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Expert Analysis

How the Takeover of Fannie Mae and Freddie Mac Will Fuel New Credit Crisis Litigation

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The Housing and Economic Recovery Act of 2008 provides statutory authority to address the potential insolvency of Fannie Mae and Freddie Mac, two government-sponsored enterprises formally called the Federal National Mortgage Association and the Federal Home Loan Mortgage Corp., respectively.[1] In many respects, the Recovery Act vests in the Federal Housing Finance Agency powers substantially similar to those provided to the Federal Deposit Insurance Corp. for the oversight of banks and thrifts that hold federally insured deposits.

U.S. Treasury Secretary Henry Paulson announced Sept. 7 that the FHFA had been appointed conservator over Fannie Mae and Freddie Mac. The conservatorship of was designed to stabilize the mortgage lending sector of the credit market, which has suffered significant and sustained liquidity problems since the housing bubble burst in 2007. One critic of the stabilization plan has ostensibly drawn the battle lines:

> There are $7 trillion in mortgage-backed securities (MBS) held by banks, hedge funds, "investors," etc. They are the means by which these investors bought collection rights on risky mortgages by the millions. They could and should be frozen and written off for the duration of the financial crisis; instead, Paulson's treasury is guaranteeing them at 100 percent face value. Fannie Mae and Freddie Mac, between them, issued about $2 trillion of these and bought another $1 trillion from other financial firms.[2]

Only time will tell if the stabilization plan will succeed, but those who do not benefit likely will seek redress from the conservator as well as other potentially responsible parties.

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While it remains unknown whether an acceptable stabilization implementation will occur, this paper is intended to shed some light on what is being viewed as the second and much darker phase of the subprime crisis. The article provides general background about Fannie and Freddie, how they function in the mortgage industry, and how the present crisis unfolded and resulted in such drastic federal intervention. It also focuses on what it means for Fannie and Freddie to be under a conservatorship. Finally, the article will forecast some current and prospective litigation trends.

Genesis of Fannie Mae and Freddie Mac

Fannie Mae and Freddie Mac are the two largest players in the U.S. mortgage industry.[3] Fannie initially was created and operated as a government agency. Congress created Fannie and, later, Freddie to serve the public interest of increasing the availability of credit to home purchasers while reducing the cost of obtaining such credit in the home finance sector of the economy.[4] Originally, Fannie's ultimate goal was to provide lending institutions with federal money to finance home mortgages in an attempt to increase the availability of affordable housing.[5] After the privatization of Fannie and the creation of Freddie, they continued operations with the goal of providing stability and liquidity to the housing market.[6]

Congress created Fannie Mae in 1938 as a part of President Franklin D. Roosevelt's New Deal.[7] Then, in 1968, Congress re-chartered Fannie as a privately owned, publicly traded government-sponsored enterprise.[8] Similarly, Congress chartered Freddie Mac in 1970 as a privately owned, publicly traded GSE. Although congressionally established, Freddie and Fannie are owned and operated by their individual shareholders.[9] In addition, the corporations each are governed by 18-member boards of directors.[10] In accordance with the companies' enabling legislation, the U.S. president appoints five of the directors, and the stockholders elect the remaining 13.[11] Accordingly, Freddie Mac and Fannie Mae are directly accountable to their shareholders and not to the federal government.

As government-sponsored enterprises, Fannie and Freddie no longer receive any federal funds. However, they both receive other substantial benefits, including exemption from state and local income taxes and from Securities and Exchange Commission oversight, as well as the ability to access a line of credit through the U.S. Treasury.[12] Additionally, Fannie and Freddie are not subject to the same capital requirements as other financial institutions, which means they are able to sell more mortgage-backed securities with less capital in reserve.[13]

The federal benefits to the GSEs do not include an explicit government guarantee of financial protection. The U.S. government does not back the securities with the full faith and credit of the federal government as it does with U.S. Treasury securities. Yet Fannie Mae and Freddie Mac have long been viewed as having the implicit backing of the federal government.[14] Investors widely believed that if either of the GSEs were in crisis, the government would take action to avoid a collapse.

The ultimate goal of Fannie Mae and Freddie Mac is to provide liquidity to the mortgage industry by providing an additional source of capital. The companies infuse funds into the home finance sector by purchasing mortgages from originating lenders and either holding them in investment portfolios or securitizing and reselling the loans as mortgage-backed securities.[15]

MBS can take a variety of structures, but their principal purpose is to transfer the right to receive the cash flow as well as to transfer the related default risks to third-party investors. This process injects additional investment dollars into the mortgage market, making more money available for lending. When more money is available for mortgages, originating lenders are able to charge lower interest rates on mortgages.

The process of securitization and sale of mortgage loans has led to the creation of the secondary mortgage market. Fannie Mae and Freddie Mac are the largest players in the secondary mortgage market. Together, they hold or guarantee $5.4 trillion in mortgage debt, which is roughly equal to the publicly held debt of the United States.[16]

Crisis in the Mortgage Industry

Throughout the 1990s and the first half of this decade, the housing market was experiencing unprecedented growth. Home prices were increasing so rapidly that

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anyone purchasing residential real estate, especially in some markets like California and southern Florida, was almost guaranteed to make money in the process. Such growth in the housing market also led to risky lending practices. Lenders throughout the mortgage industry were offering loans to people with less than perfect credit and, often, no income documentation. Many of these risky subprime and "Alt-A" loans had adjustable interest rates that would reset, usually at higher rates, after a certain number of years.[17] The present crisis ensued when these adjustable rates began to reset.

In retrospect, it is easy to blame the mortgage lenders for their inappropriate lending practices. However, as the broader implications of the subprime crisis have unfolded, it has become apparent that it was not merely the lenders' actions but a flawed industry that led us to where we are today. Mortgage lenders engaged in risky lending for two primary reasons.

First, rapidly increasing home prices provide, in essence, market security for the loans. Even if the borrower is not paying down the principal of his mortgage, he still is gaining equity in the property through the increase in his home's value. In times of trouble, equity allows a borrower to sell or refinance his mortgage under better terms to avoid a default. Further, increases in equity ensured that a lender would not lose money in the event of foreclosure.

Second, and more importantly, mortgage lenders engaged in risky lending practices because of the secondary mortgage market. In the housing boom, mortgage-backed securities were very profitable, and consequently many investors sought to purchase them. Such a strong market resulted in mortgage lenders' making more and more loans to meet the demand for mortgage-backed securities.

As discussed above, Fannie Mae and Freddie Mac were the largest players in the secondary mortgage market by far. Together they hold or guarantee nearly half of all outstanding American mortgages.[18] The decrease in home prices and the increase in mortgage defaults posed significant risks to the GSEs' balance sheets. The deterioration of the secondary mortgage market and the demand for mortgage-backed securities has reduced their ability to absorb losses and maintain liquidity.[19] If Fannie and Freddie were unable to purchase loans from mortgage lenders, many lenders would be unable to make loans to borrowers, and the mortgage industry would come to a halt. To avoid this ominous result, the federal government decided to step in.

The Federal Takeover of Fannie and Freddie

The most significant feature of the federal takeover is that both Freddie and Fannie were placed in a conservatorship overseen by the Federal Housing Finance Agency.[20] In many respects, the GSEs continued business as usual. The FHFA assumed the power of the companies' boards and management, which included the replacement of both CEOs. Further, FHFA Director James B. Lockhart has indicated that, as a matter of prudence, the boards of Fannie Mae and Freddie Mac will be replaced as well.

Under the conservatorship, all common and preferred stock dividends were eliminated, although the shares will remain outstanding. Much of the preferred stock was held by various depository and financial institutions. The stocks of both Freddie and Fannie have lost more than 80 percent of their value from a year ago. In a joint statement by the Federal Reserve Board, the FDIC, the Office of the Comptroller of the Currency and the Office of Thrift Supervision, regulators said they are ready to work with affected institutions on capital restoration plans.[21]

Both Fannie and Freddie will be forced to reduce their loan portfolios over an extended period of time. The takeover also commits the federal government to provide up to $100 billion to both companies to backstop any shortfall in capital.

Potential Litigation and Future Financial Implications

The takeover inevitably will have significant implications beyond the mortgage industry into many sectors of the global economy. The conservatorship is a benchmark for the next wave of the credit crisis. About three weeks after the FHFA announced the takeover, federal regulators seized Washington Mutual — the country's largest savings and loan — in the largest bank failure in American history. Much like the problems plaguing Freddie and Fannie, the failure of Washington Mutual was caused in large

part by heavy losses related to a high number of bad loans. The takeover also may worsen the crisis for some institutions with substantial holdings of Fannie Mae and Freddie Mac stock that has lost the majority of its value.

Litigation will likely mirror that of the sweeping subprime litigation fallout — securities fraud, breach of duty, insider trading and accounting irregularities — although consumer-mortgage-based claims may not be as prominent. The Fannie Freddie shareholders have and will continue to pursue claims related to their equity and investments in them. The investors who purchased the securitized mortgage investments likely will pursue similar claims. And in an interesting twist, the FHFA, as conservator, could assert buyback or fraud claims against the lenders and others that sponsored or originated the toxic securitized loans. The large amounts of money involved and the huge losses that may occur likely will fuel litigation for the foreseeable future.

Fannie and Freddie Shareholder Litigation

The rescue of Fannie and Freddie is likely to leave a trail of billions of dollars in losses for stockholders, including some major banks. Lawsuits by shareholders are already starting to appear in courthouses across the nation. A class action was filed Sept. 11 in a Florida federal court on behalf of purchasers of Fannie Mae stock.[22] The lawsuit alleges Fannie's board violated the Securities Exchange Act and the Florida Deceptive Trade Practices Act by making false statements, failing to disclose adverse conditions about the company and artificially inflating the stock price. This is but one example of the wave of litigation that will undoubtedly follow.

MBS Investor Litigation

The takeover also may contribute to the wave of mortgage-backed-securities investors' litigation that has been ongoing throughout the crisis. It is estimated that more than $5 trillion worth of debt and mortgage-backed securities issued by Fannie and Freddie is owned by central banks and other investors around the globe.

Many investors have filed suit against the packagers and brokers of MBS because of perceived misrepresentations in the sale of those securities. For example, a private equity fund sued Barclays Bank in Dallas for alleged misrepresentations in the sale of the MBS to the fund.[23] The plaintiff alleges Barclays misrepresented that the pooled loans had never been delinquent at the time of the security offering. According to the pleadings, many of the loans were in fact delinquent. The resulting lawsuit alleges various Texas Securities Act and fraud claims.

Fannie and Freddie Conservator Litigation

As conservator of Fannie and Freddie, the Federal Housing Finance Agency stands in their shoes and may assert claims against those who may have committed wrongdoing relative to the mortgages sold to the GSEs. These suits may include buyback or fraud claims against the lenders that sponsored or originated the securitized loans. For example, when mortgage lenders securitized loans with Fannie or Freddie, they would transfer to the GSE mortgage pools that supposedly meet certain eligibility criteria, typically pools comprised of conforming loans.

Taxpayer pressure could result in the FHFA either enforcing buyback provisions for defaulted mortgages or suing viable parties that may have defrauded Fannie and Freddie during the securitization process. Thus, similar to the S&L crisis, cases could be aimed at those who were involved in sponsoring or structuring the mortgage pools. Potentially responsible third parties could include not only the originating lenders but also the officers and directors of those entities, as well as the professionals involved. Indeed, the FBI has opened a wide-ranging probe across the financial services industry, from mortgage lenders to investment banks that bundled home loans into securities sold to investors.[24]

Conclusion

The global credit crisis has shifted to a much darker and more ominous phase. The heavy losses and federal takeover of Fannie Mae and Freddie Mac have provided shocking insight into the breadth of the mortgage crisis. Such losses inevitability will lead to a new wave of litigation from all associated parties.

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Notes

1. *See* Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289 (2008).
2. *See* Lyndon LaRouche Political Action Comm., Fact Sheet: Who Sold Out? (Sept 8, 2008), *available at* http://www.larouchepac.com/news/2008/09/08/lpac-fact-sheet-who-sold-you-out.html.
3. Rob Alford, *What Are the Origins of Freddie Mac and Fannie Mae?*, History News Network, Dec. 8, 2003, *available at* http://hnn.us/articles/1849.html.
4. *See* About Fannie Mae, http://www.fanniemae.com/aboutfm/index.jhtml.
5. Alford, *supra* note 3.
6. *See* Statement, FHFA Director James B. Lockhart (Sept. 7, 2008), *available at* http://www.ofheo.gov/media/statements/FHFA Statement 9708.pdf.
7. Alford, *supra* note 3.
8. *See, e.g.*, Guy Erb, Josh Kamin & Todd Holleman, The Government Takeover of Freddie Mac and Fannie Mae: An Immediate Look at the Legal, Governmental and Economic Ramifications of the Federal Bailout of Government-Sponsored Enterprises, 2008 Aspatore Instant Awareness 19 (2008).
9. *See* http://www.fanniemae.com/governance/principles/composition.jhtml?p=Corporate+Governance&s=Corporate+Governance+Guidelines&t=Board+Composition,+Size+%26+Membership+Criteria; http://www.freddiemac.com/corporate/about/governance/faq.html.
10. *Id.*
11. *Id.*
12. *See* Cong. Budget Office, Measuring the Capital Positions of Fannie Mae and Freddie Mac (June 2006), *available at* http://www.cbo.gov/ftpdocs/73xx/doc7323/06-23-FannieFreddie.pdf.
13. *See generally id.*
14. *See id.; see also* Erb, *supra* note 8.
15. *See* CBO report, *supra* note 12.
16. *See* Lockhart Statement, *supra* note 6.
17. *See, e.g.*, Fed. Reserve Bd., Consumer Handbook on Adjustable-Rate Mortgages (2007), http://www.federalreserve.gov/pubs/arms/arms_english.htm.
18. Stephen Labaton & Edmund Andrews, *In Rescue to Stabilize Lending*, U.S. Takes Over Mortgage Finance Titans, N.Y. Times, Sept. 7, 2008.
19. *See* Lockhart Statement, *supra* note 6.
20. *Id.*
21. *See* Barry G. Jacobs, *Government Places Fannie Mae, Freddie Mac Into Conservatorship*, 36 No. CD-18 HDR Current Developments 1 (Sept. 15, 2008).
22. *Gordon v. Ashley et al.*, No. 08-CV-81007 (S.D. Fla.).
23. *Lone Star Fund V (U.S.), L.P. et al. v. Barclays Bank PLC et al.*, No. 08-00398 (Tex. Dist. Ct., Dallas County, 95th Jud. Dist.).
24. The FBI's current focus is on accounting fraud, insider trading, rating agencies and failure to disclose the value of mortgage-related securities and other investments.

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