstockpurchaseagreementfnm1.pdf [hereinafter Fannie Mae Stock Purchase Agreement]; Freddie Mac Amended and Restated Senior Preferred Stock Purchase Agreement ¶ 2.1, Sept. 26, 2008, *available at* http://www.treasury.gov/press/releases/reports/seniorpreferredstockpurchaseagreementfrea.pdf [hereinafter Freddie Mac Stock Purchase Agreement]. The $100 billion cap was later eliminated, allowing Treasury to purchase as much preferred stock as it deems necessary. *See infra* note 414 and accompanying text.

11. Hagerty, *supra* note 1, at A1. *See also* Bob Davis & Jon Hilsenrath, *The Fannie-Freddie Takeover: U.S. Poised for Bigger Role*, WALL ST. J., Sept. 8, 2008, at A15 (noting that "the government takeover of Fannie Mae and Freddie Mac represents the most powerful federal intervention in financial markets in decades"); Wallop & Quinn, *supra* note 2, at 1 (referring to the "World's Biggest Mortgage Bailout"). About a month later, Congress overshadowed the Fannie and Freddie bailout by creating a $700 billion fund for Treasury to use to stabilize financial markets. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765, 3765–81 (to be codified in scattered section of titles 12, 15, 26, and 31 U.S.C.); David M. Herszenhorn, *Bush Signs Bill*, N.Y. TIMES, Oct. 4, 2008, at A1. But the fact remains that the government's seizure of Fannie and Freddie was, and still is, historically remarkable.

12. Paulson Statement, *supra* note 5.

13. *See* Bruce Ingersoll, *Congress Clears $4 Billion Rescue of Farm Lender*, WALL ST. J., Dec. 21, 1987, at 1; Nathaniel C. Nash, *Senate Approves Farm Banking Aid*, N.Y. TIMES, Dec. 20, 1987, at 33.

14. *See generally* Farm Credit Administration, FCS Information, http://www.fca.gov/info/index.html (last visited Mar. 1, 2010). For convenience, in this Article I used the term "farmer" broadly to include those who primarily graze

recession and falling land prices caused many farmers to default on loans made by Farm Credit System institutions.[15] Between 1985 and 1987, the Farm Credit System lost more than $5 billion.[16] In response, Congress devised a plan to inject up to $4 billion of new capital into the Farm Credit System.[17] The new capital, along with structural changes and improved economic conditions, stabilized the Farm Credit System.[18]

The history of the Farm Credit System, from its inception to its bailout, bears an uncanny resemblance to the history of Fannie and Freddie. Both histories reveal that, if left to their own devices, these GSEs fund loans in a manner that tracks the normal business and credit cycles. When the economy is good, they fund lots of lending, but when the economy is poor, they fund little lending. Policymakers, on the other hand, have repeatedly demonstrated that they believe these GSEs should fund lending in a countercyclical fashion. In particular, policymakers want these GSEs to fund lending during economic downturns when other sources of lending have dried up. This suggests that these GSEs should be regulated in ways that encourage them to act countercyclically. This Article examines three methods for encouraging the Farm Credit System, Fannie, and Freddie to act countercyclically: countercyclical capital requirements, bond insurance, and bailouts. It concludes that the most effective approach uses all three tools.

Part I examines the macroeconomic theory of business cycles and credit cycles. The Article then demonstrates that the Farm Credit System, Fannie, and Freddie have historically funded loans with private capital in a pro-cyclical manner. These GSEs have acted countercyclically only when the government has provided public funds. Part II describes how the Farm Credit System, Fannie, and Freddie came to exist in the first place. During times of economic stress, lenders failed to provide capital to those whom the government believed needed it. To remedy the problem the government created and funded

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livestock (ranchers) and others eligible to borrow from the Farm Credit System. I apologize to any ranchers who are offended by being generally referred to as farmers.

15. *See* BEN SUNBURY, THE FALL OF THE FARM CREDIT EMPIRE 233-35 (1990).

16. *Id.* at 234-35; Nash, *supra* note 13, at 33.

17. Agricultural Credit Act of 1987, Pub. L. No. 100-233, 101 Stat. 1568, 1568-718 (1988). *See also* Ingersoll, *supra* note 13, at 1; Nash, *supra* note 13, at 33. President Ronald Reagan signed the bailout measure into law on January 6, 1988. *See Reagan Signs a Bill to Rescue Troubled Farm Credit System*, N.Y. TIMES, Jan. 7, 1988, at A20.

18. *See, e.g.*, John M. Berry, *Farm Credit System: Back From the Brink, Rescue of Banks Abound With Lessons on Bailouts*, WASH. POST, June 18, 1989, at H1.

the GSEs. Part III of the Article explains that once the poor economic conditions passed, private capital became available for lending and for investing in the Farm Credit System, Fannie, and Freddie. However, as explained in Part IV, poor economic conditions eventually returned. With private investors unwilling to fund lending, the government ultimately bailed out the ailing GSEs. Part V chronicles the return of private capital to the Farm Credit System once economic conditions improved.

With an understanding of the natural tendencies of these GSEs in mind, Part VI then tackles the question of how to encourage the GSEs to operate countercyclically. It examines three countercyclical tools. First, countercyclical capital requirements could require the companies to hold more capital during good economic times. This capital could then be used to fuel lending during poor economic times. Second, the government could create an agency to insure the companies' bonds. The insurance could be funded by charging premiums that reflect the risk of default on the bonds. An insurance fund could be built up during good economic times and then used to pay bondholders if the companies experience economic distress. Third, the government could simply provide bailouts. This would provide the companies access to funds during poor economic times. If properly structured, future profits and private investment could potentially repay the bailout funds advanced by the government. This Article concludes that while each of these approaches has problems when implemented alone, taken together they could significantly smooth the credit cycle.

I. THE CREDIT CYCLE

Credit availability is not constant. During some periods credit is plentiful and loan repayment is high. During other periods credit is scarce and default is common. Economists use the term "credit cycles" to describe these "fluctuations in loan quality and quantity."[19] Credit cycles typically correspond with business cycles.[20] During times of

19. Andrew Felton, *Cycles of Thought: An Historical Context for the Modern Credit Cycle*, FDIC OUTLOOK, Summer 2006, at 3, *available at* http://www.fdic.gov/bank/analytical/regional/ro20062q/na/t2q2006.pdf. *See also* JOHN MAYNARD KEYNES, 1 A TREATISE ON MONEY: THE PURE THEORY OF MONEY 277 (1930) (defining the credit cycle as "the alternations of excess and defect in the cost of investment over the volume of saving and the accompanying see-saw in the Purchasing Power of Money due to these alternations").

20. "A business cycle is a periodic but irregular up-and-down movement of total production and other measures of economic activity." ROBIN BADE & MICHAEL PARKIN, FOUNDATIONS OF ECONOMICS 513 (3d ed. 2007). Credit cycles "are often correlated with, but not always identical to, business cycles . . . ." Felton, *supra* note

economic expansion, lending also expands. In contrast, during economic contraction, credit availability typically contracts. It is possible to see these cycles not only in the overall credit market, but also in distinct segments of the credit market, such as farm credit or home mortgage lending.

A. The Boom

During times of economic expansion, credit availability increases. As demand for products rises, businesses and individuals see the potential for profits. To meet the rising demand, businesses and individuals borrow money to increase their production. Moreover, "[a]s economic activity expands, higher transaction balances are required; so bank deposits rise."[21] This means that banks have even more money to lend. With access to plentiful deposits, banks relax their credit standards, making credit even more accessible.[22]

Not all lenders fund the supply of credit through deposits. Some fund the supply of credit by issuing bonds. The proceeds of the bonds are then used either to make or purchase loans. Like bank lending, the process of funding loans through the capital markets is also affected by the credit and business cycles. As profits expand, loan defaults decline.[23] This enhances the value of bonds issued by lenders because it reduces the perceived risk that lenders will default on bonds. It also reduces the perceived riskiness of securities backed by loans. As a result, companies that finance loans through securities have greater access to capital at a lower cost. At the same time, the economic expansion leads to an increase in wealth.[24] This wealth is invested, fueling a greater demand for bonds and mortgage-backed securities.[25]

19, at 3. There is disagreement among economists as to whether downturns in the business cycle cause downturns in the credit cycle, or vice versa. *Compare* G. Gorton, *Banking Panics and Business Cycles*, 40 OXFORD ECON. PAPERS 751, 753-55, 775-74, 778 (1988) (suggesting that downturns in the business cycle predict and explain banking crises), *with* Douglas W. Diamond & Philip H. Dybvig, *Bank Runs, Deposit Insurance, and Liquidity*, 91 J. POL. ECON. 401, 402-04 (1983) (suggesting that banking crises lead to economic downturns). Regardless of the theory, one can conclude that the business and credit cycles are correlated.

21. Alan S. Blinder, *Credit Rationing and Effective Supply Failures*, 97 ECON. J. 327, 328 (1987).

22. *See generally* John A. Weinberg, *Cycles in Lending Standards?*, 81 ECON. Q. 1, 16 (1995) (concluding that "there is a natural tendency for [lending] standards to vary inversely with the level of activity in the credit markets").

23. Blinder, *supra* note 21, at 330.

24. STEPHEN G. CECCHETTI, MONEY, BANKING, AND FINANCIAL MARKETS 133-34 (2d ed. 2008).

25. *Id.*

Again, this allows greater access to capital at a lower cost. Companies can use this capital to fuel the credit markets. Like banks, the lenders who rely on the bond market may relax their standards for lending, buying, or guaranteeing loans when their cost of funding is lower.

The increased availability of credit during economic booms is not without its costs. The expanded credit might drive prices up to unsustainable levels, creating asset bubbles.[26] Furthermore, relaxed lending standards implemented during booms might be unduly optimistic and lead to future defaults.[27]

B. The Bust

Unfortunately, it seems that "everything that expands will eventually contract."[28] During bust periods in the business cycle, credit also typically contracts. During economic downturns, borrowers demand less credit because they anticipate lower income growth.[29] Partly in response to declining demand, lenders offer fewer loans. Lenders also tighten lending standards because decreased economic growth leads to greater perceived risk of default and lower collateral values.[30] Moreover, with lower profits, defaults increase, and lenders are forced to absorb losses. This leaves lenders with less money to lend.[31] Lenders also have difficulty attracting new capital due to the greater risk of their lending activities and lower investor wealth.[32]

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26. ASSET PRICE BUBBLES: THE IMPLICATIONS FOR MONETARY, REGULATORY, AND INTERNATIONAL POLICIES 151-54, 249-56 (William C. Hunter et al. eds., 2005). Although some believe excess credit contributes to asset bubbles, there is little agreement as to causes of asset bubbles or the best way to remedy them. *See generally* Erik F. Gerding, *Laws Against Bubbles: An Experimental-Asset-Market Approach to Analyzing Financial Regulation*, 2007 WIS. L. REV. 977 (discussing various micro- and macro-economic theories for explaining bubbles).

27. *See generally* Bruce G. Stevenson, *Research Report: Capital Flows and Loan Losses in Commercial Banking*, 77 J. COM. LENDING 18 (1994).

28. Adam Gallagher, *Migration Nation: Keeping the Wheels Turning*, AM. BANKR. INST. J., Sept. 2007, at 30, 56.

29. *See* Ben S. Bernanke & Cara S. Lown, *The Credit Crunch*, *in* BROOKINGS PAPERS ON ECON. ACTIVITY 205, 211 (1991) ("It is normal for the demand for credit to fall during a recession, reflecting declines in demand for new construction, producers' investment goods, and consumer durables.").

30. *See id.* at 212.

31. *See id.* at 221-28 (explaining how a decline in the value of real estate leads to loan losses which in turn decrease bank capital).

32. "In a recession, as wealth falls, the demand for bonds falls with it . . . ." *See* CECCHETTI, *supra* note 24, at 134. Some bonds may be affected more than others because as a bond becomes more risky relative to other investments, demand for that bond decreases. *Id.* at 135.

Besides causing solvency problems for those that fund lending, lower credit availability during bust periods can lead to two potential problems. First, the amount of credit demanded may be less than the amount of credit provided. Potential borrowers may need credit and may be willing to pay a price for the credit that corresponds with the risk of default they pose. Nevertheless, these potential borrowers may be unable to access credit.[33] Because credit availability and credit demand are not readily observable, it can be difficult for researchers to definitively identify (and agree) as to whether this condition exists.[34] However, lack of concrete empirical proof of credit rationing does not keep would-be borrowers from complaining to government officials when they are denied loans.

The second potential problem with lower credit availability is that it can drive the business cycle further down, thus preventing economic recovery. As the economic downturn erodes borrowers' balance sheets, lending policies tighten and investment is discouraged. Less investment further harms borrowers' balance sheets which aggravates lending and investment.[35] The result is a downward spiral. This is not a palatable scenario for policymakers.

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33. This is known as a "credit crunch" or "credit rationing." Raymond E. Owens & Stacey L. Schreft, *Identifying Credit Crunches*, 13 CONTEMP. ECON. POL'Y 63, 63 (1995) (defining "credit crunch" as "a period of sharply increased nonprice credit rationing"); Joseph E. Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 AM. ECON. REV. 393, 394-95 (1981) (defining "credit rationing" as "circumstances in which either (a) among loan applicants who appear to be identical some receive a loan and others do not, and the rejected applicants would not receive a loan even if they offered to pay a higher interest rate; or (b) there are identifiable groups of individuals in the population who, with a given supply of credit, are unable to obtain loans at any interest rate, even though with a larger supply of credit, they would").

34. *See* Allen N. Berger & Gregory F. Udell, *Some Evidence on the Empirical Significance of Credit Rationing*, 100 J. POL. ECON. 1047, 1048 (1992) ("Despite [numerous] theoretical efforts, there remains little consensus about whether credit rationing is an economically significant phenomenon."); C.W. Sealey, Jr., *Credit Rationing in the Commercial Loan Market: Estimates of a Structural Model Under Conditions of Disequilibrium*, 34 J. FIN. 689, 689 (1979) ("In order to establish directly the existence of credit rationing and determine its magnitude, one must have *ex ante* information on both the demand for and supply of loans at alternative loan rates. Even though such data are obtainable in principal, no such data are currently available or are likely to be in the foreseeable future.").

35. *See generally* Ben Bernanke & Mark Gertler, *Agency Costs, Net Worth, and Business Fluctuations*, 79 AM. ECON. REV. 14 (1989) (describing this "credit multiplier" effect).

II. THE PUBLIC PURPOSE: EXPANSION OF CREDIT

Both the Farm Credit System and Fannie were organized in direct response to a downturn in business and credit cycles. In a sense, these companies were government bailouts from the beginning. During times of economic difficulty, credit was scarce. Congress created the Farm Credit System and Fannie to expand the availability of credit. Congress did not originally envision these companies as agencies owned by the federal government. Rather, Congress first sought to entice the private market to invest in the companies. When this approach was unsuccessful, Congress provided seed capital to spur countercyclical lending.

A. The Farm Credit System

Congress established the Farm Credit System in 1916, during a farming recession, to ensure that farmers had access to credit.[36]

1. THE NEED FOR CREDIT

Although colonial America was a land of farmers,[37] concerns about the availability of privately provided farm credit did not become widespread until the end of the 1800s.[38] For the first century of its existence, the United States government held vast tracts of unsettled land.[39] The government encouraged settlement and farming of this land.[40] In 1785, the United States offered land for sale in 640-acre sections.[41] For those who could not afford the purchase price, private

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36. Federal Farm Loan Act, Pub. L. No. 64-158, 39 Stat. 360 (1916). The preamble to the Federal Farm Loan Act states that it was intended "[t]o provide capital for agricultural development, to create standard forms of investment based upon farm mortgage, to equalize rates of interest upon farm loans, to furnish a market for United States bonds, to create Government depositaries and financial agents for the United States and for other purposes." *Id.*

37. *See generally* ALLAN KULIKOFF, FROM BRITISH PEASANTS TO COLONIAL AMERICAN FARMERS (2000).

38. W. GIFFORD HOAG, THE FARM CREDIT SYSTEM: A HISTORY OF FINANCIAL SELF-HELP 209-10 (1976).

39. *See* PUB. LAND L. REV. COMM'N, ONE THIRD OF THE NATION'S LAND: A REPORT TO THE PRESIDENT AND TO THE CONGRESS 19 (1970).

40. GEORGE CAMERON COGGINS ET AL., FEDERAL PUBLIC LAND AND RESOURCES LAW 79 (6th ed. 2007) ("For 150 years official national public land policy was directed primarily at getting the lands into the hands of the pioneer, the individual farmer seeking a new life on the frontier.").

41. Land Ordinance of 1785, *reprinted in* 1 DOCUMENTS OF AMERICAN HISTORY 123-24 (Henry Steele Commager & Milton Cantor eds., 10th ed. 1988).

financiers offered mortgage loans.[42] Some of those without access to credit headed west anyway and became squatters.[43] Congress eventually responded to the squatters by passing a number of acts giving them preferential rights to purchase the land, usually with government financing.[44] Congress also included financing plans in subsequent land sale legislation.[45] Eventually, Congress adopted legislation giving land to those who farmed it for five years.[46]

This is not to say that every farmer who moved west enjoyed financial success. Many did not. Defaults on the government-financed lands were high enough that Congress ended its financing program[47] but allowed farmers in default to keep a portion of their land.[48] Those that could not make payments on private mortgages often just moved further west and tried again.[49] This further fueled the demand for western land. Indeed, one observer noted that "[t]he inordinate demand for land and the rise in the price of exportable products caused an astonishing advance of values in southern and western real estate and brought on a

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42. MYRON T. HERRICK & R. INGALLS, HOW TO FINANCE THE FARMER: PRIVATE ENTERPRISE—NOT STATE AID 8-14 (1915).

43. JAMES RASBAND ET AL., NATURAL RESOURCES LAW AND POLICY 119-21 (2d ed. 2009).

44. "[T]he preferential right of settler-squatters to buy their claims at modest prices without competitive bidding" is known as preemption. COGGINS ET AL., *supra* note 40, at 104. Prior to 1820, "24 special acts were adopted . . . granting preemption privileges to special groups or within certain territories." *Id.* at 81. *See, e.g.*, Land Act of Mar. 26, 1804, ch. 35, §§ 7-8, 2 Stat. 277, 280 (giving preemption rights to some who had settled in the Illinois territory and providing that they had until January 1, 1806 to make their first installment payment, with the balance due in six equal annual installments). Finally, in 1841, Congress adopted a general preemption act. Preemption Act of Sept. 4, 1841, ch. 16, § 10, 5 Stat. 453, 455-56 (giving preemption rights to those who had "made or shall hereafter make a settlement in person on the public lands").

45. *See, e.g.*, Land Act of May 10, 1800, ch. 55, 2 Stat. 73 (providing for the purchase of land with a $160 down payment and the balance of the purchase price paid over four years).

46. Homestead Act of 1862, ch. 75, 12 Stat. 392.

47. Land Act of Apr. 24, 1820, ch. 51, § 2, 3 Stat. 566.

48. *See, e.g.*, Act of Mar. 2, 1821, ch. 12, 3 Stat. 612; Act of July 9, 1832, ch. 181, 4 Stat. 567. *See also* COGGINS ET AL., *supra* note 40, at 103 ("[Speculation] led to a series of relief acts by which delinquents were relieved of forfeiture threats . . . . [B]y the end of 1819, the federal government was holding many millions of dollars of delinquent debt from purchasers. In 1920, Congress ended its experiment with credit sales, although it continued its liberality toward hard-pressed settlers for decades.").

49. HERRICK & INGALLS, *supra* note 42, at 13 (noting that "immense tracts of cheap Government land . . . lay open as a refuge for disconsolate borrowers who had abandoned their old homes to escape interest and other charges"); HOAG, *supra* note 38, at 210 ("When a farmer and his family had trouble—financial or otherwise—they could pick up and go west in search of rich prairie land.").

fever of speculation."[50] The land speculation in turn led to a "farm-mortgage craze."[51]

Land speculation and farm mortgages seemed to work fine for farmers as long as commodity prices were high and productive farm land was available further west. But toward the end of the nineteenth century, farmers discovered that farming the arid land west of the Mississippi was not the same as eastern farming.[52] The climate was drier and farming required irrigation.[53] At the same time, the western expansion flooded the market with farm products, and commodity prices began to fall.[54] "The fever of speculation suddenly subsided."[55] Because most of the farm mortgages had three- to five-year terms, default and foreclosure came quickly for troubled farmers.[56] With nowhere else to go,[57] farmers looked to the government for a solution.

2. THE GOVERNMENT SOLUTION

As early as 1890, Congress recognized potential problems associated with farm credit. That year, Congress instructed the Census Bureau "to ascertain the number of persons who live on and cultivate their own farms . . . and the number of farms and homes which are under mortgage, the amount of mortgage debt, and the value of the property mortgaged."[58] In 1908, President Theodore Roosevelt appointed a commission to study "the present condition of country life"

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50. HERRICK & INGALLS, *supra* note 42, at 8.

51. *Id.*

52. *Id.* at 11 (noting that loans had typically been "easily paid by the farmers on the lands watered by the Ohio," but that conditions were different in other areas of the West).

53. *See generally* JOHN WESLEY POWELL, REPORT ON THE LANDS OF THE ARID REGION OF THE UNITED STATES (2d ed. 1879); WALLACE STEGNER, BEYOND THE HUNDREDTH MERIDIAN: JOHN WESLEY POWELL AND THE SECOND OPENING OF THE WEST (1954).

54. HERRICK & INGALLS, *supra* note 42, at 9 (blaming the fall in commodity prices on "overproduction, the result of contemporaneous development throughout the world of land and sea transportation, refrigeration in steamships, and the use of machinery in the fields of Russia, South America, and Australia"); HOAG, *supra* note 38, at 210 ("The big push westward was increasing the floodtide of farm products moving to eastern and foreign markets as more and more virgin prairie land was broken to the plow . . . . Farm and other prices went on their 25-year toboggan.").

55. HERRICK & INGALLS, *supra* note 42, at 9.

56. *Id.*

57. *Id.* ("[T]he western farmer was found to be inextricably involved in debt to an unsympathetic system which had exploited his hopes and ambitions with as little regard to the consequences as he had given to them himself.").

58. Eleventh Census, Mortgages Act, ch. 19, 26 Stat. 13 (1890).

and report its legislative recommendations for promoting farm life.[59] One of the items the commission studied was whether farmers "had satisfactory facilities for doing their business in banking, credit, [and] insurance."[60] Among other things, the commission's report concluded that "[a] method of cooperative credit would undoubtedly prove of great service."[61] The report explained that "[i]n other countries credit associations loan money to their members on easy terms and for long enough time to cover the making of a crop, demanding security not on the property of the borrower but on the moral warranty of his character and industry."[62] The report opined that a cooperative system of credit where the farmers worked together to raise capital might also prevent capital from being siphoned from rural to urban areas.[63] By 1913, the Republican, Democratic, and Progressive parties all had adopted platforms calling for the federal government to establish some sort of system to provide farm credit.[64]

Congress considered a number of different bills aimed at improving farmers' access to credit,[65] but it ultimately settled on the Federal Farm Loan Act.[66] The Act created the Farm Credit System—a cooperative system designed to provide a dependable source of credit for farmers.[67] The Farm Credit System was essentially a three-tiered organization. The top tier was the Federal Farm Loan Board, organized as a division within Treasury.[68] The Federal Farm Loan Board was envisioned as the overseer of the Farm Credit System. Among other things, it was tasked with performing regulatory functions and disseminating information about the Farm Credit System to the public.[69] The second tier of the System was the Federal Land Banks.[70] The Federal Farm Loan Board divided the United States into twelve districts and created a Federal Land Bank to serve each district.[71] The primary

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59. REPORT OF THE COUNTRY LIFE COMMISSION, S. DOC. NO. 60-705, at 24 (2d Sess. 1909).

60. *Id.* at 26. To study this, the commission distributed questionnaires to farmers and held thirty public hearings throughout the country. *Id.* at 26–27.

61. *Id.* at 59.

62. *Id.*

63. *Id.*

64. HERRICK & INGALLS, *supra* note 42, at 1.

65. *See* HOAG, *supra* note 38, at 213 (noting that "[i]n the 63rd Congress, 70 rural credit measures were introduced").

66. Federal Farm Loan Act, Pub. L. No. 64-158, 39 Stat. 360 (1916).

67. *Id.*

68. *Id.* § 3, 39 Stat. at 360.

69. *Id.* § 3, 39 Stat. at 360–62.

70. *See id.* § 4, 39 Stat. at 362.

71. *Id.*

purpose of the Federal Land Banks was to raise capital that would eventually be lent to farmers.[72] The task of actually processing the loans of farmers fell to the third tier of the Farm Credit System, the National Farm Loan Associations.[73]

3. GOVERNMENT CAPITAL

The Federal Farm Loan Act of 1916 provided that each Federal Land Bank would be capitalized with at least $750,000 in stock.[74] Because there were twelve Federal Land Banks, there would be $9 million in stock. Congress hoped private investors would purchase the initial stock. However, the Act further provided that if the public did not purchase the Federal Land Bank stock within thirty days, Treasury would purchase the remaining stock for the United States.[75] As it turned out, there was little public interest in the Federal Land Bank stock,[76] and the government purchased nearly $8.9 million of the initial offering.[77]

With government capital behind it, the Farm Credit System mobilized quickly. By the end of November 1917, "18,000 farmers had received loans for a total of $30 million."[78]

4. FURTHER REFINEMENTS

The Federal Farm Loan Act was only the beginning of the Farm Credit System. Under the Act, the Federal Land Banks and National Farm Loan Associations were focused on providing long-term loans to finance the purchase of real property. Farmers still had limited access to short-term loans.[79] A recession in 1920 and 1921, and falling farm product prices after World War I, further compounded problems with short-term farm credit.[80] Congress attempted to remedy the situation by

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72. *See id.* § 5, 39 Stat. at 364-65.
73. *See id.* § 7, 39 Stat. at 365.
74. *Id.* § 5, 39 Stat. at 364.
75. *Id.* § 5, 39 Stat. at 364-65.
76. John R. Brake, *A Perspective on Federal Involvement in Agricultural Credit Programs*, 19 S.D. L. REV. 567, 570 (1974) ("Because the program was new, there was little public interest; eventually most of the subscription was provided by the Secretary of the Treasury.").
77. Frank P. McGowan & Charles P. Noles, *The Cooperative Farm Credit System*, 4 MERCER L. REV. 263, 269 (1953).
78. HOAG, *supra* note 38, at 216.
79. *See id.* at 223.
80. *See id.* at 219 (explaining that during World War I, U.S. farmers exported products to Europe, but following the War, this demand dried up); Farnsworth L.

creating Federal Intermediate Credit Banks to purchase short-term farm loans from primary lenders,[81] but "lenders did not make substantial use of the federal intermediate credit banks."[82]

The decline in agricultural product prices continued through the 1920s. The value of agricultural land plummeted,[83] and many farmers defaulted on their existing loans.[84] "Angry and threatening mobs of farmers at . . . foreclosure sales were common occurrences."[85] By the time the stock market crashed in 1929, American agriculture had been in a depression for nearly a decade.[86] As a large number of banks throughout the country failed,[87] farmers' access to credit further declined.[88] Farmers still had little access to short-term credit.[89]

Jennings & Robert C. Sullivan, *Legal Planning for Agriculture*, 42 YALE L.J. 878, 883-88 (1933) (discussing the agricultural depression following World War I); William L. Prosser, *The Minnesota Mortgage Moratorium*, 7 S. CAL. L. REV. 353, 354 (1934) (noting that some commodity prices fell below the break-even cost for producers).

81. Agricultural Credit Act, Pub. L. No. 67-503, §§ 201-202, 42 Stat. 1454, 1454-55 (1923).

82. Christopher R. Kelley & Barbara J. Hoekstra, *A Guide to Borrower Litigation Against the Farm Credit System and the Rights of Farm Credit System Borrowers*, 66 N.D. L. REV. 127, 134 (1990).

83. A Department of Agriculture report prepared in 1933 summarized the drop in farm real estate prices:

> With 1912-14 land values used as a base and represented by 100 farm values increased to a high point of 170 in 1920. These values have since shown a continuous and more recently an almost precipitous decrease. In March 1930 farm values stood at 115 percent of 1912-14 values; in March 1931 at 106 percent; and in March 1932 at 89 percent.

SEC'Y OF AGRIC., THE FARM DEBT PROBLEM, H.R. DOC. NO. 73-9, at 1 (1933).

84. *Id.* at 26-27 (tracking the increase in farm foreclosures and bankruptcies from 1926 to 1932 and concluding that "[a]s a result of the drop in farm income and in land values following 1920 . . . , forced sales of farms and other farm property have been numerous"). *See also* Jennings & Sullivan, *supra* note 80, at 888 (noting in 1933 that "[f]oreclosures to the amount of a billion dollars have occurred since 1929 and many thousand farmers have been dispossessed or made tenants"); Wayne D. Rasmussen, *The New Deal Farm Programs: What They Were and Why They Survived*, 65 AM. J. AGRIC. ECON. 1158, 1159 (1983) ("During the early 1930s, farm foreclosures were becoming so widespread that the whole traditional system of land owning seemed threatened.").

85. HOAG, *supra* note 38, at 231. *See also* Rasmussen, *supra* note 84, at 1158 (explaining that by the 1930s farmers' financial situation was so bleak that "[f]armers in the Midwest were nearer armed revolt than any group had been since the Whiskey Rebellion of 1794").

86. *See* HOAG, *supra* note 38, at 219-20.

87. Between 1920 and 1933 there were "approximately 11,000 bank failures, the larger part of which were located in agricultural areas." H.R. DOC. NO. 73-9, at 29.

88. *Id.*

89. *See* McGowan & Noles, *supra* note 77, at 284.

Moreover, the Federal Land Banks were losing money as farmers defaulted on their existing loans.[90] As the Farm Credit System's losses mounted, it provided fewer and fewer loans.[91] To compensate for the losses, Congress appropriated $125 million to purchase stock in the Federal Land Banks.[92]

Still, by the time President Franklin D. Roosevelt took office in 1933, public opinion strongly backed taking further action regarding farm credit.[93] President Roosevelt, by executive order, rechristened the Farm Credit Board as the Farm Credit Administration and charged it with overseeing the Farm Credit System.[94] However, more sweeping reforms required legislation: the Emergency Farm Mortgage Act[95] and the Farm Credit Act of 1933.[96]

The Emergency Farm Mortgage Act provided financial assistance to the Federal Land Banks. First, the Act allowed the Federal Land Banks to issue up to $2 billion in bonds guaranteed by the government.[97] Money generated through these bonds could be used to fund new loans. Second, the Act provided that the government would advance new capital to the Banks to the extent that the Banks would give existing borrowers a five-year extension on the repayment of principal.[98] Finally, Congress provided an additional $200 million that could be used to fund first and second mortgages for farmers.[99]

With the Federal Land Banks recapitalized, the Farm Credit Act of 1933 focused on expanding the Farm Credit System to provide short-term loans and loans to agricultural cooperatives.[100] The short-term loans would be made though a system of twelve regional Production Credit Corporations and local Production Credit Associations.[101] The Production Credit Corporations acted much like the Federal Land

90. *See* HOAG, *supra* note 38, at 219.

91. *See id.* at 219-20.

92. *See* Federal Farm Loan Act Amendments of 1932, Pub. L. No. 72-3, 47 Stat. 12; HOAG, *supra* note 38, at 220; McGowan & Noles, *supra* note 77, at 269.

93. *See* HOAG, *supra* note 38, at 231-32.

94. Exec. Order No. 6084 (Mar. 27, 1933), *reprinted in* 12 U.S.C. prec. § 2241.

95. Emergency Farm Mortgage Act of 1933, Pub. L. No. 73-10, 48 Stat. 41.

96. Farm Credit Act of 1933, Pub. L. No. 73-75, 48 Stat. 257.

97. Emergency Farm Mortgage Act of 1933 § 21, 48 Stat. at 41-42.

98. *See id.* § 23, 48 Stat. at 43 (appropriating up to $50 million for this purpose). The Act also reduced interest rates on outstanding loans. The Federal Land Banks were reimbursed for lower interest rates by Treasury. *See id.* § 24, 48 Stat. at 43-44.

99. *Id.* § 32, 48 Stat. at 48.

100. Farm Credit Act of 1933 § 2, 48 Stat. at 257.

101. *Id.* §§ 2, 23, 48 Stat. at 257, 261.

Banks, except that they funded short-term credit.[102] The Production Credit Associations were the short-term credit corollary to the National Farm Loan Associations.[103] At the same time, Congress further expanded the role of the Farm Credit System by adding twelve regional Banks for Cooperatives to lend to agricultural cooperatives.[104] Both the Production Credit Corporations and the Banks for Cooperatives were initially capitalized with stock purchased by the government.[105] Congress assigned the Farm Credit Administration the task of overseeing the long-term, short-term, and cooperative lending organizations.[106] With these 1933 Acts, the basics of the Farm Credit System were in place.

B. Fannie and Freddie

Like the Farm Credit System, Fannie and Freddie were created by Congress to increase the availability of credit. The Federal National Mortgage Association—now more commonly known as Fannie Mae—was chartered in 1938 to provide liquidity for mortgages insured by the Federal Housing Administration.[107] The Federal Home Loan Mortgage Corporation—now more commonly know as Freddie Mac—was created by Congress in 1970 to provide liquidity for mortgages issued by thrifts —those mortgages not insured by any government agency.[108]

1. THE NEED FOR CREDIT

Mortgage lending in the United States prior to the Great Depression suffered from many of the same problems that afflicted agricultural lending during the same period. Mortgage lending consisted mostly of short-term, unamortized loans.[109] Moreover, mortgage

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102. *Compare* Farm Credit Act of 1933 § 2, 48 Stat. at 257 (Production Credit Corporations), *with* Federal Farm Loan Act, Pub. L. No. 64-158, § 4, 39 Stat. 360, 362-64 (1916) (Federal Land Banks).

103. *Compare* Farm Credit Act of 1933 § 20, 48 Stat. at 259-60 (Production Credit Associations), *with* Federal Farm Loan Act § 7, 39 Stat. at 365-67 (National Farm Loan Associations).

104. Farm Credit Act of 1933 §§ 2, 40, 48 Stat. at 257, 264.

105. *Id.* §§ 4, 40, 28 Stat. at 257-58, 264.

106. *Id.* §§ 2, 61, 28 Stat. at 257, 267.

107. *See infra* notes 136-140 and accompanying text.

108. Emergency Home Finance Act of 1970, Pub. L. No. 91-351, 84 Stat. 450.

109. CHARLES M. HAAR, FEDERAL CREDIT AND PRIVATE HOUSING: THE MASS FINANCING DILEMMA 78 (1960); SAUL B. KLAMAN, THE POSTWAR RISE OF MORTGAGE

financing was not evenly distributed throughout the country.[110] Capital was concentrated in northeastern cities, making mortgage rates higher in the West and South.[111]

Beginning in the late nineteenth century, mortgage lenders realized that they could use mortgages they owned to raise additional capital. In some instances, mortgage lenders would sell mortgages directly to investors in eastern cities.[112] In other instances, mortgage companies offered investors bonds or debentures collateralized by mortgages.[113] Most mortgage companies were "financially weak, unsupervised, and prone to extravagant claims for their securities."[114] Unsurprisingly, many of the companies failed, and interest and investment in a secondary mortgage market waned until the 1920s.[115]

In the 1920s, an "apartment house and commercial property real estate boom" made investing in mortgage securities "quite fashionable and widespread."[116] Again, however, the secondary mortgage market was lightly regulated and subject to fraud and abuse.[117] The Great Depression ultimately led to extensive bond holder losses and the death of the 1920s real estate bond market.[118] Even the honest bond dealers

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COMPANIES 3 (1959); LLOYD MUSOLF, UNCLE SAM'S PRIVATE, PROFITSEEKING CORPORATIONS: COMSAT, FANNIE MAE, AMTRAK, AND CONRAIL 31 (1983).

110. MUSOLF, *supra* note 109, at 31; D.M. Frederiksen, *Mortgage Banking in America*, 2 J. POL. ECON. 203, 209, 211-13 (1894).

111. *See generally* Kenneth A. Snowden, *Mortgage Rates and American Capital Market Development in the Late Nineteenth Century*, 47 J. ECON. HIST. 671 (1987).

112. *See* Frederiksen, *supra* note 110, at 207 (noting that by 1887 "newly organized Western loan companies were finding it easy to dispose of mortgages in the Eastern states").

113. Richard W. Bartke, *Fannie Mae and the Secondary Mortgage Market*, 66 NW. U. L. REV. 1, 8-9 (1971); Frederiksen, *supra* note 110, at 210 (noting that "the first company to issue debenture bonds secured by mortgages deposited in trust, seems to have been the Iowa Loan and Trust Company of Des Moines, Iowa, which made its first issue in 1881"); David G. Oedel, *Private Interbank Discipline*, 16 HARV. J.L. & PUB. POL'Y 327, 397 (1993) ("In the late Nineteenth Century, mortgage companies in the western United States attracted substantial eastern investments on the strength of relatively high western interest rates.").

114. Bartke, *supra* note 113, at 9.

115. *Id.* ("After a brief flurry of interest, [mortgage bonds] seem to have quietly passed from the scene, forgotten by most except those who suffered losses.").

116. SAUL B. KLAMAN, THE POSTWAR RESIDENTIAL MORTGAGE MARKET 196 (1961). *See also* Bartke, *supra* note 113, at 9; Oedel, *supra* note 113, at 397.

117. KLAMAN, *supra* note 116, at 197; Bartke, *supra* note 113, at 10; Maurice Finkelstein & John J. Clarke, *Mortgage Banks: A Study in Real Estate Finance*, 12 ST. JOHN'S L. REV. 52, 55 (1937).

118. KLAMAN, *supra* note 116, at 197; Bartke, *supra* note 113, at 10; Finkelstein & Clarke, *supra* note 117, at 54-55.

and investors found their business unsustainable when the real estate and money markets collapsed.

As the country sank into the Great Depression, Congress became increasingly concerned about the growing number of people who faced foreclosure and the loss of their homes.[119] While concern was primarily for these troubled borrowers, there was widespread consensus that "housing stability and growth are basically dependent upon mortgage credit and the degree to which it is available."[120] Congress also understood that a healthy primary mortgage lending environment required that mortgage loan originators be able to sell their mortgages to investors in the secondary market.[121]

2. THE GOVERNMENT SOLUTION

Because Congress' first concern was for the homeowner-borrower, its first housing policies focused directly on the borrower. In 1933, Congress created the Home Owners' Loan Corporation to provide government-funded, fully amortized loans to refinance homes facing foreclosure.[122] However, only a year later, Congress began to adopt policies that would encourage private investment in mortgages.[123] The National Housing Act encouraged private lending by providing government insurance (through the Federal Housing Administration) guaranteeing the repayment of principal and interest of mortgage loans that met specific criteria.[124]

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119. *See Learning from the Past: Lessons from the Banking Crises of the 20th Century: Hearing Before the Cong. Oversight Panel*, 111th Cong. 92-93 (2009) (prepared testimony of Rutgers Economics Professor Eugene White); 133 CONG. REC. 25,735 (1987) (statement of Rep. Henry B. Gonzalez).

120. FED. NAT'L MORTGAGE ASS'N, BACKGROUND AND HISTORY 1 (1973).

121. *Id.* at 2 ("Many financing institutions, even those with liquidity, were reluctant to lend in the environment of the 1930's, especially on long terms and with moderate down payments. Because of the foregoing, a market in which originators of mortgages could sell their loans was needed, not only to provide liquidity for [government-insured] mortgages, but also to establish lender confidence in such mortgages.").

122. Home Owners' Loan Act of 1933, Pub. L. No. 73-43, 48 Stat. 128.

123. John Kimble, *Insuring Inequality: The Role of the Federal Housing Administration in the Urban Ghettoization of African Americans*, 32 LAW & SOC. INQUIRY 399, 402 (2007) ("The passage of the National Housing Act in 1934 inaugurated a vigorously interventionist approach to the [Great Depression] in which the federal government [sought to] orchestrate private market activity without acting as a mortgage lender.").

124. National Housing Act, Pub. L. No. 73-479, §§ 201-209, 48 Stat. 1246, 1247-52 (1934).

In addition to stimulating lending in the primary lending market, Congress intended the National Housing Act to stimulate investment in the secondary mortgage market by setting standardized underwriting criteria for the insured loans.[125] "For the first time, for example, a lender in New York City could with some confidence purchase government-insured mortgages from an originator in Topeka without even seeing the property or interviewing the mortgagor."[126]

To further bolster the secondary mortgage lending market, the National Housing Act created a charter for national mortgage associations "to purchase and sell first mortgages and such other first liens as are commonly given to secure advances of real estate."[127] Private corporations could apply for a charter.[128] If granted a charter, a company could purchase Federal Housing Administration-guaranteed mortgages from mortgage lenders.[129] These national mortgage associations would fund mortgage purchases by issuing bonds backed by the mortgages.[130] The associations would be subject to regulatory supervision by the Federal Housing Administration in much the same way that commercial banks were subject to supervision by banking regulators.[131]

In spite of the National Housing Act's efforts to create a robust secondary market, it was largely ineffective in achieving this goal.[132] Although Congress, in 1935 and 1938, reduced the capital requirements for national mortgage associations,[133] private interest in such companies

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125. FED. NAT'L MORTGAGE ASS'N, *supra* note 120, at 2; KLAMAN, *supra* note 116, at 198 (noting that FHA mortgage insurance standardized mortgage contracts and "largely eliminated earlier investor problems of acquiring mortgages outside local areas").

126. FED. NAT'L MORTGAGE ASS'N, *supra* note 120, at 2.

127. National Housing Act § 301, 48 Stat. at 1253.

128. HAAR, *supra* note 109, at 79 ("The need for a secondary market for . . . mortgages was anticipated in 1934. Apparently there was little thought, however, of one financed by the government; it was expected that privately operated profit-making national mortgage associations would fulfill this function."); Bartke, *supra* note 113, at 17 ("These associations were envisaged as private profit corporations . . . .").

129. National Housing Act § 301, 48 Stat. at 1253.

130. *See* KLAMAN, *supra* note 116, at 218.

131. *See* National Housing Act §§ 305-306, 48 Stat. at 1254-55.

132. *See* Fred Wright, Commentary, *The Effect of New Deal Real Estate Residential Finance and Foreclosure Policies Made in Response to the Real Estate Conditions of the Great Depression*, 57 ALA. L. REV. 231, 259 (2005) ("Private investors, however, were still nervous about economic conditions and shied away from forming a secondary mortgage association that would purchase mortgages from primary mortgage lenders.").

133. The National Housing Act initially required that each national mortgage association be capitalized with $5 million. National Housing Act § 301, 48 Stat. at 1253. In 1935, Congress reduced the capital required to $2 million. Additional Home

was initially low and no private charters were granted.[134] During this time of financial instability, investors simply thought the secondary mortgage market was too risky.[135]

3. GOVERNMENT CAPITAL

When it became clear that no private investors were going to establish a national mortgage association, President Franklin D. Roosevelt authorized the government to charter the National Mortgage

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Mortgage Relief Act, Pub. L. No. 74-76, § 30, 49 Stat. 293, 300 (1935). In 1938, Congress left the capital required at $2 million, but stated that only 25 percent needed to be paid in before a charter could be issued. National Housing Act Amendments of 1938, Pub. L. No. 75-424, § 5, 52 Stat. 8, 23.

134. From 1934 to 1937, public interest in investing in national mortgage association charters was low. Oedel, *supra* note 113, at 397 ("No application for such charters were immediately forthcoming from the ravaged private banking industry."). However, once the government "demonstrate[d] the viability" of such associations by establishing a government-capitalized company, private investors took notice. Kenneth A. Snowden, The Anatomy of a Residential Mortgage Crisis: A Look Back to the 1930s, at 25 (June 2009) (unpublished manuscript available at http://www.uncg.edu/bae/econ/seminars/2009/Snowden.pdf). After the creation of a government-owned mortgage association, *see infra* Part III.B, applications for private charters flooded in. Lee E. Cooper, *FHA Due to Proceed Slowly in Approving Applications for New Mortgage Agencies*, N.Y. TIMES, May 28, 1938, at 25 (reporting that after the government-owned company's initial debt offering, the government received "about 150 formal or informal requests to approve new associations"). However, the Federal Housing Administration was reluctant to approve these private applications, and eventually Congress eliminated the charter. *See* Act of July 1, 1948, Pub. L. No. 80-864, 62 Stat. 1206, 1207 (eliminating the availability of private national mortgage association charters); Cooper, *supra*; Snowden, *supra*, at 23-24.

135. According to Professor Charles M. Haar, there are several possible explanations for why the private market would not initially invest capital in national mortgage associations:

> One explanation is that there simply was no capital available during the 1930s . . . . Perhaps the degree of government control over such associations made private enterprise shy of these investments. Or the answer might be found in the fact that, given a government-supported secondary market, it was more profitable for lenders to operate in the primary field where two backstops now were present. One important reason for the failure of private capital to form national mortgage associations was a feeling that the risk factor on small mortgages was high and the margin of safety and profit low.

HAAR, *supra* note 109, at 83-84. *See also* KLAMAN, *supra* note 116, at 219 ("Mortgage bankers and investors were reluctant to invest in the capital stock of untried associations dealing in untried mortgages when real estate and building activities were depressed."); Thomas H. Stanton, *Federal Supervision of Safety and Soundness of Government-Sponsored Enterprises*, 5 ADMIN. L.J. 395, 409-10 (1991) (concluding that the "economic hesitancy prevalent after 1929" prevented private individuals from seeking national mortgage association charters).

Association of Washington.[136] On February 10, 1938, the government's mortgage association was organized with capital and paid-in surplus of $11 million—all of it from public coffers.[137] By May 5, 1938, the Association had purchased its first mortgages.[138] A short time later, the company was renamed the Federal National Mortgage Association.[139] Today the company is known as Fannie Mae.[140] During its first decade of operation, Fannie purchased $318 million in mortgages.[141]

4. FURTHER REFINEMENTS

Like the Farm Credit System, Fannie underwent several refinements, most of which were designed to broaden the secondary mortgage market. As originally conceived, Fannie could only purchase mortgages insured by the Federal Housing Administration.[142] However, following World War II, Congress became concerned that there was no secondary market for mortgages guaranteed by the Veterans Administration.[143] To remedy this problem, Congress expanded Fannie's authority to allow purchases of Veterans Administration loans.[144]

Even including Veterans Administration loans, Fannie was authorized to purchase only a small portion of the overall mortgage market. The "conventional" (non-government guaranteed) loan market was still off-limits. That changed in 1970 when "[i]nflation, high interest rates, the increasing cost of land and building materials, and a shortage of mortgage money made the price of a new home unaffordable for many families."[145] Again Congress looked to the secondary market to fund new lending at lower rates. The Emergency

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136. FED. NAT'L MORTGAGE ASS'N, *supra* note 120, at 3.

137. *Id.*; KLAMAN, *supra* note 116, at 218.

138. FED. NAT'L MORTGAGE ASS'N, *supra* note 120, at 3.

139. *Id.* at 2 n.10; KLAMAN, *supra* note 116, at 219.

140. The nickname "Fannie Mae" (sometimes spelled "Fanny May") developed from the Federal National Mortgage Association's initials FNMA. *See* Karen Larsen, *Miss Grammar: The Name Game*, 57 OR. ST. B. BULL. 33, 33 (1997).

141. KLAMAN, *supra* note 116, at 219. Fannie also sold mortgages in the secondary market. *Id.* As a result, its portfolio in 1947 was only about $4 million. *Id.*

142. *See supra* note 129 and accompanying text.

143. *See* H.R. REP. NO. 80-2389 (1948), *reprinted in* 1948 U.S.C.C.A.N. 2351, 2351. Without a secondary market, Congress was concerned that mortgage originators would not have adequate capital to fund the housing required by veterans returning from World War II. *Id.*

144. Act of July 1, 1948, Pub. L. No. 80-864, 62 Stat. 1206, 1207.

145. Peter M. Carrozzo, *Marketing the American Mortgage: The Emergency Home Finance Act of 1970, Standardization and the Secondary Market Revolution*, 39 REAL PROP. PROB. & TR. J. 765, 769 (2005).

Home Finance Act of 1970 authorized Fannie to purchase conventional mortgages.[146] The Act also created the Federal Home Loan Mortgage Corporation, Freddie Mac, and authorized it to purchase conventional mortgages.[147]

The other major change for Fannie and Freddie involved mortgage-backed securities. Fannie was given authority to issue mortgage-backed securities in 1968.[148] The Emergency Home Finance Act of 1970 authorized Freddie to issue mortgage-backed securities.[149] Under this authority, Fannie and Freddie could buy mortgages, group them in pools, and then sell the pools to investors.

Today, Fannie and Freddie continue to purchase conventional and government-guaranteed mortgages (and mortgage-related securities) which they hold in their portfolios.[150] They also issue mortgage-backed securities.[151] They generate fee income on the mortgage-backed securities by guaranteeing them.[152]

III. PRIVATE CAPITAL: GSEs EMERGE

Although the Farm Credit System and Fannie were initially started with government capital, Congress eventually determined that they should be funded with private investment. Both the Farm Credit System and Fannie were created to provide access to credit during economic downturns. But, as the economy recovered, the need for government investment in lending seemed less pressing. Private investment began to fund lending willingly. The government used private investment to replace government capital, making both the Farm Credit System and Fannie completely privately owned. The government, however, retained significant control over the operations of the companies and continued to provide benefits not ordinarily enjoyed by private companies. The Farm Credit System and Fannie (and Freddie, upon its creation) were now government-sponsored enterprises.[153]

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146. Emergency Home Finance Act of 1970, Pub. L. No. 91-351, § 201, 84 Stat. 450, 450.

147. *Id.* §§ 301-310, 84 Stat. at 451-58.

148. Housing & Urban Development Act of 1968, Pub. L. No. 90-488, § 804, 82 Stat. 476, 542.

149. Emergency Home Finance Act of 1970 § 306, 84 Stat. at 455.

150. *See* Eamonn K. Moran, *Wall Street Meets Main Street: Understanding the Financial Crisis*, 13 N.C. BANKING INST. 5, 28 (2009).

151. *See id.*

152. *See id.*

153. *See supra* note 4 (defining "government-sponsored enterprise").

As these privately owned GSEs began to prosper, competitors emerged. The competitors did not have the same government benefits as the GSEs, and some competitors raised fairness concerns. Other critics of the GSEs complained that the government benefits were flowing to GSE investors rather than to borrowers. Some claimed that government support led to excessive borrowing and inflated farm and home prices. Yet most policymakers seemed satisfied with the availability of credit and the structure of the GSEs.

A. The Farm Credit System

From the adoption of the Federal Farm Loan Act, Congress contemplated that any of the Federal Land Bank stock purchased by the government would eventually be retired through investments by farmers who borrowed from the Farm Credit System.[154] In order to be eligible for a loan from a National Farmer Loan Association, a farmer was required to purchase Association stock worth 5 percent of the face value of the loan.[155] The Association, in turn, was required to buy stock in the Federal Land Bank equal to 5 percent of the capital that the Federal Land Bank provided for the Association to loan to the farmer.[156] In this manner, the Associations and Land Banks would eventually be owned by the farmer-borrowers; they would become true cooperatives.[157]

1. PRIVATE CAPITAL EMERGES

The Farm Credit System's structure of individual borrower ownership worked well, and "[d]uring the 1920's more than 99 percent of the original government capital was returned."[158] However, the privatization effort stalled when the Great Depression brought new challenges for agriculture. During the Depression, the government purchased stock in the Federal Land Banks, the Production Credit

154. *See* Federal Farm Loan Act, Pub. L. No. 64-158, §§ 5-7, 39 Stat. 360, 364-67 (1916).

155. *Id.* § 8, 39 Stat. at 368. The farmer's stock in the Association served as collateral for his loan. *Id.*

156. *Id.* § 7, 39 Stat. at 367. Association's stock in the Federal Land Bank served as collateral for its loan from the Federal Land Bank. *Id.*

157. *See* Brake, *supra* note 76, at 570.

158. McGowan & Noles, *supra* note 77, at 269.

Corporations, the Production Credit Associations, and the Banks for Cooperatives.[159]

With the beginning of World War II, economic prosperity returned for the American farmer and the Farm Credit System. The war brought new demand for farm products, higher farm product prices, and higher values for agricultural land.[160] Farmers, who had once needed the lifeline provided by government capital, began to view government ownership of the Farm Credit System as a liability that might subject them to the politically motivated whims of government officials.[161] In 1944, the Land Banks "initiated a program to pay off all their Government-owned capital."[162] By June 1947, all Federal Land Bank stock owned by the federal government was retired.[163] In the 1940s, the Production Credit Associations and the Banks for Cooperatives also began a push toward privatization.[164] By 1968 the entire Farm Credit System was privately owned.[165]

Although the Farm Credit System was now owned by private investors, it could not be considered purely private. The Farm Credit System enjoyed benefits that ordinary companies did not. It maintained a federal government charter[166] and tax advantages.[167] Its securities were exempt from registration with the Securities and Exchange Commission.[168] Moreover, the Federal Reserve was authorized to purchase Farm Credit System bonds as part of its open market operations,[169] and banks and credit unions could purchase an unlimited

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159. *See supra* notes 97–105 and accompanying text. *See also* Emergency Farm Mortgage Act of 1933, Pub. L. No. 73-10, § 23, 48 Stat. 41, 43; Farm Credit Act of 1933, Pub. L. No. 73-75, §§ 4, 40, 48 Stat. 257, 257–58, 264.

160. *See* HOAG, *supra* note 38, at 253-54.

161. *See id.* at 249–54.

162. *Id.* at 254.

163. Brake, *supra* note 76, at 570; McGowan & Noles, *supra* note 77, at 269.

164. The first Production Credit Association privatized in 1944, with others following throughout the 1940s and 1950s. HOAG, *supra* note 38, at 255. Privatizing was more problematic for the Banks for Cooperatives and the Production Credit Corporations because the Farm Credit Act of 1933 did not contain provisions allowing them to privatize. *See id.* at 134–35, 255. Congress eventually supplied this authority in 1955 and 1956. Farm Credit Act of 1955, Pub. L. No. 84-347, 69 Stat. 655; Farm Credit Act of 1956, Pub. L. No. 84-809, § 205, 70 Stat. 659, 660-61.

165. Brake, *supra* note 76, at 576.

166. 12 U.S.C. § 2001 (2006).

167. *Id.* §§ 2023, 2077, 2098, 2134.

168. 15 U.S.C. § 77c(a) (2006) (excusing certain "exempt" securities from registration); Farm Credit Admin., Designation of Securities for Exemption Under the Securities Exchange Act of 1934, 43 Fed. Reg. 24,933 (June 8, 1978).

169. 12 U.S.C. § 2158 (2006).

amount of Farm Credit System securities.[170] The Farm Credit System was privately owned, but its government benefits gave it the status of a government-sponsored enterprise.

2. COMPETITION AND CRITICISM EMERGES

As the farming economy stabilized in the years following the Great Depression, private capital flowed into farm loans not only through the Farm Credit System, but also through lenders that had always been privately held. "[L]ife insurance companies gradually sold off many of the properties they had acquired through foreclosure in the 1930s and slowly began to increase their outstanding farm loans."[171] Likewise, commercial banks again began attracting deposits and making farm loans.[172] Debt secured by farm real estate increased from $9.2 million in 1930 to $5.2 billion in 1950.[173] By 1950, more than a third of outstanding farm real estate debt was owned by commercial banks or life insurance companies.[174] In comparison, the Farm Credit System held only a 15 percent market share.[175] Thus, commercial banks and insurance companies competed with the Farm Credit System for business.

Banks and insurance companies were not always happy to be competing with the Farm Credit System. Although it was anticipated that private ownership of the Farm Credit System would lessen the resentment, it did not. Banks and insurance companies believed that the Farm Credit System still enjoyed a significant advantage because of its close association with the government. Because the Farm Credit System still enjoyed special tax advantages, they were able to offer loans on better terms than other lenders.[176]

Increasingly, however, banks and insurance companies began to believe that the Farm Credit System's financial advantage went further than just low taxes. Other lenders noticed that when the Farm Credit

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170. *See id.* §§ 24 (Seventh), 335(2), 1757(7)(E).

171. KENNETH L. PEOPLES ET AL., ANATOMY OF AN AMERICAN AGRICULTURAL CREDIT CRISIS: FARM DEBT IN THE 1980S, at 14 (1992).

172. *Id.*

173. U.S. DEP'T OF AGRIC., AGRICULTURE FACT BOOK 1996, at 25, *available at* http://www.usda.gov/news/pubs/factbook/contents.html; Jennings & Sullivan, *supra* note 80, at 887 n.21.

174. U.S. DEP'T OF AGRIC., *supra* note 173, at 25.

175. *Id.*

176. J.W. Looney, *The Future of Government Regulation of Agriculture: Finance and Credit*, 3 N. ILL. U. L. REV. 263, 274 (1983). As interest rates increased, commercial lenders found that they were also hampered by state usury laws that did not apply to Farm Credit System lenders. PEOPLES ET AL., *supra* note 171, at 15-16.

System issued bonds, its cost of borrowing was lower than the cost of borrowing for other lenders. Commentators attributed this lower cost of borrowing to investors' belief that the government would give the Farm Credit System additional capital, should the Farm Credit System ever fall on hard times.[177] Some policymakers began to wonder why the Farm Credit System needed government ties if private companies were able to participate in the same activities. In 1981, the Office of Management and Budget proposed removing some of the Farm Credit System's government benefits in order to even the playing field and make the System's bonds less attractive to investors.[178] However, this idea never gained much traction.[179]

B. Fannie and Freddie

Because Fannie was born during the Depression (and after the Federal Housing Act's attempt to encourage private investment failed), its initial structure did not contemplate privatization. Fannie was the government's creation, and the government provided the capital. As a result, privatization was slow in coming to Fannie. Eventually, however, private capital emerged, not only to fund Fannie and Freddie, but also to fund competitors in the secondary housing market. Like the Farm Credit System, Fannie and Freddie, although privately owned, retained government benefits that their competitors resented.

1. PRIVATE CAPITAL EMERGES

Although Fannie was created as a Depression-era measure, it continued to use Treasury money to finance its purchase of mortgages in the secondary market long after the Depression had passed.[180] When Congress authorized Fannie to purchase mortgages guaranteed by the Veterans Administration, Treasury provided the capital.[181] Fannie's

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177. *See, e.g.*, Farrell E. Jensen, *The Farm Credit System as a Government-Sponsored Enterprise*, 22 REV. AGRIC. ECON. 326, 335 (2000); David A. Lins & Peter J. Barry, *Agency Status for the Cooperative Farm Credit System*, 66 AM. J. AGRIC. ECON. 601, 601 (1984) (noting that the "public perception of government backing" leads to lower borrowing costs).

178. Lins & Barry, *supra* note 177, at 601; Looney, *supra* note 176, at 275.

179. *See Needed for Agriculture: Market-Oriented Policies*, AM. BANKER, Oct. 11, 1983, at 38 (acknowledging that it did not make sense to sever the Farm Credit System's ties with the government during a time of financial turmoil).

180. FED. NAT'L MORTGAGE ASS'N, *supra* note 120, at 24; Oedel, *supra* note 113, at 398.

181. To accommodate its increased authority, Congress increased Fannie's access to funds by increasing its capitalization to $20 million. *See* Act of July 1, 1948,

portfolio ballooned,[182] and the cost of these mortgages soon became a "significant drain on . . . Treasury."[183]

In 1954, Congress decided to re-examine Fannie's role in federal housing policy. After extensive hearings,[184] Congress decided that Fannie should fund its secondary market operations with private funds "to the maximum extent feasible."[185] The Housing Act of 1954 gave Fannie authority to fund its purchase of mortgages by issuing debt in the capital markets.[186] The Act also specified that Treasury would purchase preferred stock in Fannie.[187] Mortgage originators who sold loans to Fannie would be required to purchase common stock in Fannie, in much the same way borrowers were required to purchase stock in the Farm Credit System.[188] Eventually, Treasury's preferred shares would be retired using money from Fannie's capital surplus and general surplus accounts.[189] Through this process, Congress believed Fannie would eventually become a private company.[190]

Shortly after the Housing Act of 1954, Fannie began issuing debentures.[191] It also began issuing stock to mortgage originators.[192] But mortgage originators were not happy about having to purchase the stock

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Pub. L. No. 80-864, § 301(d), 62 Stat. 1206, 1208 (allowing Fannie "capital stock of not to exceed $20,000,000 . . . subscribed by the Reconstruction Finance Corporation"); HAAR, *supra* note 109, at 90-91 (explaining that the increased capital was necessary to accommodate Fannie's new role with respect to Veterans Administration loans). When this increased capital was not enough, Congress expanded funding again and again. *See, e.g.*, Act of Oct. 25, 1949, Pub. L. No. 81-387, 63 Stat. 905; Housing Act of 1950, Pub. L. No. 81-475, 64 Stat. 48, 57; Housing Act of 1952, Pub. L. No. 82-531, 66 Stat. 601, 602.

182. HAAR, *supra* note 109, at 91; Bartke, *supra* note 113, at 21 n.72 ("No VA mortgages were purchased until fiscal 1950, when 18,083 mortgages in the amount of $105,252,000 were acquired. This was followed by 27,119 mortgages for $178,513,000 in 1951.").

183. HAAR, *supra* note 109, at 93.

184. S. REP. NO. 83-1472 (1954), *reprinted in* 1954 U.S.C.C.A.N. 2723, 2724 (noting "extensive hearings over the course of 5 weeks (2,029 pages of hearings)").

185. Housing Act of 1954, Pub. L. No. 83-560, § 301, 68 Stat. 590, 612.

186. *Id.* § 303(a), 68 Stat. at 613.

187. *Id.*

188. *Id.* § 303(b), 68 Stat. at 614. Mortgage originators were originally required to purchase stock worth 3 percent of the outstanding principle of the mortgages sold to Fannie. *Id.*

189. *Id.* § 303(a), 68 Stat. at 613. Fannie's profits were periodically transferred to the general surplus account. *Id.* § 303(b), 68 Stat. at 614. Money received from the issuance of common stock was held in the capital surplus account. *Id.*

190. *See id.* § 303(g), 68 Stat. at 615 (providing that upon the retirement of Treasury's preferred shares, ownership of Fannie's secondary market operations would be "carried out by a privately owned and privately financed corporation").

191. Bartke, *supra* note 113, at 27.

192. Oedel, *supra* note 113, at 398.

as a condition of doing business with Fannie.[193] Although originators had to purchase stock at par value,[194] Fannie did not repurchase the stock once the mortgages were paid.[195] Instead, mortgage originators either held their stock or sold it in the open market for much less than par.[196] In response to pressure from originators, Congress lowered the amount of common stock originators were required to purchase.[197] As a result, Fannie was not able to rapidly raise private funds.[198]

By 1968, Fannie still had not sold enough common stock or earned enough profits to retire Treasury's preferred stock.[199] However, the drive to privatize Fannie became more intense because, for the first time, Fannie's secondary market operations would be included in the federal government's unified budget.[200] President Lyndon B. Johnson's administration was not keen on the idea of a large increase in the apparent size of the federal government's budget.[201] Privatizing

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193. Bartke, *supra* note 113, at 25 ("[M]ortgage bankers complained bitterly that they were being forced to buy [Fannie] paper as a condition of doing business with Fannie . . . .").

194. Housing Act of 1954 § 303(c), 68 Stat. at 614.

195. *Id.* § 303(b), 68 Stat. at 614 ("[Fannie] shall accumulate funds for its capital surplus account from private sources by requiring each mortgage seller to make payments of nonrefundable capital contributions . . . .").

196. Nothing in the Housing Act of 1954 required the originators to hold the stock. Bartke, *supra* note 113, at 24–25 n.90. As a result, it was "standard practice" for originators to sell their Fannie shares "in the over-the-counter market." Robert Metz, *Market Place: The Private Life of Fanny May*, N.Y. TIMES, Aug. 21, 1968, at 62. Fannie shares with a par value of $100 dollars typically traded at around $60 per share. Robert Metz, *Fanny May Nears Private Status and Investors Scent a Windfall*, N.Y. TIMES, Sept. 1, 1968, at F1 [hereinafter Metz, *Fanny May Nears Private Status*] ("For years the stock traded in the low 60s.").

197. Housing Act of 1956, Pub. L. No. 84-1020, § 202, 70 Stat. 1091, 1096 (requiring only a 1-percent investment in Fannie stock); HAAR, *supra* note 109, at 105 n.97.

198. *See Housing and Urban Development Legislation and Urban Insurance: Hearings on H.R. 15624 and H.R. 15625 Before the Subcomm. on Housing of the H. Comm. on Banking and Currency*, 90th Cong. 270 (1968) (testimony of W. Parham Bridges, Jr., Chairman, Subcomm. on Mortgage Fin., Realtors' Washington Comm., Nat'l Assoc. of Real Estate Bds.) (explaining that if the stock purchase requirement had not been reduced, Fannie would have been privately owned in 1968).

199. In February 1968, Treasury held more than $163 million in Fannie preferred stock. Bartke, *supra* note 113, at 31.

200. In 1967, a presidential commission recommended adopting a "unified" budget excluding only those GSEs that were entirely privately owned. *See* REPORT OF THE PRESIDENT'S COMMISSION ON BUDGET CONCEPTS 29-30 (1967). Following the recommendations of this commission, President Johnson began reporting a "unified" budget in 1969. *See* Cheryl D. Block, *Congress and Accounting Scandals: Is the Pot Calling the Kettle Black?*, 82 NEB. L. REV. 365, 423 (2003).

201. According to Professor Bartke:

Fannie's ownership would solve this problem.[202] President Johnson, therefore, encouraged Congress to take measures that would transfer Fannie's ownership to private investors.[203]

Congress's response was the Housing and Urban Development Act of 1968.[204] In order for Fannie to become privately owned, Fannie needed a way to raise money to retire the preferred stock owned by the government. The 1968 Act authorized Fannie to issue long-term subordinated debt.[205] This subordinated debt was callable at Fannie's option and convertible into common stock.[206] Although the debt was not guaranteed by the government, Fannie retained its ability to borrow from Treasury.[207] This reduced the perceived riskiness of the debt.[208] On September 19, 1968, Fannie "sold $250 million of debentures . . . to finance its transformation from a partially owned Government institution to a privately owned corporation."[209] Investors were much more anxious to hold the stock of a privately owned Fannie. The price of Fannie stock shot up.[210]

> Under the Commission's proposal, the secondary market operations would be included in the federal budget. An estimate was made that for the first year this would have increased the budget approximately two and one half billion dollars. The public and Congressional reaction to a sudden increase of this magnitude worried administration spokesmen.

Bartke, *supra* note 113, at 31 (citations omitted). *See also* FED. NAT'L MORTGAGE ASS'N, *supra* note 120, at 5 ("The reformation of the Federal budget to a unified basis in 1968, which would have accounted for all of [Fannie's] mortgage purchases as Federal Expenditures, made the move to private status, as soon as possible, absolutely necessary.").

202. *See* REPORT OF THE PRESIDENT'S COMMISSION ON BUDGET CONCEPTS, *supra* note 200, at 29-30; Edwin L. Dale, Jr., *Fanny May Notes to Retain Status*, N.Y. TIMES, Feb. 5, 1968, at 49 (noting that "under private ownership, [Fannie's] operations will not be included in the Federal budget").

203. *See* LYNDON B. JOHNSON, A MESSAGE ON HOUSES AND CITIES, H.R. DOC. NO. 90-261 (2d Sess. 1968); Edwin L. Dale, Jr., *U.S. Aides Concede Budget 'Gimmicks,'* N.Y. TIMES, Sept. 12, 1968, at 1, 26 (noting that the Johnson administration used the privatization of Fannie to "save" more than $100 million in the federal budget).

204. Housing and Urban Development Act of 1968, Pub. L. No. 90-448, 82 Stat. 476.

205. *Id.* § 805(e), 82 Stat. at 543.

206. *Id.*

207. John H. Allan, *Credit Markets: Fanny May Sells $250-Million Bond Offering*, N.Y. TIMES, Sept. 20, 1968, at 72 ("While the issue is not guaranteed by the Federal Government nor is it a direct obligation of the United States, [Fannie] does have a commitment from the Treasury to get borrowed funds, if it must, to pay principal or interest.").

208. *Id.*

209. *Id.*

210. Metz, *Fanny May Nears Private Status*, *supra* note 196, at F1.

Although Fannie was now officially a private company, it retained many ties to the government. As previously mentioned, Fannie maintained the ability to borrow from Treasury.[211] Fannie maintained its government charter and public purpose.[212] Fannie was not required to pay most state and local taxes.[213] Fannie's securities were exempt from SEC registration.[214] Commercial banks and thrifts could purchase Fannie's securities even though they could not purchase most other securities.[215] The Federal Reserve could purchase Fannie securities as part of open market operations.[216] In short, Fannie became a government-sponsored enterprise.

Unlike Fannie, Freddie was privately funded from its inception. Freddie's original charter provided that its stock would be owned by the Federal Home Loan Banks.[217] The Federal Home Loan Banks in turn were owned by commercial banks and thrifts who borrowed from the Federal Home Loan Banks.[218] In 1989, Congress became concerned about the financial stability of many of the thrifts that owned Freddie stock. Congress determined that one way to improve the balance sheet of the savings and loans was to increase the value of the Freddie stock they held.[219] Congress noticed the large increase in Fannie's stock price that occurred when it was converted to private ownership and decided that publicly traded ownership might also increase the value of Freddie stock.[220] Congress therefore converted Freddie to a publicly traded company.[221] Although Freddie was privately owned from its inception, its charter was modeled after Fannie's charter.[222] Thus, it enjoyed the same close association with the federal government and same status as a government-sponsored enterprise.[223]

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211. *See supra* note 208 and accompanying text.

212. 12 U.S.C. §§ 1716–1716b (2006).

213. *Id.* § 1723a(c)(2).

214. *Id.* § 1719(d).

215. *Id.* §§ 24 (Seventh), 335(2), 1464(c), 1757(7)(E).

216. *Id.* § 355(2).

217. Emergency Home Finance Act of 1970, Pub. L. No. 91-351, § 304(a), 84 Stat. 450, 454.

218. Federal Home Loan Bank Act, Pub. L. No. 72-304, §§ 2(4), 4(a), 6(c), 47 Stat. 725, 725, 726–27 (1932).

219. W. Scott Frame & Lawrence J. White, *Fussing and Fuming over Fannie and Freddie: How Much Smoke, How Much Fire?*, 19 J. ECON. PERSP. 159, 161 (2005).

220. *Id.*

221. Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, § 731, 103 Stat. 183, 432.

222. Frame & White, *supra* note 219, at 161.

223. *See* 12 U.S.C. § 1452(e) (2006) (exempt from most state and local taxes); *id.* § 1455(c) (Treasury may purchase debt); *id.* § 355(2) (Federal Reserve may

2. COMPETITION AND CRITICISM EMERGES

As private capital emerged to fund Fannie and Freddie, private money also emerged to fund mortgage securities that were not issued by Fannie or Freddie. Beginning in the late 1970s, pension funds, insurance companies, securities dealers, and other financial institutions all began to participate in the secondary mortgage market by issuing mortgage-backed securities.[224] These private label issuances grew at a steady clip during the 1980s[225] before experiencing explosive growth in the early 1990s.[226] In 1993 nearly $100 billion in private-label mortgage-backed securities were issued.[227]

Because Fannie and Freddie already had a stronghold on "conforming mortgages" (mortgages that the GSEs were allowed by regulation to purchase), the purely private mortgage-backed securities typically involved mortgages that the GSEs were not allowed to purchase.[228] This meant that "private label" securities typically involved large loans or loans where the borrower's credit was not good enough to meet Fannie's and Freddie's underwriting criteria.[229]

In the same way that commercial banks and insurance companies came to resent the Farm Credit System, some of the issuers of private-

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purchase securities as part of open market operations); *id.* § 1723c (securities exempt from SEC registration); *id.* §§ 24 (Seventh), 335(2), 1464(c), 1757(7)(E) (securities may be purchased by banks, thrifts, and credit unions).

224. Eric Bruskin et al., *The Nonagency Mortgage Market: Background and Overview*, *in* THE HANDBOOK OF NONAGENCY MORTGAGE-BACKED SECURITIES 9-10 (Frank J. Fabozzi et al. eds., 2d ed. 2000) ("The first rated publicly issued nonagency [mortgage-backed security] was issued by Bank of America in 1977."). In 1984, Congress encouraged the growth of the private-label secondary mortgage market by amending securities laws regarding mortgage-backed securities. *See* Secondary Mortgage Market Enhancement Act of 1984, Pub. L. No. 98-440, 98 Stat. 1689.

225. Edward L. Pittman, *Economic and Regulatory Developments Affecting Mortgage Related Securities*, 64 NOTRE DAME L. REV. 497, 497 (1989) ("From 1984 through 1988, the total amount of private mortgage securities offered yearly increased from ten billion dollars to over seventy-one billion dollars.").

226. Bruskin et al., *supra* note 224, at 12 ("[I]n 1990, only about 27% of nonconforming loans went into [mortgage-backed securities]; by 1993, this number had risen to about 46%, a record high."). Dr. Bruskin and his co-authors attribute this growth to lower interest rates and a "rally in the bond market." *Id.*

227. *Id.*

228. Christopher L. Peterson, *Fannie Mae, Freddie Mac, and the Home Mortgage Foreclosure Crisis*, 10 LOY. J. PUB. INT. L. 149, 158-59 (2009); David Reiss, *Fannie Mae and Freddie Mac and the Future of Federal Housing Finance Policy: A Study of Regulatory Privilege*, 61 ALA. L. REV. (forthcoming 2010) (manuscript at 7, *available at* http://ssrn.com/abstract=1357337).

229. Bruskin et al., *supra* note 224, at 9-10.

label securities came to resent Fannie and Freddie.[230] The private-label issuers believed Fannie's and Freddie's ties to the government gave these GSEs an unfair advantage.[231] Like the Farm Credit System, Fannie and Freddie enjoyed significant tax benefits.[232] Competitors also believed that Fannie and Freddie borrowed money at lower interest rates due to investors' perceptions that the government would provide financial assistance if needed.[233]

Fannie and Freddie also faced critics beyond their competitors. Some wondered why, if private-label issuers were participating in the secondary market, the government needed to maintain any ties with Fannie and Freddie.[234] They claimed that any benefits the government

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230. Richard W. Stevenson, *Fannie Mae in Center of Firestorm*, CONTRA COSTA TIMES, Apr. 22, 2000, at C01. "General Electric's GE Capital, Chase Manhattan, American International Group, Wells Fargo and many financial services industry trade groups" formed a coalition to lobby against what they viewed as unfair competition from Fannie and Freddie. *Id.* The group was originally know as FM Watch, but later changed its name to FM Policy Focus. *See* Bradley K. Krehely, Comment, *Government Sponsored Enterprises: A Discussion of the Federal Subsidy of Fannie Mae and Freddie Mac*, 6 N.C. BANKING INST. 519, 526–27 (2002); Ed Roberts, *Competitors Want Fannie, Freddie Out of Their Business*, CREDIT UNION J., June 16, 2003, at 1.

231. Stevenson, *supra* note 230, at C01.

232. *See* 12 U.S.C. §§ 1452(e), 1723a(c)(2) (2006).

233. *See* Krehely, *supra* note 230, at 526–27. Professors Ambrose and Warga quantitatively analyzed the value of the perceived implied government backing of Fannie and Freddie obligations in 1996. *See* Brent W. Ambrose & Arthur Warga, *Pricing Effects in Fannie Mae Agency Bonds*, 11 J. REAL EST. FIN. & ECON. 235 (1995). Since that time, numerous other academics have addressed the topic of the perceived implied government backing, most agreeing that there is a perceived implied guarantee. *See, e.g.*, Ron Feldman, *Estimating and Managing the Federal Subsidy of Fannie Mae and Freddie Mac: Is Either Task Possible?*, 11 J. PUB. BUDGETING, ACCT., & FIN. MGMT. 81, 82 (1998); James F. Gatti & Ronald W. Spahr, *The Value of Federal Sponsorship: The Case of Freddie Mac*, 25 REAL EST. ECON. 453, 454 (1997); Wayne Passmore, *The GSE Implicit Subsidy and the Value of Government Ambiguity*, 33 REAL EST. ECON. 465 (2005). Professor Reiss has argued that investors' perceptions of the implied guarantee are justified by the applicable statutes and regulations. David J. Reiss, *The Federal Government's Implied Guarantee of Fannie Mae and Freddie Mac's Obligations: Uncle Sam Will Pick up the Tab*, 42 GA. L. REV. 1019, 1043 (2008). However, most believe that the government has no legal obligation to bail out Fannie's and Freddie's bondholders. *See, e.g.*, Richard Scott Carnell, *Handling the Failure of a Government-Sponsored Enterprise*, 80 WASH. L. REV. 565, 584 (2005); Oedel, *supra* note 113, at 401.

234. *See, e.g.*, John Barry, *Privatize Fannie and Freddie*, J. COM., Aug. 22, 1996, at 6A; Vern McKinley, *Privatize Fannie Mae and Freddie Mac*, USA TODAY, July, 1998, at 16. Mr. McKinley has summarized this argument nicely:

> Supposedly, the reason for granting all these benefits to Freddie Mac and Fannie Mae is that a fully private corporation could not survive without them. Only through government sponsorship could such entities be viable. Whether this argument was true 30 years ago, when the Congress set them

provided to Fannie and Freddie were largely being siphoned off by investors rather than trickling down to borrowers.[235] Moreover, they feared that Fannie's and Freddie's close ties to the government exposed the taxpayers to significant risk if either company were to fail.[236] Like the private-label securities issuers, these critics called for "full privatization." The spate of criticism led to four government reports.[237] However, Fannie and Freddie's GSE status and government benefits were never in serious jeopardy.[238]

IV. COLLAPSE AND BAILOUTS

The favorable economic conditions that made it possible to privatize the ownership of Fannie, Freddie, and the Farm Credit System did not last forever. When farmers and homeowners experienced financial stress, that financial stress eventually trickled down to the GSEs.[239] Rather than let the GSEs collapse, the government provided additional capital to keep the GSEs, and borrowers, afloat.[240]

> up as privately owned corporations, such an argument is extremely suspect today, given the pace of innovation in the financial markets. For example, without the prodding or intervention of Congress creating a specialized government-sponsored enterprise, a secondary market for automobile loans has developed on its own in the private sector.

Id.

235. *See* Richard Scott Carnell, *Federal Deposit Insurance and Federal Sponsorship of Fannie Mae and Freddie Mac: The Structure of Subsidy*, *in* SERVING TWO MASTERS, YET OUT OF CONTROL 56, 68 (Peter J. Wallison ed., 2001).

236. Stephen Moore, *Will Fannie Mae, Freddie Mac Still Pick Taxpayers' Pockets?*, INVESTOR'S BUS. DAILY, July 13, 2000, at A22 (discussing then-Federal Reserve Chairman Alan Greenspan's view that Fannie and Freddie posed serious risk to taxpayers).

237. CONG. BUDGET OFFICE, ASSESSING THE PUBLIC COSTS AND BENEFITS OF FANNIE MAE AND FREDDIE MAC (1996); U.S. DEP'T OF HOUS. & URBAN DEV., PRIVATIZATION OF FANNIE MAE AND FREDDIE MAC: DESIRABILITY AND FEASIBILITY (1996); U.S. DEP'T OF THE TREASURY, GOVERNMENT SPONSORSHIP OF THE FEDERAL NATIONAL MORTGAGE ASSOCIATION AND THE FEDERAL HOME LOAN MORTGAGE CORPORATION (1996); U.S. GEN. ACCOUNTING OFFICE, HOUSING ENTERPRISES: POTENTIAL IMPACTS OF SEVERING GOVERNMENT SPONSORSHIP (1996).

238. *See Drive to Privatize GSEs Killed with Senate Vote*, MORTGAGE MARKETPLACE, June 29, 1992, at 3; Janet Novack, *Fireproof Fannie*, FORBES, Apr. 10, 1995, at 63–64 (discussing Congress' reluctance to impose taxes on Fannie); Shigdha Prakash, *Baker to Steer Hearing on GSEs Toward Safety, Not Privatization*, AM. BANKER, June 12, 1996, at 13 (discussing Congress' unwillingness to privatize Fannie and Freddie); Evelyn Wallace, *Fannie Mae Official Says that Congress is Unlikely to Privatize Fannie Mae Soon*, BOND BUYER, July 31, 1987, at 4.

239. *See infra* Parts IV.A.1 and IV.B.1.

240. *See infra* Parts IV.A.2 and IV.B.2.

A. The Farm Credit System

After converting to a GSE, the Farm Credit System enjoyed several years of profitable operations. During the 1960s and 1970s, driven by inflation, United States farm commodity prices increased rapidly.[241] Farmers, eager to take advantage of the higher prices, increased production.[242] This rapid expansion in production was financed with ever growing debt.[243] The Farm Credit System, freed from government ownership, wanted to make sure it got its share of the action, but it was still hampered by legislative restrictions. In particular, the Farm Credit System was restricted to lending to farmers, and the Land Banks could only lend up to 65 percent of the value of the land.[244] In 1969, the Federal Farm Credit Board created the Commission on Agriculture to recommend changes for the Farm Credit System.[245] The Commission recommended expanding the Farm Credit System's lending authority.[246]

Congress had little trouble seeing the benefits of expanding the Farm Credit System's authority.[247] The Farm Credit Act of 1971 allowed the Land Banks to lend up to 85 percent of the market value of property.[248] It also allowed the Land Banks and Production Credit Associations to extend credit to those outside the traditional definition of "farmer," including nonfarm rural home owners and those who

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241. H.R. REP. NO. 100-295(I), at 53 (1987), *reprinted in* 1987 U.S.C.C.A.N. 2723, 2725.

242. *Id.* ("During [the late 1960s and 1970s], the United States agricultural giant reacted to higher commodity prices, persistent hunger in some parts of the world, and technoogical [sic] gains by vastly increasing production. This was accomplished by increasing both yields per acre and bringing 70 to 80 million new acres into crop production . . . ."). According to agricultural historian Wayne Rasmussen, most experts believed prices and demand for agricultural products would stay high. *Agricultural Credit: Hearings Before the Subcomm. on Agricultural Credit of the S. Comm. on Agric., Nutrition & Forestry*, 100th Cong. 22 (1987) [hereinafter *Agricultural Credit*] (statement of Wayne Rasmussen, agricultural historian).

243. H.R. REP. NO. 100-295(I), at 53 ("[P]roduction increases required vast capital expenditures that resulted in aggregate farm debt growing from about $80 billion in 1960 to almost $220 billion by the early 1980's.").

244. *See* HOAG, *supra* note 38, at 268.

245. COMM'N ON AGRIC. CREDIT, THE FARM CREDIT SYSTEM IN THE 70'S: THE REPORT OF THE COMMISSION ON AGRICULTURAL CREDIT (1970). *See also* HOAG, *supra* note 38, at 263; Brake, *supra* note 76, at 576.

246. COMM'N ON AGRIC. CREDIT, *supra* note 245, at 17–18.

247. *See* H.R. REP. NO. 92-593, at 1 (1971), *reprinted in* 1971 U.S.C.C.A.N. 2091, 2091 (hailing the expansion of the Farm Credit System's lending authority as "a landmark in the history of the Farm Credit System" that would "bring much needed credit to a growing and changing agriculture").

248. Farm Credit Act of 1971, Pub. L. 92-181, § 1.9, 85 Stat. 584, 586.

provided farm-related services.[249] With its expanded lending authority and an aggressive lending strategy,[250] the Farm Credit System came to control a large part of the farm credit market.[251]

1. FINANCIAL DIFFICULTY

However, trouble was brewing. By the end of the 1970s, the increase in farm commodity production was more than the markets could support.[252] Farm commodity prices fell, but the costs of production increased.[253] Farm incomes plummeted.[254] With farm incomes low, the demand for agricultural land was also low.[255] In 1980,

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249. *Id.* § 1.8, 85 Stat. at 586.

250. According to some press reports, the Farm Credit System would lend money to anyone.

> Herbert Ashton, an Indiana fruit farmer, recalls being wined and dined at a local country club by bankers from his local system bank who extolled the virtues of inflation and offered to lend him $1 million on the spot. "I turned it down," he recalls. "But they sounded like a soap testimonial. They were giving money to whoever passed their way, and they didn't ask too many questions."

Charles F. McCoy, *Out of Options: Farm Credit System, Buried in Bad Loans, Seeks Big U.S. Bailout*, WALL ST. J., Sept. 4, 1985, at 1.

251. Brake, *supra* note 76, at 593 (stating in 1974 that federal land banks held "mortgage loans equal to about one-fourth of total farm mortgage debt [and] production credit associations [held] approximately thirty percent of the non-real estate institutional loans to farmers"). *See also* HOAG, *supra* note 38, at 269-70 (noting that in 1975, the Federal Land Banks held nearly 30 percent of the farm mortgage market).

252. *See* Wayne D. Rasmussen, *New Deal Agricultural Policies After Fifty Years*, 68 MINN. L. REV. 353, 363 (1984) ("Three straight bumper crops in the United States and strong crops elsewhere in the world caused [farm commodity] surpluses to build and farm prices to decline drastically."); Laurie Cohen, *Farmers Can Expect a Substantial Drop in 1980 Earnings, U.S. Agency to Report*, WALL ST. J., Nov. 2, 1979, at 38 (noting that "a record [wheat] harvest" and expanded supplies of hogs and poultry were likely to lead to lower farm commodity prices in 1980); Charles J. Elia, *Economist Sees Net Farm Income Falling 45% in 1980, the Biggest Decline Since 55% in 1921*, WALL ST. J., June 17, 1980, at 47 ("The average prices received by farmers have dropped about 8 [percent] over the past 12 months.").

253. *See* Rasmussen, *supra* note 252, at 363 ("[I]nflation, particularly the rising price of petroleum products, pushed farm production costs sharply higher."); Cohen, *supra* note 252, at 38 (recognizing that "pressure on farmers' net [income] is expected to come from surging costs of fuel and fertilizer"); Elia, *supra* note 252, at 47 (noting that average farm production costs had risen 12 percent in the preceding twelve months).

254. Elia, *supra* note 252, at 47 (reporting that farm incomes fell 40 percent in the second quarter of 1980).

255. Emanuel Melichar, *Agricultural Banks Under Stress*, 72 FED. RES. BULL. 437, 442-43 (1986).

farm land prices began to collapse.[256] Lower income meant that many farmers began to have difficulty making loan payments.[257] Low land prices meant that farmers could not sell the property and move on.[258] By 1984, the trouble in the agricultural markets had, unsurprisingly, spread to agricultural lenders.[259] With farmers unable to make loan payments, these lenders were left with nonaccrual loans[260] or foreclosed properties that were declining in value.[261] "[F]ailures of agricultural banks became increasingly common, and in 1985 on average more than one bank per week failed."[262]

The institutions of the Farm Credit System were not immune from the problems facing other agricultural lenders. In the first three months of 1985, Farm Credit System Banks lost $522 million.[263] By September the governor of the Farm Credit System announced: "We've come to realize that the deterioration in agriculture has grown beyond the ability of [the Farm Credit System] to handle it . . . . We cannot absorb the losses we face."[264] Individual farmers had also reached their breaking points and blamed the Farm Credit System for impending foreclosures. Protestors took over a Production Credit Association in Mankato, Minnesota, and chained the doors shut.[265] They demanded a moratorium on loan foreclosures and left only after the Minnesota governor agreed to a meeting.[266] By this time, the economic situation

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256. Caitlin F. Collier-Wise & Patrick Duffy, Student Agricultural Law Survey, *The Congressional Response to a Crisis in Agricultural Credit: The 1985 Farm Credit Amendments*, 31 S.D. L. REV. 471, 474 (1986) (noting that between 1980 and 1985, agricultural land values declined by 32 percent); Elia, *supra* note 252, at 47 (observing a decline in farm income and a "softening" of farm land values in 1980).

257. H.R. REP. NO. 100-295(I), at 56-57 (1987), *reprinted in* 1987 U.S.C.C.A.N. 2723, 2728.

258. Melichar, *supra* note 255, at 441-42.

259. *Id.* at 437.

260. Nonaccrual loans are "loans for which neither principal nor interest payments are expected." H.R. REP. NO. 100-295(I), at 57, *reprinted in* 1987 U.S.C.C.A.N. at 2729.

261. S. REP. NO. 99-145 (1985), *reprinted in* 1985 U.S.C.C.A.N. 1676, 1988.

262. Melichar, *supra* note 255, at 437.

263. Collier-Wise & Duffy, *supra* note 256, at 476. By the end of 1985, the Farm Credit System had lost $2.7 billion. H.R. REP. NO. 100-295(I), at 57, *reprinted in* 1987 U.S.C.C.A.N. at 2729.

264. McCoy, *supra* note 250, at 1 (quoting Farm Credit Ass'n Governor Donald Wilkinson). This announcement marked what is known as "'Black Wednesday' . . . in Farm Credit circles." SUNBURY, *supra* note 15, at xiii.

265. *Farm Group Takes Over Loan Office*, HOUS. CHRON., Dec. 18, 1985, at 17; *Protestors Seize Office, Demand Farm Action*, CHI. TRIB., Dec. 18, 1985, at 3.

266. *Farm Group Takes Over Loan Office*, *supra* note 265, at 17; *Protestors Seize Office, Demand Farm Action*, *supra* note 265, at 3.

was routinely being described as a farm credit "crisis."[267] Some commentators opined that it was the worst economic disaster since the Great Depression.[268]

2. PRELIMINARY GOVERNMENT ACTION

Congress and President Ronald Reagan's Administration generally agreed that something needed to be done.[269] Neither, however, was anxious to open the public coffers to bail out the Farm Credit System.[270] Instead, Congress attempted to shore up the System through a regulatory crackdown.[271] The Farm Credit Amendments Act of 1985 revamped the Farm Credit Administration to create a stronger, independent regulator for the Farm Credit System.[272] The Farm Credit Administration, like other banking regulators, would regularly examine the Farm Credit System institutions.[273] To ensure that the examinations could result in more than idle regulatory threats, Congress gave the Farm Credit Administration authority to issue cease-and-desist orders to stop unsafe or unsound operating practices at Farm Credit System institutions.[274]

Although the 1985 Amendments did not appropriate funds for the Farm Credit System, it did make a half-hearted effort to help Farm Credit System institutions that desperately needed additional funds. The Amendments created the Farm Credit System Capital Corporation to raise money through the issuance of securities for all of the Farm

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267. *See, e.g.*, *Bringing the Future into Focus*, AM. BANKER, Dec. 19, 1985, at 9; Eleanor Clift, *Reagan Signs History's Most Costly Farm Bill*, L.A. TIMES, Dec. 24, 1985, at 8.

268. 134 CONG. REC. 29,365 (1988) (statement of Sen. Kent Conrad) (opining that "the brutal recession in agriculture in the 1980's [was] the worst since the Great Depression"); McCoy, *supra* note 250, at 1 ("'In scope and in terms of implications for government policy, this is far and away the biggest financial blowup since the Depression' says John Urbanchuk, an economist at Wharton Econometrics Forecasting Associates in Philadelphia.").

269. Marvin R. Duncan, *Farm Credit System—Current Matters*, 38 ALA. L. REV. 537, 538-39 (1987).

270. Congress believed that "much [could] and should be done by the System itself before outside financial assistance [was] warranted." H.R. REP. NO. 99-425, at 12 (1985), *reprinted in* 1985 U.S.C.C.A.N. 2587, 2598; SUNBURY, *supra* note 15, at 50 (noting that "the Reagan administration . . . show[ed] a reluctance to rush in and rescue the Farm Credit System").

271. Collier-Wise & Duffy, *supra* note 256, at 476; Duncan, *supra* note 269, at 539.

272. Farm Credit Amendments Act of 1985, Pub. L. No. 99-205, § 201, 99 Stat. 1678, 1688-93.

273. *Id.* § 203, 99 Stat. at 1693-94.

274. *Id.* § 204, 99 Stat. at 1694-97.

Credit System components.[275] Because all of the System institutions would be jointly and severally liable on the securities,[276] Congress believed the Credit System Capital Corporation would help distribute System resources from the more solvent System institutions to those that were struggling.[277] As a back-up plan, the amendments authorized the Treasury Secretary, at his discretion, to provide financial assistance to the Farm Credit Administration.[278] Congress and President Reagan both, however, made it clear that they believed Treasury assistance would not be needed.[279]

The regulatory crackdown did little to improve the balance sheets of the Farm Credit System institutions.[280] The System's loan portfolios were just too troubled.[281] Non-accrual loans made up about 12 percent of the Farm Credit System's loan portfolio.[282] In the first half of 1986, the Farm Credit System had operational losses of nearly $1 billion.[283] The newly created Farm Credit System Capital Corporation did little to compensate for the losses. Although the Capital Corporation had success in issuing bonds,[284] the solvent parts of the Farm Credit System recoiled at the prospect of having their profits transferred to the unhealthy institutions and sought judicial relief.[285] As a result, the

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275. *Id.* § 103, 99 Stat. at 1680–86.

276. SUNBURY, *supra* note 15, at 10.

277. H.R. REP. NO. 99-425, at 14 (1985), *reprinted in* 1985 U.S.C.C.A.N. 2587, 2601. Congress also expected the Capital Corporation to act as a warehouse for bad loans made by System members. The Capital Corporation had the authority to restructure or liquidate these bad loans. *Id.*

278. Farm Credit Amendments Act of 1985 § 103, 99 Stat. at 1686–87.

279. H.R. REP. NO. 99-425, at 14, *reprinted in* 1985 U.S.C.C.A.N. at 261 (stating that "if the System uses its own resources effectively, outside assistance is not now needed and not likely to be needed"); *Reagan Signs Farm Bill, Credit Rescue Package*, AM. BANKER, Dec. 24, 1985, at 15 (describing President Reagan's statements upon signing the Farm Credit Amendments Act of 1985).

280. *See* Collier-Wise & Duffy, *supra* note 256, at 477 (stating the Farm Credit Amendments Act of 1985 was akin to "rearranging the chairs on the deck of the Titanic").

281. *See* Duncan, *supra* note 269, at 543.

282. *See Farm Credit Banks Lose $762 Million in Quarter*, N.Y. TIMES, Aug. 7., 1986, at D20 (reporting that the Farm Credit System had $7.6 billion in non-accrual loans and $61.5 billion in total outstanding loans).

283. *See id.* (reporting Farm Credit System operating losses of $968 million for the first half of 1986).

284. Denis G. Gulino, *Farm Credit Measure Breathes New Life Into System's Debt*, BOND BUYER, Dec. 31, 1985, at 4.

285. SUNBURY, *supra* note 15, at 10–11; Jack Willoughby, *What's Yours is Mine*, FORBES, July 28, 1986, at 78. For example, the healthy Amarillo Production Credit Association in Texas filed suit to enjoin the Farm Credit System from seizing its capital. *See Amarillo Prod. Credit Ass'n v. Farm Credit Admin.*, 887 F.2d 507, 510 (5th Cir. 1989). It sought to completely withdraw from the Farm Credit System. *Id.*

Capital Corporation was not able to reinforce the balance sheets of floundering institutions.[286]

The final blow to the Farm Credit System was that its most credit-worthy borrowers were getting loans elsewhere.[287] System lenders, at the insistence of their new regulator, had kept interest rates for borrowers high.[288] If farmers could get a better rate elsewhere, they did. If they could not get a better rate, they complained to their congressional representatives.[289]

At a congressional hearing in September 1986, the General Accounting Office warned that the Farm Credit System may need

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See also Colo. Springs. Prod. Credit Ass'n v. Farm Credit Admin., 695 F. Supp. 15, 19 (D.D.C. 1988) (challenging stock purchase requirements under the takings clause of the Fifth Amendment). The Farm Credit Administration, realizing that the Farm Credit System could not survive if all the healthy institutions withdrew, vigorously challenged Amarillo's withdraw. *See* Willoughby, *supra*, at 78. Ultimately courts concluded that resources could be transferred to troubled institutions and that healthy institutions could not withdraw from the Farm Credit System without the Farm Credit Administration's consent. *Amarillo Prod. Credit Ass'n*, 887 F.2d at 510–13; *Colo. Springs Prod. Credit Ass'n v. Farm Credit Ass'n*, 967 F.2d 648 (D.C. Cir. 1992).

286. H.R. REP. NO. 100-295(I), at 60 (1987), *reprinted in* 1987 U.S.C.C.A.N. 2723, 2731 ("The Capital Corporation has met with only limited success in its short tenure, primarily due to System litigation against its ability to assess healthy System institutions in order to provide financial assistance to distressed banks and associations.").

287. Editorial, *Farm Credit System Going Broke*, CHI. TRIB., Sept. 27, 1986, at 12 (explaining that due to high interest rates, "increasingly [the Farm Credit System] is losing its best and most credit-worthy customers to other lending alternatives"); Charles F. McCoy, *Farm Credit System Has Loss of $1.9 Billion: Grim '86 Results Follow Record Deficit in '85, Problem Assets Climbed*, WALL ST. J., Feb. 19, 1987, at 1 (stating that the Farm Credit System's "loans outstanding dropped to $54.2 billion at year end [1986], from $58.2 billion at Sept. 30 and $66.6 billion at Dec. 31, 1985").

288. The Farm Credit Amendments Act of 1985 had given the Farm Credit Association authority to set capital requirements. Farm Credit Amendments Act of 1985, Pub. L. No. 99-205, § 101, 99 Stat. 1678, 1678–79. The Farm Credit Association used this authority to assert control over the interest rates charged at all System institutions. Jeffrey R. Kayl, *Farm Credit Amendments of 1985: Congressional Intent, FCA Implementation, and Courts' Interpretation (and the Effect of Subsequent Legislation on the 1985 Act)*, 37 DRAKE L. REV. 271, 293 (1988).

289. *Review of Implementation of Farm Credit Amendments Act of 1985: Hearing Before the Subcomm. on Conservation, Credit, and Rural Dev. of the H. Comm. on Agric.*, 99th Cong. 14 (1986) [hereinafter *Review of Implementation of Farm Credit Amendments Act of 1985*] (prepared statement of Rep. Richard Stallings) (stating that "one of the loudest messages we heard while conducting field hearings in Idaho recently was the immediate need to lower interest rates for System borrowers who are still paying rates in excess of 12 percent"); *Farm Credit System Going Broke*, *supra* note 287, at 12 (stating that "a stingier [Farm Credit System] lending policy [has] made for some very unhappy congressional members whose constituents are bearing the brunt").

"externally supplied capital . . . in the relatively near future."[290] It was too late in the year to formulate sweeping changes to the Farm Credit System, so Congress instead opted to relax a few of the Farm Credit System's restrictions.[291] The Farm Credit Act Amendments of 1986 gave the Federal Land Banks, Federal Intermediate Credit Banks, and Banks for Cooperatives the authority to set the interest rates they charged borrowers.[292] Congress hoped this would stem the exodus of Farm Credit System borrowers. The 1986 Amendments also relieved the Farm Credit System from complying with Generally Accepted Accounting Principles.[293] Instead, with the approval of the Farm Credit Administration, System institutions could use more relaxed regulatory accounting principles which would allow deferred recognition of some loan losses.[294] Representative Leon E. Panetta likened the 1986 amendments to "a life jacket with a hole it."[295] Congress knew the 1986 Amendments were not a "cure-all" but hoped they would be enough to tide the Farm Credit System over until more comprehensive reforms could be adopted.[296]

3. THE BAILOUT

In early 1987, Congress was again holding hearings to discuss the fate of the Farm Credit System.[297] By this time, many believed the only thing that would save the Farm Credit System was an infusion of

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290. *Review of Implementation of Farm Credit Amendments Act of 1985*, *supra* note 289, at 100 (prepared statement of William J. Anderson, Assistant Comptroller General).

291. The 1986 amendments were part of a larger deficit reduction bill. Omnibus Budget Reconciliation Act of 1986, Pub. L. No. 99-509, § 1033, 100 Stat. 1874, 1877 (Subtitle D is commonly referred to as the Farm Credit Act Amendments of 1986).

292. *Id.* § 1033, 100 Stat. at 1877.

293. *Id.* § 1037, 100 Stat. at 1878.

294. *Id.*

295. *Bill Would Help Keep Farm Credit System Afloat*, LEXINGTON HERALD-LEADER, Oct. 5, 1986, at C16 (quoting Rep. Leon E. Panetta).

296. *See Review of Implementation of Farm Credit Amendments Act of 1985*, *supra* note 289, at 2 (statement of Rep. Ed Jones) (noting that the amendments were "a barebones effort to address a problem of immediate concern about the System's ability to compete in agriculture financing, but [were] by no means a cure-all to the larger and more long-term crisis that [was] confronting the System's future viability").

297. *Agricultural Credit Conditions: Hearing Before the Subcomm. on Conservation, Credit & Rural Dev. of the H. Comm. on Agric.*, 100th Cong. (1987) (February field hearing in Texas and Arkansas); *Agricultural Credit*, *supra* note 242, at 1 (statement of Sen. David L. Boren).

government money.[298] In December 1987, one of the Farm Credit System institutions, the Federal Land Bank of Jackson, Mississippi, declared itself insolvent.[299] Congress now had its back against the wall. If Farm Credit System institutions failed, the borrowers' investment in the stock of the institutions would be wiped out. These investors had essentially been forced to purchase stock as a condition of borrowing from the Farm Credit System.[300] If their investments were wiped out, future borrowers would look outside the Farm Credit System and the entire System could disintegrate. This could restrict the availability of agricultural loans and further drive down the price of agricultural land. Congress had been working on additional structural changes to the Farm Credit System, but it became apparent that "all the restructuring in the world would not be sufficient without immediate government assistance—a 'bailout.'"[301] Congress responded with the Agricultural Credit Act of 1987.

a. Bailout funds

The immediate task of the Agricultural Credit Act of 1987 was to make sure that the Farm Credit System had access to money that would shore up its institutions' balance sheets. The 1987 Act created the Farm Credit System Financial Assistance Corporation to provide funds to troubled Farm Credit System institutions.[302] To raise money, the Financial Assistance Corporation was given authority to issue up to $4 billion in fifteen-year bonds guaranteed by the federal government.[303] The government would pay all of the interest on the bonds for the first five years and part of the interest on the bonds for the second five years.[304] It was expected that by the final five years of the bonds, the Farm Credit System would again be healthy and would pay the

298. *See, e.g.*, *Agricultural Credit*, *supra* note 242, at 8-9 (statement of Sen. David L. Boren) (noting that "[f]ederal assistance appears likely to be needed soon"); Albert R. Karr, *Congress Moves Toward Financial Aid, Restructuring for Farm Credit System*, WALL ST. J., Feb. 18, 1987, at 1 (quoting Rep. Ed Jones as stating that financial assistance was necessary); McCoy, *supra* note 287, at 2 (stating that the Farm Credit System "bailout is almost certain to entail an eventual contribution of billions of federal dollars").

299. Nash, *supra* note 13, at 33.

300. *See supra* note 155 and accompanying text.

301. SUNBURY, *supra* note 15, at 227.

302. Agricultural Credit Act of 1987, Pub. L. No. 100-233, § 201, 101 Stat. 1568, 1595 (1988) ("The purpose of the Financial Assistance Corporation shall be to carry out a program to provide capital to institutions of the Farm Credit System that are experiencing financial difficulty.").

303. *Id.* § 201, 101 Stat. at 1597; SUNBURY, *supra* note 15, at 227.

304. Agricultural Credit Act of 1987, § 201, 100 Stat. at 1597-98.

interest.[305] However, the government guaranteed the payment of all principal and interest on the bonds.[306] The Financial Assistance Corporation eventually raised $1.261 billion by issuing these guaranteed bonds.[307]

Of the $1.261 billion raised, $419 million went directly to troubled institutions.[308] When an institution required assistance, the Financial Assistance Corporation issued bonds to raise the funds. In return for the financial assistance, the institution issued shares of preferred stock to the Financial Assistance Corporation.[309] When the bonds became due, the institution would reimburse the Financial Assistance Corporation by redeeming the preferred stock.[310]

The remainder of the money raised with the guaranteed bonds went to make payments that healthy System Banks would have had to make under capital preservation agreements,[311] to liquidate the Federal Land Bank of Jackson, Mississippi, and to pay operating expenses of the Financial Assistance Corporation.[312] The Financial Assistance Corporation obtained reimbursement for this money by assessing System Banks.[313] The Financial Assistance Corporation could also assess System Banks in order to reimburse Treasury for the interest payments advanced early in the life of the bonds.[314]

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305. *Id.* § 201, 100 Stat. at 1598.

306. *Id.* § 201, 100 Stat. at 1602.

307. U.S. GEN. ACCOUNTING OFFICE, FARM CREDIT SYSTEM: REPAYMENT OF FEDERAL ASSISTANCE AND COMPETITIVE POSITION 5, 32 (1994); PETER J. BARRY, THE EFFECTS OF CREDIT POLICIES ON U.S. AGRICULTURE 75 (1995).

308. U.S. GEN. ACCOUNTING OFFICE, *supra* note 307, at 33.

309. Agricultural Credit Act of 1987 § 201, 100 Stat. at 1602. *See Farm Credit Board to Aid Mississippi Bank*, L.A. TIMES, Mar. 1, 1988, at 6 (describing financial assistance provided to the Federal Land Bank of Jackson, Mississippi); Sharon Schmickle, *St. Paul Farm Credit Bank to Receive Aid of $133 Million*, STAR TRIB. (Minneapolis, Minn.), Oct. 22, 1988, at 09B (describing financial assistance provided to the Farm Credit Bank of St. Paul).

310. U.S. GEN. ACCOUNTING OFFICE, *supra* note 307, at 36.

311. Before the 1985 Act, some farm credit districts had attempted to spread risk by adopting risk-sharing plans known as capital preservation agreements. *See* HOAG, *supra* note 38, at 159.

312. U.S. GEN. ACCOUNTING OFFICE, *supra* note 307, at 32–34.

313. *Id.*

314. *Id.* at 34–35. The Agricultural Credit Act of 1987 required that Farm Credit System institutions share the cost of reimbursement for interest "on a fair and equitable basis." Agricultural Credit Act of 1987 § 201, 101 Stat. at 1598. This left ambiguity for the System banks in determining how much of the interest they would individually be responsible to repay and when it needed to be paid. In 1992, Congress resolved this ambiguity by requiring that each System Bank "make annual annuity-type payments . . . toward the eventual repayment of the Treasury interest advances." U.S. GEN. ACCOUNTING OFFICE, *supra* note 307, at 40; Farm Credit Banks and Associations

By providing guaranteed bonds, the government protected all of the Farm Credit System's investors from loss. When a company experiences financial difficulty, stockholders who own the company usually bear the first losses.[315] Once the equity in the company has been exhausted, bondholders and other borrowers lose their investment.[316] This scenario was not palatable to Congress because, in the case of the Farm Credit System, the stockholders were farmer-borrowers who were largely unable to bear the loss without financial hardship.[317] On the other hand, the Farm Credit System's bondholders were less sympathetic Wall Street investment firms. Although some proposed options that could have placed the loss on the bondholders,[318] the government bailout of the Farm Credit System ultimately protected the investment of both the stockholders and the bondholders. The 1987 Act specifically provided that the stock could be redeemed at par upon the repayment of the loan, just as had been allowed prior to the bailout.[319] Thus, the value of the stock was preserved. The Farm Credit System bondholders were protected because, through the Financial Assistance Corporation, the Farm Credit System now had access to additional borrowing. This borrowing prevented defaults on existing bonds.[320]

b. Borrower assistance

The Agricultural Credit Act of 1987 recognized that many farmer investors/borrowers needed more than stability in the value of Farm Credit System stock they held. They needed a way to prevent

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Safety and Soundness Act of 1992, Pub. L. No. 102-552, § 301, 106 Stat. 4102, 4108-09.

315. *See Kansas City Terminal Ry. Co. v. Cent. Union Trust Co. of New York*, 271 U.S. 445, 454 (1926) (noting "the familiar rule that the stockholder's interest in the property is subordinate to the rights of creditors"); CECCHETTI, *supra* note 24, at 174 ("[T]he stockholder is merely a residual claimant. If the company runs into financial trouble, only after all other creditors have been paid what they are owed will the stockholder receive what is left, if anything. Stockholders get the leftovers!").

316. *See supra* note 315 and accompanying text.

317. *See* CONG. BUDGET OFFICE, ASSISTING THE FARM CREDIT SYSTEM: AN ANALYSIS OF TWO BILLS 5, 19 (1987).

318. *See* NEIL E. HARL, THE FARM DEBT CRISIS OF THE 1980S, at 135-37 (1990) (describing a proposal by Representative James Leach to place losses on Farm Credit System bondholders).

319. Agricultural Credit Act of 1987 § 101, 101 Stat. at 1572.

320. In 1988 "the Federal Land Bank of Jackson defaulted on its trade creditors after the Farm Credit Administration placed it in receivership." CONG. BUDGET OFFICE, *supra* note 4, at 9 n.4. However, the Financial Service Corporation "provided funds to the Jackson Bank's receiver to enable it to make good on its portion of the system's consolidated obligations." *Id.*

foreclosures resulting from defaults on their loans.[321] Congress concluded that Farm Credit System institutions had "been exceedingly reluctant to restructure individual loans on a case-by-case basis."[322] To remedy the situation, the 1987 Act required that borrowers in distress be given the opportunity to request that their loans be restructured.[323] The Farm Credit System lenders were required to accept a farmer's proposal for restructuring if "the potential cost . . . of restructuring the loan [was] less than or equal to the potential cost of foreclosure."[324] If a farmer nevertheless lost his property to a Farm Credit System foreclosure, the farmer was given the opportunity to repurchase the property at fair market value.[325] The Act contained notice provisions to ensure that borrowers were informed of their rights.[326]

Plenty of Farm Credit System borrowers took advantage of these new rights. According to one Farm Credit System executive, by early 1989, the System had restructured more that $10 billion worth of its $50 billion loan portfolio.[327] Another source estimated that "[a]lmost 30% of the dispossessed farms sold by the Farm Credit System in 1987 in Minnesota went to the farmers who'd lost them."[328]

c. Preventing future bailouts

While the Agricultural Credit Act of 1987 was clearly designed to stabilize the Farm Credit System's balance sheet and assist farmers, the

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321. Congressional hearings featured dozens of witnesses representing farmers who testified to the financial calamities facing farmer debtors. *See* H. REP. NO. 100-295(I), at 62 (1987), *reprinted in* 1987 U.S.C.C.A.N. 2723, 2733.

322. *Id.*

323. Agricultural Credit Act of 1987 § 102, 101 Stat. at 1574–75. "Restructuring" was defined broadly to include "rescheduling, reamortization, renewal, deferral of principal or interest, monetary concessions, and the taking of any other action to modify the terms of, or forbear on, a loan in any way that will make it probable that the operations of the borrower will become financially viable." *Id.*

While the bulk of borrower protections in the 1987 Act focused on troubled loans, the Act also contained one provision aimed at loans that were not in default. This provision stated that the Farm Credit System could not demand that a borrower whose principal payments were current provide additional repayment of principal or additional collateral. *Id.*

324. *Id.* § 102, 101 Stat. at 1576.

325. *Id.* § 108, 101 Stat. at 1582.

326. *See id.* §§ 102, 108, 101 Stat. at 1575, 1582.

327. Paul S. Tosto, *Farm Credit Bailout Exec Sees Hope for the System*, WICHITA EAGLE, Feb. 20, 1989, at 2D (quoting Eric P. Thor, an official tasked with determining which Farm Credit System institutions needed financial assistance).

328. Barry Siegel, *Victims to Victors in Farming*, L.A. TIMES, May 19, 1991, at 1 (recounting the story of a Minnesota farmer who "lost land mortgaged at $2,000 an acre, but bought it back at $300 an acre").

Act aimed to do more than provide simple resuscitation. Having passed ineffective Farm Credit System reform legislation in 1985 and 1986, Congress was determined to put the Farm Credit System problems to rest once and for all. Congress wanted to prevent the System from returning with requests for government funds in the future.[329]

One of the recognized weaknesses of the Farm Credit System was its homogeneous asset base.[330] The Farm Credit System engaged only in agricultural lending.[331] When agriculture experienced an economic downturn, so did the Farm Credit System.[332] The Agricultural Credit Act of 1985 sought to minimize this risk by establishing joint and several liability on Farm Credit System bonds.[333] Joint and several liability gave the System geographic diversity.[334] If one Bank was unable to pay its bonds, the others would step in.

In spite of Congress's high hopes, joint and several liability had its limitations. First, it proved to be unwieldy. When one bank could not redeem its share of the bonds, healthy banks were not anxious to volunteer their capital.[335] Although the joint and several liability was "never actually . . . invoked," it sparked litigation[336] and served as "the impetus . . . for a series of complicated capital preservation agreements under which hundreds of millions of dollars . . . passed from healthy

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329. H.R. REP. NO. 100-295(I), at 53-54 (1987), *reprinted in* 1987 U.S.C.C.A.N. 2723, 2725.

330. *Id.* at 57 ("By law, the Farm Credit System's scope of lending is limited to agriculture. When agriculture suffers a severe economic crisis, the Farm Credit System will suffer as well."); HARL, *supra* note 318, at 144 ("In terms of long-term solutions to the Farm Credit System's financial difficulties, one of the most difficult features of system operation is the lack of diversity in the system's loan portfolios.").

331. As Professor Harl explained:

> Because the Farm Credit System lends principally to farmers and farm cooperatives, the system lacks the *horizontal* diversity that most commercial banks have (lending to wage earners, manufacturers, and retailers as well as to farmers, for example). . . . The system lacks the usual measure of *vertical* diversity possessed by many lenders (lending to various stages in the input supply-production-processing-marketing processes). The system also lacks *functional* diversity (engaging in brokerage, insurance sales, and real estate sales, for example, as well as lending money).

HARL, *supra* note 318, at 144.

332. *See supra* notes 83-90, 252-268 and accompanying text.

333. *See supra* note 277 and accompanying text.

334. HARL, *supra* note 318, at 144.

335. H.R. REP. NO. 100-295(I), at 61 (1987), *reprinted in* 1987 U.S.C.C.A.N. 2723, 2732.

336. *See supra* note 285 and accompanying text.

banks to distressed banks."[337] Congress had been looking for a "more expeditious" process for dealing with problem banks.[338] Moreover, pure joint and several liability could lead to moral hazard.[339] Each bank might undertake risky practices knowing that it would reap the benefits while other banks bore the ultimate risk.[340] Finally, the geographic diversity of joint and several liability was of little help during a nationwide agricultural downturn because many of the Farm Credit System banks experienced difficulty.

To ensure that a farm credit crisis would not reoccur in the future, the 1987 Act aimed to create more diversity within the Farm Credit System and ameliorate some of the problems caused by joint and several liability. It did this by creating the Farm Credit Insurance Corporation to insure the payment of both principal and interest of bonds issued by the Farm Credit System institutions.[341] Although the Farm Credit Insurance Corporation was a government agency, the insurance was not simply government-provided insurance. Rather, an insurance fund was created. It was initially funded with $260 million from Treasury.[342] The fund, however, would be primarily financed by assessing insurance premiums to each of the Farm Credit System institutions. Beginning in 1989, each institution would pay 0.15 percent on all accrual loans and 0.25 percent on all non-accrual loans.[343] "This risk-based assessment procedure [was] designed as continuing encouragement to lenders to deal with problem loans early, thereby maintaining a very high percentage of accrual loans that are assessed at the lower rate."[344] The Act provided that the premiums could be reduced when the balance in the fund equaled 2 percent of outstanding obligations or some other actuarially sound amount.[345] Because it would take time for the payment of premiums to accumulate in the fund, the

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337. H.R. REP. NO. 100-295(I), at 61, *reprinted in* 1987 U.S.C.C.A.N. at 2732.

338. *Id.*

339. COLE R. GUSTAFSON, REFORMING THE FARM CREDIT SYSTEM: ANALYSIS OF THE AGRICULTURAL CREDIT ACT OF 1987, at 12 (1988).

340. *Id.*

341. Agricultural Credit Act of 1987, Pub. L. No. 100-233, § 302, 101 Stat. 1568, 1610–11 (1988).

342. *Id.* § 302, 101 Stat. at 1616; U.S. GEN. ACCOUNTING OFFICE, *supra* note 307, at 4, 24.

343. Agricultural Credit Act of 1987 § 302, 101 Stat. at 1612. The formula used to calculate the insurance premium was changed in 2008. *See* Food, Conservation, and Energy Act of 2008, Pub. L. No. 110-246, § 5404, 122 Stat. 1651, 1916–19.

344. H.R. REP. NO. 100-295(I), at 61 (1987), *reprinted in* 1987 U.S.C.C.A.N. 2723, 2732.

345. Agricultural Credit Act of 1987 § 302, 101 Stat. at 1612.

insurance did not become effective until 1993.[346] Once it became effective, it gave the Farm Credit System the added stability of time diversity. It "build[s] up . . . funds in good times to help the system survive in adverse periods."[347]

In addition to creating the insurance fund, the Agricultural Credit Act of 1987 attempted to facilitate long-term stability of the Farm Credit System by consolidating its structure.[348] The Act required that the Federal Land Banks and Intermediate Credit Banks merge to form Farm Credit Banks.[349] Both the Federal Land Bank Associations and the Production Credit Association would be supervised by these Farm Credit Banks.[350] Under the new law, Federal Land Bank Associations and Production Credit Associations could voluntarily merge to form Agricultural Credit Associations.[351] Moreover, Congress encouraged the Farm Credit System to consolidate its operation from twelve geographic districts down to six.[352] Following the 1987 Act, there has been a substantial amount of consolidation in the Farm Credit System. "In the early 1980s, the Farm Credit System was comprised of 37 banks and more than 1,000 local lending associations. Today, there are only 6 Farm Credit System banks and a little more than 200 local lending associations."[353]

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346. U.S. GEN. ACCOUNTING OFFICE, *supra* note 307, at 23.

347. HARL, *supra* note 318, at 144–45.

348. *See* BARRY, *supra* note 307, at 75.

349. Agricultural Credit Act of 1987 § 401, 101 Stat. at 1622. The Federal Land Bank Associations would continue to make long-term loans, while the Production Credit Associations would continue to make short-term loans. *Id.* § 401, 101 Stat. at 1625, 1632, 1635.

350. *Id.* § 401, 101 Stat. at 1630, 1635.

351. *Id.* § 411, 101 Stat. at 1638. Production Credit Associations and Federal Land Bank Associations could also consolidate among themselves. *Id.* Finally, the Act required that each of the twelve Banks for Cooperatives and the Central Bank for Cooperatives consider merging to form one national Bank for Cooperatives. *Id.* § 413, 101 Stat. at 1539–42.

352. *Id.* § 412, 101 Stat. at 1638-39.

353. Farm Credit Council, The Origin of the Farm Credit System, http://www.fccouncil.com/default.aspx?pageid=14 (last visited Mar. 1, 2010). There is now only one National Bank for Cooperatives (known as CoBank). CoBank, CoBank's History, http://www.cobank.com/About_CoBank/General_Info/CoBank_history.htm (last visited Mar. 1, 2010).

In addition to restructuring the Farm Credit System, the Agricultural Credit Act of 1987 created, as a separate entity, the Federal Agricultural Mortgage Corporation, better known as Farmer Mac. Agricultural Credit Act of 1987 § 702, 101 Stat. at 1687–88. Farmer Mac was designed to spur the development of a secondary market in farm mortgages. *Id.* § 701, 101 Stat. at 1686. As originally conceived, Farmer Mac would not buy mortgages. Instead, it would set standard underwriting criteria for agricultural lenders. *Id.* § 702, 101 Stat. at 1688. Other entities, such as life insurance

B. Fannie and Freddie

Like the Farm Credit System, Fannie and Freddie enjoyed several prosperous years after becoming privately owned. During the 1970s, Fannie's and Freddie's influence grew as they began purchasing conventional mortgages and securitizing mortgages they purchased.[354] But it was not completely smooth sailing for Fannie and Freddie; the United States experienced a recession in the early 1980s.[355] Interest rates, and consequently Fannie's and Freddie's borrowing costs, rose.[356] However, Fannie and Freddie held portfolios of long-term mortgages that had been issued in the early 1970s when interest rates were lower.[357] Due to this interest rate mismatch, the market value of Fannie's debt exceeded its assets.[358] However, improved economic conditions[359] and a tax break from the federal government[360] facilitated Fannie's recovery.[361]

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companies and commercial banks, would pool the mortgages. BARRY, *supra* note 307, at 89. If Farmer Mac reviewed the pool and thought the loans complied with the underwriting criteria, Farmer Mac would guarantee securities backed by the pool. Agricultural Credit Act of 1987 § 702, 101 Stat. at 1688. Farmer Mac was not designed to stabilize the Farm Credit System; it was designed to help agricultural banks. Because any lender could sell mortgages guaranteed by Farmer Mac, lenders beyond the Farm Credit System would gain access to Wall Street funding. H.R. REP No. 100-295(I), at 65 (1987), *reprinted in* 1987 U.S.C.C.A.N. 2723, 2736. Congress hoped that Farmer Mac would "put additional competitive pressure on the Farm Credit System." *Id.*

354. *See* Thomas E. Plank, *Regulation and Reform of the Mortgage Market and the Nature of Mortgage Loans: Lessons from Fannie Mae and Freddie Mac*, 60 S.C. L. REV. 779, 796-97 (2009); Reiss, *supra* note 233, at 1030; Peter W. Salsich, *National Affordable Housing Trust Fund Legislation: The Subprime Mortgage Crisis Also Hits Renters*, GEO. J. ON POVERTY L. & POL'Y 11, 27-28 (2009).

355. GEOFFREY H. MOORE, BUSINESS CYCLES, INFLATION, AND FORECASTING 11-17 (2d ed. 1983).

356. *Fannie Mae is Seeking Tax Break*, N.Y. TIMES, Dec. 9, 1981, at D1; *Fannie Mae Loss Widens*, N.Y. TIMES, July 14, 1982, at D7. Interest rates nearly doubled between 1979 and 1981 as the Federal Reserve raised rates in an effort to choke off inflation. *See* Richard F. Janssen, *Analysts Contend that Fed's Crusade Against Inflation Cranks Up Interest*, WALL ST. J., Dec. 18, 1980, at 43; Wall Street Journal, Wall Street Journal Prime Rate History, http://www.wsjprimerate.us/wall_street_journal_prime_rate_history.htm (last visited Mar. 1, 2010).

357. *Fannie Mae is Seeking Tax Break*, *supra* note 356, at D1; *Fannie Mae Loss Widens*, *supra* note 356, at D7.

358. James R. Hagerty, *The Financial Crisis: Bailout Politics: Fannie, Freddie Share Spotlight in Mortgage Mess*, WALL ST. J., Oct. 16, 2008, at A6. Freddie escaped this market insolvency because, at that time, it did not hold a large portfolio of mortgages. *Id.*

359. MOORE, *supra* note 355, at 11-17.

By the early 1990s, Fannie and Freddie had become quite successful. Securitization of mortgages was increasingly popular. In fact, Fannie and Freddie became so successful that they attracted criticism for purchasing only the most desirable loans and not lending to underserved populations.[362] Congress responded by setting affordable housing goals.[363] By 1997, regulations mandated that 42 percent of Fannie's and Freddie's mortgage financing go to borrowers with income below the median in their area.[364] The affordable housing requirements did little to stop the tremendous and growing profitability of Fannie and Freddie.[365] Even high-profile accounting scandals could not derail their profits.[366] Real estate prices were up.[367] More Americans than ever were borrowing to buy a house.[368] And Fannie and Freddie were the leaders in purchasing and securitizing these loans.[369]

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360. Miscellaneous Revenue Act of 1982, Pub. L. No. 97-362, § 102, 96 Stat. 1726, 1727-28 (allowing Fannie to carry net operating losses back ten years and forward five years for tax purposes).

361. *Fannie Mae Loss Slows*, AM. BANKER, Oct. 20, 1982, at 36.

362. BRENT W. AMBROSE & THOMAS G. THIBODEAU, U.S. DEP'T HOUS. & URBAN DEV., AN ANALYSIS OF THE EFFECTS OF THE GSE AFFORDABLE GOALS ON LOW- AND MODERATE-INCOME FAMILIES 2 (2002). *See also supra* Part III.B.2.

363. Housing and Community Development Act of 1992, Pub. L. No. 102-550, § 1332, 106 Stat. 3672, 3956-57; Floyd Norris, *The Dilemma of Fannie & Freddie*, N.Y. TIMES, Sept. 8, 2008, at C1.

364. 24 C.F.R. § 81.12(c)(2) (1997).

365. Carnell, *supra* note 233, at 578-79 (stating that between 1993 and 2003 Fannie and Freddie's "combined total assets rose 503%" and combined "total market value of their publicly traded shares rose 321%").

366. *See generally* FANNIE MAE AND FREDDIE MAC: SCANDAL IN U.S. HOUSING (James R. Christie ed., 2007).

367. David M. Dickson, *How Does Wall Street Meltdown Affect Small Investors?*, WASH. TIMES, Sept. 17, 2008, at A09 (reporting that according to the Case-Shiller housing price index, home values increased nearly 70 percent between 2001 and 2006).

368. *See* Kristen David Adams, *Homeownership: American Dream or Illusion of Empowerment?*, 60 S.C. L. REV. 573, 587 (2009).

369. *See, e.g.*, Winston Sale, *Effect of the Conservatorship of Fannie Mae and Freddie Mac on Affordable Housing*, 18 J. AFFORDABLE HOUS. & CMTY. DEV. L. 287, 291 (2009). According to Sale:

> Since being made private entities, the GSEs have seen their share of the mortgage finance market grow exponentially. In 1980, the residential mortgage market consisted of $1.1 trillion in obligations, of which the GSEs held approximately 7 percent. By 1995, the GSEs held approximately 35 percent of the $2.9 trillion mortgage market. In the first half of 2008, the GSEs held $5.3 trillion in MBS and debt outstanding, and approximately 76 percent of all new mortgages originated in that same period.

Id. (citations omitted).

1. FINANCIAL DIFFICULTY

Trouble, however, was brewing in the subprime housing market. As it turns out, many lenders had given loans to people with poor credit who ultimately could not repay the loans.[370] Some of the loans had adjustable rate mortgages.[371] When the interest rates reset to higher rates, the borrowers could not afford to repay them.[372] Meanwhile, rising interest rates made it difficult for these borrowers to refinance their mortgages at terms they could afford.[373] Lenders began foreclosing on mortgaged property, and housing prices began a precipitous drop, making refinancing even more unlikely for troubled borrowers.[374] Mortgage lenders began to feel the pinch as borrowers began defaulting at a higher rate.[375] Before long, a subprime housing crisis turned into a worldwide economic crisis.[376]

At first some thought that Fannie and Freddie could survive the downturn in the real estate market relatively unscathed.[377] After all, Fannie and Freddie had only purchased mortgages that conformed to standards set by Congress and their regulator.[378] Some, including Fannie and Freddie themselves, even thought the GSEs were stable enough to rescue the housing market by purchasing mortgages that

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370. *See, e.g.*, Kenneth C. Johnston et al., *The Subprime Morass: Past, Present, and Future*, 12 N.C. BANKING INST. 125, 125–28 (2008); Moran, *supra* note 150, at 20-21 (discussing the rise of subprime lending); David Schmudde, *Responding to the Subprime Mess: The New Regulatory Landscape*, 14 FORDHAM J. CORP. & FIN. L. 709, 724 (2009).

371. Johnston et al., *supra* note 370, at 125–28; Moran, *supra* note 150, at 20–21.

372. Johnston et al., *supra* note 370, at 127–28.

373. Schmudde, *supra* note 370, at 724-25.

374. Johnston et al., *supra* note 370, at 130–31.

375. Todd J. Zywicki & Joseph D. Adamson, *The Law and Economics of Suprime Lending*, 80 U. COLO. L. REV. 1, 24 (2009).

376. *See generally* RICHARD A. POSNER, A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION (2009); Douglas W. Arner, *The Global Credit Crisis of 2008: Causes and Consequences*, 43 INT'L LAW. 91 (2009). A complete discussion of the causes of the 2008 credit crisis is beyond the scope of this Article. *See generally* Ellen Harnick, *The Crisis in Housing and Housing Finance: What Caused It? What Didn't? What's Next?*, 31 W. NEW ENG. L. REV. 625 (2009); Johnston et al., *supra* note 370, at 125–28; Moran, *supra* note 150, at 28; Steven L. Schwarcz, *Understanding the Subprime Financial Crisis*, 60 S.C. L. REV. 549 (2009).

377. James R. Hagerty, *Fannie, Freddie Are Said to Suffer in Subprime Mess*, WALL ST. J., July 28, 2007, at A3 (stating that a Citigroup report predicted Fannie and Freddie could "easily ride out" the housing slump).

378. *See* 12 U.S.C. §§ 1454(a)(2), 1717(b)(2) (2006). However, Fannie and Freddie had invested heavily in mortgage-backed securities of dubious quality. *See* Peterson, *supra* note 228, at 162–63.

other investors no longer wanted.[379] Congress seemed to agree. It authorized Fannie and Freddie to purchase mortgages with principal amounts up to $729,750.[380] These optimistic views were soon proven wrong.

By November 2007, losses were mounting at both Fannie and Freddie.[381] Their affordable housing obligations and aggressive buying strategy had left them with significant subprime exposure.[382] Moreover, the drop in housing prices was so large that even the less risky loans in Fannie's and Freddie's portfolios were defaulting at an alarming rate.[383] Fannie and Freddie tried to stem the losses by tightening underwriting criteria,[384] but there was little they could do to prevent losses on their existing portfolios and guarantees.

2. PRELIMINARY GOVERNMENT ACTION

By early 2008, Treasury officials became concerned about the financial condition of Fannie and Freddie.[385] Officials urged both companies to raise capital.[386] Fannie managed to raise $7.4 billion, but Freddie did not raise any additional capital.[387] Perhaps frustrated that it

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379. *See* Jeremy Grant, *Fannie Mae Offer to Ease Subprime Pain Rebuffed by Regulator*, FIN. TIMES, Aug. 11, 2007, at 3 (reporting that Fannie had asked its regulator to expand its mortgage purchasing authority); James R. Hagerty, *Big Fans for Fannie, Freddie*, WALL ST. J., Aug. 8, 2007, at C1 (reporting that, in order to stabilize the housing market, Senators Christopher Dodd and Charles Schumer recommend lifting restrictions on the mortgages Fannie and Freddie could purchase); Stacy-Marie Ishmael et al., *Freddie Mac Chief Warns of Recession*, FIN. TIMES, Sept. 28, 2007, at 27 (reporting that Freddie advocated increasing its loan purchases to alleviate the housing crisis).

380. Economic Stimulus Act of 2008, Pub. L. No. 110-185, § 201, 122 Stat. 613, 619–20.

381. Fannie Mae, Quarterly Report (Form 10-Q), at 3 (Nov. 9, 2007) (reporting a nearly $1.4 billion loss in the third quarter of 2007); Freddie Mac, Consolidated Statements of Income, at 1 (Nov. 20, 2007), *available at* http://www.freddiemac.com/investors/er/pdf/2007fin-tbls_112007.pdf (reporting an unaudited loss of $2 billion in the third quarter of 2007).

382. *See* Sale, *supra* note 369, at 297; James R. Hagerty, *Fannie, Freddie Feel Default Heat*, WALL ST. J., Nov. 19, 2007, at A14.

383. *See* Hagerty, *supra* note 382, at A14.

384. OFFICE OF HOUS. FIN. ENTER. OVERSIGHT, 2008 REPORT TO CONGRESS 41 (2008).

385. Jeffrey H. Birnbaum & Neil Irwin, *Despite Lifelines, Concerns Linger on Mortgage Giants*, WASH. POST, July 15, 2008, at D1; Charles Duhigg, *Pressured to Take More Risk, Fannie Reached Tipping Point*, N.Y. TIMES, Oct. 5, 2008, at A1.

386. Birnbaum & Irwin, *supra* note 385, at D1; Duhigg, *supra* note 385, at A1.

387. Duhigg, *supra* note 385, at D1; Saskia Scholtes, *Freddie Mac Decides Against Raising Capital*, FIN. TIMES, Mar. 13, 2008, at 42.

could not cajole Fannie and Freddie into raising more capital, Treasury called on Congress to create a new, stronger regulator for the companies.[388] Congress, however, did not act immediately.

As financial pressure on both companies mounted,[389] the Federal Reserve and Treasury jointly announced a plan that would allow Fannie and Freddie access to government capital if necessary.[390] The Federal Reserve announced that it would allow Fannie and Freddie to borrow at its discount window,[391] and Treasury formally requested that Congress give it the authority to purchase Fannie's and Freddie's securities.[392] With rumors that Fannie and Freddie would fail swirling, Congress passed the Housing and Economic Recovery Act of 2008.[393] Just as Treasury had requested, the Act strengthen the companies' regulator and provided access to government capital if necessary.

The Housing and Economic Recovery Act replaced Fannie and Freddie's existing regulator with a new independent federal agency, the Federal Housing Finance Agency.[394] Unlike the previous regulator, the Federal Housing Finance Agency was given significant discretion to increase Fannie's and Freddie's capital requirements.[395] The Agency was also given more robust powers in the event either company became undercapitalized.[396] Most significantly, the Agency was given broad

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388. *See* Henry M. Paulson, Sec'y, U.S. Treasury Dep't, Remarks on the U.S. Economy, Housing and Capital Markets at the Washington Post 200 Lunch (May 16, 2008), *available at* http://www.treas.gov/press/releases/hp981.htm.

389. *See* James R. Hagerty et al., *Mortgage Giants Face Pressure Over Capital*, WALL ST. J., July 11, 2008, at A1.

390. Stephen Labaton, *Treasury Unveils Vast Plan to Save Mortgage Giants*, N.Y. TIMES, July 14, 2008, at A1.

391. Press Release, Bd. of Governors of the Fed. Reserve Sys., Board Grants Federal Reserve Bank of New York the Authority to Lend to Fannie Mae and Freddie Mac (July 13, 2008), *available at* http://www.federalreserve.gov/newsevents/press/other 20080713a.htm.

392. Labaton, *supra* note 390, at A1.

393. Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, 122 Stat. 2654 (to be codified in scattered sections of titles 12, 15, 26, 38, and 42 U.S.C.).

394. 12 U.S.C.A. § 4511(a) (West Supp. 2009).

395. *Compare* 12 U.S.C.A. § 4611(a)(1) (West Supp. 2009) ("The Director shall, by regulation, establish risk-based capital requirements for the enterprises to ensure that the enterprises operate in a safe and sound manner, maintaining sufficient capital and reserves to support the risks that arise in the operations and management of the enterprises."), *with* 12 U.S.C. § 4611 (2006) (providing detailed economic assumptions that the regulator was required to use when setting capital requirements).

396. *Compare* 12 U.S.C.A. § 4615 (West Supp. 2009) (giving the regulator significant oversight over the capital restoration plan, asset growth, acquisitions, and new activities of any undercapitalized entity), *with* 12 U.S.C. § 4615 (2006) (providing that an undercapitalized company must submit a capital restoration plan and refrain

power to take control of either company, through either receivership or conservatorship, in the event that the company became "critically undercapitalized."[397]

The Housing and Economic Recovery Act also gave Treasury temporary authority to provide government funds to Fannie and Freddie. Under the Act, Treasury has the authority "to purchase any obligations and other securities issued by" Fannie or Freddie.[398] Such purchases are authorized, whether or not the company is undercapitalized, as long as the Director of the Federal Housing Finance Agency determines that the purchase is necessary to "(i) provide stability to the financial markets; (ii) prevent disruptions in the availability of mortgage finance; and (iii) protect the taxpayer."[399]

Although some press reports referred to the Housing and Economic Recovery Act of 2008 as "bailout" legislation,[400] regulators were quick to point out that it did not give Fannie or Freddie an immediate bailout. Capital infusions would occur only if necessary.[401] When asked why Treasury needed unlimited authority to buy Fannie and Freddie securities, then-Treasury Secretary Henry Paulson explained: "If you've got a squirt gun in your pocket, you may have to take it out. If you've got a bazooka and people know you've got it, you may not have to take it out. You're not likely to take it out."[402]

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from paying dividends). *See also* 12 U.S.C.A. § 4616 (West Supp. 2009) (providing increased regulatory scrutiny for entities classified as significantly undercapitalized).

397. *Compare* 12 U.S.C.A. § 4617(a)(2) (West Supp. 2009) (stating that the Federal Housing Finance Agency "may, at the discretion of the Director, be appointed conservator or receiver for the purpose of reorganizing, rehabilitating, or winding up the affairs of [Fannie or Freddie]"), *with* 12 U.S.C. § 4617 (2006) (giving the regulator the authority to appoint a conservator, but not a receiver). Professor Carnell has provided an excellent description of the limitations on the Office of Federal Housing and Enterprise Oversight's authority under the previous version of section 4617. Carnell, *supra* note 233, at 612–15.

398. 12 U.S.C.A. § 1719(g) (West Supp. 2009).

399. *Id.*

400. *See, e.g.*, Kathleen Pender, *Merchants and Railcars Are Part of Housing Law*, S.F. CHRON., Aug. 3, 2008, at D1 (calling the Act a "giant federal bailout of Fannie Mae and Freddie Mac"). The Act did adopt a bailout for some mortgagors who were facing foreclosure. *See* 12 U.S.C.A. § 1715z-23 (West Supp. 2009). For a complete review of the Housing and Economic Recovery Act of 2008, including provisions not related to Fannie and Freddie, see Bruce Arthur, *Housing and Economic Recovery Act of 2008*, 46 HARV. J. ON LEGIS. 585 (2009).

401. *Recent Developments in U.S. Financial Markets and Regulatory Responses to Them: Hearing Before the S. Comm. Banking, Hous., and Urban Affairs*, 110th Cong. 19 (July 15, 2008) [hereinafter *Recent Developments in U.S. Financial Markets*] (prepared testimony of Henry M. Paulson, Sec'y, Dep't of Treasury).

402. *Nightly Business Report* (PBS television broadcast July 15, 2008), transcript available at http://www.pbs.org/nbr/site/onair/transcripts/080715d) (quoting

Similarly, officials insisted that both Fannie and Freddie were adequately capitalized and were not in imminent danger of being forced into receivership or conservatorship.[403]

3. THE BAILOUT

While the Housing and Economic Recovery Act of 2008 was designed, in part, to give investors confidence in Fannie and Freddie, it "had the opposite effect."[404] In spite of assurances that no government takeover was imminent, stockholders became concerned that a government takeover would eliminate any equity left in the companies.[405] Common stock prices for both Fannie and Freddie dropped to under five dollars a share.[406] By late August, Moody's had downgraded both companies' preferred stock to just above junk status.[407] Both companies also faced increased borrowing costs.[408] To make matters even worse, the Federal Housing Finance Agency determined that Freddie had overstated it capital.[409]

Mr. Paulson's testimony before the Senate Banking, Housing, and Urban Affairs Committee).

403. *Recent Developments in U.S. Financial Markets, supra* note 401, at 5 (testimony of Henry M. Paulson, Sec'y, Dep't of Treasury).

404. Ben Levisohn, *The Final Fate of Fannie and Freddie*, BUS. WEEK ONLINE, Aug. 25, 2008, http://www.businessweek.com/investor/content/aug2008/pi20080821_660796.htm.

405. *See* James R. Hagerty & Aparajita Saha-Bubna, *Fannie Mae, Freddie Mac Are Pounded: Two Stocks Plunge on Growing Fears of a U.S. Bailout*, WALL ST. J., Aug. 19, 2008, at A3. According to one investment advisor:

> You would have to be insane to invest in [Fannie and Freddie] right now. . . . When Treasury comes in, they are guaranteed to get a better deal than [other investors], which would push down the value of [the] investment. So why would we ever invest before we know what Treasury is going to do?

Charles Duhigg & Vikas Bajaj, *Uncertainty Over Fannie and Freddie*, N.Y. TIMES, Aug. 23, 2008, at C1.

406. Levisohn, *supra* note 404; Paul Muolo & Brian Collins, *New Concerns On GSEs*, NAT'L MORTGAGE NEWS, Aug. 25, 2008, at 1.

407. James R. Hagerty & Serena Ng, *Banks Hit as Fannie, Freddie Get Downgrade*, WALL ST. J., Aug. 23, 2008, at A1.

408. *See* David Cho & Jeffrey H. Birnbaum, *Treasury's Vigil on Fannie, Freddie: Paulson Watches Preferred Stock, Debt Sales for Signs of Trouble*, WASH. POST, Aug. 23, 2008, at D1 ("Lenders have continued to buy their debt but only at higher rates."); Muolo & Collins, *supra* note 406, at 1 ("Fannie priced new five-year notes at 113 basis points over the comparable Treasury obligation. It was the highest spread the GSE had ever paid on such a debt offering.").

409. *See* Gretchen Morgenson & Charles Duhigg, *Mortgage Giant Overstated Size of Capital Base*, N.Y. TIMES, Sept. 7, 2008, at A1.

Treasury and the Federal Housing Finance Agency decided that they must act. On September 8, 2008, they announced that Fannie and Freddie would be placed in voluntary conservatorship.[410] Federal Housing Finance Agency Director James Lockhart described conservatorship as "a statutory process designed to stabilize a troubled institution with the objective of returning the entit[y] to normal business operations."[411] Under the conservatorship, the Federal Housing Finance Agency would operate the two companies until they were financially healthy again.[412]

a. Bailout funds

As part of the conservatorship, Treasury agreed to provide government capital to Fannie and Freddie, should it be necessary.[413] Treasury agreed that if either company became insolvent, it would purchase preferred stock in that company.[414] These preferred shares would be senior to the company's existing preferred shares. In exchange for this promise of future assistance, each company gave Treasury $1 billion in preferred shares.[415] Each company also provided warrants for the purchase of common stock representing a 79.9 percent

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410. Lockhart Statement, *supra* note 5, at 7; Press Release, Fed. Hous. Fin. Agency, Questions and Answers on Conservatorship 1-3 (Sept 7, 2008), *available at* http://www.fhfa.gov/GetFile.aspx?FileID=35.

411. Lockhart Statement, *supra* note 5, at 5-6.

412. *Id.* at 7; Press Release, Fed. Hous. Fin. Agency, *supra* note 410, at 2.

413. *See* Paulson Statement, *supra* note 5.

414. The initial agreements limited Treasury's purchases to $100 billion for each company. Fannie Mae Stock Purchase Agreement, *supra* note 10, ¶ 2.1; Freddie Mac Stock Purchase Agreement, *supra* note 10, ¶ 2.1. On February 18, 2009, Treasury increased its pledge of capital to $200 billion for each company. Statement of Tim Geithner, Sec'y, Dep't of Treasury, Treasury's Commitment to Fannie Mae and Freddie Mac (Feb. 18, 2009), *available at* http://www.treas.gov/press/releases/tg32.htm. On December 24, 2009, Treasury eliminated any cap of the amount of preferred stock it will purchase in the two companies. Press Release, U.S. Treasury Dep't, Treasury Issues Update on Status of Support for Housing Programs (Dec. 24, 2009), *available at* http://www.ustreas.gov/press/releases/2009122415345924543.htm.

415. Fannie Mae Stock Purchase Agreement, *supra* note 10, ¶ 3.1; Freddie Mac Stock Purchase Agreement, *supra* note 10, ¶ 3.1.

interest in each company at a nominal price.[416] The warrants are exercisable for twenty years.[417]

Within months of conservatorship, both companies announced that they needed government capital.[418] Since then, the government has purchased roughly $51 billion in Freddie and $60 billion in Fannie.[419]

By taking preferred stock and warrants for common stock, Treasury preserved the investment of Fannie and Freddie bondholders.[420] At the time of the takeover, Fannie and Freddie had more than $5.14 trillion in outstanding mortgage-backed securities and guarantees.[421] Much of this debt was held by foreign investors.[422] "Treasury could not eliminate it or otherwise impair this debt without risking significant if not catastrophic disruption to the mortgage market."[423] There was also worry that impairing subordinated debt "would drive away foreign lenders from U.S. debt at a time when the United States required this money to service its federal obligations."[424]

On the other hand, taking preferred stock and warrants for common stock did harm Fannie's and Freddie's existing stockholders. First, it diluted the existing stockholders' ownership interest. Second, the terms of the preferred stock issued to Treasury provided that no dividend could be paid on equity securities without Treasury's consent while Treasury still held preferred stock.[425] Third, the conservatorship itself prevented the existing stockholders from having any say in the

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416. Fannie Mae Warrant to Purchase Common Stock, Sept. 7, 2008, *available at* http://www.treasury.gov/press/releases/reports/warrantfnm3.pdf; Freddie Mac Warrant to Purchase Common Stock, Sept. 7. 2008, *available at* http://www.treasury.gov/press/releases/reports/warrantfrec.pdf.

417. Fannie Mae Warrant to Purchase Common Stock, *supra* note 416; Freddie Mac Warrant to Purchase Common Stock, *supra* note 416.

418. Press Release, Fannie Mae, Fannie Mae Reports Third Quarter 2008 Results (Nov. 10, 2008), *available at* http://www.fanniemae.com/media/pdf/newsreleases/q32008_release.pdf; James R. Hagerty & Aparajita Saha-Bubna, *Freddie Needs $13.8 Billion as Mortgage Defaults Worsen*, WALL ST. J., Nov. 15, 2008, at A3.

419. Press Release, U.S. Dep't of Treasury, *supra* note 414.

420. *See* Anne Bond Emrich, *Treasury Bails Out Fannie, Freddie*, GRAND RAPIDS BUS. J., Sept. 15, 2008, at 3. *See also supra* notes 315–316 and accompanying text (explaining that bondholders are paid before stockholders).

421. Steven M. Davidoff & David Zaring, *Regulation by Deal: The Government's Response to the Financial Crisis*, 61 ADMIN. L. REV. 463, 488 (2009).

422. *Id.*

423. *Id.*

424. *Id.* at 488–89.

425. Fannie Mae Stock Purchase Agreement, *supra* note 10, ¶ 5.1; Freddie Mac Stock Purchase Agreement, *supra* note 10, ¶ 5.1.

management of the companies during the period of conservatorship.[426] However, the bailout did not totally eliminate the existing stockholders' interests. Treasury's reasons for preserving existing stock are not clear. Treasury may have been concerned about the large amount of stock held by U.S. financial institutions—institutions that were already dealing with the financial crisis.[427] Others have speculated that the stockholders' interest was preserved to retain favorable tax and accounting treatment.[428]

b. Borrower assistance

Although there was little mention of homeowners when the Federal Housing Finance Agency announced the conservatorship of Fannie and Freddie,[429] it quickly became apparent that the conservatorship was more than a way to save the GSEs—it was a way to prevent mortgage foreclosure for many Americans.[430] The Housing and Economic Recovery Act of 2008 provided some incentives for mortgage holders

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426. *See* Press Release, U.S. Treasury Dep't, Fact Sheet: Treasury Senior Preferred Stock Purchase Agreement (Sept. 7, 2008), *available at* http://www.treas.gov/press/releases/reports/pspa_factsheet_090708%20hp1128.pdf ("In a conservatorship, voting rights of all stockholders are vested in the Conservator.").

427. *See* Paulson Statement, *supra* note 5 (noting that U.S. banks held Fannie and Freddie stock and urging banks to contact their regulators if they believed impairment of the stock would impact their capital).

428. Davidoff & Zaring, *supra* note 421, at 489. According to Professors Davidoff and Zaring:

> [Privately owned stock was likely retained] for one or more of the following reasons: (1) to support a position that the GSEs did not have to be consolidated onto the books of the federal government for accounting purposes (something the Congressional Budget Office disputed); (2) to build a case that each GSE was not now a government-controlled entity so that the government's unique accounting rules did not have to be adopted by these entities; (3) to ensure that these GSEs could still deduct the interest paid on their loans from the government, something they would be unable to do under § 163 of the Internal Revenue Code if they were deemed "controlled" by the government; and (4) to ensure for Employee Retirement Income Security Act (ERISA) purposes that the GSEs were not deemed "controlled" by the government, making them jointly and severally liable for these entities's ERISA plan liabilities.

Id. (citations omitted).

429. Director Lockhart did state that the conservatorship would "enhance [Fannie's and Freddie's] capacity to fulfill their mission," but he never mentioned foreclosures. Lockhart Statement, *supra* note 5, at 6.

430. *See* Stacy Kaper & Cheyenne Hopkins, *Long Tussle Over GSEs Just Starting*, AM. BANKER, June 2, 2009, at 1 ("The Obama administration is using the GSEs to implement a critical portion of its foreclosure prevention plan . . . .").

to voluntarily modify troubled mortgages,[431] but it was widely thought to be less than effective.[432] With the Federal Housing Finance Agency now at the helm of Fannie and Freddie, the government had direct authority to negotiate modifications on the 30.4 million mortgages held by the two companies.[433] By November 2008, Fannie and Freddie announced a new "streamlined" process for mortgage modifications.[434] They also temporarily suspended all foreclosure sales on owner-occupied properties while the program was implemented.[435] Under the new streamlined mortgage modification plan, both companies' mortgage modifications increased dramatically. The Federal Housing Finance Agency reported that Fannie and Freddie "initiated more than 485,000 mortgage loan modifications through December 2009."[436]

In addition to renegotiating troubled mortgages, Treasury and the Federal Reserve have aided homeowners by purchasing Fannie and Freddie debt and mortgage-backed securities.[437] Because Fannie and

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431. *See* 12 U.S.C.A. § 1715z-23 (West Supp. 2009) (creating the HOPE for Homeowners program which guaranteed payment on some voluntarily modified mortgages).

432. *See* Dina ElBoghdady, *HUD Chief Calls Aid on Mortgages a Failure: Congress Blamed for Shortcomings*, WASH. POST, Dec. 17, 2008, at A1 (noting that by mid-December the HOPE for Homeowners program had attracted only 312 applicants); Cheyenne Hopkins & Joe Adler, *Voluntary to Mandatory? Next Steps for Mods*, AM. BANKER, July 29, 2009, at 1 (noting that the HOPE for Homeowners program "failed to gain much traction [because it was] too complicated and servicers and lenders were reluctant to use [it]").

433. James Lockhart, *Open Forum: The Present and Future of the GSEs*, NAT'L MORTGAGE NEWS, June 22, 2009, at 4 (discussing loan modification efforts); Stacy Kaper, *Senators Seek GSE Foreclosure Pause*, AM. BANKER, Sept. 12, 2008, at 20 (reporting that less than a week after the conservatorship was announced Democratic senators were calling for Fannie and Freddie to stop foreclosures);.

434. Press Release, Fannie Mae, Fannie Mae to Suspend Foreclosures Until January 2009 While Streamlined Modification Program is Implemented (Nov. 20, 2008), *available at* http://www.fanniemae.com/newsreleases/2008/4531.jhtml?p=Media&s=News+Releases [hereinafter Press Release, Fannie Mae Suspends Foreclosures]; Press Release, Freddie Mac, Freddie Mac Suspends All Foreclosure Sales of Occupied Homes From Day Before Thanksgiving Until January 9, 2009 (Nov. 20, 2008), *available at* http://www.freddiemac.com/news/archives/servicing/2008/20081120_foreclosure-suspend.html [hereinafter Press Release, Freddie Mac Suspends Foreclosures].

435. Press Release, Fannie Mae Suspends Foreclosures, *supra* note 434; Press Release, Freddie Mac Suspends Foreclosures, *supra* note 434.

436. Press Release, Fed. Hous. Fin. Agency, Refinance Volumes and HAMP Modifications Increased in December (Jan. 29, 2010), *available at* http://www.fhfa.gov/webfiles/15389/Foreclosure_Prev_release_1_29_10.pdf.

437. Lockhart, *supra* note 433, at 4 ("In total as of May 29, 2009, the Federal Reserve has purchased over $507 billion in MBS and $81 billion in direct obligations. The Treasury Department has purchased $167 billion through its GSE MBS Purchase Program."); BD. OF GOVERNORS OF THE FED. RESERVE SYS., FEDERAL RESERVE SYSTEM

Freddie have had access to this borrowing, they have been able to continue purchasing mortgages from lenders.[438] Lenders, in turn, have felt more comfortable offering mortgages.

c. Preventing future bailouts

While the conservatorship provided a clear plan for stabilizing Fannie and Freddie as well as existing borrowers, it did not provide a plan to prevent future bailouts of the two companies. Even as he announced the conservatorship, then-Treasury Secretary Henry Paulson emphasized that "[t]he new Congress and the next Administration must decide what role government in general, and these entities in particular, should play in the housing market."[439] Later Federal Reserve Chairman Ben Bernanke explained that "the conservatorships of Fannie Mae and Freddie Mac can usefully be viewed as a 'time out'—one that will give everyone involved, especially the Congress, the opportunity to reconsider the appropriate roles of Fannie and Freddie in the U.S. mortgage market."[440] As a result, the question of how best to prevent future bailouts looms on the horizon.

V. RECOVERY

At the time of the GSEs' bailouts, government officials believed that in the future the economy would improve, the GSEs would return

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MONTHLY REPORT ON CREDIT AND LIQUIDITY PROGRAMS AND THE BALANCE SHEET 4 (2009), *available at* http://www.federalreserve.gov/newsevents/monthlyclbs report200906.pdf ("To help reduce the cost and increase the availability of credit for the purchase of houses, on November 25, 2008, the Federal Reserve announced that it would buy direct obligations of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks and MBS guaranteed by Fannie Mae, Freddie Mac, and Ginnie Mae."); Fannie Mae, Annual Report (Form 10-K), at 2 (May 8, 2009); Federal Home Loan Mortgage Corp., Annual Report (Form 10-K), at 1 (Mar. 11, 2009).

438. Lockhart, *supra* note 433, at 4 ("Because of [government purchases of securities], both enterprises have been able to maintain an ongoing, significant presence in the secondary mortgage market.").

439. Paulson Statement, *supra* note 5.

440. Ben S. Bernanke, Chairman, Fed. Reserve, The Future of Mortgage Finance in the United States, Address at the UC Berkeley/UCLA Symposium: The Mortgage Meltdown, the Economy, and Public Policy (Oct. 31, 2008), *available at* http://www.federalreserve.gov/newsevents/speech/Bernanke20081031a.htm. *See also Present Condition and Future Status of Fannie Mae and Freddie Mac: Hearing Before the Subcomm. on Capital Mkts., Ins., & Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.*, 111th Cong. 3 (2009) [hereinafter *Present Condition and Future Status of Fannie Mae and Freddie Mac*] (statement of Rep. Paul E. Kanjorski) ("Congress needs to begin to think about how it will structure the government's relationship with Fannie Mae and Freddie Mac once we emerge from this financial crisis.").

to financial health, and private investors would again support the GSEs. In the case of the Farm Credit System, these beliefs proved correct. In the case of Fannie and Freddie, it is too soon to tell.

A. The Farm Credit System

After passage of the Farm Credit Act of 1987, the agricultural economy's recovery was almost breathtakingly quick, at least when viewed in retrospect.[441] As early as 1987, signs of optimism were emerging. "[C]orn and soybean prices were extremely low, and the ending stocks of corn were enormous, but hog and cattle prices had rebounded sharply."[442] High livestock prices and low feed prices led to strong profits for livestock producers.[443] Moreover, farmers scarred by the financial trauma in the early 1980s became more careful financial managers.[444] Cost-cutting measures led to improved overall profitability for all types of farms.[445] Finally, government payments to farmers stabilized farm profitability.[446] The rising profitability of farming allowed farm real estate prices to stabilize.[447] By 1990, observers were concluding that the crisis for farmers had passed.[448]

Driven by the improving conditions in American agriculture, the Farm Credit System also recovered quickly.[449] The Farm Credit System posted a loss of $17 million in 1987[450]—much better than the massive $1.91 billion loss in 1986.[451] "[B]y late 1988, the System was being

441. PEOPLES ET AL., *supra* note 171, at 62 ("The 1987-90 rebound in the fortunes of farming was phenomenal, far more rapid and far stronger than virtually any agricultural observer anticipated.").

442. *Id.*

443. *Id.* at 64-65.

444. *Id.* at 62-63.

445. *Id.* at 64.

446. *Id.* at 62, 65-66 ("Government direct payments to farmers . . . reach[ed] an all-time record of nearly $17 billion in 1987.").

447. *Id.* at 62 ("Farm real estate prices rose in most regions in the first quarter of 1987.").

448. *Id.* at 66-67.

449. 142 CONG. REC. 1593 (1996) (statement of Sen. Carol Moseley-Braun) (noting that the Farm Credit System's recovery "would not have been possible without a more general turnaround in the farm economy"); BARRY, *supra* note 307, at 75 (noting the "rapid financial recovery of institutions in the [Farm Credit S]ystem"); Lee Egerstrom, *Ag Bank Continues Recovery in 1988*, ST. PAUL PIONEER PRESS, Mar. 7, 1989, at 5C (stating that the Farm Credit System's recovery was driven by "[r]ising land values and stronger crop and livestock prices").

450. Egerstrom, *supra* note 449, at 5C.

451. Orest Mandzy, *Farm System Loses Less*, AM. BANKER, Feb. 19, 1987, at 3.

complimented for its recovery efforts."[452] In 1988 and 1989 the System reported net income totaling $1.3 billion.[453] While positive income was cause for optimism, accounting changes had to be given partial credit for these positive financial results.[454] Nevertheless, the System posted profits again in 1990, 1991, and 1992.[455] Nonaccrual loans also declined.[456] The Farm Credit System was essentially healthy.[457] Even the Farm Credit System's competitors and critics were returning.[458]

In 1992, two of the Farm Credit System Banks that had received direct assistance from the government guaranteed bonds repaid the federal money by retiring the preferred stock issued to the government.[459] Repayment of these obligations was not due for more

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452. SUNBURY, *supra* note 15, at 236.

453. *Farm Credit System's Future*, ABA BANKING J., Jan. 1, 1991, at 7.

454. Harold Steele, then-chairman of the Farm Credit Administration explained that "[s]ome of these earnings were the result of reversals in provisions for loan losses, . . . but the 1989 earnings were based on $1 billion in interest income, which was enough to cover operating expenses." *Id.*

455. 138 CONG. REC. 33,544 (1992) (statement of Sen. Richard G. Lugar) ("I am pleased to report that net income for the System and individual banks has been up for the past several years, and every year . . . the level of nonaccruing loans is dropping in virtually every farm credit district. Further the System is continuing to contribute to its own self insurance fund to protect against future requests for Federal assistance. Currently that fund is capitalized at a level of approximately $660 million.").

456. PEOPLES ET AL., *supra* note 171, at 91-92.

457. *See* PETER J. BARRY ET AL., FINANCIAL MANAGEMENT IN AGRICULTURE 540 (6th ed. 2000) ("In the early 1990s, most of the [Farm Credit System] institutions had restored the soundness of their operations, improved institutional profitability, streamlined operations, and were functioning competitively in the agricultural financial markets."). The Farm Credit Administration, playing the part of a careful regulator, was slower to declare victory. *See* Ronald E. Smith, Chief Examiner, Farm Credit Administration, Conditions in the Farm Credit System, Presentation to the Farm Credit Administration Board (May 14, 1998), *available at* http://www.fca.gov/Download/ReportArchives/SPConditionsFCS.pdf ("The recovery from that [1980's farm credit crisis] was long, a recovery that is worthy of announcement. Accordingly, I now state, as the Chief Examiner of the Farm Credit Administration, that the Farm Credit System has recovered from the farm crisis of the 1980s. There are now no institutions under any supervision requirements due to the farm crisis of the 1980s."). *See also* 138 CONG. REC. 27,200 (1992) (statement of Rep. Robert F. Smith) (noting in 1992 that some components of the Farm Credit System were "still in the process of recovery").

458. U.S. GEN. ACCOUNTING OFFICE, *supra* note 307, at 26-27 ("Complaints from other agricultural lenders about unfair or unsafe System loan pricing practices persist, however. Most complaints are based on the competitive advantages that accrue from the System's GSE status . . . .").

459. *Id.* at 38 ("The Omaha [Farm Credit Bank] and AgriBank together redeemed about $240 million, or about one-half of [the assistance provided directly to troubled banks.]").

than ten years.[460] The last of the outstanding assistance bonds matured and were paid in 2005, and the Financial Assistance Corporation's charter was subsequently cancelled.[461]

Even the current economic conditions that threaten Fannie and Freddie do not appear to have reversed the Farm Credit System's recovery. The agricultural industry has not managed to avoid the economic recession.[462] Just as in the 1980s, prices for agricultural commodities have started to decline rapidly.[463] At the same time, farmers are facing increased production costs.[464] Moreover, farm land values are declining for the first time since the 1980s.[465] These factors led to a small increase in the Farm Credit System's non-performing loans and a small increase in its allowance for loan losses.[466] Although the Farm Credit System posted an increase in profits in 2008, the System faced decreasing demand for loans in 2009.[467] Yet the Farm

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460. *Id.* at 33, 38 (stating that bonds issued to purchase assistance preferred stock matured between July 2003 and September 2005).

461. Board Action Cancelling Charter of the Farm Credit System Financial Assistance Corporation, 72 Fed. Reg. 2880 (Jan. 23, 2007).

462. *Repeat of 1980 Farm Crisis Unlikely*, WALLACES FARMER, Nov. 6, 2008, http://wallacesfarmer.com/story.aspx?s=20177&c=8 (quoting agricultural economist Mike Boehlje as stating that "[a]griculture is not immune to the financial slowdown").

463. FARM CREDIT ADMIN., 2008 ANNUAL REPORT ON THE FARM CREDIT SYSTEM 10 (2009), *available at* http://www.fca.gov/Download/AnnualReports/2008AnnualReport.pdf ("[I]n the second half of 2008 and into 2009, the global recession was beginning to reduce the demand for farm products, causing commodity prices to decline . . . ."); *Repeat of 1980 Farm Crisis Unlikely*, *supra* note 462 ("Grain prices declined by almost 50% from June to October 2008. The almost $4 decline in corn prices during a four-month period is unprecedented in both speed and magnitude.").

464. David Pitt & Henry C. Jackson, *Farm Debt: Agriculture Could Be Heading Toward a Crisis*, DESERET MORNING NEWS, Apr. 25, 2008, at D14 (noting "higher prices for seed and nitrogen fertilizer"); Steven L. Klose et al., *Agriculture and the Credit Crisis: The Intersection of Farm Credit and Farm Policy*, Texas A&M University, DEP'T OF AGRIC. ECON. PUB. SERIES 2008-5, at 2, *available at* http://agecoext.tamu.edu/fileadmin/user_upload/Documents/Resources/Publications/2008-5.pdf (stating that from 2006 to 2009, "the variable cost of production for cotton has increased from around $0.46/lb to almost $0.74/lb").

465. FARM CREDIT ADMIN., *supra* note 463, at 58 ("After climbing continuously for the 21 years since the collapse of the land market in the mid-1980s, U.S. farmland values started to decline in the latter part of 2008 as the economy weakened.").

466. *Id.* at 16 (noting that non-performing loans increased from 0.44 percent to 1.49 percent and that the allowance for loan losses increased from $781 million to $936 million).

467. Press Release, Farm Credit Admin., FCA Board Hears Auditor's Report on FCA's FY 2009/2008 Financial Statements 1-2 (Jan. 1, 2010), *available at* http://www.fca.gov/newsr.nsf/5adbe4ed107bb33c8525768f0075dca4/ce81caab6f7b10a8852576ab005eb29e/$FILE/NR%2010-01%20(01-14-10).pdf.

Credit System is still financially strong.[468] Every Farm Credit System institution exceeds the regulatory capital requirements.[469] Perhaps even more telling, the Farm Credit System was able to raise money by issuing debt in the capital markets during the credit crunch.[470] Moreover, the Farm Credit System Insurance Corporation stands ready to absorb significant losses.[471] While it is possible that the Farm Credit System will experience significant losses in the future,[472] the Farm Credit System appears well positioned to survive the current economic turbulence.

B. Fannie and Freddie

Unlike the Farm Credit System, Fannie and Freddie have not had time to recover from the financial conditions that made their bailout

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468. *Id.* ("[D]espite the difficult operating environment, the [Farm Credit] System remains fundamentally sound and has been able to meet its funding needs, build capital, and sustain its earnings performance."); FARM CREDIT ADMIN., *supra* note 463, at 10 ("[T]he overall condition and performance of the Farm Credit System remained safe and sound during 2008. Earnings, asset quality, and capital levels indicate that the System is in strong financial condition."); *Hearing to Review Credit Conditions in Rural America: Hearing Before the Subcomm. on Conservation, Credit, Energy, and Research of the H. Comm. on Agric.*, 111th Cong. 16 (June 11, 2009) (testimony of Leland A. Strom, Chairman & CEO, Farm Credit Admin.) ("[D]espite the unprecedented instability in the U.S. and global financial markets and a recessionary world economy, the overall condition and performance of the [Farm Credit] System remains fundamentally safe and sound."); Ted Shelsby, *Farm Banking Thrives Amid Crisis*, BALT. SUN, Dec. 21, 2008, at 6G ("Net income for the six months ended June 30 is up nearly 20 percent to $1.55 billion from the same period last year. Its credit quality remains very favorable, with 98.4 percent of all loans ranked in the highest loan quality classification.").

469. FARM CREDIT ADMIN., *supra* note 463, at 18 ("The minimum permanent capital ratio is 7.0 percent, and, as of December 31, 2008, the permanent capital ratio ranged between 14 percent and 18.9 percent for the System's banks and between 10.1 percent and 27.5 percent for the associations.").

470. *Id.* at 37 ("At year-end 2008, outstanding Systemwide debt was $178.4 billion, up from $154.4 billion a year earlier, representing a 15.5 percent increase."). The Farm Credit System has experienced an increase in the cost of funding. *Id.* at 35. The Farm Credit Administration attributes this at least partly to "unintended consequences" of the government's response to the home mortgage crisis. *Id.* According to the Farm Credit Administration, "the Federal Deposit Insurance Corporation's approval of a program that guarantees senior unsecured debt newly issued by commercial banks and others, the Federal Reserve's purchase of debt obligations of the housing GSEs, and the U.S. Treasury's creation of a line of credit for the housing GSEs" have all made the Farm Credit System's debt obligations less appealing to investors. *Id.*

471. FARM CREDIT SYS. INS. CORP, 2008 ANNUAL REPORT 9 (2009) (showing insurance fund assets of $2.9 billion).

472. FARM CREDIT ADMIN., *supra* note 463, at 10.

necessary. In fact, it is hard to determine whether either company is even on the path to recovery. In the first quarter of 2009 Fannie lost $23.2 billion[473] and Freddie lost $9.9 billion.[474] The companies attributed the losses to the fact that the "U.S. residential mortgage market continued to experience significant deterioration."[475] And mortgage delinquencies at Fannie and Freddie are still rising. "At Freddie, 3.87% of single-family mortgages were at least 90 days past due at the end of December [2009], up from 1.72% a year earlier. Fannie is worse: 5.29% were 90 days past due in November [2009], up from 2.13% a year earlier."[476] Freddie's third quarter 2009 report warns that future losses are likely[477] and then bleakly summarizes: "There is significant uncertainty as to whether or when we will emerge from conservatorship, as it has no specified termination date, and as to what changes may occur to our business structure during or following our conservatorship, including whether we will continue to exist."[478] James Lockhart, former director of the Federal Housing Finance Agency, thinks the government is likely to lose at least some of its investment in the two companies.[479]

Yet there is still opportunity for hope. Some reports indicate that the housing market may be beginning to slowly turn the corner toward recovery.[480] Such a recovery would likely benefit Fannie and Freddie.

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473. Fannie Mae, Quarterly Report (Form 10-Q), at 4 (May 8, 2009).

474. Freddie Mac, Quarterly Report (Form 10-Q), at 1 (May 12, 2009).

475. Fannie Mae, Quarterly Report (Form 10-Q), at 2 (May 8, 2009). *See also* Freddie Mac, Quarterly Report (Form 10-Q), at 1 (May 12, 2009) ("Our financial results for the first quarter of 2009 reflect the adverse conditions in the U.S. mortgage markets.").

476. Nick Timiraos & James R. Hagerty, *No Exit in Sight for U.S. as Fannie, Freddie Flail*, WALL ST. J., Feb. 9, 2010, at A1.

477. Freddie Mac, Quarterly Report (Form 10-Q), at 2 (Nov. 6, 2009) ("We expect a variety of factors will continue to place downward pressure on our financial results in future periods, and could cause us to incur further GAAP net losses and request additional draws from Treasury . . . .").

478. *Id.*

479. Timiraos & Hagerty, *supra* note 476, at A1.

480. *See* Stephanie Armour, *Housing Prices Rounding A Corner?*, USA TODAY, July 29, 2009, at 1A ("Housing prices in May showed their first gain in three years, a sign that the beleaguered market may finally be turning around."); Robert Gavin, *Signs Point Up for State Economy*, BOSTON GLOBE, July 29, 2009, at 1 (discussing improvement in the housing market throughout Massachusetts); Francine Knowles, *Glimmer of Hope: Home Prices, Sales Increase as Local Market May Finally be Stabilizing*, CHI. SUN TIMES, July 29, 2009, at 21 (discussing possible recovery of the Chicago housing market).

VI. MODERATING THE CREDIT CYCLE

As is illustrated in Parts II through V, the trouble with Fannie, Freddie, and the Farm Credit System is that they supply credit like other providers of credit—in a manner that is pro-cyclical with the credit cycle. In particular, the farm credit crisis of the 1980s and the recent home mortgage crisis powerfully demonstrate that we cannot expect these companies (at least without government support) to continue lending or to stabilize the economy in severe downturns.

There is, however, some econometric work suggesting that during the 1970s, Fannie had a limited countercyclical effect on mortgage and housing markets. For example, in 1978, Professors Dwight M. Jaffee and Kenneth T. Rosen used econometric modeling to show that Fannie had a moderate countercyclical effect on mortgage and housing markets in periods shorter than one year.[481] Professors Jaffee and Rosen explained that this effect was probably due to Fannie's practice of issuing commitments to purchase mortgages in future periods.[482] They found that the commitments had a slight positive impact on new lending and housing starts, presumably because originators were more willing to lend if they could be sure that Fannie would purchase the mortgages.[483] However, Professors Jaffee and Rosen further found that Fannie's activity had "essentially no effect on mortgage and housing markets over extended periods; beyond say a year, [because] private sector reactions . . . fully offset the intervention of [Fannie]."[484]

Notwithstanding this early econometric work, more recent analysis has concluded that the pro-cyclical effect is not present in more recent housing cycles. For example, Professor Herbert M. Kaufman concluded that for the housing cycle occurring in the early 1980s, Fannie "did not appear to have significant countercyclical impact."[485] Professor Kaufman theorized that deregulation made the market adjust

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481. Dwight M. Jaffee & Kenneth T. Rosen, *Estimates of the Effectiveness of Stabilization Policies for the Mortgage and Housing Markets*, 33 J. FIN. 933 (1978).

482. *Id.* at 944-45.

483. *Id.* at 942.

484. *Id.* at 933. *See also* Patric Hendershott & Kevin Villani, *The Federally Sponsored Credit Agencies: Their Behavior and Impact*, *in* CAPITAL MARKETS AND THE HOUSING SECTOR: PERSPECTIVES ON FINANCE REFORM 291 (Robert M. Buckley et al. eds., 1977) (finding a similar, but slightly longer-term effect); William L. Silber, *A Model of Federal Home Loan Bank System and Federal National Mortgage Association Behavior*, 55 REV. ECON. & STAT. 308 (1973) (suggesting that Fannie and the Federal Home Loan Bank System both have a countercyclical effect).

485. Herbert M. Kaufman, *FNMA's Role in Deregulated Markets: Implications from Past Behavior*, 20 J. MONEY, CREDIT & BANKING 673, 681-82 (1988).

more quickly than in the past.[486] Professor Kaufman also questions whether Fannie has any desire to act in a countercyclical manner.[487] He believes that during economic downturns, Fannie, like other lenders, may desire to reduce its risk.[488] Professor Kaufman's work when combined with the narrative analysis in Parts II through IV leads to the conclusion that Fannie, Freddie, and the Farm Credit System act procyclically.

Yet by repeatedly providing funds for these companies during economic downturns, government policymakers indicate that they want the companies to have at least a limited countercyclical role. They want the companies to continue lending in economic downturns. From the initial capitalization of the Farm Credit System in 1916, to the Depression-era investment in both the Farm Credit System and Fannie, to the Farm Credit System bailout of the 1980s, to the recent bailout of Fannie and Freddie, government officials have stood ready with capital to help the GSEs. Support for these government infusions of capital has been widespread and crossed party lines. The Farm Credit System bailout legislation, for example, passed the Senate by a vote of 85 to 2.[489] And the Fannie and Freddie bailout was initiated under Republican President George W. Bush,[490] but has been continued under the administration of Democratic President Barack Obama.[491] Based on this history, it seems reasonable to conclude that the government will want the GSEs to moderate low points in future credit cycles.

If Fannie, Freddie, and the Farm Credit System are to be a mechanism for smoothing the credit and business cycles, there must be a mechanism for them to access capital and lend in periods when low

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486. *Id.* at 676–77 (noting that originators were no longer subject to interest rate caps and were allowed a larger range of investments).

487. *Id.* at 674, 681–82.

488. *Id.* at 682.

489. *Senate Approves $4 Billion Farm Loan Package*, DALLAS MORNING NEWS, Dec. 20, 1987, at 5A. The House of Representatives vote was an equally lopsided 365 to 18. *Senate Approves $4 Billion Bailout for Farm Lenders*, CHI. TRIB., Dec. 20, 1987, at 5. Although there were initial indications that President Ronald Reagan would veto the bill, he ultimately signed it into law. *President Signs Farm Credit Bill*, CHI. TRIB., Jan. 7, 1988, at C3.

490. Michael Abramowitz & Dan Eggen, *Administration Decided in Late August that Takeover Was Needed*, WASH. POST, Sept. 9, 2008 at A08 (detailing the role of President Bush and his administration).

491. *See, e.g.*, James B. Lockhart, Dir., Fed. Hous. Fin. Agency, FHFA's First Anniversary and the Challenges Ahead, Speech to the National Press Club 14 (July 30, 2009), *available at* http://www.fhfa.gov/webfiles/14715/FHFA1stAnnSpeechandPPT73009.pdf ("President Obama has stated clearly his Administration's intent that the Enterprises will continue to play a key role in helping the mortgage market recover.").

credit availability would typically be expected.[492] Additionally, if the government ultimately supplies this capital and does not believe taxpayers should bear this cost, there must be a mechanism for transferring the costs to private investors during periods of economic growth.[493] Countercyclical measures could also dampen lending during boom periods and potentially prevent asset bubbles from forming.

This Part discusses three possible ways to encourage Fannie, Freddie, and the Farm Credit System to act countercyclically: countercyclical capital requirements, bond insurance, and bailouts. The first two of these options are classic macroprudential tools for regulating privately owned financial institutions.[494] In contrast, bailouts are sometimes thought to be an inappropriate remedy for privately owned companies.[495]

This Article does not attempt to address the optimal corporate structure for Fannie, Freddie, and the Farm Credit System.[496] Rather, the Article seeks to identify principles that can be used to reach policymakers' objectives, regardless of the structure of these GSEs.[497]

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492. *See* FED. NAT'L MORTGAGE ASS'N, *supra* note 120, at 6 (stating that Fannie needed to provide "secondary market facilities that do not depend on cyclical credit availability"); Lockhart, *supra* note 491, at 15 ("I cannot overemphasize the need for countercyclical policies.").

493. In order to behave in a truly countercyclical manner, the companies must increase funding in poor economic times *and* decrease funding in good economic times. While policymakers have consistently supported the proposition that Fannie, Freddie, and the Farm Credit System should supply credit in poor economic times, the support for decreasing funding in good economic times is less robust. For example, before the recent home mortgage crisis, Fannie and Freddie were sometimes criticized for failing to provide funding for mortgages for underserved populations. *See supra* notes 362-369 and accompanying text. Countercyclical policies must recognize the potential danger in excessive expansion during booms.

494. *See, e.g.*, 12 U.S.C. §§ 3.6, 6.4 (2006) (setting capital requirements for privately owned banks); *id.* § 1821 (establishing insurance for deposits at privately owned banks).

495. Those who oppose government bailouts of private companies often argue that the government should allow the market to fix itself, even if the companies fail. *See, e.g.*, Barbara Gibbons, Letter to the Editor, *No Bailout for Fiscal Foul-Ups Fannie, Freddie*, PALM BEACH POST, July 29, 2008, at 11A. Others more stridently argue that government bailouts of private companies are the first steps down an irreversible path to socialism. *See, e.g.*, Jess Roy, Opinion, *A Dangerous Path to Socialism*, TULSA WORLD, Dec. 18, 2008, at A17.

496. A number of articles do address the question of whether Fannie, Freddie, and the Farm Credit System are best conceptualized as private companies, government entities, or some combination of the two. *See supra* notes 176-179, 230-233, and accompanying text.

497. Because it is probably most likely that Fannie and Freddie will continue in some form of public-private partnership, this Article continues to refer to them as GSEs. Nick Timiraos, *Support Grows for Fan-Fred Plan*, WALL ST. J., Dec. 14, 2009,

Each of the identified tools can be implemented whether the companies are owned and managed by government or private actors. Although we might normally think of capital requirements as regulations the government imposes on a private company, nothing would prevent the government from setting capital requirements for a government-owned company. Although we might normally think of insurance as something purchased by a private company, nothing would prevent a government-owned company from contributing to a fund that could be tapped during an economic downturn. Similarly, although the government might be more willing to provide funds to a government-owned company, policymakers can partially fund private companies without completely destroying their private nature.

After examining countercyclical capital requirements, bond insurance, and bailouts, this Article concludes that each tool has benefits and limitations. The Article concludes that policymakers who want these GSEs to act countercyclically should use a combined approach to offset the GSEs' natural tendencies.

A. Countercyclical Capital Requirements

Fannie and Freddie's regulator has suggested that one way to encourage the GSEs to act countercyclically is to adopt countercyclical capital adequacy requirements.[498] As currently written, the law requires that the GSEs hold a certain percentage of capital in relation to their assets.[499] In this manner regulators hope to protect the institution's debtors who should not lose money so long as assets exceed liabilities.[500] However, current capital adequacy requirements for the GSEs do not operate in a countercyclical manner. The current capital requirements may even operate in a pro-cyclical manner that exacerbates fluctuations in credit cycles. By changing the capital requirements so that more capital is required in boom periods and less

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at A7 (explaining that "[m]ost proposals avoid the extremes of turning Fannie and Freddie into national agencies or leaving the market to the private sector, opting instead for a middle ground" because a hybrid approach is the easiest to achieve politically).

498. *Present Condition and Future Status of Fannie Mae and Freddie Mac*, *supra* note 440, at 151 (testimony of James B. Lockhart, Dir., Fed. Hous. Fin. Agency) (stating that the Federal Housing Finance Agency was "in the process of examining options to strengthen minimum and risk-based capital requirements and to make them more countercyclical").

499. *See* 12 U.S.C.A. §§ 4611-4614 (West Supp. 2009) (capital requirements for Fannie and Freddie); 12 C.F.R. §§ 615.5205-.5215 (2009) (capital requirements for the Farm Credit System).

500. *See generally* RICHARD SCOTT CARNELL ET AL., THE LAW OF BANKING AND FINANCIAL INSTITUTIONS 252-53 (4th ed. 2009).

capital is required in bust periods, regulators can partially moderate credit cycles.[501]

The GSEs have mandated capital adequacy requirements modeled after bank capital adequacy requirements.[502] These capital adequacy requirements can operate in a pro-cyclical way—requiring more capital (and restricting lending) during busts and requiring less capital (and stimulating lending) during booms. The Farm Credit System's capital adequacy requirements sort each institution's assets into risk-weighted categories.[503] For asset categories that are defined as riskier, the institution must maintain more capital.[504] Although this type of capital adequacy requirement builds up capital to the required level during boom periods, the Farm Credit System cannot access this capital during bust periods. The required amount of capital must be maintained at all times. This leads the Farm Credit System to restrict lending during bust periods to conserve capital.[505]

Fannie and Freddie's regulatory capital adequacy requirements are currently in flux. Prior to July 30, 2008, the statutory capital adequacy requirement contained elements that were pro-cyclical. Fannie and Freddie were required to maintain capital consistent with a risk-based capital level determined by stress testing.[506] One of the factors

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501. *See* COMM. OF EUROPEAN BANKING SUPERVISORS, PAPER ON COUNTERCYCLICAL CAPITAL BUFFERS (2009); FIN. SERV. AUTH., THE TURNER REVIEW: A REGULATORY RESPONSE TO THE GLOBAL BANKING CRISIS 53-62 (2009) [*hereinafter* TURNER REVIEW]; MARKUS BRUNNERMEIER ET AL., THE FUNDAMENTAL PRINCIPLES OF FINANCIAL REGULATION 29-38 (2009); Charles W. Calomiris, *Financial Innovation, Regulation, and Reform*, 29 CATO J. 65, 80 (2009).

502. *See* sources cited *supra* note 499. *See also* Carnell, *supra* note 233, at 600.

503. *See* 12 C.F.R. § 615.5211. This method for regulating capital is based on the International Convergence of Capital Measurement and Capital Standards (Basel I) as published by the Basel Committee on Banking Supervision. *See* Notice of Proposed Rulemaking, Farm Credit System Basel Accord, 72 Fed. Reg. 34,191-92 (proposed June 21, 2007).

504. *See* 12 C.F.R. §§ 615.5205-.5211.

505. Statistical analysis of other institutions operating under similar capital adequacy requirements suggests that Basel I-type capital requirement have a slight pro-cyclical effect. *See* Juan Ayuso et al., *Are Capital Buffers Pro-Cyclical?: Evidence from Spanish Panel Data*, 13 J. FIN. INTERMEDIATION 249 (2003); Saibal Ghosh & D.M. Nachane, *Are Basel Capital Standards Pro-cyclical? Some Empirical Evidence from India*, 38 ECON. & POL. WEEKLY 777 (2003).

506. *See* 12 U.S.C. §§ 4612, 4614(a)(1)(A) (2006). Fannie and Freddie's regulator summarized the stress test as follows:

> The risk-based capital standard requires each Enterprise to have total capital (core capital plus general loss reserves) that meets or exceeds its risk-based capital requirement. Stress test results are calculated for two interest rate scenarios, one in which 10-year Treasury yields rise 75 percent and another in which they fall 50 percent. Changes in both scenarios are

considered in the stress test was credit risk.[507] Credit risk is pro-cyclical; defaults are highest when housing prices are declining and economic conditions are poor.[508] By including credit risk in the calculation, the risk-based capital standard required Fannie and Freddie to hold more capital during busts and less capital during booms.[509] In 2008, as part of the Housing and Economic Recovery Act, Congress changed the law to give the Federal Housing Finance Agency nearly complete discretion in setting capital requirements.[510] However, before new capital requirements could be prepared, Fannie and Freddie entered conservatorship. The Federal Housing Finance Agency has determined that while in conservatorship, Fannie and Freddie are not subject to capital requirements.[511] This action was taken, in part, to ensure that Fannie and Freddie continued to support the housing market by purchasing and securitizing loans rather than hoarding capital.[512]

In contrast to the established capital requirements for Fannie, Freddie, and the Farm Credit System, a countercyclical capital requirement would raise capital requirements during boom periods.[513]

> generally capped at 600 basis points. The risk-based capital level for an Enterprise is the amount of total capital that would enable it to survive the stress test in whichever scenario is more adverse for that Enterprise, plus 30 percent of that amount to cover management and operations risk.

Press Release, Office of Fed. Hous. Enter. Oversight, OFHEO Issues Risk-Based Capital Stress Tests For Fannie Mae and Freddie Mac (June 27, 2002), *available at* http://www.fhfa.gov/webfiles/2240/62702stresstestresults.pdf.

Fannie and Freddie's capital adequacy requirements also contained simple leverage ratios. *See* 12 U.S.C. §§ 4612, 4614(a)(1)(B). The pro-cyclical effect of the leverage ratios can be analyzed in much the same way as the Farm Credit System capital adequacy requirements. The leverage ratio is unlikely to be countercyclical.

507. *See* 12 U.S.C. § 4611(a)(1) (2006).

508. *See supra* note 30 and accompanying text.

509. *See* Mark Illing & Graydon Paulin, *Basel II and the Cyclicality of Bank Capital*, 31 CANADIAN PUB. POL'Y 161, 161–78 (2005) (explaining how including credit risk in risk-based capital calculations increases the pro-cyclical effect of the capital requirement). *See also* Press Release, Office of Fed. Hous. Enter. Oversight, *supra* note 506 (explaining that in 2002 Fannie and Freddie passed the stress test in part because housing price increases led to an environment with little credit risk).

510. *See supra* notes 395–396 and accompanying text.

511. DIV. OF ENTER. REG., FED. HOUS. FIN. AGENCY, SUPERVISION HANDBOOK 2.1, at 22–23 (June 16, 2009).

512. *Cf. id.* (explaining that it was "in the best interests of the market to suspend capital classifications of Fannie Mae and Freddie Mac").

513. This could be accomplished either through a formula-driven system that behaves in a countercyclical manner or by allowing regulators to set capital standards in an ad hoc countercyclical fashion. *See* TURNER REPORT, *supra* note 501, at 61. Each approach has benefits and drawbacks. An ad hoc system would be flexible but would depend on individual judgments that might be influenced by lobbying. *Id.* On the other hand, a formula-driven system, while not as subject to lobbying, would not be as

By mandating additional capital, the requirements would dampen lending and help prevent bubbles from forming.[514] When bust periods emerge, the capital requirement would drop, thus allowing the GSEs access to capital built up during the boom period. This would "reduce the extent to which [each GSE] need[s] to cut back on [loan funding] to maintain capital ratios when capital is depleted by losses."[515]

The chief shortcoming of countercyclical capital adequacy requirements for Fannie, Freddie, and the Farm Credit System is that decreasing capital requirements during bust periods increases the risk of insolvency. When the capital cushion is smaller, the risk that losses will be passed along to debt holders is larger. In addition, reduced capital requirements are an indirect route to increasing loan funding. The GSEs rely primarily on the bond market—not capital—to fund lending. Decreasing capital requirements might indirectly allow the GSEs to increase debt to fund new lending, but it would not guarantee the GSEs access to that debt. The increased risk from the decreased capital requirement might deter some bond investment. In addition, poor economic conditions reduce the wealth available for investment in bonds.[516] In sum, countercyclical capital requirements might have only a minimal affect on the GSEs' ability to fund lending during an economic downturn. Moreover, decreasing capital requirements during bust periods decreases the capital cushion and increases the risk of insolvency. For these reasons, if the goal is to encourage the GSEs to provide loan financing in a countercyclical fashion, countercyclical capital requirements cannot be the only solution.

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nuanced or flexible. *Id.* It is possible that Fannie and Freddie's regulator could adopt an ad hoc system using discretion already established under the current law. *See* 12 U.S.C. § 4612(d)(1) (West Supp. 2009) (giving the Director of the Federal Housing Finance Agency authority to "increase the minimum capital level for a regulated entity on a temporary basis, when the Director determines that such an increase is necessary and consistent with the prudential regulation and the safe and sound operations of a regulated entity."). More rigid countercyclical capital requirements would require changes to existing statutes and regulations. *See supra* notes 503–504, 506 (describing the legislative and regulatory capital standards). This Article leaves to other scholarship the task of developing optimal countercyclical capital requirements. As one group of macro and financial economists concluded: "The need is to achieve counter-cyclical regulatory mechanism(s). Details of how this might be achieved are important, but secondary." BRUNNERMEIER, *supra* note 501, at 38.

514. *See* TURNER REPORT, *supra* note 501, at 61.

515. *See id.*

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

B. Bond Insurance

Because access to funding in the bond market determines whether the GSEs can fund new lending, effective countercyclical measures should focus on the GSEs' bonds. The Farm Credit System bailout implemented a countercyclical measure targeted at bonds. The bailout created a government agency that insures Farm Credit System debt by charging premiums.[517] By paying risk-based premiums, the Farm Credit System creates an insurance fund that will be used to pay System bonds if the System ever defaults. Federal Reserve Board economists Diana Hancock and Wayne Passmore have suggested that a similar process could be used to create a fund to insure bonds issued by Fannie and Freddie.[518]

The bond insurance approach has several advantages. First, by making the government insurance explicit and funded by risk-based premiums, it eliminates the perceived implied guarantee problem that has long been a sore point for GSE critics.[519] If the GSEs pay a risk-premium they, rather than the government, are internalizing the risk of their portfolios. It also eliminates the government subsidy. Moreover, a risk-based premium should encourage them to "hold adequate capital and manage their risks appropriately" in order to keep the cost of the premiums down.[520]

More importantly however, bond insurance is a mechanism that helps GSEs operate in a countercyclical fashion. When GSEs pay a premium to purchase bond insurance, their lending activities are somewhat dampened. This may prevent excessive lending and help prevent bubbles from forming during boom periods.[521] Moreover, during bust periods, bond insurance can help the GSEs maintain access to the bond markets. During a bust period, investors may become concerned about the risk and reduce investment in the GSEs' debt.[522]

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517. *See supra* Part IV.A.3.c.

518. Diana Hancock & Wayne Passmore, *Three Initiatives Enhancing the Mortgage Market and Promoting Financial Stability*, 9 BERKELEY ELEC. J. ECON. ANALYSIS & POL'Y, Iss. 3, Art. 16, at 20, *available at* http://www.bepress.com/bejeap/vol9/iss/3/art16. Because Fannie's and Freddie's outstanding debt is much larger than outstanding Farm Credit System debt, Fannie and Freddie's insurance fund would have to be much larger.

519. *See supra* notes 233, 236 and accompanying text.

520. Hancock & Passmore, *supra* note 518, at 20.

521. To increase this effect, insurance premiums could be set in a countercyclical fashion so that the premiums increased during boom. This approach, however, would likely decrease the risk-deterrent effect achieved by making the premiums risk-based.

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

By providing an explicit guarantee, bond insurance allows investors to have confidence in the GSEs' debt even during times of economic difficulty.[523] If the GSEs can still issue bonds, they will still be able to fund lending.[524]

The primary weakness of bond insurance is that it does not guarantee increased lending during economic downturns. Notwithstanding the bond insurance, the GSEs may be reluctant to fund new loans during economic downturns. During downturns, the GSEs, like other lenders, will still perceive loan financing as increasingly risky. In order to protect stockholders (who are not covered by the bond insurance), the GSEs may raise underwriting criteria or simply quit funding loans.[525]

In addition, during an economic downturn, insurance only enhances the GSE bonds' attractiveness when compared with other available investments. Yet in a bust, overall investment decreases because wealth decreases.[526] Some of this decrease in demand for bonds may be offset by a decrease in the supply of bonds as businesses curtail borrowing in anticipation of lower future profits.[527] However, during a severe economic downturn, there is no guarantee that sufficient private funds will be available at a price such that bonds can be used to fund lending. This explains why, during the current crisis, the government has purchased Fannie and Freddie bonds in addition to effectively guaranteeing the bonds sold to other investors.[528] In sum, bond insurance is useful, but it is not a panacea.

C. Bailouts

And so policymakers turn to the countercyclical measure that they have used time and time again: bailouts. Bailouts, or government injections of investment, are a mechanism for providing access to funds

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523. Hancock & Passmore, *supra* note 518, at 20.

524. The insurance fund itself does not provide a source of capital that can be used to spur lending. When insolvency occurs, the insurance fund allows only those who previously purchased bonds to be paid. It does not, however, provide the GSE with additional money that may be used to make new loans or purchase mortgages in the secondary market.

525. *See supra* note 30 and accompanying text. This effect might be lessened in bailouts, like the Farm Credit System bailout, where the stockholders were guaranteed a specific return on their investment. In that scenario, investors should be indifferent about the riskiness of the GSE's portfolio.

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

527. *See* CECCHETTI, *supra* note 24, at 137.

528. For a description of the government's purchase of Fannie and Freddie bonds see *supra* notes 437-438 and accompanying text.

during times of economic difficulty and transferring GSEs' profits from good years to bad years. In both the Farm Credit System bailout and the Fannie and Freddie bailout, the government ensured that the GSEs had access to new investment by effectively guaranteeing the interest and principal on bonds issued by the GSEs. This guarantee attracted new investors who would otherwise have been concerned about the financial condition of the GSEs.[529] The government has also provided Fannie and Freddie access to funds by purchasing their bonds.

Simply allowing the GSEs access to money does not guarantee that they will fuel lending, thereby alleviating any credit rationing and stopping a downward spiral of credit availability. Absent some intervening force, the GSEs, like other lenders, might retreat from loan investment during periods of economic contraction.[530] However, by providing the bailout, the government gains leverage over the GSEs and can require that existing loans be modified.[531] This stops further asset price declines by preventing foreclosures.[532] As a result of the bailout, the government can also gain influence over the amount and terms of new funds made available to borrowers. For example, as conservator of Fannie and Freddie, the Federal Housing Finance Agency has authority to oversee the prices Fannie and Freddie charge, the amount of money Fannie and Freddie borrow in the bond market, the amount of mortgages Fannie and Freddie purchase and hold in their portfolios, and the amount of mortgages Fannie and Freddie securitize.[533] In particular, the Federal Housing Finance Agency has ensured that Fannie and Freddie continue to underwrite and finance multifamily mortgage loans.[534]

In addition to providing the government significant control over new lending, bailouts can be structured to give the government a way to recoup money invested in the GSEs. In exchange for the capital (or access to future capital), the government can acquire stock. That stock can be retired using earnings or private investment once the economic downturn passes and the GSEs are healthy. In this manner the government can recover funds invested in the GSEs. The histories of

529. In the case of Fannie and Freddie, the government has also ensured access to funds by purchasing the GSEs' bonds. *See* sources cited *supra* notes 437-438.

530. *See supra* note 30 and accompanying text.

531. *See supra* notes 321-323, 433-436 and accompanying text.

532. Because loan modification is typically undertaken only as an alternative to foreclosure, it is conceptually similar to sustaining the supply of credit. If the foreclosures were to proceed, the GSE would, in effect, be withdrawing credit from the market.

533. FED. HOUS. FIN. AGENCY, 2008 REPORT TO CONGRESS 79-84 (2009).

534. *See id.* at 85.

Fannie, Freddie, and the Farm Credit System demonstrate that it is possible for GSEs to attract private investment after government infusions of capital.[535] Of course, the government must structure its bailout in such a way that it is fully compensated, but this should not be a significant hurdle if it is addressed at the outset.[536] Using private capital to retire government investment in GSEs might also have the added benefit of dampening bubble-inducing lending[537] during boom periods.

While a bailout can serve to moderate the downturn in a credit cycle, one of the potential problems with a bailout is that the government bears some repayment risk. The GSE must recover in order for the government to recoup its investment. If the GSE ultimately fail, the stock will not be retired and the government will lose most, if not all, of the money it forwarded.[538] In the case of the Farm Credit System bailout, the System institutions had little trouble repaying the government investment once profitable times returned.[539] However, it is possible that Fannie's and Freddie's losses are so deep and the government investment so large that Fannie and Freddie will never be able to retire the preferred stock owned by the government.[540] Bailouts are more risky when the economic downturn is severe and when the entity receiving capital is large and faces significant losses. In these situations, policymakers should realize that the government may ultimately bear some of the costs of inducing countercyclical behavior.

Another potential problem with a government injection of capital is that the financial condition of the government is also affected by the credit and business cycles. Absent legal changes, tax receipts are lower and welfare payments are higher when the economy is contracting.[541]

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535. *See supra* notes 204-210, 459-461 and accompanying text.

536. There are likely transaction costs associated with negotiating and documenting each bailout, but as long as bailouts do not occur on a frequent basis, these costs will not be large.

537. *See supra* note 26 and accompanying text.

538. The government could also lose any investment in the GSEs' bonds.

539. *See supra* notes 459-461 and accompanying text.

540. *See* Interview by Peter Cook with James B. Lockhart, Dir., Fed. Hous. Fin. Agency, Washington, D.C. (July 20, 2009), *available at* 2009 WLNR 14713422. When asked whether taxpayers would be repaid the $85 billion they have invested in Fannie and Freddie, Director Lockhart said: "Well, they may get some of their money back, but it's very unlikely that they'll get the $85 billion back at this point." *Id.*

541. CONG. BUDGET OFFICE, MEASURING THE EFFECTS OF THE BUSINESS CYCLE ON THE FEDERAL BUDGET 2 (2009), *available at* http://www.cbo.gov/ftpdocs/102xx/doc10299/06-23-BusinessCycle.pdf ("During cyclical slowdowns and recessions, revenue growth automatically declines and growth in outlays, for example to pay unemployment insurance claims or provide benefits under the Supplemental Nutrition

GSEs are likely to need bailouts when the government is less likely to have budget surpluses. In recent decades, the United States government has been able to borrow at relatively low rates even during times of economic distress, but there is no guarantee that this will be the case in the future.[542]

In spite of these problems, bailouts have been used again and again. The have been proven to be an effective countercyclical tool.

CONCLUSION

Because of the problems associated with bailouts, policymakers should actively consider other countercyclical measures like countercyclical capital requirements and bond insurance. While countercyclical capital requirements and bond insurance are unlikely to completely eliminate pro-cyclical behavior by the GSEs, these measures can have some smoothing effect on the credit cycle. This may lessen the need for future government bailouts. At the same time, bailouts should be recognized for what they are: an effective countercyclical tool for stimulating lending and preventing further declines during severe economic downturns.

Assistance Program (formerly food stamps), automatically increases. The opposite occurs with upturns in the business cycle.").

542. Carolyn Lochhead, *U.S. Debt Swelling to Historic Amounts*, S.F. CHRON., May 24, 2009, at A1 (discussing the possibility that the U.S. could lose its AAA credit rating).

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