

# CATO

---

## WORKING PAPER

### **THE CONSERVATORSHIPS OF FANNIE MAE AND FREDDIE MAC: ACTIONS VIOLATE HERA AND ESTABLISHED INSOLVENCY PRINCIPLES**

MICHAEL KRIMMINGER  
PARTNER, CLEARY GOTTlieb STEEN & HAMILTON LLP.

MARK A. CALABRIA  
DIRECTOR, FINANCIAL REGULATION STUDIES  
CATO INSTITUTE

**FEBRUARY 9, 2015**

**Cato Institute 1000 Massachusetts Avenue, NW Washington D.C. 20001**

The Cato Working Papers are intended to circulate research in progress for comment and discussion. Available at [www.cato.org/workingpapers](http://www.cato.org/workingpapers).

# **The Conservatorships of Fannie Mae and Freddie Mac: Actions Violate HERA and Established Insolvency Principles**

**By Michael Krimminger<sup>1</sup> and Mark Calabria<sup>2</sup>**

## **I. Executive Summary**

When the Federal Housing Finance Agency (“FHFA”) was appointed conservator for Fannie Mae and Freddie Mac<sup>3</sup>, 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. 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”). While the FDIC most often uses its receivership authority to resolve failing banks and thrifts, it rehabilitated dozens of weak financial institutions through open bank assistance and conservatorships by returning the banks and thrifts to full compliance with regulatory capital and other requirements, recouping the FDIC's investments in the institution, if possible, and treating stakeholders fairly. If the bank or thrift could not meet regulatory requirements, it was resolved through the FDIC's well-established receivership powers with statutory protections for all stakeholders. This approach has been recognized by the courts, Congress, and the public as providing invaluable predictability, fairness, and stability. The success of the FDIC's approach to rehabilitating or resolving failing banks and thrifts has led it to become the principal international model used by the Financial Stability Board and national regulators.

---

<sup>1</sup> Partner, Cleary Gottlieb Steen & Hamilton LLP.

<sup>2</sup> Director, Financial Regulation Studies, Cato Institute.

<sup>3</sup> The Federal National Mortgage Association (“Fannie Mae”) and the Federal Home Loan Mortgage Corporation (“Freddie Mac”) will be collectively referred to in this paper as the “Companies”.

The predictability, fairness, and acceptance of this model led Congress to adopt it as the basis for authorizing the FHFA with conservatorship powers over Fannie Mae and Freddie Mac in HERA. Instead of following this precedent, however, FHFA and Treasury 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. Known as the “net worth sweep” or “Third Amendment,” this decision ignored HERA and decades of established practice, undermined public trust in the government role in insolvencies, and undercut the vital role that fair treatment in insolvencies plays in a market economy.

This paper will:

- Describe the historical precedent and resolution practice on which Congress based FHFA’s and Treasury’s statutory responsibilities over Fannie Mae and Freddie Mac;
- Explain the statutory requirements, as well as the procedural and substantive protections, in place so that all stakeholders are treated fairly during the conservatorship;
- Detail the important policy reasons that underlie these statutory provisions and the established practice in their application, and the role these policies play in a sound market economy; and
- Demonstrate that the conservatorships of Fannie Mae and Freddie Mac ignore that precedent and resolution practice, and do not comply with HERA. Among the Treasury and FHFA departures from HERA and established precedents are the following:

- continuing the conservatorships for more than 6 years without any effort to comply with HERA's requirements to "preserve and conserve" the assets and property of the Companies and return them to a "sound and solvent" condition or place them into receiverships;
- rejecting any attempt to rebuild the capital of Fannie Mae or Freddie Mac so that they can return to "sound and solvent" condition by meeting regulatory capital and other requirements, and thereby placing all risk of future losses on taxpayers<sup>4</sup>;
- stripping all net value from Fannie Mae and Freddie Mac long after Treasury has been repaid when HERA, and precedent, limit this recovery to the funding actually provided<sup>5</sup>;
- ignoring HERA's conservatorship requirements and transforming the purpose of the conservatorships from restoring or resolving the Companies into instruments of government housing policy and sources of revenue for Treasury;
- repeatedly restructuring the terms of the initial assistance to further impair the financial interests of stakeholders contrary to HERA, fundamental principles of insolvency, and initial commitments by FHFA; and

---

<sup>4</sup> On January 27, 2015, FHFA Director Melvin Watt again reiterated that FHFA is preventing the Companies from rebuilding capital during the conservatorships. Statement of Melvin L. Watt, Director of FHFA, before the House Committee on Financial Services at 3 (Jan. 27, 2015), available at [www.financialservices.house.gov/uploadedfiles/hhrg-114-ba00-wstate-mwatt-20150127.pdf](http://www.financialservices.house.gov/uploadedfiles/hhrg-114-ba00-wstate-mwatt-20150127.pdf).

<sup>5</sup> Director Watt confirmed in his January 27, 2015 testimony that both Fannie Mae (total received \$116.1 billion; repaid \$130.5 billion through Sept. 30, 2014) and Freddie Mac (total received \$71.3 billion; repaid \$88.2 billion through Sept. 30, 2014) had more than fully repaid any monies due to Treasury. However, Watt reported that none of those payments reduced the amount claimed by Treasury. Statement of Melvin L. Watt, Director of FHFA, before the House Committee on Financial Services at 4.

- disregarding HERA's requirement to “maintain the corporation’s status as a private shareholder-owned company” and FHFA’s commitment to allow private investors to continue to benefit from the financial value of the company’s stock as determined by the market.

The authors of this paper were intimately involved in the policy discussions and legislative drafting that led to the creation of HERA, Mr. Calabria in his capacity as one of the senior professional staff to Chairman Richard Shelby of the U.S. Senate Committee on Banking, Housing and Urban Affairs, and Mr. Krimminger in his capacity as a senior policy advisor with the FDIC. During his more than twenty-one years with the FDIC, Mr. Krimminger participated in the management of receiverships and bridge banks, in the practical and policy development of the FDIC's resolution strategies, and served as Deputy to the Chairman for Policy and General Counsel during the recent financial crisis.

As a result, we bring practical experience in the application of these laws and policies along with extensive experience in the regulatory and legislative analysis that led to HERA. We feel that the precedents and their application under HERA have not been adequately discussed in considering Treasury's and the FHFA's actions during the conservatorships.

Although a new statute, HERA was well-grounded in the long history of FDIC bank conservatorships. In fact, in adopting HERA, Congress virtually replicated the FDIA’s conservatorship and receivership provisions in part to provide comfort to stakeholders in two of the largest, and most important, U.S. financial institutions.<sup>6</sup>

---

<sup>6</sup> See David H. Carpenter & M. Maureen Murphy, Cong. Research Serv., RL34657, Financial Institution Insolvency: Federal Authority Over Fannie Mae, Freddie Mac, and Depository Institutions 5 (2008), available at <http://fpc.state.gov/documents/organization/110098.pdf> (“Among the reforms included in [HERA] were extensive provisions providing the FHFA with powers that substantially parallel those accorded the Federal Deposit Insurance Corporation (FDIC) to deal with every aspect of insolvencies of any bank or thrift institution that holds federally insured deposits.”).

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. In 2012, Treasury and FHFA adopted the Third Amendment to the original 2008 agreements governing Treasury's investment and recoveries from the conservatorships.<sup>7</sup>

The Third Amendment implemented a "net worth sweep" that strips the Companies of their entire net worth each quarter and prevents the accumulation of any funds to repay pre-conservatorship shareholders, or build capital or any buffer against future losses. In addition, it explicitly eliminates the Companies' minimal reserve against losses to zero by 2018. HERA requires FHFA to conduct the conservatorships in order to "preserve and conserve" the Companies and to rehabilitate them so that they return to a "sound and solvent" condition.<sup>8</sup> Moreover, Congress consciously chose to vest with FHFA, not Treasury, the sole authority over invoking and conducting a conservator or receivership. The role of Treasury is exclusively that of a creditor. Based on the past precedents, as demonstrated below, the requirement to return to a "sound and solvent condition" requires at a minimum that the Companies must meet the minimum capital and other regulatory standards required by the regulators and the market to conduct their normal business. If the Companies cannot be returned to a "sound and solvent" condition, then they must be placed into receivership. However, FHFA and Treasury have ignored these specific requirements and, instead, have used the Companies as "cash cows" to divert tens of billions of dollars to the Treasury.

---

<sup>7</sup> "Third Amendment to Amended and Restated Senior Preferred Stock Purchase Agreement", between Treasury and FHFA, dated Aug. 17, 2012.

<sup>8</sup> 12 U.S.C. §4617(b)(2)(B) and (D).

To some, this may sound fair. After all, the Companies received billions of dollars in Treasury support. However, all of that money was repaid long ago. As of today, Treasury has diverted nearly \$40 billion beyond what it initially invested in the Companies.

This is not a dispute that only affects the Companies' stakeholders. First, because the Third Amendment deprives Fannie and Freddie of 100% of their net worth, it means that no capital is accumulated against future losses. That leaves the taxpayers on the hook once again. Second, as described below, it manipulates the conservatorship process to redirect billions of dollars to the government's general operating budget, with no accountability over how funds are spent. Finally, these 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. 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. This is particularly troubling because it is the government that has subverted the normal conservatorship process. It could call into question the reliability of any process where the government controls the rehabilitation or resolution of a company. Given the important role that government bodies play in the resolution of many financial institutions, such as banks under the FDIA or systemically important financial institutions under the Dodd-Frank Act's new Orderly Liquidation Authority, it is essential that the performance of this role assure all stakeholders of fairness and predictability.

## **II. Introduction**

A market economy depends upon predictable rules to govern competition. These rules must include sound and observed standards to govern contracts, commercial interactions, consumer protections, and the adjudication of disputes. Another critical, but often forgotten, set of rules are predictable and fair standards to allocate losses and rehabilitate or liquidate a company when it cannot pay its debts. Insolvency rules have an enormous impact on the efficiency of commercial dealings by determining the risks that stakeholders, including shareholders and creditors, as well as consumers must bear in dealing with a company or individual.<sup>9</sup> If, as shown in many emerging economies, the insolvency laws are inadequate or not enforced fairly, the costs of starting, funding, and expanding businesses is likely to be much higher because the underlying uncertainty distorts investment decisions, short-circuits many potentially valuable innovations, and strangles many profitable companies. In short, fair application of the rule of law is a critical foundation for a market economy – and this very clearly includes insolvency law.

Common law and statutory requirements for fair treatment of stakeholders under insolvency laws have a very long history in the United States. Article I, Section 8 of the U.S. Constitution recognizes the importance of insolvency laws to our economy by providing to Congress authority to establish "uniform laws on the subject of Bankruptcies throughout the United States." State common law, as well as the earliest iterations of the national bankruptcy laws all recognized that a substantively and procedurally fair process to address stakeholders' claims was a fundamental element of insolvency law. Indeed, this principle has been one of the

---

<sup>9</sup> See James W. Ely, Jr., "Whatever Happened to the Contract Clause?", 4 Charleston L. Rev. 371, 374 (Winter 2010).



foremost reasons for international efforts to improve domestic and international insolvency frameworks.<sup>10</sup>

One of the principal goals of the U.S. Bankruptcy Code is to provide procedural and substantive fair treatment of stakeholders through an adjudicative process to resolve claims and ensure consistent treatment for similarly situated creditors. The Bankruptcy Code is rightly viewed as a foundation for the availability of financing that fuels the U.S. economy. Similarly, the FDIA provides parallel protections to stakeholders of failed insured banks when the FDIC is appointed as conservator or receiver. While the FDIC has broad authority and flexibility to rehabilitate an insured bank as conservator or through open bank assistance, or to resolve the bank as receiver – which reflects the public interest in deposit insurance – stakeholders of failing banks continue to be protected by the statutory duties imposed on the FDIC to protect all creditors under the FDIA. Those protections include the requirement that the FDIC “preserve and conserve the assets and property” of the bank for the benefit of its stakeholders and pay those stakeholders either as part of the normal operations of the bank in a conservatorship or under the statutory priorities for distribution in a receivership.<sup>11</sup>

While shareholders and other stakeholders typically suffer losses under these laws when a company or bank fails, the amount of those losses is determined in a fair and predictable process with rights to contest any disputed decisions. This is fundamental to an accurate evaluation of the risks and rewards of investing in or doing business with a company or bank. If

---

<sup>10</sup> See American Bankruptcy Institute, “Commission to Study the Reform of Chapter 11: 2012-2014 Final Report and Recommendations” at 8-10 (2014); National Bankruptcy Review Commission, “Final Report: Bankruptcy The Next 20 Years” at ii (1997)(In adopting the 1978 Bankruptcy Code, “Congress retained two basic principles that long have characterized American bankruptcy law: fair treatment for creditors and a fresh start for debtors, both businesses and consumers”). See also World Bank, “Principles and Guidelines for Effective Insolvency and Creditor Rights Systems (Principles 12, 19, 29, and 34) (April 2001); Kurt Nadelmann, “Legal Treatment of Foreign and Domestic Creditors” 11 Law & Contemp. Probs (1946).

<sup>11</sup> 12 U.S.C. §§ 1821(d)(2)(B)(iv), (d)(2)(D), (d)(11). See FDIC, Managing the Crisis: The FDIC and RTC Experience 1980-1994, Chapter 5 at 155-56 (1998).

stakeholders, including shareholders, cannot reliably recover their share of the value of the failed company, future investors and vendors will require higher premiums on investments and higher prices on goods and services to protect themselves against the resulting uncertainty. This will increase the costs of doing business and significantly reduce the ability of the U.S. economy to serve the needs of businesses and all Americans. A chief reason many other countries struggle to achieve their economic potential is precisely because they lack a predictable rule of law.<sup>12</sup>

Under the FDIA, as under HERA, conservatorships were intended to be relatively short-term proceedings designed to achieve either the rehabilitation of the failing bank with its full return to "sound and solvent" operations under private control or the relatively prompt appointment of a receiver. The "open bank" assistance transactions and conservatorships used during the 1980s and early 1990s during the thrift crisis provided direct protection for stakeholders either through negotiated transactions that, while diluting shareholders' and some other stakeholders' interests, protected their rights in the open thrift or bank or through the receivership, and accompanying statutory priorities for distribution. The whole purpose of open bank assistance and conservatorships was to rehabilitate the troubled banks and return them to full compliance with bank regulatory capital and other prudential standards so that they would be strong, viable banking enterprises. As discussed below, the FDIC expressed its goals very clearly: to return the banks given assistance to "sufficient tangible capitalization . . . to meet the regulatory capital standards of the appropriate federal banking agency." Only in this way, and through compliance with the other requirements for assistance, could there be "a reasonable assurance of the future viability of the institution."<sup>13</sup> The FDIA imposes the exact obligation on

---

<sup>12</sup> See American Bankruptcy Institute, "Commission to Study the Reform of Chapter 11: 2012-2014 Final Report and Recommendations" at 8 and authorities cited therein (2014).

<sup>13</sup> 57 FR 60203-01, FDIC, "Statement of Policy on Assistance to Operating Insured Depository Institutions (Dec. 18, 1992) (Criteria 5 and 6).

the FDIC as conservator as HERA does on the FHFA as conservator. Both statutes require return to "sound and solvent" operations meeting all regulatory capital, liquidity and other prudential requirements. If that was impossible, then the institutions in conservatorship must be placed into receivership and resolved. This is the critical purpose of any assistance or conservatorship - if it cannot be achieved or if it is disregarded, then the express requirements and entire framework of HERA, as well as every precedential statutory framework, are meaningless.

In addition, in all cases, the amounts recovered by the FDIC, Federal Savings and Loan Insurance Corporation ("FSLIC"), or Resolution Trust Corporation ("RTC") were limited to the funding provided to the conservatorship or receivership of the failing bank. These conservatorships most certainly were not profit-making enterprises for the regulators. In contrast to Treasury's actions in the Companies' conservatorships, banking regulators never considered it as possible that they could impose new, harsher deals after providing assistance or initiating conservatorship or use those transactions as vehicles to strip all remaining value from the banks. Why? Because it is not permitted under the law and would have devastating consequences to the future of banking.

Unfortunately, Treasury's and FHFA's actions in the conservatorships of the Companies after the 2012 Third Amendment and the advent of the net worth sweeps violate these longstanding principles of U.S. and international insolvency law as well as the express requirements of HERA. Since HERA was designed to mirror the FDIA conservatorship and receivership provisions, including the creditor protections, it should be interpreted consistent with long-standing interpretations of the parallel FDIA provisions. The fundamental goals of FDIC interventions into open banks always were to restore the banks to financial health in

compliance with regulatory requirements and recover, wherever possible, the FDIC funds injected into the banks.

However, as implemented by Treasury and FHFA, the Companies' conservatorships serve principally as the instruments for government management of national mortgage policy and enrichment for Treasury. The Companies remain the principal sources of liquidity to the U.S. mortgage industry and the dominant secondary mortgage market companies through their issuance of guaranteed mortgage-backed securities, and have produced billions of dollars of new value. Despite having been repaid far more than it injected into the Companies, Treasury has ignored the creditor protections required under HERA or, for bank shareholders and other stakeholders, under the FDIA by using the conservatorships to strip all value from the shareholders, rather than complying with the HERA requirement that it "preserve and conserve" the Companies for the benefit of all stakeholders. In addition to violating the fundamental element of creditor protection required by statute and the principles underlying all insolvency laws, Treasury has consciously prevented accumulation of any buffer against future losses - thereby ensuring that taxpayers will again bear the risks. Treasury has purposefully refused to return the Companies to a "sound and solvent" condition as required by HERA. In internal documents, Treasury officials have expressly stated that Treasury will not allow the rehabilitation of the Companies or any return of value to the stakeholders.

This is all due to a Treasury decision, rather than a decision consistent with FHFA's duties as conservator, implemented through the Third Amendment. As described below, the Third Amendment strips any net worth from the Companies with the intended effect of leaving them with a declining capital buffer against future losses and guaranteeing that the pre-existing shareholders would receive no value from any future operations of the Companies. In

effect, Treasury has restructured its assistance package after the creation of the conservatorships to make them “profit-making” enterprises for Treasury alone. Treasury has transformed the concept of conservatorships from “preserving and conserving” to one of diverting value back to Treasury far in excess of the funds put into the Companies and conducting housing policy through the Companies’ predominant position in the current housing finance system.

The long-standing statutory and policy interpretations of the parallel FDIA conservatorship and open bank assistance provisions would never have permitted such a departure from insolvency principles. These actions violate HERA as well as the past practice and public policies underlying insolvency proceedings under the U.S. Bankruptcy Code, the FDIA, and other statutory and common law frameworks. The Treasury and FHFA actions could lead to long-term questions about the potential for the government’s role in insolvency proceedings – particularly where the government has a predominant role in the resolution framework. The consequences for corporate and bank investment and operations could be significant. Given the stakes involved, it is essential to follow HERA and ensure that the ultimate resolution for the Companies comports with sound and sensible practices in insolvency proceedings as shown by the FDIA and other insolvency frameworks.

### **III. Factual Background**

On September 6, 2008, FHFA placed the Companies into conservatorships and appointed itself as conservator pursuant to HERA. At the time, FHFA Director James Lockhart explained that the conservatorships were “a statutory process designed to stabilize a troubled institution with the objective of returning the entities to normal business operations. FHFA will

act as the conservator to operate the Enterprises until they are stabilized.”<sup>14</sup> He also emphasized that the Companies would continue to operate “as normal, only with stronger backing for the holders of MBS, senior debt and subordinated debt.”<sup>15</sup>

The next day, Treasury announced that, pursuant to temporary authority granted under HERA,<sup>16</sup> it had entered into Senior Preferred Stock Purchase Agreements (the “PSPAs”) with each of the Companies acting through FHFA as conservator. Under the PSPAs, Treasury committed to funding liquidity of up to \$100 billion for each of the Companies. In return, Treasury received four principal rights. First, Treasury received one million senior preferred shares in each company with an initial senior liquidation preference of \$1,000 per share equivalent to \$1 billion. The PSPAs provided that Treasury’s liquidation preference would increase dollar-for-dollar with each draw by Fannie Mae or Freddie Mac on Treasury’s funding commitment. Second, Treasury was entitled to a quarterly cash dividend equal to 10% of its outstanding liquidation preference that could have been paid in kind without any borrowing from Treasury. Third, Treasury received a warrant to purchase 79.9% of the common stock for a nominal price. Finally, Treasury gained the right to collect a Periodic Commitment Fee (“PCF”) beginning in 2010, which was to be set by mutual agreement with FHFA at the market price.<sup>17</sup> Under the PSPAs, Treasury was allowed to waive the PCF a year at a time.

---

<sup>14</sup> Statement of FHFA Director James B. Lockhart at News Conference Announcing Conservatorship of Fannie Mae and Freddie Mac, Sept. 7, 2008, available at <http://www.fhfa.gov/Media/PublicAffairs/Pages/Statement-of-FHFA-Director-James-B--Lockhart-at-News-Conference-Announcing-Conservatorship-of-Fannie-Mae-and-Freddie-Mac.aspx>.

<sup>15</sup> Id.

<sup>16</sup> 12 U.S.C. § 1455(l).

<sup>17</sup> See David Reiss, An Overview of the Fannie and Freddie Conservatorship Litigation, 10 N.Y.U. J. L. & Bus. 479, 486-87 (2014). Treasury subsequently waived the Periodic Commitment Fee for each year until the Third Amendment, which suspended it.

Importantly, under the PSPAs, Treasury's senior preferred stock could be redeemed if its liquidation preference was paid down with interest. While the PSPAs were certainly dilutive of the existing shareholders' interests in the Companies, the fact that such privately held shares continued to exist in companies that continued to operate and generate substantial cash flows implied a continued right to recovery and were consistent with a potential return to full private control. In addition, despite the dilutive effect of the PSPAs, both Treasury and FHFA explicitly emphasized that there was no nationalization and that the rights of stakeholders would be protected. For example, then-Treasury Secretary Paulson explained that "conservatorship does not eliminate the outstanding preferred stock."<sup>18</sup> FHFA also confirmed that the "[s]tockholders will continue to retain all rights in the stock's financial worth; as such worth is determined by the market."<sup>19</sup>

During 2009, Treasury and FHFA amended the PSPAs twice. In the First Amendment, executed on May 6, 2009, Treasury agreed to expand its potential funding commitment to \$200 billion. On December 24, 2009, Treasury and FHFA agreed to a Second Amendment, which modified the \$200 billion commitment in the First Amendment into a maximum commitment based on a formula permitting each company to draw the higher of \$200 billion or \$200 billion plus the company's negative net worth. The Second Amendment delayed

---

<sup>18</sup> Stmt. by Sec. Henry M. Paulson, Jr. on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers, Sept. 7, 2008, available at <http://www.treasury.gov/press-center/press-releases/Pages/hp1129.aspx>; see also Treasury memorandum, Housing Government Sponsored Enterprise Program, available at <http://www.treasury.gov/about/budget-performance/budget-in-brief/Documents/CJ-GSE.pdf> ("Conservatorship preserves the status and claims of the preferred and common shareholders").

<sup>19</sup> Fed. Housing Fin. Agency, Questions and Answers on Conservatorship, available at [http://www.treasury.gov/press-center/press-releases/Documents/fhfa\\_conserv\\_faq\\_090708hp1128.pdf](http://www.treasury.gov/press-center/press-releases/Documents/fhfa_conserv_faq_090708hp1128.pdf); see also Stmt. of FHFA Director James B. Lockhart at News Conference Announcing Conservatorship of Fannie Mae and Freddie Mac, Sept. 7, 2008, available at <http://www.fhfa.gov/Media/PublicAffairs/Pages/Statement-of-FHFA-Director-James-B--Lockhart-at-News-Conference-Announcing-Conservatorship-of-Fannie-Mae-and-Freddie-Mac.aspx> ("the common and all preferred stocks will continue to remain outstanding"); Hearing before the House Comm. on Financial Services, Sept. 25, 2008 (Director Lockhart's testimony that "the shareholders are still in place; both the preferred and common shareholders have an economic interest in the [C]ompanies").

the imposition of the PCF to January 2011, but did not otherwise alter the structure of the fee. Treasury's authority under HERA to purchase securities from the Companies expired on December 31, 2009. Treasury then proceeded to waive imposing the PCF twice—in December 2010 and December 2011—before the 2012 Third Amendment suspended the Fee indefinitely while the Net-Worth Sweep remained in effect. Throughout this period, Treasury continued to state that the Companies could repay the amounts due to Treasury and exit conservatorship. Ultimately, the Companies combined draws from the Treasury commitment totaled \$189.4 billion.<sup>20</sup>

Despite the unnaturally high quarterly cash dividend which the Companies initially had to pay through further draws from Treasury, the Companies began to recover. FHFA itself projected growing positive net income even after payment of the dividends. By May 2012, both Companies were able to announce net profits for the first quarter of 2012. As the Companies continued to improve they began to steadily pay back the amounts received from Treasury. As of September 30, 2014, FHFA reported that Fannie Mae had paid to Treasury \$14.4 billion more than it had received and Freddie Mac had paid \$16.9 billion more than it had received.<sup>21</sup>

But as the fortunes of the Companies improved, in August 2012, Treasury announced a change in course to ensure that none of that value would ever accrue to the private shareholders and that it would not be used to build capital.<sup>22</sup> Nearly four years after FHFA placed the Companies into conservatorship, Treasury and FHFA announced the so-called “Third

---

<sup>20</sup> Statement of Melvin L. Watt, Director of FHFA, before the House Committee on Financial Services at 4 (Jan. 27, 2015).

<sup>21</sup> Id.

<sup>22</sup> See U.S. Treasury, Dec. 20, 2010 Action Memorandum for Secretary Geithner (“Makes clear the Administration's commitment to ensure existing common equity holders will not have access to any positive earnings from the GSEs in the future”).



Amendment”. The Third Amendment modified the PSPAs by replacing the quarterly dividend to Treasury of 10% of its liquidation preference with a quarterly dividend to Treasury equal to the Companies’ entire net worth, minus a small reserve that shrinks to zero by 2018.<sup>23</sup> The Third Amendment does specifically note that the suspension of the PCF is in consideration of the net worth sweep: “in consideration of the modification made to the Senior Preferred Stock effective September 30, 2012 [i.e., the net worth sweep], for each quarter commencing January 1, 2013, and continuing for as long as [the net worth sweep is in effect], no Periodic Commitment Fee shall be set, accrue, or be payable.” Importantly, the Third Amendment characterizes the net worth sweep as a dividend.<sup>24</sup> As a result, the net worth sweep payments do not reduce Treasury’s liquidation preference, which is thus effectively fixed at about \$189.4 billion in both Companies combined. In effect, there can be no repayment and the Treasury retains a predominant, preferred priority despite full repayment with interest.

In addition, the recognized effect of this new arrangement is that the Companies are prevented from building a capital buffer, which makes their rehabilitation impossible. Indeed, at the time of the Third Amendment, Treasury stated that it would prevent the Companies from “retain[ing] profits” or “rebuild[ing] capital.”<sup>25</sup> FHFA’s then-Acting Director DeMarco explained that the Third Amendment “reinforce[d] the notion that the [Companies] will not be building capital as a potential step to regaining their former corporate status.”<sup>26</sup> The

---

<sup>23</sup> See Press Release, Treasury Department Announces Further Steps to Expedite Wind Down of Fannie Mae and Freddie Mac, Aug. 17, 2012, [available at](http://www.treasury.gov/press-center/press-releases/Pages/tg1684.aspx) <http://www.treasury.gov/press-center/press-releases/Pages/tg1684.aspx>

<sup>24</sup> See Third Amendment to Amended and Restated Senior Preferred Stock Purchase Agreement, [available at](http://www.treasury.gov/press-center/press-releases/Documents/Fannie.Mae.Amendement.pdf) <http://www.treasury.gov/press-center/press-releases/Documents/Fannie.Mae.Amendement.pdf>.

<sup>25</sup> Press Release, Treasury Department Announces Further Steps to Expedite Wind Down of Fannie Mae and Freddie Mac, Aug. 17, 2012, [available at](http://www.treasury.gov/press-center/press-releases/Pages/tg1684.aspx) <http://www.treasury.gov/press-center/press-releases/Pages/tg1684.aspx>

<sup>26</sup> Speech, FHFA’s Conservatorship Priorities for 2013, March 4, 2013, [available at](http://www.fhfa.gov/Media/PublicAffairs/Pages/Remarks-as-Prepared-for-Delivery-Edward-J-DeMarco-Acting-Director-FHFA-National-association-for-Business-Economics-.aspx) <http://www.fhfa.gov/Media/PublicAffairs/Pages/Remarks-as-Prepared-for-Delivery-Edward-J-DeMarco-Acting-Director-FHFA-National-association-for-Business-Economics-.aspx>

Companies themselves have described the Third Amendment accurately as a “risk factor” because it “do[es] not allow [them] to build capital reserves.”<sup>27</sup>

This sweep arrangement continues to this day, despite the fact that the Companies have been generating enormous profits and have now paid back \$40 billion more than they borrowed from Treasury.<sup>28</sup> In 2013, several holders of preferred and common stock in the Companies filed suit challenging the Third Amendment under various legal theories, including that the sweep violated HERA and so must be enjoined under the Administrative Procedure Act, and that the sweep constituted an unconstitutional taking such that the government should be ordered to provide just compensation. On September 30, 2014, Judge Lamberth of the U.S. District Court for the District of Columbia dismissed several such suits, finding that the court did not have jurisdiction to enjoin the conservator because the net worth sweep was within the conservator’s broad powers.<sup>29</sup> The plaintiffs’ appeal of that decision is pending.

#### **IV. HERA’s Conservatorship And Receivership Provisions**

HERA was enacted on July 30, 2008 in response to the threat posed by the housing crisis on the Companies. Among other provisions, HERA abolished the Companies’ former regulator and created a new one, FHFA, which was given broad conservatorship and receivership authority over the Companies. The co-authors of this White Paper both participated heavily in the policy discussions surrounding the creation of HERA.

---

<sup>27</sup> See Fannie Mae Offering Circular, Universal Debt Facility 11 (May 14, 2013), available at <http://www.fanniemae.com/resources/file/debt/pdf/tools-resources/519479ACL.pdf>.

<sup>28</sup> See <http://www.bizjournals.com/atlanta/news/2015/01/05/mayopoulos-fannie-mae-s-rebound-means-taxpayers.html?page=all> (“Fannie Mae was able to repay the taxpayer within five years.”) (statement by Timothy Mayopolous, CEO of Fannie Mae).

<sup>29</sup> See Perry Capital LLC v. Lew, -- F. Supp. 2d --, 2014 WL 482559 (D.D.C. Sept. 30, 2014).

*a. Legislative Background*

Importantly, the HERA conservatorship and receivership provisions were designed to virtually replicate the pre-existing model of the FDIA conservatorship and receivership provisions.<sup>30</sup> As will be demonstrated in the following discussion, HERA followed this model because it had been proven to provide two key protections essential in resolving the Companies: 1) preservation of critical functions and 2) protection of creditor rights through specific conservator and receiver duties and responsibilities, statutory priorities, and rights to judicial adjudication. Foremost in the drafters' minds was the importance of both continuing the Companies' operations without disruption and maintaining market confidence in the fair treatment of the Companies' stakeholders by the government.

The final conservatorship and receivership provisions of HERA were those initially included in the draft Federal Housing Enterprise Regulatory Reform Act of 2005 (S.190) reported out of the Senate Banking Committee. Despite a change in Senate majority between 2005 and 2008, the Senate Banking Committee incorporated the conservator and receiver provisions of S. 190, as reported, largely unchanged. In drafting the reported version of S. 190, then Chairman Shelby directed his staff to make those provisions as "bank-like" as possible.<sup>31</sup> Staff quite literally "marked-up" Sections 11 and 13 of the FDIA as the base text for HERA. The Banking Committee consciously wished to incorporate the existing body of FDIC legal

---

<sup>30</sup> Compare 12 U.S.C. § 4617(b)(2)(D) with § 1821(d)(2)(D).

<sup>31</sup> Hearing before the Senate Committee on Banking, Housing and Urban Affairs, February 24, 2004 (Statement of Chairman Greenspan) ("the Congress needs to create a GSE regulator with authority on a par with that of banking regulators, with a free hand to set appropriate capital standards, and with a clear process sanctioned by the Congress for placing a GSE into receivership."), <http://www.gpo.gov/fdsys/pkg/CHRG-108shrg21980/html/CHRG-108shrg21980.htm>.

precedent into any conservatorship or receivership for the Companies.<sup>32</sup> In doing so the Committee believed that building upon the established framework of the FDIC would provide both courts and market participants with greater predictability.<sup>33</sup>

In “marking-up” the provisions of the FDIA, the Committee staff did make a handful of changes to accommodate differences between the Companies and insured depositories. One crucial departure is that the Committee was concerned about potential “takings” should Fannie Mae or Freddie Mac enter receivership with a positive value of shareholder equity. Accordingly, a mandatory receivership is only invoked after Fannie or Freddie becomes balance-sheet insolvent. Although a receivership for an insured depository can be invoked by either its primary regulator or the FDIC, the Committee explicitly choose to vest with FHFA the sole authority over invoking a conservatorship or receivership. The role of other entities, including the Department of the Treasury, were purposely made more limited.

Under Section 13(G) of the FDIA the Treasury Secretary plays a crucial policy role in the decision to invoke the FDIC’s special authority to respond to a systemic event, which would allow for a departure from least cost resolution requirements. HERA does not provide for either a systemic risk exception nor a policy role for the Treasury Secretary. A systemic risk exception was not included, nor a least cost resolution, as the Committee did not consider the taxpayer to be a residual claimant, as is the deposit insurance fund in the instance of a depository

---

<sup>32</sup> Mark Calabria, 2015. The Resolution of Systemically Important Institutions: Lessons From Fannie and Freddie. Cato Institute Working Paper No. 25. <http://www.cato.org/publications/working-paper/resolution-systematically-important-financial-institutions-lessons-fannie>.

<sup>33</sup> Hearing before the Senate Committee on Banking, Housing and Urban Affairs, February 24, 2004 (Statement of Chairman Greenspan) (“the Congress needs to clarify the circumstances under which a GSE can become insolvent and, in particular, the resultant position--both during and after insolvency--of the investors that hold GSE debt. This process must be clear before it is needed; otherwise, should these institutions experience significant financial difficulty, the hands of any regulator, and of public authorities generally, would be constrained by uncertainties about the process.”), <http://www.gpo.gov/fdsys/pkg/CHRG-108shrg21980/html/CHRG-108shrg21980.htm>.

insolvency. The Banking Committee’s intent in HERA was to limit the role of Treasury to one of creditor, even if a preferred creditor. The rights of Treasury under HERA are exclusively those of a creditor.

The Committee weighed giving Treasury a policy role and rejected such. The Bush Administration’s proposal for reform housed the new regulator for the Companies within Treasury, similar to the Office of the Comptroller of the Currency (“OCC”). Legislation (H.R. 2803) was introduced in the House of Representatives in July of 2003 by Congressman Ed Royce that mirrored this proposed role for Treasury. Both House and Senate Committees debated such a role and ultimately rejected it. As Section 1117 of HERA, from which the Treasury’s authority flows, makes clear, that authority is temporary in nature. Section 1117 also makes clear Congress’ intent to “maintain the corporation’s status as a private shareholder-owned company.”<sup>34</sup> The drafters of HERA never envisioned, nor intended, for Treasury to maintain a large equity stake in the companies. Treasury assistance was meant to be temporary, in the nature of debtor-in-possession financing. HERA also makes clear, as was intended by the Banking Committee, that FHFA maintain sole authority over when the Companies would enter or leave conservatorship. There simply is no authority for Treasury in this regard. Additionally Treasury could no more, as a creditor, create such a role than could a bank creditor trump the powers of the FDIC in a resolution. Whatever authorities Treasury has over the Companies under HERA is limited to those rights “received in connection with such purchases” it may make as a creditor under Section 1117.

Congress had a number of concerns in mind when it rejected an expanded role for Treasury. Some members of the Banking Committee were suspicious of what was seen as a

---

<sup>34</sup> 12 U.S.C. § 1455(l)(1)(C)(v).

culture at Treasury that was antagonistic to the Companies as Government Sponsored Enterprises (“GSEs”) and felt that having a significant policy role for Treasury would threaten the very existence of the GSE model. Other members, including Senator Shelby, worried that placing the new regulator for the Companies at Treasury and giving Treasury a policy role would “harden” the guarantee as Treasury was viewed as having a “bailout” culture (the role of Treasury in the 1990’s “peso crisis,” for instance, had not been forgotten). Regardless of the varying reasons, members of the Banking Committee felt strongly that Treasury should have no policy or supervisory role in day-to-day supervision of the Companies.

*b. Analysis of the Statutory Framework*

FHFA’s authority as conservator of the Companies arises under Section 1145 of HERA, codified at 12 U.S.C. § 4617. As with the FDIA, HERA requires that conservatorships must be designed to restore the company to a “sound and solvent” position or, if that is not possible, to place it into receivership (in particular, to “preserve and conserve” the Company’s assets until it can be placed in receivership).<sup>35</sup> FHFA’s regulations explain that these provisions “charge[ ] [FHFA] with rehabilitating the regulated entity.”<sup>36</sup> While the FHFA’s regulations permit the agency “to suspend capital classifications . . . during the duration of the conservatorship or receivership of that regulated entity”, this authority does not undercut the explicit statutory and regulatory duty to place the troubled Companies back into a “sound and solvent” condition or appoint a receiver.<sup>37</sup>

---

<sup>35</sup> See 12 U.S.C. § 4617(b)(2)(D) (FHFA’s “powers as conservator” are defined as the ability to “take such action as may be (i) necessary to put the regulated entity in a sound and solvent condition; and (ii) appropriate to carry on the business of the regulated entity and preserve and conserve the assets and property of the regulated entity.”).

<sup>36</sup> 76 Fed. Reg. at 35,727; see also *id.* at 35,730 (“A conservator’s goal is to continue the operations of a regulated entity, rehabilitate it and return it to a safe, sound and solvent condition.”).

<sup>37</sup> See 12 C.F.R. §1237.3(c).

Given FHFA's clear obligation as conservator to return the Companies to a "sound and solvent" condition, it is important to understand the meaning of this phrase. It is drawn directly from the FDIC's obligation as conservator under the FDIA to "put the insured depository institution in a sound and solvent condition" and "preserve and conserve the assets and property of the institution."<sup>38</sup> It should be indisputable that this phrase can only mean that the Companies, like insured banks in conservatorship, must be returned to full compliance with all regulatory capital, liquidity and other prudential standards to permit normal or "sound" operations. If there could be any doubt, that doubt should be eradicated by examination of the longstanding practice of the FDIC to require any insured institution with open bank assistance or in conservatorship to achieve rehabilitation with "sufficient tangible capitalization and reasonable assurance of the future viability of the bank."<sup>39</sup>

That Congress intended conservatorship under HERA to be a temporary measure, and not a substitute for receivership, is evident from the statute itself. Section 1145 gives the Director of FHFA discretionary authority to place the Companies into conservatorship or receivership if one of a long list of statutory grounds is satisfied.<sup>40</sup> But the Director is required to place the Companies into receivership if the Director finds them to be insolvent or unable to pay their debts as they come due.<sup>41</sup> To discipline this process, the Director is required to "make a determination, in writing," as to whether the Companies meet the requirements for mandatory receivership every thirty days after they become "critically undercapitalized."<sup>42</sup> FHFA's

---

<sup>38</sup> 12 U.S.C. §1821(d)(2)(D).

<sup>39</sup> See, e.g., 48 FR 38669-01, FDIC, "Statement of Policy and Criteria on Assistance to Operating Insured Banks Which Are in Danger of Failing" (August 25, 1983) and subsequent Statements of Policy cited infra footnote 65 and discussed in text.

<sup>40</sup> 12 U.S.C. § 4617(a).

<sup>41</sup> Id. § 4617(a)(4).

<sup>42</sup> Id. § 4617(a)(4)(B).

appointment as a receiver “shall immediately terminate any conservatorship established for the regulated entity under this chapter.”<sup>43</sup>

It is important to examine these requirements more closely in the overall statutory context. Because conservatorships are designed to rehabilitate failing companies, their duration must be limited to the time needed to stabilize operations and determine whether the company can be returned to full private control or whether the Company must be placed into receivership proceedings.

However, in the context of the present conservatorships of the Companies, for six years FHFA and Treasury have refused to make a determination regarding the Companies’ solvency or ability to pay their debts, or to place them into receiverships, despite the explicit requirements in HERA.<sup>44</sup> In defending its failure to do so, the government has argued that so long as Treasury’s commitment to the Companies under the PSPAs remains, they are solvent and do not require capital.<sup>45</sup> This response does not comply with the letter or spirit of HERA, nor does it make logical sense. If the Companies cannot pay their debts as they come due without Treasury assistance, then they are insolvent under the HERA statutory test.<sup>46</sup> HERA’s test for a mandatory receivership self evidently was designed to prevent either continued operation of the Companies while insolvent without some intervention by the FHFA as well as continuation of conservatorships without rehabilitation to a “sound and solvent” condition. If the Companies

---

<sup>43</sup> *Id.* § 4617(a)(4)(D).

<sup>44</sup> 12 U.S.C. §4617(a)(4)(B) (“Periodic determination required for critically undercapitalized regulated entity”)

<sup>45</sup> *See, e.g.,* Treasury Defs.’ Reply In Support of Their Dispositive Mots. and Opp. to Pls.’ Summ. J. Mots. at 49 n.21, *Perry Capital LLC v. Lew*, Case No. 13-cv-01025 (May 2, 2014), ECF No. 41 (“The point of the Third Amendment is that the funding capacity from Treasury will be available to cover all of the GSEs’ net losses . . . . The Third Amendment thus protects the GSEs from the mandatory receivership that would follow upon the GSEs’ experiencing a net worth deficit (i.e., insolvency) after their funding capacity is exhausted.”).

<sup>46</sup> 12 U.S.C. §4617(a)(3) and (4). Subsection 4617(a)(4) requires appointment of a receiver if the regulated entity is not “generally paying the debts of the regulated entity (other than debts that are the subject of a bona fide dispute) as such debts become due.” If the Companies can only do so due to Treasury’s commitment under the PSPAs, then logically the “Companies” cannot do so, and would fail this test and a receivership would be required.



cannot be rehabilitated through the conservatorships, then HERA requires appointment of receivers for them. A contrary conclusion would result in the farcical position that so long as the Companies are government-guaranteed they can never be insolvent, rendering HERA's protections for taxpayers meaningless.<sup>47</sup> If, as Treasury argues as justification for the Net Worth Sweep, any profits made by the Companies are due exclusively to the Treasury investment, it must also be true that the Companies could not pay their debts without the continuing backstop of the Treasury, and thus receivership is mandatory.<sup>48</sup> Conversely, if FHFA agrees to allow Treasury to seize all of the net assets from the Companies simply because Treasury has decided to prevent the Companies from returning to private control, FHFA is violating its obligations under HERA to "preserve and conserve" the Companies' assets and protect the interests of stakeholders.

Like the FDIA, HERA directs that FHFA, when acting as receiver, "shall" liquidate the Companies, whether "through the sale of assets, the transfer of assets to a limited-life regulated entity" or otherwise, and distribute to stakeholders according to defined priorities.<sup>49</sup> Before HERA's passage, certain parties objected that an FDIC-style receivership or liquidation would be inappropriate for the Companies, believing that conservatorship was an adequate method to deal with the Companies if they became critically undercapitalized. But Congress clearly rejected this position.<sup>50</sup> In other words, Congress was specifically aware of, and rejected,

---

<sup>47</sup> For example, although Congress authorized Treasury to purchase securities from the Companies for a limited time in HERA, it specifically required that Treasury make a determination before doing so that such purchases would "protect the taxpayer." See 12 U.S.C. § 1455(l)(i)(B).

<sup>48</sup> Press Release, Treasury Department Announces Further Steps to Expedite Wind Down of Fannie Mae and Freddie Mac, Aug. 17, 2012, (one of the defined objectives of the Net Worth Sweep was "[m]aking sure that every dollar of earnings that Fannie Mae and Freddie Mac generate will be used to benefit taxpayers for their investment in those firms"), available at <http://www.treasury.gov/press-center/press-releases/Pages/tg1684.aspx>.

<sup>49</sup> 12 U.S.C. § 4617(b)(2)(E), 4617(c).

<sup>50</sup> See Richard Scott Carnell, Handling the Failure of A Government-Sponsored Enterprise, 80 Wash. L. Rev. 565, 629-30 (2005) ("Both Fannie and Freddie dismiss receivership as inappropriate for GSEs. . . . In Fannie's view,

the notion that a receivership of the Companies should be avoided because it would “create harmful uncertainty and make mortgages more costly and less available.”<sup>51</sup>

Instead, Congress gave FHFA, as receiver, the authority to sell the Companies’ assets and determine claims against the Companies, pursuant to specific notice and process requirements.<sup>52</sup> Such claims are to be evaluated based on a predetermined set of priorities, similarly situated stakeholders are to be treated similarly, and all parties are to be treated fairly. Although FHFA’s disallowance of a claim is not subject to judicial review during the initial determination,<sup>53</sup> the claimant may file (or continue) suit in district court after receiving notice by the receiver of the initial disallowance.<sup>54</sup>

In short, although HERA provided FHFA with broad powers to act as either conservator or receiver for the Companies, those powers were clearly based on the standards developed by the body of law regarding the substantially identical FDIA provisions, and other internationally recognized principles, as explained below.

V. **HERA Is Modeled After the FDIA, As Well As State Law and International Benchmarks**

a. *The FDIC Experience As Conservator And Receiver*

The FDIC has had extensive experience acting as both conservator and receiver for troubled financial institutions pursuant to the FDIA. Just as the FDIA provided the model for

---

the government has a mere ‘financial stake’ in federally insured depository institutions, whereas it has a broader policy stake in using Fannie and Freddie to ‘mak[e] homeownership more affordable and more available. That is why a conservator is the appropriate tool to deal with a capital inadequacy problem at a GSE. The conservator’s role is to rebuild the capital of the GSE and ensure it remains an ongoing concern.’ Freddie emphasizes that receivership--here equated with liquidation—‘would have substantial economic, market and public policy consequences’ and ‘threaten the public policy mission of the GSEs.’”).

<sup>51</sup> See *id.* at 633.

<sup>52</sup> 12 U.S.C. §4617(b)(3).

<sup>53</sup> *Id.* §4617(b)(5)(E).

<sup>54</sup> *Id.* §4617(b)(6).

HERA, Congress did not legislate on a blank slate when it created the FDIC's conservatorship and receivership powers. Quite to the contrary, there was a well-developed body of law, both federal and state, governing bank conservatorships and receiverships long before the 1980s. These long-standing principles always distinguished between the powers of a conservator to conserve assets and rehabilitate financial institutions versus the powers of a receiver to liquidate a financial institution.

For decades, the FDIC has been successful in using its conservatorship and receivership authority under the FDIA to maintain stability and confidence in the nation's banking system, including in the resolution of systemically important financial institutions. In particular, while receiverships have been the norm under the FDIA in the past twenty-five years, conservators were commonly used during the Great Depression and then again during the 1980s. In fact, prior to the 1990s, the FDIC had frequently made use of open bank assistance and conservatorships as a preferred method to resolve failing insured banks and thrifts.<sup>55</sup> It is illustrative of the commonly understood rights and obligations of the conservator to examine some of those earlier uses of the conservatorship authority.

Under many state laws, bank conservators were authorized as one option to allow for the rehabilitation of a troubled bank. These laws often pre-existed the FDIA and its specific federal standards. An example of the requirements of such state laws is a conservatorship for a bank during the 1930s under Michigan law.<sup>56</sup> In a challenge to the state conservator's actions, a court observed that under the Michigan banking statute a bank conservator's "duties are to

---

<sup>55</sup> See FDIC, Managing the Crisis: The FDIC and RTC Experience 1980-1994, Chapter 5 at 164-69 (1998).

<sup>56</sup> While this case involved a state law conservator appointed before creation of the FDIC, many state laws allowed the state authorities to appoint conservators other than the FDIC and some still do. The FDIC today has the authority to appoint itself if necessary to protect the federal Deposit Insurance Fund.

conserve the assets of the bank for the purpose of rehabilitation, and he is given powers designed to effectuate that purpose.”<sup>57</sup>

Federal law has always imposed similar duties on conservators. Under the Bank Conservation Act of 1933, the Comptroller of the Currency can appoint conservators for national banks and provide them with power to conduct the bank’s business.<sup>58</sup> The conservator is charged with the duty to preserve and conserve the bank’s assets and operations and terminate the conservatorship when the Comptroller “becomes satisfied that it may safely be done and that it would be in the public interest” to “permit the involved bank to resume the transaction of its business” or by appointing a receiver.<sup>59</sup> Essential to this process is that the bank return to full compliance with the capital, liquidity, and operational requirements for operation in the public interest under the Comptroller’s regulatory standards for safe and sound national banks. As the New York Court of Appeals noted in 1934, the federal Bank Conservation Act of 1933 defines “the function of a conservator to conserve and not, as in the case of a receiver, to liquidate.”<sup>60</sup>

The FDIC has never considered an open bank or closed bank conservatorship to be a long-term solution to maintain banking operations. Initially, it is important to understand that conservatorships can be either “closed bank” or “open bank”. A “closed bank” conservatorship occurs when a bank or thrift is first placed into formal insolvency proceedings in a receivership and the valuable operations of the institution are “passed through” the receivership

---

<sup>57</sup> Bicknell v. Cent. Hanover Bank & Trust Co., 169 Misc. 7, 8, 6 N.Y.S.2d 704, 705 (Sup. Ct.) aff’d 255 A.D. 956, 8 N.Y.S.2d 668 (App. Div. 1938) (emphasis added). See also 9 Ohio Jur. 3d Banks § 594 (“The Superintendent of Financial Institutions may appoint a conservator for any savings and loan association whenever it is necessary in order to conserve the assets of the association for depositors, members, and creditors. . . .” (emphasis added)); 10 S.C. Jur. Banks and Banking § 132 (“The conservator takes possession of the books, records and assets of every description of the bank. He is obligated to take such action as is necessary to conserve the assets pending further disposition of the bank's business.”).

<sup>58</sup> 12 U.S.C. §§201-212.

<sup>59</sup> 12 U.S.C. §205(a) and (b).

<sup>60</sup> Gray v. First Nat. Bank & Trust Co. of Yonkers, 263 N.Y. 479, 484, 189 N.E. 557, 559 (1934).

into a new bank or thrift, which is then put into conservatorship to be managed by the resolution authority. Since the original institution was normally deeply insolvent, the closed bank conservatorships used by the RTC were typically used to maintain and down-size operations until the thrift could be put into receivership. Pre-existing stakeholders of the failing thrift were protected by the statutory protections contained in the FSLIC and RTC statutes. Such closed bank conservatorships were frequently used by the FSLIC and RTC to resolve insolvent thrifts during the late 1980s and early 1990s.<sup>61</sup>

Open bank conservatorships have been used infrequently by the FDIC. More often, the FDIC has intervened into open insured banks through so-called “open bank assistance”. The goal of this process was to rehabilitate the troubled bank and return it to normal banking operations in full compliance with requisite regulatory standards, including adequate capitalization. Open bank assistance had many of the hallmarks of an open bank conservatorship because the FDIC would require significant changes in the board of directors and management, as well as in the operations of the bank, in an effort to return it to profitable operations.<sup>62</sup>

In 1950, the FDIA was amended to give the FDIC authority to keep a failing bank open with direct FDIC financial assistance if the bank was determined to be “essential” to the community.<sup>63</sup> The FDIC did not use this authority until 1970 due to the infrequency of troubled

---

<sup>61</sup> See FDIC, Managing the Crisis: The FDIC and RTC Experience 1980-1994, Chapters 3-5 and particularly at 117-118. The FSLIC and RTC sometimes used conservatorships for open institutions that had never been placed into receiverships, but most savings and loan and banking conservatorships were so-called “pass-through” conservatorships in which the institution was closed and placed into receivership before its assets and operations “passed through” to a new institution that was immediately placed into conservatorship. This was done principally due to the absence of financial and other resources to close and resolve the many institutions in danger of failing during the late 1980s and early 1990s. See id. at 117.

<sup>62</sup> See, e.g., FDIC, Managing the Crisis: The FDIC and RTC Experience 1980-1994, Chapter-5 and Case Studies of open bank assistance at 158-163 and Part II, Chapters 2, 4, and 5.

<sup>63</sup> 12 U.S.C. §1823(c)(1) (1950).

banks, but it remained an important tool available for use when no acquiring bank could be located or a liquidation and pay-off of depositors was likely to be too disruptive.<sup>64</sup>

However, as the 1980s began, both the complexity and the frequency of troubled banks required the FDIC to consider open bank assistance as an important tool to stabilize and rehabilitate larger failing banks. In order to provide guidance about its approach to this strategy, beginning in 1983 the FDIC adopted a series of statements of policy to govern its assistance to operating insured banks in danger of failing.<sup>65</sup>

These four FDIC Statements of Policy included certain common requirements focused on restoring the soundness of the bank, ensuring that shareholders incur losses comparable to the bank's failure, and that the FDIC receive "full payment, at present value, of all assistance granted before any benefit is realized by former shareholders." These criteria illustrate the essential nature of bank conservatorships and open bank assistance. First, the goal was always to ensure rehabilitation of the bank as measured by "sufficient tangible capitalization and reasonable assurance of the future viability of the bank."<sup>66</sup> Tangible capitalization, in turn, required that the bank meet the requisite minimum regulatory capital standards in effect for open banks.<sup>67</sup> In case there was any doubt about the meaning of this requirement, the FDIC made it explicit: the goal was return the banks given assistance to "sufficient tangible capitalization . . .

---

<sup>64</sup> See FDIC, History of the Eighties – Lessons for the Future, Vol.I at 248 (1997).

<sup>65</sup> See 57 FR 60203-01, FDIC, "Statement of Policy on Assistance to Operating Insured Depository Institutions (Dec. 18, 1992) (Criteria 5 and 6); 55 FR 12559-02, FDIC, "Statement of Policy on Assistance to Operating Insured Banks and Savings Associations" (April 4, 1990); 51 FR 44122-01, FDIC, "Statement of Policy and Criteria on Assistance to Operating Insured Banks" (Dec. 8, 1986); 48 FR 38669-01, FDIC, "Statement of Policy and Criteria on Assistance to Operating Insured Banks Which Are in Danger of Failing" (August 25, 1983). The FDIC rescinded the last of these Statements of Policy in 1997 as a consequence of intervening statutory changes.

<sup>66</sup> 48 FR 38669-01.

<sup>67</sup> See, e.g., "Banking Agencies Adopt Permanent Assistance Program for Continental Illinois National Bank, 1984-85 CCH ¶ 86,019 ("B. Capital Infusion", "Thus, the bank's regulatory capital . . . will approximate \$2.2 billion or over 7.0 percent of assets").

to meet the regulatory capital standards of the appropriate federal banking agency." Only in this way, and through compliance with the other requirements for assistance, could there be "a reasonable assurance of the future viability of the institution."<sup>68</sup>

Second, shareholders and other stakeholders were to incur losses consistent with their protection under bank insolvency statutes. The value of the bank was not stripped by the FDIC. The FDIC recognized that the shareholders were to be diluted, but only to the extent of the assistance actually provided by the FDIC.<sup>69</sup> If the assisted bank returned to profitability, that was success, and after the repayment of the FDIC's assistance all future value would inure to the benefit of the shareholders.

Third, the FDIC received repayment of the assistance that was provided, with interest, but it did not receive all future value and profits that might be earned by the bank. To do so, would have completely negated the whole purpose of the conservatorship or open bank assistance – to return the bank to “sufficient tangible capitalization and reasonable assurance of the future viability of the bank.” This is confirmed by the actual cases in which the Statements of Policy were put into effect.

The fundamental issue is the cost imposed for the assistance provided. Treasury's actions in the Third Amendment, as well as through the quarterly dividend, completely changed the relationship between Treasury and the Companies from one in which Treasury provided statutory assistance that the Companies would repay, which would be consistent with FDIC precedents, to one in which Treasury seizes all current and future net worth. This latter approach

---

<sup>68</sup> 57 FR 60203-01, FDIC, “Statement of Policy on Assistance to Operating Insured Depository Institutions (Dec. 18, 1992) (Criteria 5 and 6).

<sup>69</sup> See 57 FR 60203-01, FDIC, “Statement of Policy on Assistance to Operating Insured Depository Institutions (Dec. 18, 1992) (Criterion 10: "Preexisting shareholders and debtholders of the assisted insured institution shall make substantial concessions. In general, any remaining ownership interest of preexisting shareholders shall be subordinate to the FDIC's right to receive reimbursement for any assistance provided.").

is confiscatory and has no relationship to repayment of the assistance provided and completely disregards all past precedents from FDIC open bank assistance and conservatorships. While Treasury is entitled to be, and has been, repaid for the assistance provided, nothing in HERA or its antecedents supports the Third Amendment. Even the PSPA's quarterly cash dividend (given the current interest rate environment) far exceeded any structure used by the FDIC in its open bank assistance, conservatorship, or receivership authority.

In contrast, the FDIC resolutions – whether open bank assistance, conservatorships, or receiverships – limited the FDIC's potential repayment to the amount of the assistance or funding provided to the bank or thrift plus interest calibrated closely to the FDIC's cost of funds. Since the FDIC's cost of funds was the investment it made in Treasury bills, the interest on the funds provided repayment typically was limited to a modest increase of the rate on Treasury bills. FDIC open bank transactions and receiverships typically charged only a rate a little in excess of the FDIC's cost of funds, which was normally less than 100 basis points above the Treasury bill rate for comparable maturities.<sup>70</sup> The costs imposed by the FDIC on assisted insured banks and thrifts were designed to recoup the FDIC's costs of providing the assistance and allow the recovery of the institutions to fully capitalized and viable banking businesses. This shows that the Treasury ten percent quarterly cash dividend charged to the Companies was far above the normal rates charged by the FDIC for funding provided in open bank assistance, conservatorships, or receiverships. The Third Amendment simply dispenses with any pretense that Treasury is seeking repayment. Treasury's actions in the Companies' conservatorships are clearly designed to prevent rehabilitation of the Companies through the seizure of all net worth.

---

<sup>70</sup> See, e.g., *Managing the Crisis: The FDIC and RTC Experience* at Part II, Chapter 5, p. 572 (FDIC Notes used to provide assistance to First City subsidiary banks bore interest at U.S. Treasury Bill rate plus 50 bps); *Federal Bank Regulatory Agencies Approve Financial Assistance Program for Oklahoma Bank*", 1985-87 CCH ¶ 918-10 (dividend rate on FDIC preferred stock tied to Treasury rates).



During the 1980s, the FDIC used the strategies outlined in these statements of policies to resolve 133 insured institutions with total assets of \$82.45 billion from 1980 through 1994.<sup>71</sup> In the “open bank assistance” transactions used by the FDIC during the 1980s, the FDIC explicitly diluted shareholder interests through a negotiated transaction, assisted the institution and returned it to private control on average within a matter of months. Importantly, the shareholders and other stakeholders did not suffer further dilution in their interests during the term of the initial transaction.

Among the more noteworthy examples of open bank assistance were the interventions into Continental Illinois National Bank and Trust Company (“Continental Illinois”) in 1984 and First City Bancorporation in 1988.<sup>72</sup> These transactions consisted of providing the troubled bank and/or holding company with financial help in the form of loans, contributions, deposits, asset purchases, or assumption of liabilities and/or equity investments combined with some restructuring of the bank. Generally, the FDIC required new management, some dilution of shareholders’ interests, and new private sector capital. In such a transaction, the FDIC immediately would inject temporary financial resources into the insured depository institution and/or make financial assurances to depositors and certain stakeholders to stabilize the situation.<sup>73</sup>

---

<sup>71</sup> See *Managing the Crisis: The FDIC and RTC Experience* at Chapter 5.

<sup>72</sup> See *Managing the Crisis: The FDIC and RTC Experience* at 545-593.

<sup>73</sup> The financial assistance could come in the form of a subordinated note in the bank that is senior to all other subordinated debt. The bank would issue this debt to the FDIC and it would be payable on demand. By its terms, the note would be revocable to allow the FDIC to prepare for a permanent assistance package (phase two). This note would afford protection to all depositors and general creditors because it would define the extent of the obligation to the FDIC, but still would be senior to bank subordinated debt and shareholders. Even for these ‘subordinated’ creditors, the note provided a defined limit to their losses and left them with the potential to recoup the losses when the bank returned to normal operations. See “Banking Agencies Adopt Permanent Assistance Program for Continental Illinois National Bank, 1984-85 CCH ¶ 86,019.

In Continental Illinois, the FDIC and other banking regulators cooperated to resolve the then seventh largest bank in the U.S. The intervention involved two phases of assistance: an initial assistance package to stabilize the bank and a final assistance package to complete the restructuring and rehabilitation of the bank. While a thorough description of the assistance transactions is beyond the scope of this paper, there are several components important to the FHFA’s conduct of the Companies’ conservatorships under HERA. First, the final assistance package entailed a capital infusion by the FDIC in return for preferred stock. While this diluted the interest of Continental Illinois shareholders, it did not eliminate their interest nor did it allow the FDIC to seize all future value in the bank.<sup>74</sup> Second, the Continental Illinois shareholders ultimately received no value for their stock, but this was a result of the losses that the FDIC incurred on the assets acquired in the assistance transaction and pursuant to the original agreements involved in the FDIC’s acquisition of those assets. It was not through transactions designed to eliminate their interest. In effect, the shareholders received the value of their stock as of the time of the assistance package. Third, the bank was “preserved and conserved” and returned to a “sound and solvent” condition through the restructuring and capital investments and sold to private investors. By the time of that sale, Continental Illinois met all of the regulatory capital and liquidity requirements applied to open and operating banks.<sup>75</sup> Finally, while the Federal Reserve provided a line of credit for liquidity purposes, it received only repayment for liquidity used. The Federal Reserve did not receive payments beyond the liquidity provided.

---

<sup>74</sup> This is an important common feature of FDIC assistance transactions. While shareholders were diluted to approximate the losses they would have incurred if the bank had been closed and placed into receivership, the shareholders retained their economic interest in the bank and could benefit from future profitability – since the FDIC’s goal was to return the bank to viability. See, e.g., Federal Bank Regulatory Agencies Approve Financial Assistance Program for Oklahoma Bank”, 1985-87 CCH ¶ 91040.

<sup>75</sup> See Managing the Crisis: The FDIC and RTC Experience at 550-563; “Banking Agencies Adopt Permanent Assistance Program for Continental Illinois National Bank, 1984-85 CCH ¶ 86,019.

This history highlights an important difference in the shareholders' position under a receivership compared to a conservatorship. In a receivership, the shareholders retain no rights of voting control in the affairs of the insured institution. They retain solely their interest as equity stakeholders in the failed institution, although subordinated to all other stakeholders, including depositors, general stakeholders, and corporate debt holders. However, if the institution is placed into conservatorship without appointment of a receiver, the shareholders retain their beneficial interests in the institution. A significant difficulty for the FDIC in those open bank conservatorships from the 1980s was that it was essential to negotiate management changes and dilution of shareholder control with the shareholders. While the need to negotiate the assistance package and management changes created complications for the FDIC, this "difficulty" itself illustrates the major distinctions between the FDIC's operation of conservatorships and receiverships, and shows that conservatorships were never used by the FDIC to strip all value and rights from equity holders.

In reaction to the 1980s wave of thrift and bank failures, Congress amended the FDIA with the Financial Institutions Recovery, Reform and Enforcement Act of 1989 ("FIRREA") to clarify and strengthen the statutory powers available to the FDIC (and the newly created RTC). FIRREA, among other things, empowered the FDIC (along with the RTC) with broad authority to act as either conservator or receiver for many failing thrifts and banks. The provisions of FIRREA confirmed the historical distinctions between conservatorships and receiverships, while providing the FDIC with broad powers to implement resolution transactions subject to specific statutory duties to stakeholders.<sup>76</sup>

---

<sup>76</sup> See Neal J. Curtin et. al., The FDIC and Creditors' Rights in the Event of an Insured Bank Failure, 126 Banking L.J. 325, 326 (2009).

The framework for the FDIC acting as conservator or receiver (or using other interim devices such as bridge banks) is set forth in Section 11 of the FDIA, codified at 12 U.S.C. § 1821. Pursuant to Section 11(c) of the FDIA, the FDIC may be appointed either as conservator or receiver.<sup>77</sup> As conservator, the FDIC is charged to “take such action as may be (i) necessary to put the insured depository institution in a sound and solvent condition; and (ii) appropriate to carry on the business of the institution and preserve and conserve the assets and property of the institution.”<sup>78</sup> In contrast, as receiver the FDIC has the responsibility to “place the insured depository institution in liquidation and proceed to realize upon the assets of the institution.”<sup>79</sup>

Consistent with these statutory commands, as shown above, the FDIC has exercised its conservatorship authority as a temporary measure designed to preserve the assets and existing franchise value of the institution.<sup>80</sup> Although the goal of a conservatorship is to restore the bank to a sound and solvent condition so that it can be returned to private control, conservatorships sometimes end in receivership when that is not possible, or when only certain assets of the institution can be sold.<sup>81</sup>

---

<sup>77</sup> The Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) virtually eliminated the FDIC’s use of conservatorships. Although it was possible before Dodd-Frank to implement an open bank conservatorship through invocation of the systemic risk exception, Dodd-Frank amended the systemic risk provisions to require that such funds could only be used “for the purpose of winding up the [institution] for which the Corporation has been appointed receiver . . . .” See 12 U.S.C. § 1823(c)(4)(G)(i).

<sup>78</sup> 12 U.S.C. § 1821(d)(2)(D).

<sup>79</sup> Id. § 1821(d)(2)(E).

<sup>80</sup> See FDIC, Managing the Crisis: The FDIC and RTC Experience 116 (1998), available at <http://www.fdic.gov/bank/historical/managing/history1-04.pdf> (“A conservatorship is established . . . to take control of a failing financial institution to preserve assets and protect depositors.”); id. at 27 (conservatorship allowed FDIC to “operate and manage large, complex failing financial institutions. . . . The management goal of the newly organized institution was to preserve any existing franchise value of the failing institution, reduce the ultimate cost to the insurance funds, and lessen any disruption to the local community.”); id. at 117 (“The RTC was expected to manage the thrifts assigned to its conservatorship program for a period no longer than necessary . . . .”).

<sup>81</sup> Id. at 118 (“At the time the conservatorship was resolved, either through a sale or deposit payoff, the institution was . . . placed into a receivership . . . [in which] unsecured creditors and other claimants [were paid] on a pro rata basis according to the recoveries within [the] receivership.”).

In contrast to the goal of conservatorships, receiverships necessarily assume there will be no rehabilitation of the company. Generally, the FDIC will be appointed as receiver based on the bank’s failure to maintain adequate capital under the “prompt corrective action scheme,”<sup>82</sup> and/or on a finding that the insured depository institution is operating in an unsafe and unsound condition. The FDIC’s mandate as receiver is “to determine the bank’s assets and liabilities, liquidate the assets, resolve all claims and liabilities and distribute the proceeds of the asset liquidation to the failed bank’s stakeholders.”<sup>83</sup> The FDIA “set[s] out the exclusive process by which unsecured claims in the receivership are to be presented and determined.”<sup>84</sup> Under the U.S. depositor preference process for distributing the proceeds from the resolution of a failing institution, secured stakeholders recover from the pledged collateral to the extent of that collateral, but unsecured stakeholders recover in the following order: (1) administrative expenses of the receiver, (2) depositors, (3) other stakeholders, (4) subordinated debt holders, and (5) shareholders.<sup>85</sup> The FDIC, as receiver, must generally pay all valid obligations of the institution involved to the extent of the assets of the failed institution.

*b. International Benchmarks: The FSB’s “Key Attributes” and EU Directive*

The United States is not the only jurisdiction to recognize the important functions to be exercised by conservators and receivers in rehabilitating or winding up systemically significant financial institutions. In November 2008, in response to the deepening financial crisis G20 leaders called for a “review of resolution regimes and bankruptcy laws in light of recent experience to ensure that they permit an orderly wind-down of large complex cross-border

---

<sup>82</sup> See 12 U.S.C. § 1831o.

<sup>83</sup> Stanley V. Ragalevsky & Sarah J. Ricardi, Anatomy of A Bank Failure, 126 Banking L.J. 867, 885 (2009).

<sup>84</sup> Id. at 887.

<sup>85</sup> Id. at 888-89.

institutions.”<sup>86</sup> The result was the Financial Stability Board’s “Key Attributes of Effective Resolution Regimes for Financial Institutions,” which was endorsed by the G20 leaders in 2011. As a Treasury official observed in 2012, “[t]he Key Attributes provide guidelines for how jurisdictions should develop recovery and resolution plans for specific institutions and for assessing the resolvability of their institutions. This new international standard also sets forth the elements that countries should include in their resolution regimes while avoiding severe systemic consequences or taxpayer loss.”<sup>87</sup>

The Key Attributes make clear that “[r]esolution authorities should have at their disposal a broad range of resolution powers,” which include (among others) the distinct powers to “(ii) [a]ppoint an administrator to take control of and manage the affected firm with the objective of restoring the firm, or parts of its business, to ongoing and sustainable viability” and, separately, to “(xii) [e]ffect the closure and orderly wind-down (liquidation) of the whole or part of a failing firm with timely payout or transfer of insured deposits and prompt (for example, within seven days) access to transaction accounts and to segregated client funds.”<sup>88</sup>

The Key Attributes further provide that when an institution is wound up pursuant to the latter authority, the priorities of stakeholder claims should be respected, and stakeholders should have the right to compensation where they do not receive at a minimum what they would have received in a liquidation under applicable insolvency regimes (the “no creditor worse off

---

<sup>86</sup> See EU Bank Recovery and Resolution Directive (BRRD): Frequently Asked Questions, [http://europa.eu/rapid/press-release\\_MEMO-14-297\\_en.htm](http://europa.eu/rapid/press-release_MEMO-14-297_en.htm)

<sup>87</sup> Remarks by Assistant Secretary for Financial Institutions Cyrus Amir Mokri, April 18, 2012, <http://www.treasury.gov/press-center/press-releases/Pages/tg1540.aspx>

<sup>88</sup> Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions § 3.2 (emphasis added), available at [http://www.financialstabilityboard.org/wp-content/uploads/r\\_111104cc.pdf?page\\_moved=1](http://www.financialstabilityboard.org/wp-content/uploads/r_111104cc.pdf?page_moved=1)

than in liquidation” safeguard).<sup>89</sup> Notably, the Key Attributes make clear that where government injections of capital are “needed to accomplish orderly resolution,” any losses should be imposed on shareholders and unsecured creditors, but always subject to the “no creditor worse off than in liquidation” safeguard.<sup>90</sup>

In response to the FSB’s Key Attributes, and following the example provided by the long-standing FDIC model for resolution of banks, the European Union adopted the EU Bank Recovery and Resolution Directive (BRRD).<sup>91</sup> Like the FSB’s Key Attributes and the FDIA, the BRRD distinguishes between the goal and powers of a “temporary administrator” and the resolution authority when it is winding up the institution. The role of the temporary administrator is to “manag[e] the business or part of the business of the institution with a view to preserving or restoring the financial position of the institution and [to] tak[e] measures to restore the sound and prudent management of the business of the institution.”<sup>92</sup> The temporary administrator’s powers are temporary<sup>93</sup> and must remain “proportionate” to these goals,<sup>94</sup> and in the event that rehabilitation is not possible, the institution must be resolved in accordance with carefully designed “resolution tools” discussed below. These are key safeguards protecting the rights of creditors and shareholders during a temporary government intervention.

---

<sup>89</sup> See *id.* § 5.1, 5.2.

<sup>90</sup> See *id.* § 6.2.

<sup>91</sup> See EU Bank Recovery and Resolution Directive (BRRD): Frequently Asked Questions, [http://europa.eu/rapid/press-release\\_MEMO-14-297\\_en.htm](http://europa.eu/rapid/press-release_MEMO-14-297_en.htm) (“The BRRD is fully in line with the Financial Stability Board (FSB) recommendations.”).

<sup>92</sup> *Id.* art. 29 (Temporary administrator) ¶ 3 (emphasis added).

<sup>93</sup> See *id.* ¶ 7 (“The appointment of a temporary administrator shall not last more than one year. That period may be exceptionally renewed if the conditions for appointing the temporary administrator continue to be met. The competent authority shall be responsible for determining whether conditions are appropriate to maintain a temporary administrator and justifying any such decision to shareholders.”).

<sup>94</sup> See *id.* ¶ 2 (“The competent authority shall specify the powers of the temporary administrator at the time of the appointment of the temporary administrator based on what is proportionate in the circumstances.”).

A particular focus of the BRRD is the use of the “bail-in” tool, which can be applied either to recapitalize an open institution before it fails or to impose losses on creditors after it fails. When the bail-in tool is used to intervene while the institution remains open and operating, the clear goal is to recapitalize the institution to meet regulatory capital standards and to attract market funding by virtue of its restored balance sheet strength.<sup>95</sup> Intervening under these circumstances is only permitted if there is a reasonable prospect that it will restore the institution to financial soundness and long-term viability.<sup>96</sup> If the institution closes, the bail-in tool can also be used to ensure that stakeholders absorb losses in accordance with the statutory priority for claimants. In a closed institution, the bail-in tool may also be used to convert creditor claims into new equity so that the institution can be recapitalized and restarted as an open bank.

Most important for our current discussion is that creditors are protected whether the BRRD resolution tools are applied to an open bank or a closed bank. In either case, the resolution authority must respect normal creditor protections, including creditor hierarchies and the “no creditor worse off” principle. In addition, under the BRRD, member states must set up compensation schemes to compensate the affected creditors and shareholders if the exercise of resolution tools – whether to an open or closed bank – imposed losses greater than the stakeholders would have suffered if the bank had been liquidated.

As required by the Key Attributes, the BRRD provides safeguards to insure that shareholders and creditors are protected to the extent of the relative priority of their claims against the institution’s assets in a liquidation. To this end, Article 34 directs that “resolution authorities take all appropriate measures to ensure that the resolution action is taken in

---

<sup>95</sup> Id. art. 43(2)(a).

<sup>96</sup> Id. art. 43(3).



accordance with” certain principles, including that shareholder and creditors bear losses “in accordance with the order of priority of their claims under normal insolvency proceedings.”

The overarching principle is that “no creditor shall incur greater losses than would have been incurred if the institution . . . had been wound up under normal insolvency proceedings.”<sup>97</sup> The “no creditor worse off” principle ensures that a floor on losses protects creditors from incurring further losses by virtue of subsequent decisions in the resolution process. Where there is a risk that a shareholder or creditor may have incurred greater losses than it would have under “normal insolvency proceedings,” a valuation process is to be “carried out by an independent person as soon as possible after the resolution action or actions have been effected,”<sup>98</sup> and if the independent valuation determines that in fact the shareholder or creditor “incurred greater losses than it would have incurred in a winding up under normal insolvency proceedings, it is entitled to the payment of the difference from the resolution financing arrangements.”<sup>99</sup> If the ex post definitive valuation of the net asset value of the covered institution is higher than the provisional valuation, the institution’s equity holders and creditors will have the right to additional compensation.

As a result, it is clear that HERA, FDIA, and international standards for insolvency frameworks all embody consistent principles requiring the protection of stakeholder interests.

---

<sup>97</sup> *Id.* art. 34 ¶ 1. This issue is addressed in the U.S. FDIA and Orderly Liquidation Authority principally through a guarantee that creditors will receive no less than they would in a liquidation or Chapter 7 proceeding under the U.S. Bankruptcy Code, respectively. In addition, in a bridge bank resolution the creditors with claims left behind in the receivership are entitled to share in the net proceeds of the bridge bank sale in accordance with the statutory provisions governing the distribution of proceeds from the sales of assets of the failed institution. In the U.S. context, those issues are addressed by requiring that creditors receive no less than they would in liquidation under the FDIA or the Bankruptcy Code. *See* 12 U.S.C. §§ 1821(i), 5390(a)(7)(B). In addition, the receivership creditors are entitled to share in the net proceeds, if any, from the potentially greater value achieved through the bridge bank or company operations compared to a liquidation.

<sup>98</sup> *Id.* art. 74.

<sup>99</sup> *Id.* art. 75.

## **VI. The Distinction Between A Conservator And Receiver Reflects Sound Public Policy**

All of these regimes reflect a fundamental difference between the missions of a conservator, which seeks to reorganize, and a receiver, which seeks to liquidate, in dealing with a failing institution. As embodied in HERA – and in the FDIA – this distinction is not a mere label.<sup>100</sup> Although both HERA and the FDIA grant many of the same broadly defined powers to both a receiver and conservator, those powers must be applied consistently with the authority and direction given to the separate roles of conservator or receiver. Thus, for example, because “as conservator, the FDIC’s purpose is to preserve the value of the depository institution and continue its operations[.] . . . when acting in its capacity as conservator, the FDIC’s powers in dealing with creditors are more limited [than when it is acting as receiver].”<sup>101</sup> HERA and the FDIA are explicit about the difference in the roles. As receiver, the agency may “place the . . . [“regulated entity” or “insured depository institution”, respectively] in liquidation and proceed to realize upon the assets.” In contrast, as conservator the agency is directed to put the regulated entity or insured depository institution, respectively, “in a sound and solvent condition” and “preserve and conserve the assets and property.”<sup>102</sup>

The distinction matters because each provides unique protections for stakeholders. Under a conservatorship, a troubled institution is not closed, but remains open subject to the control of its conservator. The conservator’s duty is to operate, rehabilitate, reorganize, and

---

<sup>100</sup> See RTC v. CedarMinn Bldg. Ltd. P’ship, 956 F.2d 1446, 1454 (8th Cir. 1992) (“Had Congress intended RTC’s status as a conservator or a receiver to be mere artifice, it would have granted all duties, rights, and powers to the Corporation. . . . That Congress intended conservators and receivers to have different missions is clear.”). See also 1185 Ave. of Americas Associates v. Resolution Trust Corp., 22 F.3d 494 (2d Cir. 1994) (“Congress did not use the phrase ‘conservator or receiver’ loosely. Throughout FIRREA, Congress used ‘conservator or receiver’ where it granted rights to both conservators and receivers, and it used ‘conservator’ or ‘receiver’ individually where it granted rights to the RTC in only one capacity.”).

<sup>101</sup> Neal J. Curtin et. al., The FDIC and Creditors' Rights in the Event of an Insured Bank Failure, 126 Banking L.J. 325, 328 (2009).

<sup>102</sup> 12 U.S.C. §§1821(d)(2)(D) and (E); 12 U.S.C. §§4617(b)(2)(D) and (E).

restore the health of the troubled institution. When the company is rehabilitated, the conservatorship is terminated and the institution is returned to the private sector.<sup>103</sup> In a conservatorship, stakeholders are protected because the company is operating and stakeholders are being paid according to their contractual rights (as modified by any contract changes and resulting payment of damages by the conservator). As a result, all stakeholders including shareholders receive payment in the normal course of business and there is no need to resort to the priority of payment provisions of an insolvency law.

In drafting HERA, Committee staff did not contemplate or intend for conservatorship to be used to liquidate the Companies. Nor was it expected that conservatorship would last much longer than a few months. Either the companies would enter receivership or they'd leave conservatorship.<sup>104</sup> An endless "holding tank" is completely contrary to the expectations of the Committee. Conservatorship was intended as a "time out" in which the regulator would help get Fannie Mae or Freddie Mac back on its feet, after which the company would walk on its own. Such is one of the reasons why receivership spells out a chain of priorities while HERA's conservatorship sections do not.

Congress also rejected using HERA as a vehicle for eliminating the GSEs. One of the differences between FDIA and HERA, for instance, is that the FDIC can revoke a bank's charter under FDIA, while under HERA the Companies' charter remains in existence, its fate to be determined by Congress. This question of what to do with the overall GSE model is one that

---

<sup>103</sup> Panelists: Barry Adler, Richard Epstein, Arthur Gonzalez, Randall Guynn, & Moderator: Steven Menashi, Panel Three: Conservatorship and the Takings Clause, 10 N.Y.U. J. L. & Bus. 301, 302-03 (2014) ("The conservator's duty is to operate, rehabilitate, reorganize, and restore the health of the troubled institution. When that is achieved, the conservatorship is terminated, and the institution is returned to the private sector.").

<sup>104</sup> Mark Calabria, 2015. The Resolution of Systemically Important Institutions: Lessons From Fannie and Freddie, Cato Institute Working Paper No. 25. <http://www.cato.org/publications/working-paper/resolution-systematically-important-financial-institutions-lessons-fannie>

Congress reserved for itself. Congress gave neither FHFA nor Treasury any authority to decide the fate of the GSE model.

Under a receivership, a troubled institution is closed and liquidated. Its assets and liabilities may be transferred to a third party, or they may be temporarily transferred to a bridge bank until the bridge bank can be sold, recapitalized, and returned to the private sector, or liquidated.<sup>105</sup> But stakeholders are protected by the rules of priority of distributing proceeds of asset sales, the liquidation minimum (requiring that stakeholders receive no less than what they would receive in a liquidation), and the claims process.

Under this framework, a conservator must, by definition, allow the company under its control to build capital and certainly cannot take actions that are designed to deplete its capital. Having a capital buffer large enough to withstand downturns without government assistance is, after all, what it means to be in a “sound and solvent” position, which under HERA is the conservator’s goal for the Companies.<sup>106</sup> For example, other provisions of HERA impose on the Director of FHFA the duties to make sure the Companies, regardless of whether they are in conservatorship or receivership, “operate in a safe and sound manner,” which specifically includes the “maintenance of adequate capital and internal controls.”<sup>107</sup> Thus, before the

---

<sup>105</sup> See Del E. Webb McQueen Dev. Corp. v. RTC, 69 F.3d 355, 361 (9th Cir. 1995) (“The RTC is often required to act in different capacities as a conservator and as a receiver. The RTC, as conservator, operates an institution with the hope that it might someday be rehabilitated. The RTC, as receiver, liquidates an institution and distributes its proceeds to creditors according to the priority rules set out in the regulations. There is no hope of rehabilitation when an institution is placed in receivership.”); Richard Scott Carnell, Handling the Failure of A Government-Sponsored Enterprise, 80 Wash. L. Rev. 565, 602-03 (2005) (“A receiver winds up the bank’s business, liquidates the bank’s affairs, determines the validity of creditors’ claims against the bank, and pays creditors-- all in a streamlined and almost purely administrative process. A conservator, unlike a receiver, operates a bank as a going concern, seeking to rehabilitate the bank or prepare it for orderly sale in receivership, and has no authority to liquidate the bank.”).

<sup>106</sup> See 12 U.S.C. § 4617(b)(2)(D)

<sup>107</sup> 12 U.S.C. § 4513(a)(1).

conservatorships, the Companies were required to meet minimum capital requirements.<sup>108</sup> Since the recent financial crisis, much more attention has been given to the need for adequate capital reserves to ensure the safety and soundness of institutions,<sup>109</sup> which is defined as common equity, not government support.<sup>110</sup> Indeed, a plethora of “safety and soundness” regulations require various institutions to maintain an adequate capital buffer supplied by the company’s own retained earnings (rather than any government backstop).<sup>111</sup>

This resolution framework, which has served the FDIC and others well for decades, addresses the key issues that are recognized as crucial to all well-developed insolvency frameworks for systemically significant institutions.<sup>112</sup> First, there must be clear criteria for initiating insolvency proceedings to avoid prolonged operations of unsalvageable institutions to minimize a drag or diversion of economic capital. Clear, mandatory criteria permit prompt and decisive action before the company’s equity is exhausted. Next, sound insolvency laws provide clear protections to stakeholders through a defined “waterfall” of priorities for distributing the proceeds from asset sales of the failed firm and guarantee that stakeholders receive a minimum

---

<sup>108</sup> See <http://www.fhfa.gov/SupervisionRegulation/FannieMaeandFreddieMac/Documents/2Q2008RBC.pdf>

<sup>109</sup> See, e.g., Federal Reserve Governor Daniel Tarullo, George Washington University, November 12, 2010 (“[T]he crisis reinforces the point that robust capital requirements should continue to be a central component of the financial regulatory system. The U.S. banking agencies, and most of our counterparts from countries represented in the Basel Committee on Banking Supervision, made strengthening the capital regime a high priority in the latest financial reform agenda.”), <http://www.federalreserve.gov/newsevents/speech/tarullo20101112a.htm>.

<sup>110</sup> See, e.g., Sheila Bair, Chairman of FDIC, Senate Banking Committee Testimony, June 30, 2011 (“Importantly, the new [Basel] requirements must be met with common equity. The FDIC strongly supported this requirement since equity capital is the only instrument which proved to have loss-absorbing capacity during the crisis... think it will make the system more resilient by providing a greater cushion of capital to absorb losses.”), <http://www.gpo.gov/fdsys/pkg/CHRG-112shrg73309/html/CHRG-112shrg73309.htm>.

<sup>111</sup> See, e.g., Interagency Guidelines Establishing Standards for Safety and Soundness, 12 C.F.R. Chapter I, Part 30, Appendix A, ¶ II.H (“An insured depository institution should establish and maintain a system that is commensurate with the institution’s size and the nature and scope of its operations to evaluate and monitor earnings and ensure that earnings are sufficient to maintain adequate capital and reserves.” (emphasis added)).

<sup>112</sup> See FSB, [KEY ATTRIBUTES](#); BASEL COMM. ON BANKING SUPERVISION (BCBS), [REPORT AND RECOMMENDATIONS OF THE CROSS-BORDER BANK RESOLUTIONS GROUP](#) (2010); GLOBAL BANK INSOLVENCY INITIATIVE, LEGAL, INSTITUTIONAL, AND REGULATORY FRAMEWORK TO DEAL WITH INSOLVENT BANKS (2004); IMF LEGAL DEPT., ORDERLY & EFFECTIVE INSOLVENCY PROCEDURES (1999).

recovery at no less than what they would receive in a normal liquidation, while controlling for costs of administration that could undercut these protections. A third component is that the insolvency laws must empower the resolution authority to immediately control, manage, marshal and dispose of the company's assets and liabilities once it is appointed. Finally, insolvency laws must confer adequate legal powers on the resolution authorities that are sufficient to permit flexible and decisive action to maximize recoveries on assets and minimize delays in returning deposits to customers and limit disruptions from any failures. However, this flexibility must be subject to constraint imposed by statutory obligations that ensure fair and consistent treatment of stakeholders, with the goal of maximizing recoveries to stakeholders and avoiding preferential treatment of certain creditors and the like.

While government intervention in systemically important institutions may be justified by the public interest in certain situations, protecting stakeholders by respecting established priorities and providing for predictability and clarity are essential to make such a system effective. As the FSB states, “[a]n effective resolution regime . . . should . . . (iii) allocate losses to firm owners (shareholders) and unsecured and uninsured creditors in a manner that respects the hierarchy of claims; . . . (v) avoid unnecessary destruction of value, and therefore seek to minimize overall costs of resolution . . . and, where consistent with the other objectives, losses for creditors; (vi) provide for speed and transparency and as much predictability as possible through legal and procedural clarity and advanced planning for orderly resolution . . . .”<sup>113</sup> Similarly, the EU Directive is based on the principle that a resolution regime should “apportion losses in a manner that is fair and predictable.”<sup>114</sup>

---

<sup>113</sup> Preamble, FSB Key Attributes, available at [http://www.financialstabilityboard.org/wp-content/uploads/r\\_111104cc.pdf?page\\_moved=1](http://www.financialstabilityboard.org/wp-content/uploads/r_111104cc.pdf?page_moved=1) (emphasis added).

<sup>114</sup> BRRD ¶ 5 (emphasis added).

Failure to abide by these principles will undermine market confidence, and “uncertainty about the priority of and process for resolving creditors’ claims against Fannie or Freddie could curtail the firm’s access to credit and reduce the market value and liquidity of those claims.”<sup>115</sup>

Not only is respect for stakeholder rights sound policy, it is compelled by our Constitution. Thus, under HERA and the FDIA, although both the conservator and receiver have the authority to repudiate pre-appointment contracts,<sup>116</sup> the conservator no less than the receiver is liable for “actual direct compensatory damages” for such repudiation.<sup>117</sup> Conservators are bound to comply with contractual rights, just as receivers are.<sup>118</sup> Were these statutes drafted otherwise, allowing “the federal government . . . simply [to] vitiate the terms of existing assets, [and] tak[e] rights of value from private owners with no compensation in return, [they] would raise serious constitutional issues.”<sup>119</sup>

## **VII. Treasury’s Actions in the Conservatorships Do Not Comply With HERA**

As detailed in the preceding sections of this paper, HERA is designed to virtually replicate the effective resolution process that has been used for more than three thousand banks

---

<sup>115</sup> Richard Scott Carnell, Handling the Failure of A Government-Sponsored Enterprise, 80 Wash. L. Rev. 565, 620 (2005).

<sup>116</sup> See 12 U.S.C. § 4617(d)(1).

<sup>117</sup> Id. § 4617(d)(3).

<sup>118</sup> See id. § 4617(b)(2)(H) (“The Agency, as conservator or receiver, shall, to the extent of proceeds realized from the performance of contracts or sale of the assets of a regulated entity, pay all valid obligations of the regulated entity that are due and payable at the time of the appointment of the Agency as conservator or receiver, in accordance with the prescriptions and limitations of this section.”).

<sup>119</sup> See Waterview Mgmt. Co. v. FDIC, 105 F.3d 696, 699 (D.C. Cir. 1997). See also BRRD ¶ 13 (“The use of resolution tools and powers provided for in this Directive may disrupt the rights of shareholders and creditors. . . . Accordingly, resolution action should be taken only where necessary in the public interest and any interference with rights of shareholders and creditors which results from resolution action should be compatible with the Charter of Fundamental Rights of the European Union (the Charter). In particular, where creditors within the same class are treated differently in the context of resolution action, such distinctions should be justified in the public interest and proportionate to the risks being addressed . . . .” (emphasis added)).

and thrifts since 1980 by the FDIC. This process incorporates principles underlying the U.S. Bankruptcy Code and the new Orderly Liquidation Authority as well as the international standards set by the FSB and being implemented around the globe in response to the financial crisis. Fundamental to these principles is protection of the legitimate interests of stakeholders through fair and consistent treatment both in conservatorships and receiverships.

The FDIC has applied these principles for decades both in providing assistance to open banks and thrifts to return them to a “sound and solvent” condition and in acting as receiver for failed banks and thrifts. The resolution framework that Congress intended when it enacted HERA in 2008 very clearly requires FHFA, when acting as conservator, to “preserve and conserve” the assets of the Companies and rehabilitate them to a “sound and solvent” condition in compliance with all regulatory capital and other prudential standards to permit their safe return to private control. Had that not been possible because the Companies became insolvent or unable to pay their debts as they came due, FHFA would have been required under the statute to place them into receivership, sell off their assets, and pay stakeholders from the proceeds, with the government receiving only its administrative expenses, and certainly not all of the Company’s value beyond what it had invested. While it may be understandable that Treasury decided to take a different approach due to the absence of a final, political decision on the future of the Companies, the actions Treasury and FHFA have taken do not comply with HERA.

There is no place in this statutory framework to allow a permanent conservatorship in which the Companies are generating billions of dollars in profits, but their assets are continually being stripped down to zero when the Treasury has been repaid billions of dollars more than its funding to the Companies. These actions violate HERA and the long-



standing precedents on which it is based because they avoid the stakeholder protections built into open bank assistance, conservatorships and receiverships.

In open bank assistance and conservatorships, the stakeholders' interests are protected by their contractual rights since the institution is continuing to function as an open and operating company. The provider of the assistance, formerly the FDIC for banks and Treasury for the Companies, receives repayment plus interest like any creditor based on the assistance agreement. All past open bank assistance and conservatorships, and all principles underlying HERA and related insolvency statutes, limited that repayment to the actual funding provided because the statutory goal explicitly is to restore the company to a "sound and solvent" condition. That cannot be accomplished with a confiscatory seizure of current and future value. In receiverships, stakeholders are protected by the duty of the receiver to maximize their recoveries and ensure they receive no less than the amount they would have received in a liquidation. Treasury's actions through the Third Amendment and its subsequent sweeps of all net worth cannot be justified under HERA, the FDIC's past practice under its virtually identical statutory authority, or the underlying principles of insolvency law.

In the litigation over the Net Worth Sweep, FHFA and Treasury have argued that the Net Worth Sweep is consistent with HERA's conservatorship provisions obligating the conservator to bring the Companies to a "sound and solvent condition" because the Companies have (minimal) positive net worth, defined as either the capital cushion that declines to zero in a few years and/or Treasury's funding commitment.<sup>120</sup> That is wrong. As shown above, the "preserve and conserve" mandate does not mean that a conservator only has to do the bare

---

<sup>120</sup> See, e.g., Treasury Defs.' Reply In Support of Their Dispositive Mots. and Opp. to Pls.' Summ. J. Mots. at 49 n.21, Perry Capital LLC v. Lew, Case No. 13-cv-01025 (May 2, 2014), ECF No. 41 ("The point of the Third Amendment is that the funding capacity from Treasury will be available to cover all of the GSEs' net losses . . . . The Third Amendment thus protects the GSEs from the mandatory receivership that would follow upon the GSEs' experiencing a net worth deficit (i.e., insolvency) after their funding capacity is exhausted.").

minimum to keep the Companies afloat. The conservator’s duty is to rehabilitate the Companies to a “sound and solvent condition” by restoring their compliance with regulatory capital and other prudential requirements since the whole goal is to return the Companies to normal, operating businesses. Contrary to this fundamental requirement for conservators, the effect of the Net Worth Sweep is that the Companies will never be able to build capital, as both Treasury and FHFA have stated publicly. This necessarily means that the Companies are being prevented from returning to a “sound and solvent condition” by Treasury and the FHFA. On its face, this violates HERA. If there were any doubt, it also violates the past FDIC practice in hundreds of open bank assistance transactions and conservatorships.

Second, the government has argued that FHFA’s “preserve and conserve” duty is satisfied because the Companies remain operating, even if solely for the benefit of Treasury.<sup>121</sup> But that also cannot be right, as FHFA is required to preserve and conserve assets, which will either allow the Companies to return to normal operations under private control or will result in assets being available to satisfy stakeholders in a receivership.<sup>122</sup> Sweeping the Companies’ entire net worth to Treasury is certain to accomplish neither, even if the Companies continue to operate. Again, FHFA’s actions are not consistent with its duties as conservator under HERA.

---

<sup>121</sup> See, e.g., Defs. FHFA, Watt, Fannie Mae, and Freddie Mac’s Combined Reply in Support of their Mot. to Dismiss [ ] at 13-14, Perry Capital LLC v. Lew, Case No. 13-cv-01025 (May 2, 2014), ECF No. 43 (“[T]he Conservator has not liquidated the Enterprises, as Plaintiffs must concede. . . . The Enterprises remain in operation today. Indeed, Plaintiffs’ entire lawsuit is predicated on the increased revenues the Enterprises recently have earned while under FHFA conservatorships. Thus, whether ‘winding up’ really means ‘liquidation’ is irrelevant because the Conservator has not exercised or attempted to exercise any power to liquidate the Enterprises.”).

<sup>122</sup> See Richard Scott Carnell, Handling the Failure of A Government-Sponsored Enterprise, 80 Wash. L. Rev. 565, 616 (2005) (“pursuing a de facto liquidation would tend to impede using the firm’s going-concern value for the benefit of creditors.”); Panelists: Barry Adler, Richard Epstein, Arthur Gonzalez, Randall Guynn, & Moderator: Steven Menashi, Panel Three: Conservatorship and the Takings Clause, 10 N.Y.U. J. L. & Bus. 301, 307 (2014) (“While Section 1145 does not appear to have any express requirement that FHFA carry out its duties as conservator in a manner that maximizes the value of Fannie and Freddie for the benefit of its creditors and shareholders, there are some provisions that imply such a duty, and those similar provisions exist in the FDIA and the FDIC, at least, has interpreted those to mean that it has a duty to maximize the value of the failed banks or failed non-bank financial companies for the benefit of their stakeholders, including the Deposit Insurance Fund, subject, of course, to whatever discretion they have to help stabilize the system, that is kind of a countervailing power.”).

In short, HERA requires that FHFA as conservator return the Companies to “a sound and solvent condition” and act to carry on the business to “preserve and conserve the assets and property” of the Companies. Unfortunately, through the Third Amendment, Treasury and FHFA have expressly rejected complying with these requirements, as confirmed in testimony by Director Watt of FHFA.<sup>123</sup> That these continuing actions violate HERA’s explicit requirements is demonstrated by the long-standing practices of the FDIC under the virtually identical provisions of the FDIA and of the principles underlying other U.S. and international insolvency frameworks.

This is important to the stakeholders in Fannie Mae and Freddie Mac, of course. However, it is perhaps more important to the future of public policy and the government role in future insolvency proceedings. If Treasury and FHFA can conduct the conservatorships of the Companies to strip out any value and prevent the restoration of regulatory and market capital despite their obligations under HERA, this manipulation of the process will dramatically affect public confidence in the fairness and predictability of government’s participation in insolvency proceedings. These 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. It is essential that HERA be enforced and that Treasury and FHFA comply with their duties. 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. Without public confidence in this process, a critical foundation of our market economy will be lost.

---

<sup>123</sup> Statement of Melvin L. Watt, Director of FHFA, before the House Committee on Financial Services at 3 (Jan. 27, 2015), available at [www.financialservices.house.gov/uploadedfiles/hhrg-114-ba00-wstate-mwatt-20150127.pdf](http://www.financialservices.house.gov/uploadedfiles/hhrg-114-ba00-wstate-mwatt-20150127.pdf).