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Conservatorships of Fannie Mae, Freddie Mac violate law and established insolvency principles, according to Cato Institute paper

"When the Federal Housing Finance Agency ('FHFA') was appointed conservator for Fannie Mae and Freddie Mac, it was the first use of the conservatorship authority under the Housing and Economic Recovery Act of 2008 ('HERA'), but it was not without precedent," begins a February working paper from the Cato Institute in Washington, D.C. "For decades, the Federal Deposit Insurance Corporation ('FDIC') has successfully and fairly resolved more than a thousand failing banks and thrifts using the virtually identical sections of the Federal Deposit Insurance Act ('FDIA')."

The paper, "The Conservatorship of Fannie Mae and Freddie Mac: Actions Violate HERA and Established Insolvency Principles," was written by Michael Krimminger and Mark A. Calabria. Krimminger is a partner at Cleary Gottlieb Steen & Hamilton. Calabria is the director of financial-regulation studies at Cato, the Center for Monetary and Financial Alternatives at which is substantially supported by Milwaukee's Lynde and Harry Bradley Foundation.

"The predictability, fairness, and acceptance of [the FDIC] model led Congress to adopt it as the basis for authorizing the FHFA with conservatorship powers over Fannie Mae and Freddie Mac in HERA," according to Krimminger and Calabria. "Instead of following this precedent, however," FHFA and the U.S. Treasury Department "have radically departed from HERA and the principles underlying all other U.S. insolvency frameworks and sound international standards through a 2012 re-negotiation of the original conservatorship agreement.

"Unfortunately, FHFA and Treasury have ignored the stakeholder protections in HERA and the long-established requirements and interpretations embodied in the FDIA as well as other U.S. and international insolvency laws," they write.

"[T]hese unprecedented deviations from settled insolvency practices and creditor protections undercut one of the critical foundations of a market economy, and could call into question the reliability of the government as a resolution authority," Krimminger and Calabria conclude. "Fair and predictably applied insolvency rules allow investors, creditors and even consumers to judge the risks of investing in, doing business with, or buying products or services from a company. If that process can be manipulated to favor one creditor -- as FHFA has favored Treasury -- then there is no basis to judge what could happen if a company fails."