RETHINKING FANNIE AND FREDDIE'S NEW INSOLVENCY REGIME

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Faced with the potential collapse of mortgage giants Fannie Mae and Freddie Mac, Congress created a new insolvency regime for these government-sponsored entities based on the procedure applied to failing federal banks. This Note argues that this new insolvency regime will create unnecessary taxpayer exposure to financial risk without preventing a similar problem from recurring, unless the implicit federal guarantee of Fannie Mae and Freddie Mac more closely mirrors the explicit federal guarantee of bank deposits.

The Note begins by identifying three essential elements for an effective insolvency regime. First, creating such a regime is only appropriate to address a substantial societal concern that private ordering cannot solve. Second, the government should provide explicit, federal backing targeted specifically to solving that social problem. Recognizing that a federal guarantee may create a moral hazard, the third essential element is establishing a mechanism to ensure the limited federal backing does not expand to an undefined guarantee of the entire entity.

Applying this model to the secondary mortgage market, this Note proposes the creation of a Covered Bond Insurance Corporation (CBIC), modeled after the Federal Deposit Insurance Corporation, that will explicitly provide mortgage insurance to entities that issue covered bonds. This solution would facilitate a liquid secondary mortgage market, while ensuring taxpayers' potential liabilities remain limited, thereby mirroring the federal guarantee provided to banks.

INTRODUCTION

The government's decision to "bail out" American International Group (AIG) and the "Big Three" American automobile manufacturers in late 2008 attracted extensive media attention[1] and sparked public outrage.[2] Instead of allowing these companies to file for bankruptcy, the government provided limited financing so they could continue opera-

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1. See Edmund L. Andrews, Fed in an $85 Billion Rescue of an Insurer Near Failure, N.Y. Times, Sept. 17, 2008, at A1 (calling AIG bailout "the most radical intervention in private business in the central bank's history"); Stephen Labaton, Agency's '04 Rule Let Banks Pile Up New Debt, and Risk, N.Y. Times, Oct. 3, 2008, at A1 (describing investment bank bailout as "the most serious financial crisis since the 1930s").

2. See Ken Bensinger, Masses Aren't Buying Bailout, L.A. Times, Sept. 26, 2008, at C1 ("[T]he increasingly loud roar coming from all corners of the nation shows that the idea of a bailout has touched a particularly sensitive nerve among the public."); David Brooks, Op-Ed., Bailout to Nowhere, N.Y. Times, Nov. 14, 2008, at A33 ("[The bailout] is all a reminder that the biggest threat to a healthy economy is not the socialists of campaign lore. It's C.E.O.'s. It's politically powerful crony capitalists who use their influence to create a stagnant corporate welfare state."); Mitt Romney, Op-Ed., Let Detroit Go Bankrupt, N.Y. Times, Nov. 19, 2008, at A35 ("Detroit needs a turnaround, not a check.").

tions.[3] The idea of the government—and therefore taxpayers—guaranteeing private companies' debts, while allowing these same companies to keep their profits, seems fundamentally unfair.[4] Unbeknownst to most of the public, however, the government serves as a guarantor—either explicitly or implicitly—of other private entities.[5] For example, the government will repay personal bank deposits if a bank becomes insolvent, even if a bank manager's risky behavior led to the collapse.[6] To limit this guarantee's potential burden on taxpayers, and for other reasons discussed below, the government created an independent insolvency regime for banks.[7] Specifically, when a bank is failing, it does not go into bankruptcy as all other private companies do.[8] Instead, the government intervenes and a government regulatory agency takes control for "resolving" the bank in the manner least costly to taxpayers.[9]

Government-sponsored entities (GSEs) such as Fannie Mae and Freddie Mac provide another example of the federal government guaran-

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3. See Matthew Karnitschnig et al., U.S. to Take Over AIG in $85 Billion Bailout; Central Banks Inject Cash as Credit Dries Up, Wall St. J., Sept. 16, 2008, at A1 (describing $85 billion bailout of AIG); Rick Newman, A $25 Billion Lifeline for GM, Ford, and Chrysler, U.S. News & World Rep., Sept. 24, 2008, at http://www.usnews.com/blogs/flowchart/2008/09/24/a-25-billion-lifeline-for-gm-ford-and-chrysler.html (on file with the *Columbia Law Review*) (detailing $25 billion bailout for car makers).

4. See Andrews, supra note 1 ("[T]he bailout [of AIG] is likely to prove controversial, because it effectively puts taxpayer money at risk while protecting bad investments made by A.I.G. . . ."); Brooks, supra note 2 ("Big Three executives will make decisions knowing that whatever happens, Uncle Sam will bail them out . . . .").

5. While this Note focuses on banks and government-sponsored entities, there are other systems in place that have the same effect. The Pension Benefit Guarantee Corporation (PBGC), for example, provides a federal guarantee of a private company's pension funds if that company can no longer pay the pension to its employees. See generally Cong. Budget Office, The Risk Exposure of the Pension Benefit Guarantee Corporation (2005), available at http://www.cbo.gov/ftpdocs/66xx/doc6646/09-15-PBGC.pdf (on file with the *Columbia Law Review*) (providing overview of PBGC). This fund is financed through private insurance premiums, but it has recently reported increasing deficits, which could mean taxpayers would bear the burden of paying for a private company's pensions if the fund becomes insolvent. See Alan B. Krueger, Looking Out for the Next Bailout, N.Y. Times Economix Blog, Dec. 22, 2008, at http://economix.blogs.nytimes.com/2008/12/22/looking-out-for-the-next-bailout/ (on file with the *Columbia Law Review*) ("[T]here are reasons to be concerned that taxpayers will eventually be on the hook for a substantial bailout [of PBGC]."). Although not directly addressed, many of the arguments made in this Note are also applicable to entities like the PBGC.

6. See FDIC, Who is the FDIC?, at http://www.fdic.gov/about/learn/symbol/index.html (last updated June 9, 2009) (on file with the *Columbia Law Review*) (providing overview of federal deposit insurance).

7. An "insolvency regime," as used in this Note, refers generally to the mechanism by which a failing entity's debts are resolved. Bankruptcy, for example, is the most common type of insolvency mechanism in the United States, and it is defined as, "A statutory procedure by which a (usu[ally] insolvent) debtor obtains financial relief and undergoes a judicially supervised reorganization or liquidation of the debtor's assets for the benefit of creditors." Black's Law Dictionary 166 (9th ed. 2009).

8. See infra note 63 (noting exception for banks in Bankruptcy Code).

9. See infra Part I.B.1 (describing banking's unique insolvency regime).

teeing a privately operated company.[10] Fannie and Freddie are the largest residential mortgage companies in the United States, and were created to increase the availability of home financing.[11] Although the government does not explicitly guarantee Fannie and Freddie (as it does with bank deposits[12]), the market recognizes an implicit guarantee of government backing.[13] Unlike banking, however, where the government limits its guarantee to the statutory maximum of $100,000 per deposit,[14] the implicit backing of Fannie and Freddie has no external limits and could therefore result in a staggering burden on taxpayers.[15]

To limit the potential taxpayer burden from this implicit guarantee, experts[16] advocated for an independent insolvency regime for Fannie and Freddie.[17] In 2008, in response to warnings that Fannie and Freddie were not fiscally sound, Congress passed the Housing and Economic

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10. The perceived unfairness of such a structure is readily apparent. See, e.g., Susan Lee, Giant Losers, Forbes.com, Nov. 14, 2008, at http://www.forbes.com/2008/11/13/fannie-freddie-frank-oped-cx_sl_1114lee.html (on file with the *Columbia Law Review*) ("[Fannie and Freddie's] business model—publicly subsidized but privately profited firms—yields massively leveraged portfolios, incompetent but grossly compensated management, a huge lobbying establishment and political pork galore.").

11. Fannie Mae's official name is the Federal National Mortgage Association (FNMA) and Freddie Mac's official name is the Federal Home Loan Mortgage Corporation (FHLMC). See infra Part I.A.1.a for an overview of Fannie and Freddie's current role in the mortgage marketplace.

12. See Financial Institution Letter, FDIC, Deposit Insurance Coverage: Temporary Increase in Coverage (Oct. 23, 2008), available at http://www.fdic.gov/news/news/financial/2008/fil08102.pdf (on file with the *Columbia Law Review*) [hereinafter FDIC, Increase in Coverage] (noting explicit deposit insurance limits).

13. See infra Part I.A.1.b (detailing implicit federal guarantee of Fannie and Freddie).

14. See infra notes 56–58 and accompanying text (describing recent, temporary increase to $250,000 and ability to manipulate deposit limits).

15. Fannie and Freddie's $5.2 trillion of outstanding debt in 2007 illustrates the potential impact of a taxpayer bailout. At that time, this amount was more than the publicly held debt for the entire federal government. Ben S. Bernanke, Chairman, Fed. Reserve, Remarks Before the Independent Community Bankers of America's Annual Convention and Techworld, Honolulu, Hawaii: GSE Portfolios, Systemic Risk, and Affordable Housing (Mar. 6, 2007), available at http://www.federalreserve.gov/newsevents/speech/Bernanke20070306a.htm (on file with the *Columbia Law Review*) [hereinafter Bernanke, GSE Portfolios]; see also infra note 60 (describing potential impact of failed Fannie and Freddie).

16. The most prominent advocate for such an insolvency regime is Professor Richard Scott Carnell, who has authored multiple reports detailing his suggestion. See, e.g., Richard Scott Carnell, Handling the Failure of a Government-Sponsored Enterprise, 80 Wash. L. Rev. 565, 598–608 (2005) [hereinafter Carnell, Failure] (advocating insolvency regime for GSEs modeled on bank insolvency law); id. at 569 n.19 (listing Carnell's research since 1999 calling for GSE insolvency mechanism).

17. GSEs cannot currently go through bankruptcy because they are instrumentalities of the federal government. See infra note 62 and accompanying text (outlining Bankruptcy Code's exclusion of instrumentalities). Professor Carnell, however, briefly suggests using bankruptcy as an alternative to a unique insolvency regime, and notes that Congress could change the Bankruptcy Code to allow it. Carnell, Failure, supra note 16, at 640–41. Although this is an alternative, he concludes, "I would prefer to rely on specialized insolvency regimes rather than the Bankruptcy Code." Id. at 641.

Recovery Act, which created an insolvency regime for the two GSEs modeled almost identically on the bank system.[18]

While government action is necessary to limit taxpayer liability, the new insolvency regime for Fannie and Freddie will be ineffective until the government guarantee of the GSEs more closely mirrors the guarantee for bank deposits. Unfortunately, although the three largest GSEs—Fannie, Freddie, and the Federal Home Loan Bank System—are one-third the size of the entire U.S. commercial banking industry, GSEs have received "remarkably little scrutiny from legal scholars."[19] Moreover, virtually no academic research has addressed the new insolvency regime as a solution to Fannie and Freddie's potential taxpayer liability.[20] This Note addresses this void by analyzing the rationales underlying insolvency regimes. It concludes that the newly minted insolvency regime modeled on banks fails to limit the risky behavior of Fannie and Freddie and will perpetuate the potentially unlimited taxpayer guarantee of the entire entity.

After an overview of the current structure of bank and GSE insolvency regimes in Part I, Part II outlines the three-step justification for creating independent insolvency regimes by analyzing the banking system. First, the formation of a federal guarantee (deposit insurance) was necessary to eliminate the systemic effects of bank runs. Second, once federal backing was explicitly given, the government was justified in creating a unique insolvency regime because the taxpayers could be liable for the bank's failure. Third, because federal backing creates incentives to engage in risky behavior, bank regulators imposed "least-cost resolution" requirements to ensure taxpayers' liability would be limited to the defined amount guaranteed by the deposit insurance. Part II concludes that this rationale for banking's independent insolvency system is currently inapplicable to Fannie and Freddie. Specifically, no problem analogous to systemic bank runs exists to justify the unquantifiable, implicit federal guarantee for GSEs. Most importantly, the new insolvency regime for Fannie and Freddie does not have policies such as least-cost resolution to limit the extent of potential taxpayer liabilities.

Part III argues that an insolvency regime modeled on banks will not solve the problem of taxpayers bearing a substantial portion of Fannie and Freddie's debt. Instead, this Note proposes creating federally guaranteed mortgage insurance, similar to deposit insurance, to further the policy objectives of Fannie and Freddie while limiting the potential burden on taxpayers. Once such an insurance mechanism has been estab-

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18. Housing and Economic Recovery Act (HERA) of 2008, Pub. L. No. 110-289, § 1145, 122 Stat. 2654, 2734–67.

19. Carnell, Failure, supra note 16, at 567–69 (describing few attempts by legal scholars to discuss GSEs).

20. Professor Carnell proposed a new insolvency regime in his 2005 article, Handling the Failure of a Government-Sponsored Enterprise. Id. The article has been widely accepted by policymakers with little debate or dissent.

lished, an insolvency regime for Fannie and Freddie modeled on the banking insolvency regime would be effective.

I. Instrumentalities and Their Insolvency Regimes

Government instrumentalities combine the standard purpose of private firms—maximizing shareholder wealth—with the traditional governmental purpose of pursuing public goals. A unique type of government instrumentality is the government-sponsored entity (GSE). A GSE is created by the federal government with a public purpose and endowed with special benefits, but remains a private, for-profit enterprise without explicit federal backing.

One of the important differences between private companies and instrumentalities (such as GSEs) is the exit strategy used by each when the firm fails and becomes insolvent. While private companies go through bankruptcy,[21] instrumentalities are excluded from bankruptcy under the Bankruptcy Code.[22] As such, Congress must create unique insolvency regimes for instrumentalities. The most widely used regime is the banking insolvency model, on which Fannie and Freddie's insolvency regime is now based.

A. *Overview of Government Instrumentalities*

An instrumentality of the federal government is a private entity that the government creates to further a public goal.[23] Organizations such as the American Red Cross and Amtrak, for example, are instrumentalities.[24] As early as 1824, in *Osborn v. Bank of the United States*, the Supreme Court recognized the federal government's power to create a private entity, such as a national bank, to serve public purposes.[25] Specifically, the Court noted:

> The Bank is not considered as a private corporation, whose principal object is individual trade and individual profit; but as a

21. See infra note 61 (detailing bankruptcy process for companies).

22. See infra note 62 (noting Bankruptcy Code's exclusion of instrumentalities).

23. See generally Thomas H. Stanton, Government-Sponsored Enterprises: Mercantilist Companies in the Modern World 13–32 (2002) [hereinafter Stanton, Government-Sponsored Enterprises] (providing overview of instrumentalities). Creation by federal legislation alone does not guarantee that an institution will be an instrumentality. Instead, it is the service to public purposes that distinguishes government instrumentalities from private firms and organizations. The National Consumer Cooperative Bank, for example, began as an instrumentality of the United States to create long-term, low-interest federal loans. Subsequent legislation, however, transformed it into a federally chartered private bank, and today it raises money to fund large and profitable cooperatives without regard to public purposes. Id. at 15.

24. Lebron v. Nat'l R.R. Passenger Corp., 513 U.S. 374, 394 (1995) ("Facing the question of Amtrak's status for the first time, we conclude that it is an . . . instrumentality of the United States . . . ."); Dep't of Employment v. United States, 385 U.S. 355, 358 (1966) ("[W]e hold that the Red Cross is an instrumentality of the United States . . . .").

25. 22 U.S. (9 Wheat.) 738, 808–10 (1824).

> public corporation, created for public and national purposes. . . . [T]he Bank is an instrument which is "necessary and proper for carrying into effect the powers vested in the government of the United States." . . . It is, undoubtedly, capable of transacting private as well as public business. While it is the great instrument by which the fiscal operations of the government are effected, it is also trading with individuals for its own advantage.[26]

As *Osborn* implies, instrumentalities exist in the middle of the organizational spectrum between government agencies and purely private companies.[27] Instrumentalities differ from government agencies because they are not part of the government, and therefore are not covered by the laws that apply to government agencies.[28] Additionally, while the government directly manages a government agency, it can only regulate and supervise an instrumentality.[29]

Instrumentalities differ from private companies because they are created with a public goal in mind, and their charters are limited to enacting that public purpose.[30] While private firms can expand into whatever field they choose, as well as exit markets they deem unprofitable, this flexibility is limited for instrumentalities. The instrumentality's enacting legislation specifies the purpose of the entity and limits the scope of its powers to those required to fulfill its purpose.[31] Therefore, while purely private companies can conduct any business that is not expressly prohibited by the law, instrumentalities may only conduct those activities expressly permitted by the law.[32]

Federal banks were one of the first instrumentalities.[33] They were established "to provide a uniform and secure currency for the people, and to facilitate the operations of the Treasury of the United States,"[34] yet they operate as private, profit seeking companies.

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26. Id. at 860.

27. Stanton, Government-Sponsored Enterprises, supra note 23, at 15–17 (comparing government agencies to instrumentalities).

28. Many laws apply to government agencies but not to instrumentalities. First, employees of instrumentalities do not become employees of the federal government. Second, agency restrictions on staffing, procurement, and resources do not apply to instrumentalities. Third, an instrumentality's actions do not constitute "state action" for purposes of constitutional violations. Fourth, the benefit of sovereign immunity does not apply to instrumentalities. See id. at 16.

29. Id. at 16–17.

30. Id. at 18–20 (comparing private companies to instrumentalities).

31. Id. at 25.

32. For a useful table highlighting the differences between government agencies, instrumentalities, and private companies, see id. at 25 tbl.2-3 (detailing "legal attributes of GSEs compared with ordinary private companies and government agencies").

33. Osborn v. Bank of the United States, 22 U.S. (9 Wheat.) 738, 860 (1824) ("[T]he Bank is an instrument which is 'necessary and proper for carrying into effect the powers vested in the government of the United States.'" (quoting McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316, 324 (1819))).

34. Mercantile Nat'l Bank v. New York, 121 U.S. 138, 154 (1887).

1. *Government-Sponsored Entities.* — A GSE is a specific form of instrumentality, generally defined as "a privately owned, federally chartered financial institution with nationwide scope and specialized lending powers that benefits from an implicit federal guarantee of all its obligations to enhance its ability to borrow money."[35] Similar to other instrumentalities, GSEs must serve both their shareholders (in earning a profit) and the government (in pursuing a public purpose). Although there are currently five GSEs, this Note focuses only on Fannie Mae and Freddie Mac.[36]

a. *Overview of Fannie Mae and Freddie Mac.* — Congress established Fannie and Freddie "to address concerns that private financial institutions were not adequately meeting the credit needs of homebuyers."[37] Although they were created at different times and have taken different forms, today the two institutions are largely indistinguishable.[38] Fannie and Freddie operate in the private financial market by creating a secondary market for mortgages.[39] In very simplified terms, banks or other lenders loan money to individuals in the primary mortgage market. At this point, the bank holds a mortgage, on which it expects to earn money in the future, but it does not currently have that money to loan out to other individuals. This is referred to as an "illiquid" asset. To provide liquidity to the banks, the GSE purchases these mortgages from the

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35. Stanton, Government-Sponsored Enterprises, supra note 23, at 1–2; see also Cong. Budget Office, Federal Subsidies and the Housing GSEs 7 (2001), available at http://www.cbo.gov/ftpdocs/28xx/doc2841/GSEs.pdf (on file with the *Columbia Law Review*) (defining GSEs as "financial intermediaries, established and granted preferential treatment by federal law to increase the flow of funds to specific uses but owned by investors to whom they owe a fiduciary responsibility").

36. The other three GSEs are the Federal Home Loan Bank System, the Farm Credit System, and Farmer Mac. See Stanton, Government-Sponsored Enterprises, supra note 23, at 2–3 (listing GSEs by size and function). Sallie Mae, which originated as a GSE, has since become fully privatized. Id. at 96–101 (describing process of privatizing Sallie Mae). Although many of the arguments made in this Note are applicable to all of the GSEs, this Note will focus only on Fannie Mae and Freddie Mac because Congress's new insolvency regime applies only to those two. As this Note only addresses Fannie Mae and Freddie Mac, I will use the term GSE in the remainder of the Note to refer only to those two entities. Therefore, "GSE" and "Fannie and Freddie" are synonymous for the purposes of this Note.

37. Proposals for Improving the Regulation of the Housing Government Sponsored Enterprises: Hearings Before the S. Comm. on Banking, Housing, and Urban Affairs, 108th Cong. 309 (2004) [hereinafter GSE Hearings] (statement of David M. Walker, Comptroller General of the United States).

38. See Thomas H. Stanton, Federal Supervision of Safety and Soundness of Government-Sponsored Enterprises, 5 Admin. L.J. 395, 409–11 (outlining creation and development of Fannie Mae and Freddie Mac); Robert Van Order, A Microeconomic Analysis of Fannie Mae and Freddie Mac, Regulation, Summer 2000, at 27, 28 ("[Fannie and Freddie] are now quite similar and compete in the conventional mortgage market as buyers of mortgages and in the securities markets as sellers of mortgage-backed securities and issuers of debt.").

39. See generally End of Illusions, Economist, July 19, 2008, at 79 (providing detailed overview of Fannie and Freddie's role in housing market).

banks. It then bundles the mortgages together to create mortgage-backed securities (MBS) that are sold to investors—a procedure known as securitization.[40] This process of buying mortgages from originating banks, repackaging them, and selling them to investors, creates liquidity in the mortgage market by indirectly providing capital for home loans from sources who would not otherwise invest in the mortgage market. Fannie and Freddie together financed approximately $822 billion of new MBS during 2006.[41]

Because a GSE is privately financed, however, it must earn a return on its investment to satisfy its shareholders. The GSE earns revenue by charging a fee for guaranteeing the timely payment of principal and interest on the MBS backed by the mortgage pool.[42] They can also earn revenue by purchasing (instead of selling) MBS and holding them in their own portfolios. This portfolio investment activity is seen as a separate "line of business" from the securitization activity.[43] While the purpose of the securitization activity is to create a secondary mortgage market, the purpose of the portfolio investments is to earn a profit for the shareholders. Fannie and Freddie have traditionally been very successful in this regard, earning returns on equity consistently exceeding twenty percent.[44]

Similar to instrumentalities generally, Fannie and Freddie also occupy the organizational middle ground between purely private companies and government agencies.[45] As Fannie and Freddie were created through federal charters, they were granted some benefits that purely private companies do not receive. Some of the explicit benefits listed in the federal charters include exemption from state and local corporate income taxes, exemption from registering their securities with the Securities and Exchange Commission, lines of credit from the Treasury Department, and use of the Federal Reserve as a transfer agent.[46] The

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40. See U.S. Gen. Accounting Office, Housing Enterprises: Potential Impacts of Severing Government Sponsorship 2 (1996), available at www.gao.gov/archive/1996/gg96120.pdf (on file with the *Columbia Law Review*) [hereinafter Potential Impacts] (detailing GSE's strategy of "operating in the secondary market and purchasing mortgages made by primary lenders, such as banks, thrifts, and mortgage bankers" and "obtain[ing] the funds needed to purchase mortgages . . . by pooling mortgages and selling mortgage-backed securities, known as MBS, to investors").

41. Securitization Became More Popular Funding Strategy in 2006, but GSE Programs Played a Smaller Role, Inside Mortgage Fin., Mar. 16, 2007, at 9.

42. Potential Impacts, supra note 40, at 4.

43. Bernanke, GSE Portfolios, supra note 15.

44. See Stanton, Government-Sponsored Enterprises, supra note 23, at 6 (calculating returns on equity for Fannie Mae and Freddie Mac every two years between 1990 and 2000).

45. See supra notes 27–32 and accompanying text (providing overview of differences between instrumentalities, private companies, and government agencies).

46. See Stanton, Government-Sponsored Enterprises, supra note 23, at 22–23 (listing unique legal attributes of GSEs).

biggest benefit Fannie and Freddie enjoy, however, is the perception of federal backing for all of their debts.

b. *Fannie and Freddie's Implicit Federal Guarantee.* — Although there is no explicit federal guarantee of Fannie and Freddie's actions,[47] the market historically operates under a widespread belief that such a guarantee is implicit.[48] An implicit federal guarantee means that if Fannie and Freddie were to become insolvent, the federal government would step in to ensure that creditors received their money, even though the government is under no obligation to do so. This belief is well founded. For example, Alan Greenspan, then Chair of the Federal Reserve, warned that, "in the event of a crisis involving Fannie and Freddie, policymakers would have little alternative than to have the taxpayers explicitly stand behind the GSE debt."[49] Further, Congress has assisted GSEs in the past when they were faced with financial instability,[50] and has most recently provided similar relief to a failing Fannie and Freddie.[51]

Regardless of the accuracy of the belief in an implied federal guarantee, Fannie and Freddie can borrow money at a rate much lower than private firms because "market players *perceive* the risk of default of Fannie and Freddie . . . as nearly as unlikely as the risk of default by the U.S. Government itself."[52] In short, it is the perception of a federal guarantee that results in the competitive benefits to Fannie and Freddie,[53] even though the federal government formally maintains that there is no guarantee.[54] Fannie and Freddie seem to understand that only a perception

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47. In fact, Fannie and Freddie's charters require each GSE to include language noting that its "obligations [and securities], together with the interest thereon, are not guaranteed by the United States and do not constitute a debt or obligation of the United States or any agency or instrumentality thereof other than the [C]orporation." 12 U.S.C. § 1455(h)(2) (2006) (detailing requirement for Freddie Mac); id. § 1719(b) (detailing requirement for Fannie Mae).

48. See David 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, 1042–51 (2008) ("[W]hile the federal government's support may not be a legally enforceable obligation of the federal government, it is more solid than the mere perception of support; it is an actual 'implied guarantee' that has been written into the statutes and regulations . . . .").

49. GSE Hearings, supra note 37, at 374 (statement of Alan Greenspan, Chairman, Board of Governors of the Federal Reserve).

50. See Bradley K. Krehely, Government Sponsored Enterprises: A Discussion of the Federal Subsidy of Fannie Mae and Freddie Mac, 6 N.C. Banking Inst. 519, 536–37 (2002) (noting government bailout of GSE known as "Farm Credit System" in 1987 and grant of tax relief to Fannie when it faced insolvency in 1980s).

51. See infra Part I.B.2 (describing federal government's takeover of Fannie and Freddie in 2008).

52. Reiss, supra note 48, at 1043 (emphasis added).

53. See Martin Neil Baily et al., The Great Credit Squeeze: How it Happened, How to Prevent Another 23 (Econ. Studies at Brookings Inst., Discussion Paper, 2008) (noting implicit backing results in other financial institutions only able to operate in markets where Fannie and Freddie could not).

54. See Reiss, supra note 48, at 1044–45 & nn.120–121 (noting instances where federal government denied existence of federal guarantee).

of an implied guarantee is required, and they actively encourage the belief that a guarantee exists. As Professor Richard Carnell aptly notes, the GSEs are effectively "telling Congress and the press, 'Don't worry, the Government is not on the hook,' and then turning around and telling Wall Street, 'Don't worry, the Government really is on the hook.'"[55]

Federal guarantees of private companies are not unique to Fannie and Freddie. The FDIC, for example, generally insures bank deposits up to $100,000.[56] This means that even if the bank becomes insolvent, the federal government will pay the depositors the amount of their insured deposit.[57] The difference with respect to Fannie and Freddie is that the government backing of the GSEs is not explicit, therefore it is not limited to any defined amount. While an individual can structure her banking transactions strategically, and thus insure more than $100,000,[58] the government still knows the amount of the insured deposits, so the government guarantee is quantifiable and limited.[59] The extent of the government's potential liability for Fannie and Freddie, however, is not similarly quantifiable because there is no maximum amount (such as the $100,000) for which the government is liable. Fannie and Freddie's failure, therefore, could result in a staggering burden on taxpayers.[60]

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55. GSE Hearings, supra note 37, at 289 (statement of Richard S. Carnell, Professor, Fordham University School of Law).

56. A recent provision temporarily raised this amount to $250,000, but is set to expire December 31, 2009. FDIC, Increase in Coverage, supra note 12.

57. This Note frequently observes the government's explicit guarantee of deposit insurance. This may imply that the federal government directly pays for any insured deposits when a bank fails. In reality, the Federal Deposit Insurance Fund covers payment of the insured deposits, and this fund is paid into by all federally insured banks. Therefore, often taxpayers do not directly bear the cost of paying back lost deposits (although one could argue that banks simply pass along the cost of paying into the fund to their clients). Deposit insurance, however, is "backed by the full faith and credit of the United States government," so if the Deposit Insurance Fund can no longer provide the required insurance, the government (and therefore the taxpayer) is ultimately liable. FDIC, Deposit Insurance Summary, available at http://www.fdic.gov/deposit/deposits/dis/index.html (last updated Aug. 6, 2009) (on file with the *Columbia Law Review*).

58. See Kathy M. Kristof, How to Make Sure Your Bank Deposits Are Insured, L.A. Times, Nov. 23, 2008, at C3 (noting an individual could open "an individual account, a joint account, an IRA and a business account," resulting in "as much as $550,000 in coverage").

59. As evidence of the limit on the federal guarantee, over one-third of bank deposits were uninsured in 2008. See Sandra Block, Most Bank Deposits Are Insured, but It's Best to Check, USA Today, Mar. 4, 2008, at B3 ("Despite the widespread availability of deposit insurance, about 38% of the $6.9 trillion in bank deposits are uninsured, according to the FDIC."). When IndyMac failed in 2008, for example, it "had about $1 billion of potentially uninsured deposits held by approximately 10,000 depositors." Press Release, FDIC, FDIC Establishes IndyMac Federal Bank, FSB as Successor to IndyMac Bank, F.S.B., Pasadena, California (July 11, 2008), available at http://www.fdic.gov/news/news/press/2008/pr08056.html (on file with the *Columbia Law Review*).

60. Although the potential liability of a failed GSE is inherently unquantifiable, as there is no defined amount that the government explicitly guarantees, various estimates have been published. See, e.g., Assessing Conservatorship for Freddie Mac and Fannie

B. *Overview of Instrumentalities' Insolvency Regimes*

Instrumentalities differ from private companies and government agencies in another very important respect. When purely private companies fail to generate profits, and become insolvent, they will enter bankruptcy, either voluntarily or involuntarily.[61] However, when a bank or a GSE fails, by law it cannot go into bankruptcy,[62] so the government instead must establish insolvency regimes for the various instrumentalities.

1. *Banking Insolvency Regime.* — Banks today have the most widespread insolvency regime outside of bankruptcy.[63] The idea of a special insolvency regime for banks was evident as early as 1837 when President Van Buren suggested a federal bankruptcy system exclusively for banks—a sentiment echoed by President Buchanan twenty years later.[64] In 1864, Congress passed the National Bank Act, which established the now prevalent practice of giving bank receivers some different powers than those

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Mae, Knowledge@Emory, Sept. 11, 2008, at http://knowledge.emory.edu/article.cfm?articleid=1178 (on file with the *Columbia Law Review*) ("[T]he Fannie Mae and Freddie Mac conservatorship might add up to a $200 billion price tag for taxpayers."). Another scholar has estimated that a government bailout of Fannie and Freddie would cost every taxpayer more than $16,000. John F. Wasik, Fannie, Freddie Need a Tougher Watchdog, Nat'l Post (Toronto), Mar. 9, 2004, available at Factiva (on file with the *Columbia Law Review*).

61. In general there are two options for companies declaring bankruptcy. The first is a Chapter 7 bankruptcy, whereby the company's nonexempt assets are sold and the proceeds are distributed to the creditors. This is known as liquidation. The second option is under Chapter 11, whereby the company is reorganized and kept open, and the creditors are paid over time. For more information on bankruptcy law, see generally U.S. Courts, Bankruptcy Basics, Chapter 7: Liquidation Under the Bankruptcy Code, at http://www.uscourts.gov/bankruptcycourts/bankruptcybasics/chapter7.html (last visited Aug. 13, 2009) (on file with the *Columbia Law Review*); U.S. Courts, Bankruptcy Basics, Chapter 11: Reorganization Under the Bankruptcy Code, at http://www.uscourts.gov/bankruptcycourts/bankruptcybasics/chapter11.html (last visited Aug. 13, 2009) (on file with the *Columbia Law Review*).

62. The Bankruptcy Code clearly states, albeit in an assortment of places within the statute, that instrumentalities cannot claim bankruptcy protection. The code permits only a "person" to be a debtor under Chapter 7 or 11. See 11 U.S.C. § 109(a), (b), (d) (2006). The Bankruptcy Code then defines "person" as "includ[ing] individual, partnership, and corporation, but does not include governmental unit." Id. § 101(41). Finally, the Bankruptcy Code defines the term "governmental unit" to mean "United States; State; Commonwealth; District; Territory; municipality; foreign state; department, agency, or instrumentality of the United States." Id. § 101(27). The tougher question is what government entities qualify as instrumentalities. For a discussion of whether government-sponsored entities constitute instrumentalities, see Carnell, Failure, supra note 16, at 609–12 ("GSEs are almost certainly federal 'instrumentalities' for purposes of the Bankruptcy Code . . . .").

63. The Bankruptcy Code explicitly eliminates the possibility of bankruptcy protection for banks in addition to the provision excluding instrumentalities. See 11 U.S.C. § 109(b) ("A person may be a debtor under . . . this title only if such person is not . . . a domestic insurance company, bank, savings bank, cooperative bank, savings and loan association . . . .").

64. Charles Warren, Bankruptcy in United States History 56–57, 95–96 (1935) (discussing history behind national bankruptcy legislation).

awarded under normal bankruptcy proceedings.[65] After the Great Depression, Congress created the Federal Deposit Insurance Corporation (FDIC), which was first appointed as the receiver for failed national banks in 1933.[66] Today, the FDIC, which also serves as the bank regulator, has control over the banking insolvency regime and can appoint itself as receiver or conservator for a failing or undercapitalized bank.[67] In a receivership, the FDIC liquidates the failed institution and divides the assets among the creditors as established by the statute.[68] In a conservatorship, the FDIC maintains the failing institution as a going concern in hopes of reselling it.[69] As will be described at length in Part II, the FDIC is constrained to one outcome when deciding how to resolve a failing bank—the resolution that is least costly to the taxpayers.

2. *Government-Sponsored Entities' Insolvency Regime.* — As Fannie and Freddie's regulatory mechanisms closely parallel those of the FDIC and the banking industry,[70] a parallel insolvency regime has followed.[71] Until recently, however, that insolvency structure only allowed for a conservator, not a receiver.[72] Contrary to the powers of bank regulators, the GSE regulator had "no explicit authority to wind up [the GSE's] operations.

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65. An Act to Provide a National Currency, Secured by a Pledge of United States Bonds, and to Provide for the Circulation and Redemption Thereof, ch. 106, 13 Stat. 99 (1864) (granting comptroller of the currency power to demand assurances and to appoint receiver for failing bank).

66. See Peter P. Swire, Bank Insolvency Law Now That It Matters Again, 42 Duke L.J. 469, 479–81 (1992) (discussing receivership and regulatory roles of FDIC from its inception through late twentieth century).

67. See David A. Skeel, Jr., The Law and Finance of Bank and Insurance Insolvency Regulation, 76 Tex. L. Rev. 723, 729–31 (1998) (describing regulatory framework behind bank's insolvency regime).

68. See id. (explaining receivership option for FDIC).

69. See id. at 729 (noting availability of conservatorship for FDIC). The option to put a bank into a receivership or a conservatorship closely parallels the options available under traditional bankruptcy law. See supra note 61 (describing Chapter 7 "liquidation" bankruptcy and Chapter 11 "reorganization" bankruptcy). The biggest difference in banking's insolvency regime is not the options available to deal with the failing institution, but who is in control. Only under the banking regime is the federal government the sole entity able to declare the bank insolvent and where the federal government is solely responsible for resolving the failure.

70. The Administrative Perspective on GSE Regulatory Reform: Hearing on H.R. 1461 Before the H. Comm. on Financial Servs., 109th Cong. 7 (2005) [hereinafter Regulatory Reform Hearing] (statement of Rep. Paul E. Kanjorski, Member, H. Comm. on Financial Servs.) ("[T]he general goal of our reform debates heretofore has been to make GSE supervision more bank-like.").

71. See Carnell, Failure, supra note 16, at 599 ("This streamlined, nonjudicial regime [for banks] has served as a model for GSE insolvency law—just as banking regulation has, more broadly, served as a model for GSE regulation.").

72. This difference is relevant because only in a receivership is the federal government able to completely close the operations of the company and liquidate its assets. In a conservatorship, the federal government assumes control for the failing institution, but the institution is preserved and its operations are maintained. See Skeel, supra note 67, at 729–31 (describing differences between conservatorship and receivership). Therefore, without the option of a receivership, the federal government

The ultimate sanction of dissolution, which applies to virtually all other private companies that fail, does not apply by statute to Fannie Mae or Freddie Mac."[73] Without a receivership provision, the belief in an implicit federal guarantee became even stronger because the only option available for a failing GSE was to continue its operations.[74]

In 2008, to help alleviate this concern and to address the impact of the subprime mortgage meltdown adversely affecting Fannie and Freddie,[75] Congress passed the Housing and Economic Recovery Act (HERA).[76] This Act created a new regulator, the Federal Housing Finance Agency (FHFA), and gave it the power to place a financially troubled GSE in either conservatorship or receivership.[77] However, as will be discussed in Part II, the FHFA is not as constrained as the FDIC in its decision as to how to resolve a failing GSE because there is no least-cost resolution requirement. In August 2008, a spokeswoman for the Treasury indicated that there were "no plans to utilize the temporary authorities," and that the "action should be interpreted as a prudent preparedness measure, and nothing more."[78] On September 7, 2008, however, the FHFA put Fannie and Freddie into conservatorship, seizing full control over the GSEs' operations.[79]

It is not disputed that Congress had the legal authority to create an insolvency regime for banks and GSEs. The policy justifications for such an independent system, however, are not so clear. The rationale for creating a banking insolvency regime has been only briefly analyzed,[80] and

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could not credibly threaten to allow the organizations to completely go out of business, thereby resulting in losses to the shareholders.

73. Stanton, Government-Sponsored Enterprises, supra note 23, at 42.

74. See Carnell, Failure, supra note 16, at 624–25 ("The lack of a credible receivership mechanism reinforces investors' perception of implicit government backing by giving Congress little practical alternative to rescuing [Fannie and Freddie], . . . as though the government had painted itself into a corner.").

75. For an in-depth description of the subprime mortgage crisis and the ensuing credit crunch, see Baily et al., supra note 53.

76. Housing and Economic Recovery Act (HERA) of 2008, Pub. L. No. 110-289, 122 Stat. 2654.

77. See David H. Carpenter & M. Maureen Murphy, Cong. Research Serv., Financial Institution Insolvency: Federal Authority over Fannie Mae, Freddie Mac, and Depository Institutions 3 (2008), available at http://fpc.state.gov/documents/organization/110098.pdf (on file with the *Columbia Law Review*) ("In contrast to OFHEO's authority as conservator to resolve a failed Fannie or Freddie prior to the enactment of P.L. 110-289, the FHFA's authority is broader and more flexible, having been modeled on the Federal Deposit Insurance Act . . . .").

78. Louise Story, Morgan Stanley to Advise U.S. on Fannie and Freddie, N.Y. Times, Aug. 6, 2008, at C2 (quoting Brookly McLaughlin, spokeswoman for U.S. Department of Treasury).

79. Mark Jickling, Cong. Research Serv., Fannie Mae and Freddie Mac in Conservatorship 3 (2008), available at http://fpc.state.gov/documents/organization/110097.pdf (on file with the *Columbia Law Review*).

80. See, e.g., Carpenter & Murphy, supra note 77, at 4 (limiting discussion of bank's unique insolvency regime to: "Because of the possible threat to the federal fisc and for other reasons, depository institution insolvencies are not handled according to the

this analysis has never been applied to Fannie and Freddie. Even the leading GSE scholar advocating for a parallel insolvency regime for Fannie and Freddie does so without addressing the underlying rationale for the creation of banking's unique regime.[81] Yet, even without this analysis, policymakers concluded that a GSE insolvency regime modeled after banks is appropriate and enacted such a mechanism for Fannie and Freddie.[82]

II. Creation of a Bank Insolvency Regime and Its Inapplicability to GSEs

The unique insolvency regime for banks was created to solve specific social problems, and has evolved to narrowly address those problems without creating additional federal liabilities. The unique insolvency regime for Fannie and Freddie, however, was created without similar social justifications, and is not narrowly tailored. As such, Fannie and Freddie's newly minted regime lacks policy justifications and will only perpetuate the potential taxpayer burden from an insolvent GSE.

A. *Justifications for, and Resulting Structure of, a Bank-Specific Insolvency Scheme*

The current bank insolvency scheme emerged from the interplay of three factors, together justifying the need for such a regime. First, banks feared contagious bank runs, which threatened to undermine the entire banking system. In solving the bank run problem through deposit insurance, the government created a second problem—a moral hazard for bank managers that encouraged risky behavior. Finally, the most recent changes to the banking insolvency model were enacted to limit this moral hazard, effectively reducing the potential taxpayer liability from a failing bank.

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procedures available in the case of other corporate bankruptcies") (citations omitted); Swire, supra note 66, at 471–72 ("[L]egal academics have almost entirely failed even to notice the existence of a special bank insolvency regime."). But see E. Gerald Corrigan, Are Banks Special?, *in* Federal Reserve Bank of Minneapolis Annual Reports 1982 (1982), available at http://www.minneapolisfed.org/pubs/ar/ar1982a.cfm (on file with the *Columbia Law Review*) (identifying three characteristics that distinguish banks: transaction accounts, liquidity source, and transmission belt for monetary policy).

81. See, e.g., Carnell, Failure, supra note 16, at 599–602 (noting "substantive and institutional reasons" for utilizing banking as model for GSE regulation, but failing to analyze justifications for banking's unique insolvency regime or to apply those justifications to GSEs); see also infra Part II.B.3 (detailing, and rebutting, arguments made by advocates of new insolvency regime).

82. Housing and Economic Recovery Act (HERA) of 2008, Pub. L. No. 110-289, 122 Stat. 2654; see also Carpenter & Murphy, supra note 77, at 1 ("Among the reforms included in P.L. 110-289 were extensive provisions providing the FHFA with powers that substantially parallel those accorded the . . . [FDIC] to deal with every aspect of insolvencies of any bank or thrift . . . .").

1. *Fear of Bank Runs Led to Creation of Federal Deposit Insurance.* — Before federal deposit insurance, bank failures posed two potential threats: immediate loss of an individual depositor's money, and a bank run leading other depositors to try to withdraw their deposits.[83] The potential for a depositor run on banks resulted from banks' unique asset and liability structure. Unlike other private entities, a significant portion of banks' liabilities are liquid, while a significant portion of their assets are illiquid.[84] The liquid liabilities are in the form of deposits that depositors can extract in full whenever they demand. The illiquid assets are in the form of long-term loans. Because banks use the deposits to make the loans, individual depositors may withdraw their funds at anytime, but the depositors as a whole, or even in some substantial part, cannot demand payment simultaneously.[85] Banks do not have sufficient funds to cover all of the depositors at once because most of the funds have been loaned out with longer repayment terms.

A prisoner's dilemma[86] arises because depositors, as a class, are better off when everybody keeps their deposits in the bank yet, when financial panic hits, individual depositors have an incentive to be the first to withdraw their funds to ensure a full payout.[87] The key is that while investors as a class will benefit most if no one withdraws, each has an incentive to individually attempt to withdraw. Therefore, withdrawal, and the ensuing bank run, is the equilibrium solution. While these runs are often believed to be unique to banking, such runs also occur outside of banking when financial insecurity hits firms in other industries.[88] Given the

83. Swire, supra note 66, at 490–91.

84. See Daniel R. Fischel et al., The Regulation of Banks and Bank Holding Companies, 73 Va. L. Rev. 301, 306–07 (1987) (contrasting banks with money market funds—liquid assets and liabilities—and pension funds—illiquid assets and liabilities—and concluding "[n]o other entity combines liquid liabilities with illiquid assets in the same manner as banks").

85. See id. at 307 ("[D]epositors as a class cannot demand payment simultaneously because the bank has insufficient funds on hand to meet all of its obligations.").

86. A prisoner's dilemma is a game theory problem where two people are arrested for a crime and face the following choice: If both suspects remain silent, the prosecutor will only be able to prove a lesser violation, and each will only get one year in prison. If suspect A confesses, however, while suspect B remains silent, the prosecutor will cut a deal with A whereby A will not serve any time, and B will receive ten years. The reverse is true if suspect B confesses while A remains silent. If both confess, the prosecutor will give each of them five years. As such, both suspects have an incentive to confess, but the outcome if both confess (five years each) is worse than the outcome if both remain silent (one year). For further explanation of the prisoner's dilemma, see Walter J. Wessels, Economics 441–45 (4th ed. 2006). While the situation facing banks is more aptly characterized as a collective action problem because there are more than two participants, this Note will use the term prisoner's dilemma, as that is what has been widely used in the banking literature.

87. See Fischel et al., supra note 84, at 307–08 (describing how prisoner's dilemma leads to bank runs).

88. See id. at 308 ("Financial panics leading to runs are generally perceived as a phenomenon unique to banking. This perception is false. An analogous prisoner's dilemma confronts the short-term creditors of any firm.").

unique structure of a bank's assets and liabilities, however, where depositors can immediately demand full withdrawal of their money, depositors have greater opportunities to engage in "me-first" behavior.[89]

Runs on individual banks would not pose a great threat to the economy because depositors could simply transfer their deposits to another bank.[90] In the early 1900s, however, most people believed bank failures were contagious.[91] A Kansas court in 1911 exemplified this widely held belief that bank failures had systemic effects, noting that "[i]f a merchant cannot meet his bills promptly, the general public is not disturbed."[92] In contrast, if a bank should fail, "the mischief takes a wide range."[93] An individual bank run leads other banks to "call in their loans and refuse to extend credit in order to fortify themselves against . . . their own depositors. Confidence is destroyed. Enterprises are stopped. Business is brought to a standstill . . . and disaster spreads from locality to locality."[94] These apparently catastrophic results "clearly distinguish banking from the ordinary private business."[95] During the Great Depression, these fears were realized as banks failed nationwide at a rate considerably higher than the failure rates for other firms.[96]

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89. See id. at 308–09 (noting "nothing in economic theory suggests that runs are peculiar to the banking industry," yet, "bank depositors are more likely . . . to adopt a me-first attitude at the first signs of financial distress"); Swire, supra note 66, at 495 ("The collective action problem is more acute for banks because most depositors have the right to demand immediate payment, whereas many corporate creditors can demand payment only over a longer period.").

90. See Fischel et al., supra note 84, at 311 n.33 ("If bank failures were not widespread, there would be no reduction in money supply. Deposits withdrawn from one bank would simply be reinvested in another bank.").

91. A significant portion of the recent authority on bank runs, however, concludes that bank runs are not contagious today, and that the unique economic factors before and during the Great Depression led to the industry-wide bank failures seen then. See George G. Kaufman, Bank Runs: Causes, Benefits, and Costs, 7 Cato J. 559, 566–71 (1988) (concluding nationwide bank runs rarely undermine banking industry, having occurred only in 1893 and 1929–1933). As a result, many scholars argue that special bank insolvency rules are no longer necessary. See Fischel et al., supra note 84, at 317–18 (noting traditional bankruptcy regime is used in other industries to deal with prisoner's dilemma and questioning why "banks [are] specifically exempted from the bankruptcy laws"); Skeel, supra note 67, at 726 (suggesting financial insolvency procedure should reflect similarities with nonfinancial firms); Swire, supra note 66, at 495 ("A number of observations, however, may lead one to doubt that the collective action problem justifies today's special insolvency rules only for banks and not for other corporations."). The systemic effects of bank runs, and whether banking should continue to enjoy a unique regime, are beyond the scope of this Note, which instead focuses only on whether the banking regime's justifications apply to GSEs.

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

93. Id.

94. Id.

95. Id.

96. See Fischel et al., supra note 84, at 311 n.32 (citing G. Benston et al., Perspectives on Safe and Sound Banking 58 (1986)) ("From 1930 to 1933, 13.05% of all banks failed annually, as compared with an average annual failure rate for other businesses of 1.27%.").

Believing that banks were a crucial part of society, Congress created the FDIC in 1933 to insure deposits, effectively reducing the risk of bank runs by decreasing the incentive for depositors to withdraw their money during financial panics.[97] Unfortunately, solving the prisoner's dilemma problem resulted in a new problem: Federal backing through deposit insurance encouraged banks to engage in risky behavior because, while banks reap the rewards if such behavior succeeds, the government will pay the costs if it fails.

2. *Solving the Prisoner's Dilemma Results in Justifiable Moral Hazard.* — The moral hazard[98] that resulted from the creation of federal deposit insurance has been widely documented.[99] The federal government guarantee was justified, however, because it successfully deterred bank runs, and the $100,000 insurance limit helped ensure that taxpayers would not have to pay for risky behavior beyond a specified amount.[100] Therefore, once the government guaranteed the deposits, it logically appointed a governmental agency, the FDIC, as the sole receiver of failed banks, in-

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97. See Swire, supra note 66, at 493–94 ("The avalanche of bank failures during the Great Depression led to widespread political support for drastic changes in the banking system . . . . [C]oncerns about immediacy and bank runs explain the early special bank insolvency rules." (citation omitted)). But see David S. Holland, When Regulation Was Too Successful 8 (1998) ("The fact that no insured deposits were lost . . . could also be viewed as an indication of an overly protected industry, one in which normal market forces were not allowed to cull the inefficient and the excess.").

98. Economists use the term moral hazard to describe how a party insulated from risk behaves differently than a party fully exposed to risk. Insurance exemplifies this idea. For example, car insurance creates a moral hazard by sheltering insured drivers from the full cost of accident-related repairs. Because they do not have the same incentives to drive safely, insured drivers engage in risky behavior more frequently than their uninsured counterparts. For a detailed overview of the term moral hazard, see Wessels, supra note 86, at 390–91.

99. See Holland, supra note 97, at 9 (noting few banks were liquidated, meaning "uninsured deposits and other liabilities were subject to minimal risk . . . . At the extreme, the concept of 'moral hazard' took over. Managers, and in some cases owners, of depository institutions had little to lose and possibly much to gain from risk-embracing behavior"); Richard Scott Carnell, A Partial Antidote to Perverse Incentives: The FDIC Improvement Act of 1991, 12 Ann. Rev. Banking L. 317, 319–21 (1993) [hereinafter Carnell, Perverse] (describing "perverse incentives" confronting bank owners and managers); Fischel et al., supra note 84, at 314–16 ("A trade-off exists between the goal of minimizing me-first behavior [i.e., bank runs] and the goal of internalizing the costs of risky activities. The more complete the insurance scheme, the lower is the probability of me-first behavior but the greater is the incentive to engage in risky activities."); Jonathan R. Macey & Geoffrey P. Miller, Bank Failures, Risk Monitoring, and the Market for Bank Control, 88 Colum. L. Rev. 1153, 1165 (1988) ("Although deposit insurance generally achieves its purpose of preventing bank runs, it does so at the cost of providing incentives for excessive risk taking by banks. This excessive risk taking leads in turn to a greater risk of bank failure.").

100. For a description of deposit limits, see supra notes 56 and 58. The FDIC also requires banks to meet minimum capital requirements and lending limits which help internalize the costs of risky activities. See Fischel et al., supra note 84, at 315–16 (describing regulatory provisions available to reduce moral hazard).

stead of using the normal bankruptcy proceeding.[101] Because the taxpayers potentially had liability for the actions of a private company, the government should be the one to decide the appropriate exit strategy that minimizes taxpayers' financial burden.

Between the 1930s and the 1980s, the federal guarantee generally remained limited to the defined, insured deposit limit. In the mid-1980s, however, the banking industry developed a belief that the FDIC would not let the largest banks be liquidated in the event of a failure. Instead, there was a perception that the FDIC would maintain the bank's operations, thereby guaranteeing that both the insured and uninsured depositors received full protection of their assets.[102] This belief became known as "Too Big to Fail."[103] Even though the FDIC never acknowledged a policy of keeping the largest banks open regardless of the cost,[104] the widespread perception that the government would rescue the largest banks increased risk taking and decreased discipline "not only by insured depositors but by uninsured depositors, other creditors, and even stockholders."[105] As such, the moral hazard created by the government guarantee, which began as a justifiable evil to stem bank runs, expanded dangerously. Not only did the perception create more incentive for risky behavior, but the limited, explicit guarantee of $100,000 per deposit became an undefined, implicit guarantee for the entire bank.[106] In short, the government was no longer insuring the deposits, it was insuring the bank.

3. *Too Big to Fail Policy Creates Unjustifiable Moral Hazard.* — Faced with the expanding risky behavior by uninsured depositors due to the assumed too big to fail policy, Congress passed the FDIC Improvement Act (FDICIA) in 1991.[107] This Act attempted to eliminate the perception of a too big to fail policy, thereby reducing the government backing to its

101. See supra Part I.B.1 (detailing history of FDIC's establishment as exclusive receiver for failed banks at the same time deposit insurance was created).

102. See Holland, supra note 97, at 39 (detailing distinction between closing bank and keeping bank in existence, noting "that only with the first method did uninsured depositors suffer losses").

103. Tim Carrington, U.S. Won't Let 11 Biggest Banks in Nation Fail, Wall St. J., Sept. 20, 1984, at 2 (reporting government "created a new category of bank: the 'TBTF' bank, for Too Big To Fail"). For a detailed history of the development of the too big to fail "policy," see Holland, supra note 97, at 37–47.

104. Indeed, the FDIC went to great lengths to discount the belief in such a policy. See Holland, supra note 97, at 45 (quoting Congressional testimony illustrating FDIC's continued, difficult attempt to discredit belief in too big to fail policy).

105. Carnell, Perverse, supra note 99, at 320.

106. When a bank is closed and liquidated, the federal government is only responsible for the insured deposits, and it can help pay for these guarantees by liquidating the bank's assets. When the bank is kept open, however, the federal government must satisfy all of its creditors, regardless of whether they were previously insured. See Holland, supra note 97, at 39.

107. Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, 105 Stat. 2236 (codified in scattered sections of 12 U.S.C. §§ 1811–1833(d) (2006)).

defined, (and justified) explicit guarantee, by imposing a least-cost resolution requirement when dealing with failing banks.[108]

The least-cost resolution requirement reduced the FDIC's discretion in deciding whether to put the bank into receivership or conservatorship. Prior to the FDICIA, the law imposed a "less-than-liquidation" requirement whereby the FDIC could keep the bank open (and avoid liquidation) as long as the cost of the alternative did not exceed the estimated cost of liquidation.[109] Under the new least-cost resolution policy, the FDIC is constrained to one outcome—the one least costly to the taxpayers—and therefore banks cannot be sure that the FDIC, even if facing political pressure because of their size, will protect the uninsured assets.[110] As such, the least-cost resolution requirement helps impose "the perception . . . that [bank debt holders'] investments are not guaranteed if the bank gets into financial trouble," thereby constraining the excessive moral hazard created by the implied too big to fail policy.[111]

In summary, the unique insolvency regime for banks evolved in three steps. First, the federal government was initially justified in providing an explicit government guarantee (deposit insurance) of a private company's actions because of the threat of contagious bank runs undermining the entire banking industry. Second, once the federal government provided this guarantee, it was justified in creating a unique insolvency regime to resolve failed banks in the method that proved least expensive for the taxpayers since the guarantee increased risky behavior and the

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108. 12 U.S.C. § 1823(c)(4); see also Carnell, Perverse, supra note 99, at 363 ("The least-cost rule curtails the implicit protection the too-big-to-fail policy has provided to a large depository institution's uninsured depositors, nondepositor creditors, and stockholders, and thereby increases these stakeholder's incentive to monitor and discipline the institution's risk-taking." (citation omitted)). The FDICIA, however, also contained a "systemic risk" provision that created a narrow exception to the least-cost requirement when such a resolution "would have serious adverse effects on economic conditions or financial instability." 12 U.S.C. § 1823(c)(4)(G) (2006); see also Holland, supra note 97, at 48 (questioning whether "the enactment of the least cost requirement and the systemic risk exception end[ed] a too big to fail 'policy,' or [whether] the 'policy' [was] bequeathed an official existence"). That exception, however, has never been invoked to deal with a failing bank and has been interpreted narrowly. Id.

109. See Carnell, Perverse, supra note 99, at 363–65 (explaining impact of least-cost resolution requirement).

110. See id. at 364 ("The FDIC cannot simply accept the lowest bid it happens to receive, much less steer prospective bidders toward a method it finds ideologically congenial."). But see id. at 364–65 (acknowledging that least-cost requirement could encourage manipulation by "clever bidders"). However, even if the least-cost resolution method encourages manipulation by bidders, the moral hazard is still reduced as bank managers cannot predict when their bank will be rescued instead of liquidated.

111. Bernanke, GSE Portfolios, supra note 15; see also Ben S. Bernanke, Chairman, Fed. Reserve, Address at Federal Reserve Bank of Kansas City's Annual Economic Symposium (Aug. 22, 2008), available at http://www.federalreserve.gov/newsevents/speech/bernanke20080822a.htm (on file with the *Columbia Law Review*) ("Importantly, a well-designed supervisory regime complements rather than supplants market discipline. Indeed, regulation can serve to strengthen market discipline.").

taxpayers were bearing the potential liability. Third, when this limited, explicit guarantee turned into an undefined, implicit guarantee in the form of a too big to fail perception, the government was able to enact regulations that reduced the guarantee to its original, justified level.

B. *The Justifications Underlying the Bank Insolvency Regime Are Not Applicable to GSEs*

The three-step rationale for creating a unique insolvency regime for banks is not applicable to Fannie and Freddie. While the existence of the implicit federal guarantee is used as justification for creating a bank-like insolvency regime—since taxpayers could have liability for the failure of a GSE—this insolvency regime will be ineffective at limiting potential taxpayer liability without the safeguards in place in the banking industry.

1. *GSEs Are Not Faced with an Analogous Prisoner's Dilemma.* — The threat of bank runs justified the federal guarantee for banks, but this situation is not applicable to Fannie and Freddie. The risk from such a run that is unique to banks stems from their asset to liability structure, which makes banks more susceptible to failure as a result of the run.[112] Specifically, the deposits are subject to immediate withdrawal, yet the banks have loaned that money out to others, so the money is not immediately available.[113] Fannie and Freddie, however, do not have anything equivalent to a deposit that is subject to immediate withdrawal. Additionally, while Fannie and Freddie may be subject to a run—whereby creditors that suspect it of being insolvent may attempt to be the first to be paid while others will refuse to lend—this scenario is no different from the situation facing any other private firm.[114] In fact, these runs are less of a problem for Fannie and Freddie because of the implicit guarantee, which encourages investors to lend to the GSEs even when they appear close to insolvency, under the assumption the government will pay them back if the GSE fails.[115]

As Fannie and Freddie do not face the prisoner's dilemma that banks did before deposit insurance, there is no similar justification for a federal guarantee of their activity. This, however, does not imply that no societal goal is worthy of federal backing for the GSEs. Instead, as de-

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112. See supra notes 84–89 and accompanying text (describing banks' asset and liabilities structure and resulting effect from runs).

113. See supra notes 84–85 and accompanying text (detailing impact of immediate withdrawal on banks' ability to sustain run).

114. See Stanton, Government-Sponsored Enterprises, supra note 23, at 30 (describing "harsh and unforgiving" process of firm failure through refusal by lenders); supra note 88 and accompanying text (noting falsity of myth that runs are specific to banks).

115. See Bernanke, GSE Portfolios, supra note 15 (noting "increased risk-taking by the GSEs does not significantly increase their cost of funding or reduce their access to credit, as it would for other private firms" and concluding "the spread of GSE debt over Treasuries has been remarkably unresponsive to the recent problems of the GSEs[,] . . . suggesting that investors' faith in an implicit government guarantee remains unshaken").

scribed in Part III, maintaining a liquid secondary mortgage market may justify such federal backing. This Part simply notes that the rationale applicable to banks for creating a federal guarantee in the form of deposit insurance does not currently apply to Fannie and Freddie. Therefore, if the government does back the GSEs, it needs to articulate a different policy rationale.

2. *Implicit Government Backing Leads to Unjustifiable Moral Hazard.* — As discussed above, deposit insurance created a defined, justified moral hazard problem for banks by increasing risky behavior.[116] To limit the risky behavior and potential taxpayer liability, Congress imposed two requirements. First, it constrained the risky behavior by limiting the government's guarantee to specified deposit maximums. Second, Congress created a least-cost resolution requirement in order to dispel the myth of an undefined, implicit guarantee. With the undefined, implicit guarantee of Fannie and Freddie, the government has created the same incentives for risky behavior as seen in banks, without simultaneously limiting the risks.[117]

a. *Federal Backing Encourages Risky Behavior.* — Private companies are designed to make profits for their shareholders and "[this] principle does not change when an investor-owned company is [a GSE]."[118] Purely private companies therefore take some risks in their profit maximizing behavior, but they internalize the costs of those risks because they bear the burden if the company fails. Fannie and Freddie, however, do not face the same constraint because of the belief that the government will assume the costs of their risky behavior.[119] Indeed, the risky behavior at Fannie and Freddie has been widely documented over the last decade,[120] and is now cited as one of the leading causes of their current financial troubles.[121] For example, Fannie and Freddie engaged in billions of dollars

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116. See sources cited supra note 99 (detailing rise of risky behavior due to deposit insurance).

117. This Note limits the discussion of the moral hazard facing GSEs to Fannie and Freddie specifically. However, all GSEs face a similar perverse incentive. For an in-depth discussion of the risks of moral hazard on the other housing GSE, the Federal Home Loan Bank System (FHLB System), see generally Mark J. Flannery & W. Scott Frame, The Federal Home Loan Bank System: The "Other" Housing GSE, 91 Fed. Res. Bank of Atlanta Econ. Rev. 33 (2006). While the FHLB System is outside the scope of this Note, many of the same principles are applicable to the FHLB and GSEs generally.

118. Stanton, Government-Sponsored Enterprises, supra note 23, at 79.

119. See supra Part I.A.1.b (describing implicit federal guarantee of Fannie and Freddie).

120. See Regulatory Reform Hearing, supra note 70, at 9 (statement of Alphonso Jackson, Secretary, U.S. Dep't Housing & Urban Dev.) (suggesting accounting scandals at Fannie and Freddie motivated the introduction of H.R. 1461, a GSE reform bill); Carnell, Failure, supra note 16, at 590–92 ("GSEs can take greater risks—such as relying more heavily on borrowed money, investing in more volatile assets, and mismatching the duration of their assets and liabilities—without correspondingly increasing their borrowing costs.").

121. See Krehely, supra note 50, at 538–40 (noting GSEs "are engaging in riskier endeavors" such as issuing subprime loans); Baily et al., supra note 53, at 76 ("There is

of accounting irregularities, with Fannie alone losing $10.8 billion to wrongful accounting practices.[122]

Additionally, Fannie and Freddie began to expand the investment side of their business,[123] using the implicit guarantee to borrow money at a very low interest rate and purchase mortgage-backed securities (MBS) to hold in their own portfolio. Between 1990 and 2003, the GSEs' combined portfolios grew more than tenfold, from $135 billion to $1.56 trillion.[124] This move, while potentially very beneficial to Fannie and Freddie stockholders due to the high rate of return from MBS, was very risky to the taxpayers providing an implicit guarantee if the GSEs failed. As Chairman Bernanke noted, "GSE portfolios . . . are not only large but also potentially subject to significant volatility and financial risk . . . . [T]he GSE portfolios may be a source of systemic risk."[125]

b. *Federal Backing Results in Too Big to Fail Policy.* — The risky behavior caused by the implicit federal backing can be contained if there is widespread belief that the government will only guarantee a limited portion of the GSEs' debt. However, the implicit guarantee also facilitates artificial growth by the GSEs such that policymakers now believe they are too big to fail.

The growth of most private firms is limited by competition in the marketplace. Those companies that are being run effectively grow, while the others are forced out of business. Fannie and Freddie, however, use the government backing to enjoy extremely low interest rates, thereby creating a virtual monopoly in the mortgage market simply by virtue of the perceived federal guarantee.[126] As such, "[t]he government rather than economic efficiency is picking the winners."[127]

As a result of this competitive advantage, Fannie and Freddie have artificially grown to a size that does not reflect their true economic value

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considerable hostility stemming from the fact that the GSEs have reported huge profits in the past, paid their senior executives large amounts, and spread political contributions around liberally, only to reveal accounting errors that required billion dollar restatements of income.").

122. Annys Shin, Cut Fannie's Holdings, Critics Say, Wash. Post, Feb. 25, 2006, at D01 (noting release of report detailing "$10.8 billion accounting scandal").

123. Fannie and Freddie currently operate two lines of business. The first is the securitization business, which issues mortgage-backed securities (MBS) and creates a secondary mortgage market. The second is the investment business, which buys MBS and keeps them in their portfolios to earn revenue for their shareholders. See infra notes 162–163 and accompanying text.

124. Bernanke, GSE Portfolios, supra note 15.

125. Id. (emphasis omitted).

126. Stanton, Government-Sponsored Enterprises, supra note 23, at 8 ("Fannie Mae and Freddie Mac enjoy profound competitive advantages versus all other mortgage market participants, which confer on the agencies [sic] virtual dominance of our largest financial market." (internal quotation marks omitted) (quoting Bernstein Research, The GSEs: Hegemony in the Mortgage Market 11 (2000))).

127. Id. at 8.

to society.[128] This extreme growth has resulted in Fannie and Freddie being perceived as too big to fail.[129] Academic analysis to date, however, largely ignores the role of the implied backing in facilitating Fannie and Freddie's extreme growth.[130] Instead, the resulting size is used as a justification for a too big to fail policy,[131] similar to the policy that was seen in the banking industry prior to the imposition of least-cost resolution requirements.[132]

The least-cost resolution requirement is explicitly lacking in the new insolvency regime created for Fannie and Freddie.[133] The justification given for the absence of this requirement is the lack of insured deposits to protect,[134] exemplifying the problems that stem from attempting to create an insolvency regime for Fannie and Freddie when they do not mirror the asset and liability structure of banks. With banks, there is a specific amount for which taxpayers are definitely liable (equal to the

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128. See Carnell, Failure, supra note 16, at 591–92 ("The GSEs have . . . grown enormously—at the expense of better-capitalized (and perhaps better managed) competitors."); Wayne Passmore, The GSE Implicit Subsidy and the Value of Government Ambiguity, 33 Real Estate Econ. 465, 466 (2005) (concluding GSEs would be "much smaller organizations" if purely private).

129. See Regulatory Reform Hearing, supra note 70, at 10 (statement of John W. Snow, Secretary, U.S. Dep't of Treasury) ("[Fannie and Freddie] are large and important financial institutions that affect not only the housing markets and the mortgage markets, they also affect, because of their size, the financial risks to the country as a whole."); Office of Federal Housing Enterprise Oversight, Systemic Risk: Fannie Mae, Freddie Mac and the Role of OFHEO 1 (2003) ("[I]n the unlikely circumstance that [Fannie or Freddie] experience[ ] severe financial difficulties, they could cause disruptions to the housing market and financial system."); Baily et al., supra note 53, at 71–73 ("[T]he federal government cannot afford to allow [the GSEs] to default . . . . [T]he insolvency of either or both of the GSEs would cause the thousands of financial institutions that currently hold GSE debt . . . to suffer potentially substantial losses, further weakening the financial system at an already precarious time.").

130. See Carrie Stradley Lavargna, Government-Sponsored Enterprises Are "Too Big to Fail": Balancing Public and Private Interests, 44 Hastings L.J. 991, 992 (1993) (basing argument on *assumption* that "[t]hese part-private, part-public institutions are indispensable components of the nation's economy and are 'too big to fail'").

131. See GSE Hearings, supra note 37, at 312 ("[I]f [the GSEs] were unable to meet their financial obligations, other financial market participants depending on payments from these GSEs, may in turn become unable to meet their financial obligations. This risk, called systemic risk, is often associated with the housing GSEs because of the sheer size of their financial obligations."); Jickling, supra note 79, at 4 ("The risks of not acting, however, clearly appeared intolerable to the government. A failure or default by Fannie or Freddie would have severely disrupted financial markets around the world . . . . These market disruptions would have negative impacts on the economy as a whole.").

132. See supra Part II.A.3 (detailing too big to fail policy in banking industry and resulting least-cost resolution requirements).

133. See Jickling, supra note 79, at 2. ("[T]he FHFA is not bound by the bank regulators' mandate that failing institutions be resolved at the lowest possible cost.").

134. See Carpenter & Murphy, supra note 77, at 22–23 ("The lack of insured deposits held by Fannie and Freddie appears to account for the majority of the differences in the [FDIC and FHFA]. For example, the FHFA does not have to adhere to a least-cost requirement like that imposed by the FDI Act.").

insured deposits), and the FDIC is constrained to resolving banks in a way that limits (as closely as possible) taxpayer loss to that amount.[135] As such, a bank's incentive to engage in risky behavior is limited to the insured deposits, while the bank managers, shareholders, and uninsured depositors internalize their risky behavior for fear of losing their investments.[136] The amount of the federal government's guarantee of Fannie and Freddie, however, is not explicitly defined, so there is no "ceiling" on the loss that the taxpayers must bear. Instead, Fannie and Freddie operate under the belief that all of their losses will be guaranteed because they are too big to fail. This creates a situation where the federal government is not backing an instrument (such as a deposit), but the entire entity that controls the instrument.

3. *Potential Liability from Federal Backing Leads to Demands for a Special Insolvency Regime.* — Given the implicit backing, which creates risky behavior and artificial growth, the potential cost to taxpayers of a failed Fannie and Freddie today is staggering.[137] To solve this problem, policymakers determined that Fannie and Freddie needed an insolvency mechanism modeled after the banking system and subsequently enacted HERA to allow the FHFA to put GSEs into receivership.[138] However, instead of relying on the rationale behind creation of a special banking insolvency mechanism, those who advocated a similar model for GSEs relied principally on two arguments.

First, proponents of the insolvency regime argued that since Fannie and Freddie's regulatory regime is already largely modeled on banks, their insolvency regime should be as well.[139] This argument simply assumes, without analysis, that since we have compared the two in the past, we should continue to do so. Further, it merely demonstrates that private industries with federal backing face a moral hazard, imposing a need to closely regulate their activities, without first addressing the problems with, or justifications for, federal backing.

The second argument advanced by advocates of a special insolvency regime for Fannie and Freddie is that banks and GSEs both rely heavily

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135. See supra Part II.A.3 (describing least-cost resolution requirement for banks).

136. See supra note 106 and accompanying text (explaining uninsured depositors can lose their money if the bank fails, which leads them to internalize risks and decreases risky behavior).

137. See supra note 60 (attempting to estimate potential cost of Fannie and Freddie bailout).

138. Housing and Economic Recovery Act (HERA) of 2008, Pub. L. No. 110-289, § 1145, 122 Stat. 2654, 2734–67; see also supra notes 76–77 and accompanying text (discussing HERA).

139. See Carnell, Failure, supra note 16, at 598–600 ("This streamlined, nonjudicial [banking] regime has served as a model for GSE insolvency law—just as banking regulation has, more broadly, served as a model for GSE regulation.").

on borrowed money, so a failure could harm their creditors.[140] This argument fails because it ignores the unique assets and liabilities structure present in banks (whereby depositors can demand immediate withdrawal), which distinguishes banks from other companies, including Fannie and Freddie.[141] Almost all private companies borrow money and a failure would harm creditors, yet traditional bankruptcy is sufficient to handle their claims.

These arguments advocating for the creation of a bank-like insolvency regime for Fannie and Freddie skip over the justification (or lack thereof) for the federal guarantee. Instead, they simply conclude that since there is a federal guarantee, the government should be the one to put them into bankruptcy, as it does with banks because of deposit insurance. As such, this new insolvency regime is not only ineffective, because receivership is not a credible threat for Fannie and Freddie given the implicit guarantee for the entire entity, but it perpetuates the cause of the problem—a belief in an undefined and unquantifiable federal guarantee.

In summary, the insolvency regime works for banks because the threat of allowing a bank to fail and be put into receivership, thereby allowing uninsured depositors to lose their money, is credible due to the defined, limited nature of the guarantee.[142] There is no defined guarantee for Fannie and Freddie, however, and no threat of allowing them to fail. Instead, the federal backing of Fannie and Freddie resulted in extreme artificial growth, such that a perception now exists that the entities are too big to fail.[143] Therefore, although the government now has the option of receivership, this threat is not credible, so it does not serve to constrain the GSE's risky behavior. Indeed, even though the FHFA had the authority to place Fannie and Freddie into receivership, it did not do so in September 2008.[144] Finally, by not imposing limits such as a least-cost resolution requirement, the new insolvency regime fails to address the root of the problem—the implicit backing of Fannie and Freddie as entire entities.

III. Develop a Covered Bond Insurance Corporation

Due to the implicit backing of Fannie and Freddie, the government, and therefore the taxpayers, must pay for the risky actions of a private

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140. See id. ("Even more so than banks, GSEs rely heavily on borrowed money. Like nineteenth century U.S. banks [before deposit insurance], GSEs have no federal guarantee and could harm their creditors if they failed.").

141. See supra notes 84–85 (describing banks' unique asset to liability structure resulting in bank runs).

142. See supra note 59 (noting one billion dollars of uninsured deposits potentially lost in IndyMac bank failure).

143. See supra Part II.B.2.b (explaining role of federal backing in GSE's growth, and subsequent size as justification for too big to fail policy).

144. See supra note 79 and accompanying text (explaining FHFA decision to place Fannie and Freddie into conservatorship).

company. The solution advocated by most academics, and adopted by Congress, was to create an insolvency regime for Fannie and Freddie that models the one for banks.[145] This solution will not succeed, however, until Fannie and Freddie's structure actually parallels that of banks. Until then, simply announcing a new insolvency regime will not limit the risky behavior of these entities[146] and will further increase the perception of undefined, and potentially unlimited, federal backing of both entities.

As illustrated in Part II, there are three elements that, when taken together, justify a unique insolvency regime. The first is the existence of a substantial societal concern that private ordering cannot solve. With banks, this problem was bank runs. Once such a problem is defined, the federal government should, and did, provide explicit federal backing as a solution. The second element, which becomes necessary after the government provides backing, is a defined, limited federal guarantee. With banks, the solution was deposit insurance. Recognizing that such a federal guarantee increases risky behavior, the third element is an insolvency structure that ensures the limited federal backing is not expanded to an undefined guarantee of the entire company. With banks, the least-cost resolution requirement provided this limit.

As this Note explains, it is possible to create a similar regime for Fannie and Freddie that would promote the GSEs' goal of a liquid secondary mortgage market, while ensuring taxpayers' potential liabilities remain limited. Specifically, Congress should create a Covered Bond Insurance Corporation (CBIC),[147] modeled after the Federal Deposit Insurance Corporation, that will explicitly provide mortgage insurance. The CBIC will not be limited to covered bonds issued by Fannie and Freddie, but will also insure covered bonds issued by federal banks.

A. *Element One—Identifying a Pervasive Social Problem Requiring Government Backing*

During the Great Depression, the fear of bank runs justified the creation of federal deposit insurance. As discussed in Part II, a similar run is not applicable to Fannie and Freddie because they are not funded through deposits subject to immediate withdrawal. However, just as the perceived need for stable banks provided the policy justification for deposit insurance, an equally important policy justification—a liquid secondary mortgage market—could warrant federal insurance for other financial instruments.[148] Congress has consistently expressed its belief in the

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145. See supra Part II.B.3.

146. See supra Part II.B.2.b (concluding too big to fail perception undercuts credibility of threat to put Fannie or Freddie into receivership).

147. Covered bonds are a form of debt instrument secured by a perfected security interest in a specific pool of collateral. For a further discussion of covered bonds and the benefits of insuring only covered bonds, see infra Part III.B.

148. Critics may argue that a liquid secondary mortgage market is not a public interest sufficient to warrant explicit federal backing. Although this Note does not take a

need for access to affordable housing through home mortgage loans,[149] and expanded access to these loans is made possible through the secondary mortgage market provided by Fannie and Freddie.[150] Additionally, the existence of the secondary mortgage market reduces the cost to the taxpayer of securing a home loan.[151]

The secondary mortgage market, however, is susceptible to financial panic. While the risk in the banking industry was bank runs, the risk in the mortgage market is a nationwide, prolonged downturn in the housing market, since banks will not issue new home loans unless they believe that someone (typically Fannie and Freddie) will purchase them.[152] In 2008, for example, mortgage lending standards became unreasonably (or

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position on whether this is a worthwhile goal in the abstract, Congress has deemed it to be an important national priority, evidenced most clearly by the creation and implicit backing of Fannie and Freddie. If one believes that the goal of a secondary mortgage market is not a sufficient public goal, then Fannie and Freddie no longer serve any compelling governmental purpose and should be eliminated on policy grounds alone. Considering that elimination of Fannie and Freddie seems to be politically infeasible, however, this Note assumes that most of the public believes that securing affordable housing through a strong secondary mortgage market justifies the creation of some government backing. Given this assumption, the solution provided by this Part focuses on how to limit the taxpayer burden of such federal backing.

149. As Federal Reserve Chairman Bernanke notes, Congress has done this through "the provision of various housing programs and tax incentives aimed at increasing the availability of moderately priced homes and rental housing. The Congress has also determined that financial institutions have a role in providing credit to low- and moderate-income households." Bernanke, GSE Portfolios, supra note 15.

150. As described in supra notes 39–40 and accompanying text, Fannie and Freddie create a secondary mortgage market by buying the home loans from the issuing banks, so that the banks then have capital to make additional home loans. As one Senator noted, "the housing GSEs have contributed meaningfully to th[e home ownership] cause, helping to give us perhaps the best housing market in the world." Oversight of Government-Sponsored Enterprises: The Risks and Benefits of GSEs to Consumers: Hearing Before the Subcomm. on Financial Management, the Budget, and International Security of the S. Comm. on Governmental Affairs, 108th Cong. 1 (2003) (statement of Sen. Peter G. Fitzgerald, Chairman, Subcomm. on Financial Management, the Budget, and International Security).

151. See Waste, Fraud, Abuse, and Mismanagement: Hearing Before the Task Force on Housing and Infrastructure of the H. Comm. on the Budget, 106th Cong. 137 (2000) (statement of Thomas J. McCool, Director, Financial Institution & Market Issues, General Government Division, Gen. Accounting Office) ("Most analysts agree that the enterprise's activities have successfully lowered mortgage costs and increased home ownership in the United States."); Steven Todd, The Effects of Securitization on Consumer Mortgage Costs, 29 Real Est. Econ. 29, 30–31 (2001) ("[S]ecuritization appears to lower mortgage loan origination fees, resulting in substantial savings for homebuyers. . . . In 1993 alone, securitization likely produced consumer savings of more than $2 billion in loan origination fees.").

152. See Avi Salzman, Covered Bonds: What the Paulson Plan Means for You, BusinessWeek, July 30, 2008, at http://www.businessweek.com/bwdaily/dnflash/content/jul2008/db20080729_334483.htm (on file with the *Columbia Law Review*) ("With the [secondary] market stalled, banks are much less willing to make mortgages because they can't expect to sell them.").

at least historically) stringent.[153] Without a well-functioning secondary mortgage market, the congressional goal of increasing the availability of housing loans may be threatened. Further, private insurance cannot guard against the type of systemic risk that affects the entire market. The government is uniquely capable of insuring against such an extreme event.[154] Therefore, Congress should now explicitly create federal mortgage insurance to guarantee against systemic risk and ensure a liquid secondary mortgage market.

B. *Element Two—Developing a Limited Federal Guarantee*

The federal government already backs the secondary mortgage market through the implicit guarantee of Fannie and Freddie. However, as discussed earlier in this Note, that unquantifiable guarantee leads to excessive risk taking and an indefinite liability for taxpayers. Further, the proposed insolvency regime does not adequately limit the moral hazard because there is no defined, limited guarantee. To solve these problems, Congress should create an explicit, limited federal guarantee, narrowly tailored to the goal of stabilizing the secondary mortgage market, by providing covered bond insurance.

1. *Overview of the Covered Bond Market.* — A covered bond is defined as "a debt instrument secured by a perfected security interest in a specific pool of collateral."[155] While covered bonds have only recently been utilized in the United States,[156] they have a long and extensive history in Europe. The European covered bond market now stands at over €2 tril-

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153. See Mortgage Bankers Ass'n, Mortgage Origination Estimates, July 10, 2009, at http://www.mbaa.org/files/Research/HistoricalWAS/HistoricalMortgageOrigination Estimates071009.xls (on file with the *Columbia Law Review*) (estimating $3.8 trillion of originations in 2003 and only $1.6 trillion in 2008).

154. A governmental mortgage insurance fund would require firms to set aside capital to cover future financial problems, similar to the structure of the Federal Deposit Insurance Fund. Although the government would bear the costs of future systemic risk, the mortgage insurance fund would provide the resources to handle such events.

155. Dep't of the Treasury, Best Practices for Residential Covered Bonds 7 (2008), available at http://www.treas.gov/press/releases/reports/USCoveredBondBestPractices.pdf (on file with the *Columbia Law Review*). Although the compilation of the collateral can vary, for the purposes of this Note, the collateral will be residential mortgages. Cf. Heidi Crebo-Rediker & Douglas Rediker, Covered Bonds Can Rebuild America, Forbes.com, July 28, 2008, at http://www.forbes.com/2008/07/28/covered-bonds-infrastructure-oped-cx_hcr_dr_0728bonds.html (on file with the *Columbia Law Review*) (advocating using public sector debt as collateral for covered bonds to "unlock sorely lacking investment for U.S. infrastructure").

156. The FDIC and the Treasury have recently attempted to stimulate a covered bond market in the United States by issuing Policy Statements and Best Practices for their use. See generally Covered Bond Policy Statement, 73 Fed. Reg. 43754 (July 15, 2008) [hereinafter FDIC, Policy Statement]; Dep't of the Treasury, supra note 155. In particular, the FDIC addressed concerns about how covered bonds will be handled when a bank fails, confirming that the collateral used to secure the covered bond is immune from being used to pay off insured deposits. FDIC, Policy Statement, supra. As such, the covered-bond holder currently has recourse to both the collateral pool and to the issuing bank.

lion.[157] Covered bonds have not been used widely in the United States because other funding sources, such as the MBS offered by Fannie and Freddie,[158] have been effective and have provided higher returns.[159] Additionally, investors looking for a safe investment believed that Fannie and Freddie were federally backed, so a low-risk alternative market (such as covered bonds) never developed. With the recent subprime crisis, however, mortgage funding available through securitization has been very limited, "making a potentially new funding source such as covered bonds much more compelling."[160]

2. *Covered Bonds Reduce Moral Hazard.* — The Covered Bond Insurance Corporation would limit the moral hazard present in the current undefined backing of Fannie and Freddie in two important ways. First, it would narrowly tailor the insurance to the problem of providing a liquid secondary mortgage market. Second, it would limit risky behavior by only insuring covered bonds and not the more risky MBS that Fannie and Freddie currently issue.

a. *Narrowly Tailored Insurance Promotes Public Goal.* — Banks limit the risky behavior created by deposit insurance by narrowly tailoring the insurance to the problem of bank runs, which are created by depositors seeking to withdraw their money. Therefore, banks only insure the deposits, not the entire bank, and only up to a limited amount. Notably, the FDIC could have decided to insure other banking activities in addition to deposits, but the Glass-Steagall Act, passed in the same year as the creation of federal deposit insurance, aimed to ensure "separation of investment banking from commercial banking" to "remov[e] a constant and often accepted temptation to involve the bank financially and risk its rep-

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157. European Cent. Bank, Covered Bonds in the EU Financial System 4, 8 (2008), available at http://www.ecb.int/pub/pdf/other/coverbondsintheeufinancialsystem200812en_en.pdf (on file with the *Columbia Law Review*).

158. For those readers without an in-depth knowledge of structured finance, securitization is the process by which illiquid assets, such as mortgages, are packaged and then sold to investors to create liquidity in the market. For an overview of the securitization process, see generally Richard J. Rosen, Fed. Reserve Bank of Chi., The Role of Securitization in Mortgage Lending (2007), available at www.chicagofed.org/publications/fedletter/cflnovember2007_244.pdf (on file with the *Columbia Law Review*).

159. O. Emre Ergungor, Fed. Reserve Bank of Cleveland, Covered Bonds: A New Way to Fund Residential Mortgages (2008), at http://www.clevelandfed.org/research/commentary/2008/0708.cfm (on file with the *Columbia Law Review*) ("Despite their low-risk features, covered bonds could not compete in the past for investors' attention against the seemingly high, risk-adjusted returns of the mortgage-backed securities.").

160. Bruce Klein, Covered Bonds—A Timely Alternative, Mortgage Banking, Oct. 2008, at 116. As this article aptly notes:

> European financial institutions have often wondered why the United States was never interested in emulating their successful covered-bond experience, while U.S. institutions had typically looked at those programs as staid and unexciting. In the current credit crisis, staid and unexciting products are just what investors are looking for . . . .

Id. at 117.

utation for the sake of quick profits."[161] In other words, deposit insurance was created to provide government backing only for the portion of the bank that operated to further the public interest in securing deposits and making loans, not the portion of the bank that operated to earn a profit for the bank.

Similar to banks after the implementation of the Glass-Steagall Act, "Fannie Mae and Freddie Mac each run two lines of business."[162] The first line of business is similar to the commercial bank, in that it operates to serve a public purpose—increasing liquidity in the secondary mortgage market. This is the portion of Fannie and Freddie that purchases mortgages and issues MBS. The second line of business involves the purchase of MBS for Fannie and Freddie's own portfolios. Unlike the first line of business, these GSE portfolios do not serve any public purpose[163] and, as previously noted, pose a significant risk to taxpayers.[164] The Covered Bond Insurance Corporation will only insure activities within Fannie and Freddie's first line of business, as only those promote the public purpose for creating mortgage insurance—a liquid secondary mortgage market.[165]

Additionally, the covered bond insurance will not be limited to covered bonds issued by GSEs. It will apply to all covered bonds, even if federal banks issue them.[166] As the public purpose is to promote a liquid mortgage market, not to guarantee Fannie and Freddie specifically, it is not important which entity issues them. In this way, the insurance is narrowly tailored to the public purpose, not to the GSEs.

b. *Covered Bonds Reduce Risky Behavior.* — While covered bonds and MBS both provide mortgage market liquidity, there is one important difference that decreases the potential risk associated with covered

161. The Glass-Steagall Banking Act of 1933, 47 Harv. L. Rev. 325, 326–27 (1933).

162. Bernanke, GSE Portfolios, supra note 15.

163. See Andreas Lehnert, Wayne Passmore & Shane M. Sherlund, GSEs, Mortgage Rates, and Secondary Market Activities, 36 J. Real Est. Fin. & Econ. 343, 345 (2008) (finding GSE portfolios have no material effect on cost or availability of residential mortgages).

164. See supra notes 124–125 and accompanying text.

165. The Covered Bond Insurance Corporation should not only set limits on the type of activity it will insure, but also limits on the amount of that activity. Banks, for example, limit their deposit insurance to a specified amount of $100,000 to further reduce the moral hazard and to establish a defined ceiling for the potential taxpayer liability. The Covered Bond Insurance Corporation should set up parallel limits by restricting the amount of covered bonds an institution can issue. While the Covered Bond Insurance Corporation will ultimately determine this number, potential standards already exist. For example, the FDIC recently issued a Policy Statement indicating that covered bonds receiving a priority claim during an insolvency proceeding should be limited to "covered bonds that comprise no more than 4% of a financial institution's total liabilities after issuance." FDIC, Policy Statement, supra note 156.

166. Allowing banks to issue covered bonds will also increase competition in the secondary mortgage market, thereby helping to reverse the artificial growth experienced by Fannie and Freddie as a result of their implicit federal backing.

bonds.[167] Unlike MBS, the mortgages that secure a covered bond remain on the issuer's balance sheet.[168] Therefore, with a covered bond, any credit, default, or prepayment risk on the loans remains with the bank, whereas with MBS these risks are transferred to the investors. This is important because keeping the mortgages on the bank's balance sheet decreases the risk of moral hazard by ensuring the banks bear the cost of any risky behavior.[169] As one analyst noted, "The good news about covered bonds . . . is that they reduce the moral hazard that is so evident in the way banks have been handling private mortgage issuance up to now."[170] Therefore, the covered bond insurance should be limited to only covered bonds and should not insure MBS, even though both covered bonds and MBS serve the public purpose of creating a secondary mortgage market.[171]

Additionally, during times of panic investors seek safe securities. This makes the safety of covered bonds an attractive option for investors during periods of economic instability, thereby helping to inject capital into the mortgage market at the times it is most necessary. In 2008, for example, investors accepted a zero rate of return for purchasing Treasury bonds, indicating that "in these troubled economic times, when people have lost vast amounts on stocks, bonds and real estate, making an investment that offers security but no gain is tantamount to coming out ahead."[172] While investors are, understandably, frightened by MBS during a financial panic, a government-guaranteed covered bond will encourage more investment and further increase the liquidity of the mortgage market.

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167. Although this Note only addresses one of the risk-reducing features of covered bonds, they possess several other features that reduce their risk. For example, if a mortgage in the cover pool defaults, the GSE must replace it with a conforming mortgage, so the cover pool is consistently comprised of high value assets. Additionally, there are stringent requirements for the type of collateral that can be used to secure the bond. For an in-depth discussion of these requirements and the differences between MBS and covered bonds, see Dep't of the Treasury, supra note 155, at 7–8, 11–16.

168. Id. at 7.

169. See Crebo-Rediker & Rediker, supra note 155 ("Crucially, unlike the way banks securitized and sold mortgages . . . the underlying loans for a covered bond stay on the bank's balance sheet. This leaves less risk that the bank will ignore prudent lending standards.").

170. Liz Moyer, FDIC May Stall Paulson Mortgage Plan, Forbes.com, July 28, 2008, at http://www.forbes.com/2008/07/28/fdic-mortgage-paulson-biz-wall-cx_lm_0728covered.html (on file with the *Columbia Law Review*).

171. This does not mean that Fannie and Freddie will no longer be able to issue and purchase MBS. They will still be able to engage in those activities, but investors will know that the government only insures the covered bond activity. If investors want the riskier MBS, perhaps to earn a higher return, Fannie and Freddie will still be free to issue them.

172. Vikas Bajaj & Michael M. Grynbaum, Eager Investors Buying U.S. Debt with Zero Yield, N.Y. Times, Dec. 10, 2008, at A1.

C. *Element Three—Insolvency Structure to Enforce Limited Federal Guarantee*

Although deposit insurance was narrowly tailored to further the public goal of eliminating bank runs, the FDIC soon faced a perception that some banks were too big to fail. In order to eliminate this perception, and return the federal guarantee to its defined limit, the FDIC imposed a least-cost resolution, which required that an insolvent bank be resolved in the manner least costly to the taxpayers. A similar limitation should be imposed on the Covered Bond Insurance Corporation.[173]

In this way, although Fannie and Freddie will be allowed to engage in other activities beneficial to their shareholders, such as purchasing MBS for their portfolios, the government will not guarantee the risks inherent in this type of behavior. Instead, the Covered Bond Insurance Corporation will have a mandatory requirement to resolve the failing GSE at the least expense to the taxpayer, regardless of the potential impact on the shareholders.[174] As Chairman Bernanke noted, "Only if GSE debt holders are persuaded that the failure of a GSE will subject them to losses will they have an incentive to exert market discipline."[175] A least-cost resolution mechanism would effectively signal to investors that the federal government only protects the instrument (the covered bond) and not the entity (the GSE).

Conclusion

The implicit federal guarantee of Fannie and Freddie has created unlimited public exposure to risks taken by private entities, even when those risks are unrelated to the entities' public mission. To reduce the potential taxpayer liability in the future, the government must eliminate the general federal guarantee of Fannie and Freddie and replace it with a more limited backing aimed at ensuring liquidity in the secondary mortgage market. Specifically, Congress should create a Covered Bond Insurance Corporation to insure covered bonds issued by both banks and GSEs. Only then will the new insolvency regime established for GSEs be effective at limiting the burden on taxpayers.

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173. As described earlier, taxpayers are not immediately liable for the deposits of a failed bank. Instead, banks pay into a Deposit Insurance Fund, which covers the deposits. The deposits, however, are backed by the full faith and credit of the United States, so taxpayers are liable if the Deposit Insurance Fund becomes insolvent. See supra note 57. Similarly, Fannie and Freddie (and any other entity issuing covered bonds) would pay into a Covered Bond Insurance Fund, which would first be used to insure the covered bonds when either GSE failed.

174. Critics may contend that it is impossible to remove the implicit federal backing from Fannie and Freddie's activities. A similar perception has been effectively communicated with banks, however, and although there is always some risk of an entity being perceived as too big to fail, the least-cost resolution requirement most effectively reduces such a perception.

175. Bernanke, GSE Portfolios, supra note 15.