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Crony Capitalism and Its Effects on GSE’s within the US Housing Industry

Carley Herrick

Economist and Nobel Prize winner Paul Samuelson stated, “Investing should be more like watching paint dry or watching grass grow. If you want excitement, take $800 and go to Las Vegas.” In the past, corporate America has strived to follow Samuelson’s advice by growing companies through long-term business strategies and continuous development of company products and services. However, in recent years through the use of crony capitalism many businesses have found a “Vegas shortcut” to wealth and success by utilizing government power to stack the deck in their favor.

By definition, crony capitalism, also known as corporate welfare, occurs when government officials obtain a powerful influence over the corporate sector by using regulation and intervention to impact business success. While corporate welfare incorporates a variety of activities, this article will focus solely on crony capitalism presented in the form of government-sponsored entities (GSEs), specifically concentrating on the effects of corporate welfare within the GSEs of the mortgage industry and housing market, namely The Federal National Mortgage Association (Fannie Mae) and The Federal Home Loan Mortgage Corporation (Freddie Mac).

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The purpose of these GSEs is to create a secondary market for mortgages to increase the flow of credit within the mortgage industry and reduce risk for investors. As part of their GSE status, Fannie Mae and Freddie Mac benefit from various government-granted rights such as tax exception and exclusive lines of credit from the Federal Reserve, giving them a significant competitive advantage in the market. These privileges have allowed Fannie and Freddie to capture a monopolistic share of the housing market in violation of Sherman Act, an antitrust law that seeks to promote fairness and competition within the business sector by preventing monopolies. Crony capitalism is not only responsible for the creation of the Fannie and Freddie’s monopoly but also its preservation, as it has facilitated Fannie and Freddie in circumventing antitrust laws and regulations. Failure to properly apply these laws has resulted in negligent and risky behavior within these GSEs, and is at least, in part, responsible for the 2009 crash of the mortgage industry and housing market.

This article will make a legal argument in favor of privatizing Fannie and Freddie in order to prevent crony capitalism in the form of GSEs from initiating any future market failures within the housing industry. Section I will explore the historical background behind the creation of Fannie and Freddie, and their involvement in the 2009 housing bubble and subsequent market failure of the housing industry. Section II will discuss relevant antitrust laws and case precedent, specifically Section 2 of the Sherman Act and the 2009 United States v. Microsoft Corp antitrust case. In Section III and IV, these laws and case study will be utilized to explore the legality of Fannie and Freddie’s market monopoly and support a movement toward privatization. Finally, in Section V potential counterarguments to this legal analysis will be addressed.

I. BACKGROUND

(i) Fannie Mae and Freddie Mac

Fannie Mae and Freddie Mac are government-sponsored enterprises that establish a secondary market for mortgages in an effort to increase the flow of credit within sectors of the economy and reduce risk for investors. Fannie and Freddie were originally created in an effort to bring affordable housing financing options to Americans through expanding the secondary mortgage market by pooling together mortgaged backed securities. These securities were then sold to investors, allowing for an increased supply of money for new home purchases, resulting in lower mortgage rates.

Fannie and Freddie are unique from other GSEs because they are both privately and publicly owned. Both are traded on the New York Stock Exchange and run by a board of directors partially appointed by the government and partially elected by stockholders. The unique combination of being a private and government-sponsored enterprise has allowed Fannie and Freddie to obtain a strong competitive advantage in the market and created an environment easily susceptible to crony capitalism. Prior to the 2008 financial crisis, both companies benefited from lower federal interest rates, were legally allowed to disregard industry regulations, and were exempt from all Securities and Exchange Commission (SEC) oversight. These exclusive government-granted privileges resulted in Fannie and Freddie gaining a reputation of being too-big-to-fail with the public, inflating investor confidence, and allowing both companies

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7 Peter J. Wallison, The Dead Shall be Raised: The Future of Fannie and Freddie, AMERICAN ENTERPRISE INSTITUTE (Feb. 12, 2010).
8 SECURITIES AND EXCHANGE COMMISSION, PRUDENTIAL CORE BOND FUND (2014).
to gain a market share of over 75 percent within the secondary mortgage market.9

The government further contributed to the conditions of crony capitalism within Fannie and Freddie by using their influence over the GSEs to pressure both organizations to lower loan standards and guarantee housing loans to increasingly risky investors, including those with bad credit ratings, or incomes that could not support mortgage payments.10 These government mandates and executive policies, combined with the resulting false market confidence, created the conditions that led to the fallout of 2008, putting both the housing market and the U.S. economy in jeopardy.

(ii) U.S. Housing Crisis

In 2006, U.S. housing prices reached an all-time high during a phenomenon that was later referred to as the U.S. housing bubble. The housing bubble was created due to a dramatic increase in housing prices, caused by a surge in demand during a time of limited supply.11 As prices continued to increase, the number of speculators investing in the housing market spiked, due to the belief that they could make large profits through short-term buying and selling. However, shortly after the housing industry’s peak in 2006, supply began to overtake market demand and by December 2008, the US


home price index reported the largest price drop in history, declining 18.2% in just under a year. The bubble had burst.

What began as an opportunity for investors to get rich quick soon turned into a global economic crisis as the US slipped into one of largest recessions since the Great Depression. Mortgage delinquencies and foreclosures soared; housing securities were reduced to almost nothing; and investments and spending plummeted. The government reacted to the crisis by proposing a bailout of the U.S. housing market and allocated over $900 billion in federal funds to rescue the housing industry, $400 billion of which went to government sponsored enterprises Fannie Mae and Freddie Mac.

II. PRINCIPLE LAWS AND CASE PRECEDENCE

(i) Sherman Antitrust Act

In 1890, Congress created the first statute establishing antitrust laws, the Sherman Act. This federal anti-monopoly statute consists of seven sections that have aided in reducing the occurrence of crony capitalism within the business sector by setting guidelines for restrictions on interstate commerce and competition in the marketplace. Section 2 of the Sherman Act is specifically relevant to the issue of constraining corporate welfare in the form of government-induced monopolies within GSEs. Section 2 states that:


Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a felony.\textsuperscript{16}

In the Supreme Court Case \textit{United States v. Grinnell Corp}, the court provided a more detailed interpretation of Section 2 of the Sherman Act by specifying the requirements for monopolization as:

The possession of monopoly power in the relevant market [and] the willful acquisition or maintenance of that power as distinguished from growth or development as a consequence of a superior product, business acumen, or historic accident.\textsuperscript{17}

In order to meet the court’s first requirement for monopolization, the company must possess substantial market power through the ability to raise prices above the competitive market price or exclude new entry of competitors. This power must be prevalent over a long period of time within the market without experiencing a significant loss in profitability. In addition to these laws, the Court of Appeals in the Third Circuit 2005 decision in the \textit{United States v. Dentsply Int’l, Inc.} case established the case precedent that “a share significantly larger than 55% has been required to establish prima facie market power”\textsuperscript{18} and stated that a market share between 75% and 80% is “more than adequate to establish a prima facie case of power.”\textsuperscript{19}

After possession of monopoly power has been established, anticompetitive conduct must then be found. To be deemed anticompetitive, corporations must take exclusionary or predatory action to acquire and maintain a monopoly. This anticompetitive conduct may incorporate a wide variety of activities such as dumping, price discrimination, and exclusive dealing. The court uses the Rule of

\textsuperscript{16} \textit{Id.}
\textsuperscript{17} \textit{United States v. Grinnell Corp}, 73 U.S. 563 (1966).
\textsuperscript{18} \textit{United States v. Dentsply Int’l, Inc.}, 399 F.3d 181, 187 (3d Cir. 2005)
\textsuperscript{19} \textit{Id.} at 188.
Reason to determine the illegality of these actions on a case-by-case basis. Under this rule, the court considers all benefits and detriments of the actions, which includes whether the conduct has unnecessarily restricted and impaired the competition, or if any valid justifications for the conduct exist. If the court determines that detriments of the conduct outweigh the benefits, the action is labeled as anticompetitive and judged an illegal restraint of trade.

(ii) United States v. Microsoft Corp

In the 2009 *US v. Microsoft Corp* case, Microsoft was found in violation of Section 2 of the Sherman Act by employing anticompetitive means to maintain its monopoly in the personal computer market.\(^{20}\) Microsoft was found to be in possession of monopoly power in the market, due to the company’s 95% share of the operating system market. The court found that Microsoft had the power to create barriers to entry into the market because software developers preferred to write Microsoft compatible programs due to consumer preferences.

Upon evaluation of the second criteria, the willful acquisition or maintenance of monopolistic power, the court found that Microsoft had worked to maintain its monopoly in the market using anticompetitive and exclusionary means through its agreements with Internet access providers, which allowed Microsoft to put its icon on the Windows desktop in exchange for exclusive promotion of Microsoft’s browser. In addition, Microsoft also threatened their supplier Intel, stating that they would work with another computer chip company unless Intel abandoned its project with Sun Microsystems, which was creating a program to compete with Microsoft’s products. Using the Rule of Reason, the court determined that the detrimental effects of these practices on the market outweighed the benefits and ruled them as anticompetitive and in violation of the Sherman Act.

III. Legal Analysis

The unanimous decision from the United States Court of Appeals in the Microsoft Antitrust case supports the claim that Fannie and Freddie are in violation of the antitrust laws, as these GSEs have committed monopolistic acts comparable to those of Microsoft. The Microsoft case will be used as an analytical framework along side the Sherman Act to demonstrate how Fannie and Freddie have violated the law.

First, in order to show proof of monopolization, Fannie and Freddie must meet all legal requirements specified by the Sherman Act in Section 2. Like Microsoft, Fannie and Freddie meet the first condition, of possessing substantial market power, by holding 75% of the market share within the secondary mortgage industry, well above the 55% minimum set by the courts.21 Fannie and Freddie meet the second criteria, willful acquisition or maintenance of monopoly power through anticompetitive and exclusionary actions, through the crony capitalistic activities of these GSEs. The creation of Fannie and Freddie made homeownership possible for millions of Americans, causing a huge boom in the housing market. The mortgagees, investors, banks, and industry workers that benefited from this market explosion quickly gained power and wealth. This group then used this influence and money to buy political leverage. In the ten-year period before the 2008 market crash, Fannie, Freddie, and their allies spent over $176 million in lobbying efforts and campaign contributions to buy political favors from key congress committee members in order to block legislation calling for removal of their special privileges.22

These practices led the Federal Elections Commission (FEC) to investigate many of the GSEs’ political contributions. In 2006, Freddie Mac was forced to pay out $3.8 million in fines, the largest in FEC

21 See supra note 10, 309.
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Unfortunately, this did little to impede the flow of money or favor-mongering coming from the GSEs. Those who attempted to expose the cronyism occurring within the GSEs were met with strong resistance and political retribution. For example, when Congressman Jim Leach proposed to decrease GSE federal subsidies, the bill was killed within twelve hours of its creation.24 Congressman Paul Ryan, who attempted to increase GSE regulation, received over 6,000 complaints from angry local mortgage holders, who had been contacted individually by lobbyists claiming that Ryan was trying to increase their mortgage rates.25

Similarly, when Congressman Christopher Shays proposed to end the GSEs’ exemption from SEC oversight, the GSEs responded by canceling all home-buying forums in his congressional district.26 Additional proof of willful maintenance of monopolistic power can be found in the 2001 report from the Wall Street Journal, stating that the CEOs of Fannie and Freddie had threatened executives of Wells Fargo Bank, American International Group and GE Capital Services that they would stop doing business with their companies if they continued to support lobbyist groups attempting to limit the GSEs’ power.27 These actions provide sufficient proof that Fannie and Freddie have engaged in anticompetitive and exclusionary actions in order to maintain a monopoly within the industry, and thus meet the second and final criteria set by the Sherman Act for monopolization.

26 See supra note 24.
IV. RECOMMENDED LEGAL SOLUTION

The legal analysis presented in Section III demonstrates that Fannie and Freddie meet the two criteria for illegal monopolization and are in violation of the Sherman Act. However, unlike the Microsoft Corporation where the Court found that the company possessed monopoly power due to external forces (consumer preferences) Fannie and Freddie created and maintained their monopoly power through internal means of crony capitalism. These internal methods included lower federal interest rates, exclusion from state and federal tax, and prior to 2008 exemption from SEC regulations.²⁸

In order to inhibit corporate welfare and reestablish free market competition within the industry, the courts must apply the Sherman Act and Microsoft decision to Fannie and Freddie and order the discontinuance of the government interventions that have prevented potential competitors from entering the market and allowed Fannie and Freddie to gain an illegal monopoly. It is recommended that the federal government breakup this monopoly by taking steps toward fully privatizing Fannie and Freddie by liquidating their stake in the company and retracting all special rights and privileges granted to these GSEs. This would include stripping Fannie and Freddie of their GSE title by restructuring the companies as two completely private organizations, terminating all exemptions from state and federal taxes and other fees, and discontinuing them from obtaining exclusive lines of credit and interest rates from the U.S. Treasury. These actions will reduce Fannie and Freddie’s competitive advantage in the marketplace by diminishing their monopolistic power and disabling barriers to entry.

V. COUNTERARGUMENTS

(i) Fannie and Freddie are Market Competitors

It could be argued that Fannie and Freddie do not hold possession of monopoly power within the mortgage industry, because the two GSEs are competitors and do not individually control a majority share of the market. Although the case of Fannie and Freddie differs from Microsoft in that Fannie and Freddie are legally separate entities, the two cannot be considered competitors. A study conducted by the Department of Housing and Urban Development revealed that Fannie and Freddie regularly engage in tacitly colluding behavior. Evidence of this tactical collusion can be found through analysis of the GSEs financial data, which signifies that Fannie and Freddie have been able to maintain unprecedented profits over the past few years through a silent agreement between the two companies to set guarantee fees for securitizing mortgages well above competitive levels.\(^{29}\) Although tactical collusion is not unlawful, it does provide the legal proof needed in an antitrust case to show that Fannie and Freddie are not acting as competitors and would allow Fannie and Freddie to be treated as though they were one company responsible for creating a single monopoly in the market.

(ii) Fannie and Freddie’s actions are Procompetitive

In order to comply with the second criteria of the Sherman Act, the Court must find anticompetitive actions to outweigh any possible procompetitive arguments that the actions of the company in question stimulate healthy competition within the industry.\(^{30}\) As in the case of Microsoft, the GSEs would have the opportunity to show that their actions were procompetitive. It is likely that Fannie and Freddie would argue that their monopoly and anticompetitive

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30 CORNELL LEGAL INFO. INST., SHERMAN ANTITRUST ACT, SECTION 2
actions within the housing market allow them to bring affordable mortgage options to Americans who would otherwise be unable to purchase a home. However, it is estimated that Fannie and Freddie currently only reduce mortgage interest rates by about a quarter of a percentage point.\textsuperscript{31}

Furthermore, a recent analysis completed by Genworth Financial shows that the primary barrier for most home buyers in today’s market is the required deposit (typically 20%), not the interest rate.\textsuperscript{32} Although it is true that Fannie and Freddie were needed in the past to encourage home ownership in America, the mortgage market has matured significantly since the GSEs conception, and is no longer in need of their support. As a report from the Congressional Budget Office published in 1996 states:

Dramatic innovations that have occurred in the mortgage market since the GSEs were created, the case for Fannie Mae and Freddie Mac’s GSE status is weaker today than 30 years ago and policymakers should weigh the desirability of continuing to provide the current subsidy.\textsuperscript{33}

Market maturity is further sustained by the fact that both Fannie and Freddie have moved away from their original purpose of simply buying, packaging, and then selling mortgages. Over the past decade, the two companies have made significant profits, with Fannie Mae reporting a net income of $84 billion\textsuperscript{34} and Freddie Mac a net income

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\begin{itemize}
  \item Dan Green, \textit{Mortgage Rates Still Dropping}, THE MORTGAGE REPORTS, Feb. 4, 2015.
  \item Steve Wilcox, \textit{Financial Barriers to Home Ownership}, GENWORTH FINANCIAL INC. (2010).
  \item Vern McKinley, \textit{The Mounting Case For Privatizing Fannie Mae And Freddie Mac}, CATO POLICY ANALYSIS, Dec. 29, 1997.
\end{itemize}
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of $48.7 billion in 2011\textsuperscript{35}, by retaining vast amounts of high-yield mortgages, a practice clearly outside the GSEs’ original purpose of lowering market interest rates. Due to these facts, it is clear that the negative effects of Fannie and Freddie’s anticompetitive actions outweigh any current procompetitive benefits derived from their market monopoly.

VI. CONCLUSION

This article has analyzed the effects of crony capitalism within government-sponsored enterprises by examining Fannie Mae and Freddie Mac. Through the examination of Section 2 of the Sherman Act and the \textit{U.S vs. Microsoft Corp} case, it is clear that crony capitalism has allowed Fannie and Freddie to receive special government-granted advantages that have permitted them to create and maintain an illegal market monopoly. Due to the innovations and progression in the housing market over the past decades, continuing to give Fannie and Freddie government support will provide negligible benefits to the American public. In order to correct this illegal market monopoly, it is recommended that the US government liquidate all their stock within these GSEs and allow them to become fully privatized. In addition, all special privileges and exemptions previously granted to these GSEs should be discontinued. These legal ramifications will not only reestablish free market competition and help prevent corporate welfare from initiating another market failure within the housing industry, but will also prompt further transformation within other sectors and organizations of the economy suffering from the negative effects of crony capitalism.
