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LAUDABLE GOALS AND UNINTENDED CONSEQUENCES: THE ROLE AND CONTROL OF FANNIE MAE AND FREDDIE MAC

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INTRODUCTION

The United States is struggling to emerge from an era of loose mortgage underwriting standards—lapses in credit analysis that led to origination and securitization of toxic loans.[1] The fallout has been crippling, costing borrowers their homes,[2] investors their money,[3] and the government its taxes.[4]

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1. In 2006 alone, nearly 3 million subprime loans were originated and funded with an aggregate of over $1 trillion. *State of the U.S. Economy and Implications for the Federal Budget: Hearing Before the H. Comm. on the Budget*, 110th Cong. 10 (2007); *see also* Yulia Demyanyk & Otto Van Hemert, *Understanding the Subprime Mortgage Crisis* 32 (Dec. 5, 2008), http://ssrn.com/abstract=1020396.

2. From July 2007 to August 2009, 1.8 million homes were lost to foreclosure and 502 million more residential foreclosures were begun. *See* CONGRESSIONAL OVERSIGHT PANEL, MAY OVERSIGHT REPORT, REVIVING LENDING TO SMALL BUSINESSES AND FAMILIES AND THE IMPACT OF THE TALF 1-3 (2009). Nationally, between 10% and 13% of mortgage borrowers have defaulted and face foreclosure, according to the Lender Processing Services figures, as reported at PR Newswire, *LPS September 'First Look' Mortgage Report: August Month-End Data Shows More Delinquent Loans Entering Foreclosure Process*, REUTERS (Sept. 15, 2010, 6:47 PM), http://www.reuters.com/article/idUS224331+15-Sep-2010+PRN20100915. Another article reporting these figures calculates that this rate indicates more than 7.2 million mortgage loans are behind on their payments. Carrie Bay, *Residential Mortgage Delinquency Rate Surpasses 10%: LPS*, DSNEWS.COM (Feb. 4, 2010), http://www.dsnews.com/articles/mortgage-delinquency-rate-surpasses-10-lps-2010-02-04. The foreclosure rate is ten times pre-crisis levels, and the aggregate number of foreclosure sales in one month (around 100,000 nationwide) is now similar to the number of pre-crisis foreclosure sales for an entire year. Alex Viega, *Foreclosure Rate: Americans on Pace for 1 Million Foreclosures in 2010*, HUFFINGTON POST (Aug. 15, 2010, 5:07 PM), http://www.huffingtonpost.com/2010/07/15/foreclosure-rate-American_n_647130.html.

3. MAUREEN F. MAITLAND & DAVID BLITZER, S&P/CASE-SHILLER HOME PRICE INDICES 2009, A YEAR IN REVIEW 3 (2010), *available at* http://www.anderson-real-estate.com/PDFs/spcs/SPCaseShillerYearinReview_Jan2010.pdf (real estate prices tumbled after 2005, reaching a record low in real estate price decline at -19% through the first quarter of 2009).

> The Dow Jones industrial average tumbled 7 percent, or 777.68 points, eclipsing the record point drop after the Sept. 11, 2001, terrorist attacks, to close at 10,365.45. The technology-heavy Nasdaq composite index slid 9.14 percent, or 199.61, to 1983.73, and the broader Standard & Poor's 500-stock index lost 8.79 percent, or 106.62, to close at 1106.39.

Heather Landy & Renae Merle, *A Record Fall on Wall Street: Stocks Dive as Bailout Bill Fails to Pass*, THE WASH. POST (Sept. 30, 2008), http://www.washingtonpost.com/wp-dyn/content/article/2008/09/29/AR2008092900271.html?sid=ST2008092903526; *see also* ROBERT J. SHILLER, THE SUBPRIME SOLUTION: HOW TODAY'S GLOBAL FINANCIAL CRISIS HAPPENED, AND WHAT TO DO ABOUT IT, 29-38, 87-113 (2008) (attributing the financial crisis to un-tempered increases in home prices); Ruth Mantell, *Home Prices Off Record 18% in Past Year, Case-Schiller Says*, MARKETWATCH (Dec. 30, 2008, 11:49 AM), http://www.marketwatch.com/story/home-prices-off-record-18-in-past-year-case-shiller-says.

4. The Economic Stimulus Act of 2008, Pub. L. No. 110-185, provided for various types of economic stimuli, including tax rebates, intended to boost the U.S. economy, with a total taxpayer cost of an estimated $152 billion. *See* CONGRESSIONAL

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), passed last summer, was the first comprehensive effort to address the problems in the system that led—in sequence—to the subprime crisis, the housing crisis, and the financial crisis.[5] This Act, which contains over 2,300 pages of legislation, is very broad as well as very detailed—even though hundreds of rulemakings have yet to completely define its parameters.[6] But this extensive legislation deliberately did not deal with the biggest elephant (or perhaps elephants) in the room: Fannie Mae and Freddie Mac. These government sponsored enterprises (GSEs), behemoths of the secondary mortgage market, are currently in conservatorship and have (so far) cost taxpayers over $130 billion.[7] Yet, our current residential mortgage market is utterly

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BUDGET OFFICE, COST ESTIMATE: H.R. 5140 ECONOMIC STIMULUS ACT OF 2008 3–5 (2008). The Emergency Economic Stabilization Act of 2008 which created the Troubled Asset Relief Program (TARP) permitted government purchase of "toxic" assets from financial institutions. When passed in 2008, TARP was anticipated to cost taxpayers $356 billion, but more recent estimates put its cost at $89 billion. *US Bailout Cost Seen Lower at $89 billion*, REUTERS (Apr. 11, 2010), http://http://www.reuters.com/article/2010/04/12/us-financial-bailout-idUSTRE63B05N20100412. The American Recovery and Reinvestment Act of 2009 ("Stimulus Act"), Pub. L. No. 111-5, mandated government appropriations to be used in job creation, investment promotion and stimulation of consumer spending, reflecting the Keynesian concept that a government should spend to pull a country out of recession. *See* John Maynard Keynes, *The Maintenance of Prosperity is Extremely Difficult*, *in* NEW DEAL THOUGHT 403, 403-06 (Howard Zinn ed., 1966) (explaining that economic recovery could not continue without relying on government investment). *See generally* JOHN MAYNARD KEYNES, THE GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY (1935).

5. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter Dodd-Frank Act] (to be codified at 12 U.S.C. § 5518). The 2,300-page text of the Dodd-Frank Act is available at http://banking.senate.gov/public/ and http://thomas.loc.gov/cgi-bin/bdquery/z?d111:H.R.4173. The law has been called the most sweeping financial reform legislation since the Great Depression. *See, e.g.*, Damian Paletta and Aaron Lucchetti, *Law Remakes U.S. Financial Landscape: Senate Passes Overhaul That Will Touch Most Americans; Bankers Gird for Fight Over Fine Print*, THE WALL ST. J. (July 16, 2010), http://online.wsj.com/article/SB10001424052748704682604575369030061839958.html.

6. Dodd-Frank Act, 124 Stat. 1376 (to be codified at 12 U.S.C. § 5518); *see also* DAVIS, POLK & WARDWELL LLP, SUMMARY OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT, ENACTED INTO LAW ON JULY 21, 2010 i (2010), *available at* http://www.davispolk.com/files/Publication/7084f9fe-6580-413b-b870-b7c025ed2ecf/Presentation/PublicationAttachment/1d4495c7-0be0-4e9a-ba77-f786fb90464a/070910_Financial_Reform_Summary.pdf.

7. Bloomberg BusinessWeek speculated that, "[t]he cost of fixing Fannie Mae and Freddie Mac, the mortgage companies that last year bought or guaranteed three-quarters of all U.S. home loans, will be at least $160 billion and could grow to as much as $1 trillion after the biggest bailout in American history. Fannie and Freddie, now 80 percent owned by U.S. taxpayers, already have drawn $145 billion from an unlimited line of government credit granted to ensure that home buyers can get loans while the private housing-finance industry is moribund. That surpasses the

dependent upon them for credit and liquidity.[8] With political pressures to stop taxpayer bailouts[9] and the reality of a frozen mortgage market should Fannie Mae and Freddie Mac cease to exist,[10] when it comes to the GSEs, the administration may be damned if it does and damned if it doesn't.

For decades, the U.S. mortgage finance system was the envy of the world—the only industrialized nation to have a significant segment of housing costs covered by private capital through a securitization investment system.[11] The United States is the only country to

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amount spent on rescues of American International Group Inc., General Motors Co. or Citigroup Inc., which have begun repaying their debts." Lorraine Woellert & John Gittelsohn, *Fannie-Freddie Fix at $160 Billion with $1 Trillion Worst Case*, BLOOMBERG BUSINESSWEEK (June 14, 2010, 3:00 AM) http://www.businessweek.com/ news/2010-06-14/fannie-freddie-fix-at-160-billion-with-1-trillion-worst-case.html. Other figures put the bailout cost at $135 thus far and costing a total of $156 billion. Binyamin Applebaum, *Fannie and Freddie May Need Infusion*, THE N.Y. TIMES, Oct. 21, 2010; Zachary Goldfarb, *Fannie Mae, Freddie Mac Bailout Cost is Likely to Rise to $154 Billion, Agency Projects*, THE WASH. POST, Oct. 22, 2010.

8. *See infra* notes 164-165and accompanying text.

9. *See, e.g.*, Dwight Jaffee, *Private Markets Offer More Choices*, THE N.Y. TIMES (March 8, 2011, 11:17 AM), http://nytimes.com/roomfordebate/2011/03/07/should-fannie-and-freddie-be-dissolved-private-mortgage-market-offers-more-choices (opining that winding down Fannie Mae and Freddie Mac "will provide significant benefits for housing and markets while saving taxpayers the costs of future bailouts").

10. *See, e.g., Congress Warned to Tread Cautiously with Repair of Housing Office*, NATION'S BUILDING NEWS ONLINE (April 4, 2011) [hereinafter NAHB April Statement], http://www.nbnnews.com/NBN/issues/2011-04-04/Front+Page/3.html (arguing that "it is critical that any reforms be well-conceived, orderly and phased in over time" and pointing out that a "piecemeal approach to reform" would "disrupt the housing market and could push the nation back into a deep recession"). The NAHB pleads with Congress to avoid making "damaging, ill-advised changes to the housing finance system at such a critical time." *Id.* Other associations have likewise urged a continuing and predictable government role in housing finance and, at the very least, a reasonable transition period to a less-taxpayer-supported system. Jann Swanson, *Non-Agency Lending: How to Attract Private Funding to a Riskier Market*, MND NEWSWIRE (Feb. 16, 2011, 2:31 PM), http://www.mortgagenewsdaily.com/02162011_housing_finance_reform.asp. These include the American Bankers Association, American Financial Services Association, CRE Finance Council, Housing Policy Council of the Financial Services Roundtable, the Mortgage Bankers Association, the National Multi Housing Council and the Real Estate Roundtable. *Id.* David Stevens, who recently stepped down as Assistant Secretary of the Federal Housing Administration, agrees that too-rapid government withdrawal from the housing market will have a severe adverse market effect. *Id.* Timothy Geithner echoes this statement. Zachary Goldfarb & Dina ElBoghdady, *Geither Warns of Mortgage System Risks*, THE WASH. POST, Mar. 2, 2011, at A11.

11. Touting the rising homeownership rate and the role of Fannie and Freddie, Leland Brendsel told Congress that "America enjoys the world's best housing-finance system . . . . In fact, our nation's mortgage-finance system works so well that most Americans take for granted a reliable supply of low-cost mortgage credit in communities across the nation every day." *H.R. 3703—The Housing Finance Regulatory Improvement Act—Part I: Hearings Before the Subcomm. on Capital Markets, Securities and Government Sponsored Enterprises of the H. Comm on Banking and Financial Services*, 106th Cong. 267 (2000) (statement of Leland C. Brendsel, Chairman and C.E.O., Freddie Mac). The unique characteristics of the U.S. real estate finance market attracted

routinely offer homebuyers thirty-year fixed-rate prepayable mortgage loans.[12] Better capital accessibility has made homeownership opportunities available to more Americans.[13] The GSEs have performed a vital role in financing the production of rental housing as well.[14] Our real estate capital markets set the gold standard worldwide for what is possible in freeing trapped asset values and increasing the wealth of borrowers and investors alike.

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foreign investment. *Id.* In addition, "many foreign markets copied the United States model by creating similar debt instruments based on their housing markets." Randolph C. Thompson, *Mortgage Backed Securities, Wall Street, and the Making of a Global Financial Crisis*, 5 AM. U. BUS. L. BRIEF 51, 52-53 (Fall 2008); *see also* Pelma Jacinth Rajapakse, *Issuance of Residential Mortgage Backed Securities in Australia—Legal and Regulatory Aspects*, 29 U.N.S.W.L.J. 173, 173–76 (2006) (describing similar securities in Australia). Recent studies of different mortgage finance systems have suggested that perhaps the United States would not suffer by conforming to European or Canadian housing finance models. Canada, for example, typically has five to ten-year terms loans that either have adjustable interest rates or are fixed rate loans that impose a prepayment penalty. Denmark's mortgage financing system in particular has earned recent attention as a potential model for the United States in the absence of a GSE-supported secondary market and mortgage backed securities. Anthony Sanders & Michael Lea, *Do We Need the 30-Year Fixed Rate Mortgage?* (Mercatus Ctr., Working Paper No. 11-15, March 2011); Michael Lea, *International Comparison of Mortgage Product Offerings*, RESEARCH INST. FOR HOUS. AM. (Sept. 2010), http://www.housingamerica.org/RIHA/RIHA/Publications/74023_10122_Research_RIHA_Lea_Report.pdf; Arnold Kling, *20 Percent Down, for Starters*, THE N.Y. TIMES (March 8, 2011, 4:04 PM), http://www.nytimes.com/roomfordebate/2011/03/07/should-fannie-and-freddie-be-disssolved/what-to-do-right-now-about-housing; s*ee also* Jaffe, *supra* note 9; Christopher Mayer, *Mortgage Examples from Abroad*, THE N.Y. TIMES (March 8, 2011), http://www.nytimes.com/roomfordebate/2011/03/07/should-fannie-and-freddie-be-disssolved/mortgage-examples-from-abroad (discussing Denmark's mortgage finance system).

12. Sanders & Lea, *supra* note 11; Binyamin Applebaum, *Without Loan Giants, 30-Year Mortgage May Fade Away*, THE N.Y. TIMES (Mar. 3, 2011), http://www.nytimes.com/2011/03/04/business/04housing.html; Donna Borak, *Are 30-Year Fixed's Days Numbered?* AM. BANKER, March 29, 2011, *available at* http://www.highbeam.com/doc/1G1-252576360.html. *But see* Lea, *supra* note 11; Mayer, *supra* note 11 (pointing out that Denmark offers thirty-year fixed rate mortgage loans even though originators in Denmark retain the credit risks of such loans). *The Economist* points out, however, that "[i]n truth, however, there is no magic system. The Danish mortgage banks are clearly too big to fail, so the problem of an implicit government guarantee for banks remains. The same is true for Canada." *A Special Report on Property: Bricks and Slaughter*, THE ECONOMIST (Mar. 3, 2011) [hereinafter Economist Special Report], http://www.economist.com/node/L8250385.

13. U.S. CENSUS BUREAU, HISTORICAL CENSUS OF HOUSING TABLES: HOMEOWNERSHIP, HOUSING AND HOUSEHOLD ECONOMICS STATISTICS DIVISION (2004), *available at* http://www.census.gov/hhes/www/housing/census/historic/owner.html; *see also* ROBIN MALLOY & JAMES SMITH, REAL ESTATE TRANSACTIONS: PROBLEMS, CASES AND MATERIALS 314–15 (3d ed. 2007) (showing increase in homeownership rates among black, Asian & Pacific Islander and Hispanic populations increasing at greater than average rates from 1994-2004).

14. *See infra* notes 74-84 and accompanying text.

Over the past decade, this system undoubtedly became unhinged—and it is now critical to reform its failings. But a complete wind-down of the GSEs, which are the linchpin of our housing finance system, goes too far. Subtracting Fannie Mae and Freddie Mac from the finance equation may very well be market suicide, and the repercussions for borrowers, communities, and investors would be dire indeed. Furthermore, this extreme step is unnecessary: the system's failures can be adequately (and better) addressed within the GSE framework.

Undoubtedly there is still ample dirty "bathwater" to throw out as we reform the mortgage finance market system. But it would be an excruciating mistake to bow to political pressures and throw out the "baby" too.[15] Current and future mortgage borrowers will only be adequately "protected" if they are empowered through access to capital, appropriately constrained by valid underwriting criteria. A well functioning market—rather than political scapegoating—is the best way to emerge from the recession and protect future buyers and investors alike.

This article first discusses the history and purposes of the GSEs and what went wrong with the system that led to the 2008 conservatorship and bailout. With reference to the Obama Administration's February 2011 Report to Congress, "Reforming America's Housing Finance Market,"[16] Part II analyzes proposals to reform and wind down the GSEs in light of their likely legal and market impact. Part III offers some general suggestions on better approaches to crafting America's future mortgage market and advocates for solutions more precisely tailored to remedy apparent systemic problems while achieving the identified policy goals.

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15. A week after the author used this metaphor at the Law Review Symposium on March 3, 2011, the March 2011 edition of SoutheastREBusiness.com coincidentally quoted Willy Walker, head of Walker & Dunlop, using the same metaphor to describe the same problem. Coleman Wood, *The Future of Fannie/Freddie?*, SE. REAL ESTATE BUS., Mar. 2011, *available at* http://www.southeastrebusiness.com/articles/MAR11/cover2.html ("Before they go and dismantle these things [Fannie Mae and Freddie Mac], they really need to make sure they're not throwing the baby out with the bathwater, because what I read in that white paper is that they're contemplating doing just that.")

16. U.S. DEP'T OF TREASURY & U.S. DEP'T OF HOUS. & URBAN DEV., REFORMING AMERICA'S HOUSING FINANCE MARKET: A REPORT TO CONGRESS (2011) [hereinafter Treasury/HUD Report], *available at* http://www.treasury.gov/initiatives/Documents/Reforming%20America's%20Housing%20Finance%20Market.pdf.

I. WHY THEY EXIST AND WHAT WENT WRONG

A. The History and Purposes of the GSEs

America's current residential mortgage market was born in the ashes of the Great Depression through the National Housing Act of 1934.[17] As part of an effort to promote residential mortgage lending and homeownership, the Act established the Federal Housing Administration (FHA) and the Federal National Mortgage Association (Fannie Mae).[18] By 1970, Fannie Mae, together with its "sister" entity, the Federal Home Loan Mortgage Corporation (Freddie Mac), became privately funded, government sponsored enterprises, or GSEs, chartered by Congress and regulated by federal agencies, but owned by private shareholders.[19] Fannie Mae and Freddie Mac were charged with the mandate of promoting quality housing options by: (a) purchasing qualifying residential loans from mortgage originators to increase home finance market liquidity, and (b) providing capital support to multifamily housing projects. In fulfilling their mandate, these GSEs created a secondary mortgage market: a market for buyers of funded mortgages. The existence of a robust secondary market for mortgages markedly changed the nature of the U.S. residential mortgage system and increased market liquidity and capital available for home financing.

Mortgage originators set up and fund loans to homeowners in what is called the primary mortgage market.[20] The secondary market for mortgages encourages the flow of mortgage capital directly by

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17. National Housing Act of 1934, Pub. L. No. 73–479, 48 Stat. 1246 (1934) (codified at 12 U.S.C. § 1716 et seq.).

18. *Id.* § 1.

19. Emergency Home Finance Act of 1970, Pub. L. No. 91–351, §§ 303(a), 303(e), 304(a), 84 Stat. 450, 452–54 (1970). For details on the structure and purposes of Fannie Mae and Freddie Mac, *see* Richard Green, *Robert Van Order on Fannie and Freddie*, RICHARD'S REAL ESTATE AND URBAN ECONOMICS BLOG (July 31, 2008, 10:59 AM), http://real-estate-and-urban.blogspot.com/2008/07/robert-van-order-on-fannie-and-freddie.html. Previously, in 1968, Fannie Mae had been split into a "private" corporation (Fannie Mae) and a publicly-financed institution with explicit government guaranty of repayment of securities (Government National Mortgage Association or Ginnie Mae). GINNIEMAE.COM, http://www.ginniemae.gov/media/ginnieFAQ.asp?Section=Media (last visited May 14, 2011). Ginnie Mae bought and securitized mortgages which were made to government employees or veterans (such mortgages also being guaranteed by the government). In addition to Fannie Mae and Freddie Mac, there are twelve Federal Home Loan Banks (the FHLBs, sometimes called the "mini-GSEs"). These banks perform similar functions as Fannie Mae and Freddie Mac (providing funds to originating lending institutions). While not explicitly discussed in this article, many of the principles applicable to Fannie Mae and Freddie Mac also apply to the FHLBs.

20. Robert Van Order, *The U.S. Mortgage Market: A Model of Dueling Charters*, 11 J. HOUS. RESEARCH 233, 233 (2000).

replenishing the lending funds of mortgage originators almost immediately rather than over thirty years of repayments.[21] A secondary market for mortgages also indirectly encourages increased real estate capital by (a) matching up the cost of lending capital to loan returns and (b) spreading risks borne by a mortgage lender.[22] Prior to the creation of the GSEs, most home lenders obtained capital to lend from deposits in savings accounts.[23] The availability of such funds is highly market sensitive, as investors will allocate their investment capital according to competitive market options.[24] While attracting funds requires a flexible interest rate structure, most mortgages in the United States are thirty-year fixed rate prepayable mortgages. Selling funded mortgages, however, permits a lender to immediately recoup its capital, and solves the "time horizon imbalance" created by pairing a fixed rate mortgage with a market-sensitive savings rate structure.[25] Not only does this structure move more capital into mortgages, it encourages fixed rate loans to be made by taking the interest rate risk away from the originating banks.

In addition, the community-bank-based lending model in the United States suffered from geographic limitations. Capital availability was dependent on wealth and savings in a particular community, creating great regional disparity with respect to the availability of mortgage capital.[26] The vast size of the United States and the extreme diversity of its communities and populations proved

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21. Richard Green, *Robert Van Order on Fannie and Freddie*, RICHARD'S REAL ESTATE AND URBAN ECONOMICS BLOG (July 31, 2008, 10:59 AM), http://real-estate-and-urban.blogspot.com/2008/07/robert-van-order-on-fannie-and-freddie.html; *see also* Van Order, *supra* note 20, at 233-239 (2000); FRANK J. FABOZZI & FRANCO MODIGLIANI, MORTGAGE AND MORTGAGE-BACKED SECURITIES MARKETS 19–20 (1992) (discussing the congressional intent for establishing Fannie Mae and Freddie Mac).

22. *About Fannie Mae*, FANNIEMAE.COM, http://www.fanniemae.com/kb/index?page=home&c=aboutus (last visited Apr. 12, 2011).

23. Before the Savings & Loan crisis in 1980, local thrifts (saving/lending institutions) dominated residential home finance in the United States. During the decades prior to 1980, deposits by local residents into savings accounts formed the source of primary mortgage capital. Because of the narrow geographic focus of these home lenders, funding decisions were made in the context of the applicable locality. For a concise description of how the primary mortgage market dominated home lending prior to the 1970s and securitization, *see* Thompson *supra* note 11, at 51-52.

24. *See* MALLOY & SMITH *supra* note 13, at 380.

25. *Id.* at 380-82.

26. *The 2009 Economic Landscape, The Sand States: Anatomy of a Perfect Housing-Market Storm*, *in* FDIC QUARTERLY BANKING PROFILE: FOURTH QUARTER 2008, THE ECONOMIC LANDSCAPE: HOW THE RECESSION IS UNFOLDING ACROSS FOUR U.S. REGIONS, 30–31 (2009), *available at* http://www.fdic.gov/bank/analytical/quarterly/2009_vol3_1/AnatomyPerfectHousing.html.

a stumbling block to equal access of housing finance capital.[27] Fannie Mae and Freddie Mac transformed mortgage lending from a local to a national industry, allowing wealth from one area of the country to be efficiently allocated to housing support in another region.[28] This helped improve capital access for poorer regions as well as poorer neighborhoods, which is one reason that homeownership increased most rapidly over the past few decades in minority population groups. In addition, having a diverse geographic spread of mortgages within an investment pool helped spread the risk of default, since real estate prices, employment rates and other factors most relevant to likelihood of default are usually quite localized.[29]

The secondary mortgage market creates a structure whereby all lender risks can be spread. Mortgage lenders of long-term, fixed-rate, prepayable loans face several types of risk. First, there is the risk inherent in all lending transactions that the borrower will default. The credit risk in mortgage loans—like all secured loans—is mitigated by the existence of valuable collateral. The borrower's credit is backed up by the lien on real property securing the payment obligation of the loan. The fixed interest rate structure of a mortgage creates another risk—the risk that interest rates will increase and the borrower will stay locked in to a below-market loan. In the late 1970s when interest rates rose precipitously because of inflation sparked by the Arab oil embargo coupled with the birth of

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27. *See id.* (explaining the combination of factors that led to housing imbalances).

28. *See* Van Order, *supra* note 20, at 237 (elaborating on Fannie Mae and Freddie Mac's influence on the secondary market).

29. This is apparent in the localized nature of even the current international financial crisis. Shayna M. Olesiuk & Kathy R. Kalser, *The 2009 Economic Landscape, The Sand States: Anatomy of a Perfect Housing-Market Storm*, 3 FDIC QUARTERLY 30, 31–32 (2009), *available at* http://www.fdic.gov/bank/analytical/quarterly/2009_vol3_1/vol3_1_sand_states.pdf; *see also* Anthony Sanders, *The Subprime Crisis and Its Role in the Financial Crisis*, 17 J. HOUS. ECON. 254, 258 (2008) ("California, Arizona and Nevada provide an excellent laboratory to examine the issue of housing price declines and increasing mortgage defaults. These states had the largest increase in housing prices during the 2000-2005 period. In addition, given the rapid deterioration in housing affordability, these states experienced a fundamental change away from the traditional full asset and income documentation, fixed-rate mortgage to low-documentation adjustable-rate mortgages."); Dina ElBoghdady, *Foreclosure Activity Rises in Most Metropolitan Areas*, THE WASH. POST (July 30, 2010), http://www.washingtonpost.com/wp-dyn/content/article/2010/07/29/AR2010072906271.html ("The 20 regions with the worst foreclosure rates were in the four states—Florida, California, Nevada and Arizona."). Properties concentrated in a mere thirty-five counties accounted for half of the country's foreclosure actions and eight counties in Arizona, California, Florida and Nevada were the source of a quarter of the nation's foreclosures in 2008). Brad Heath, *Most Foreclosures Pack into Few Counties*, USA TODAY (Mar. 6, 2009, 7:13 PM), http://www.usatoday.com/money/economy/housing/2009-03-05-foreclosure_N.htm.

new investment vehicles such as mutual funds, banks were imperiled because they underestimated this very risk.[30] While a renewed focus on "due on sale" clauses in mortgage loan agreements offered a limited way for lenders to mitigate this risk—by allowing lenders to "reset" the interest rate when a home was sold[31]—there was no vehicle in a standard thirty-year fixed rate loan to "call" prepayment or to increase the interest rate.[32]

The ability of a mortgage borrower to prepay the mortgage loan creates a problem for lenders should the interest rate decrease rather than increase. A non-prepayable fixed-rate loan merely allocates interest rate risk and interest rate upside to the lender. If the interest rate increases, the lender loses money, but if the interest rate decreases, the lender gains the benefit of an above-market return. Not so with prepayable loans. Falling interest rates motivate a borrower to refinance and repay the loan, resetting at the lower rate, which not only spells the lender's loss of the valuable upside of interest rate fluctuations, but risks a lower total return on investment should the loan be repaid prior to its maturity. The difference in total return on investment for a lender can be significant: a borrower paying off a thirty-year mortgage after fifteen years can reduce its total interest payment to the lender by about a third.[33] Both the interest rate risk and prepayment risk inherent in the thirty-year fixed rate prepayable loan structure can be, and typically is, allocated to a secondary mortgage purchaser.[34] All these categories of risk—credit risk, interest rate risk and prepayment risk—are greater for longer-term loans, and the standard mortgage loan term in the United States is thirty years. A lender can avoid this temporal risk factor by a secondary market mortgage sale as well.[35]

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30. *See* Thompson *supra* note 11, at 51-52.

31. The Garn–St. Germain Depository Institutions Act of 1982, Pub. L. No. 97–320, § 413, 96 Stat. 1469, 1451–52 (1982) (clarifying that due-on-sale clauses in residential mortgages are enforceable). Lenders did not widely employ these sorts of clauses prior to the late 1970s. *Id.*

32. This is one reason for the failure of traditional savings and loan institutions. *See* Thompson, *supra* note 11, at 51-52 (outlining the events leading up to the financial crisis).

33. *See* MALLOY & SMITH, *supra* note 13, at 393 (using a $200,000 loan at a 7% fixed interest rate as an example and calculating that a borrower will pay $279,018 in interest over thirty years in addition to the loan principal, but only $123,579 in interest over a fifteen-year term).

34. *See generally* ANDREW DAVIDSON, ET AL., SECURITIZATION: STRUCTURING AND INVESTMENT ANALYSIS (2003). The lender pays the secondary market purchaser for taking on this risk by selling mortgages at a discount from the face value of the loan. MALLOY & SMITH, *supra* note 13, at 382. The cost of selling the mortgage at a discount on the secondary market is typically passed on to the borrower through collection of an upfront fee. *Id.* at 382-83.

35. MALLOY & SMITH, *supra* note 13, at 380.

Fannie Mae and Freddie Mac were the first—and still by far the biggest—purchasers of mortgages on the secondary market. The GSEs purchase mortgages from originating lenders, taking on most credit risks as well as interest rate, prepayment, and related temporal risks. This risk shifting, along with direct replenishing of lending capital, vastly increased the number of loans that mortgage originators were both willing and able to make.[36] Increased capital availability for home financing decreased the cost of homeownership and increased mortgage access.[37] The FHA worked with Fannie Mae and Freddie Mac to provide insurance for lower income homebuyers, filling in gaps in capital availability that the market left open.[38] The GSEs greased the wheels of finance to help middle-income Americans buy homes,[39] and the FHA offered government insurance on loans to lower-income Americans so that homeownership was an option for them as well.[40]

Together, Fannie Mae, Freddie Mac and the FHA (along with certain other specialized government programs) played an enormous role in promoting home ownership and in subsidizing the cost of capital for would-be mortgage borrowers. In response to these developments in the residential mortgage market, homeownership in this country increased from less than 40% to more than 60% in a few short years.[41] Not only did homeownership increase, but access to mortgage capital through federally sponsored entities began to make homeownership a realizable dream for previously underserved minority populations across the country.[42]

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36. *Id.* at 380. *See generally* DAVIDSON ET AL., *supra* note 34.

37. Thompson, *supra* note 11, at 55.

38. Dan Immergluck, *From Minor to Major Player: The Geography of FHA Lending During the U.S. Mortgage Crisis*, 33 JOURNAL OF URBAN AFFAIRS, 1 (2011).

39. From the beginning, GSE-purchased loans had a size limit, intended to focus the entities' repurchasing capital toward middle-income homebuyers.

40. *See The Federal Housing Administration (FHA)*, U.S. DEP'T OF HOUS. & URBAN DEV., http://portal.hud.gov:80/hudportal/HUD?src=/program_offices/housing/fhahistory; *see also* Albert Monroe, *How the Federal Housing Administration Affects Homeownership*, HARV. U. DEP'T OF ECONS. (2001), http://www.jchs.harvard.edu/publications/governmentprograms/monroe_w02-4.pdf.

41. In 1940, 40% of Americans owned their home; by 2000, homeownership hit a record level of 66%, rising to over 69% by 2005. U.S. CENSUS BUREAU, HISTORICAL CENSUS OF HOUSING TABLES: HOMEOWNERSHIP, HOUSING AND HOUSEHOLD ECONOMICS STATISTICS DIVISION (2004), *available at* http://www.census.gov/hhes/www/housing/census/historic/owner.html. and http://www.census.gov/hhes/www/housing/hvs/qtr308/q308tab5.html A significant portion of homeownership increase is also due to the GI bill and veterans administration loans, offered to soldiers returning from World War II and, later, Korea and Vietnam.

42. Homeownership has often been called "The American Dream" by politicians and lawmakers alike. *See* Treasury/HUD Report, *supra* note 16 at 1;

To fulfill their mission of increasing homeownership opportunity by growing market liquidity, Fannie Mae and Freddie Mac purchased, and continue to purchase, qualifying residential loans from mortgage originators.[43] The GSEs will only purchase mortgages that meet certain standards; theoretically, loans purchased by the GSEs could not be too big or too risky.[44] The specific requirements for GSE purchase have fluctuated over time.

For example, qualifying loans can represent no more than a set percentage of asset value (defined as the purchase price).[45] Historically, the loan-to-value ratio for conforming mortgages was set at 20% (although 10% ratios were permitted with the enhanced

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William J. Clinton, Remarks on The National Homeownership Strategy (June 5, 1995) ("Expanding homeownership will strengthen our nation's families and communities, strengthen our economy, and expand this country's great middle class. Rekindling the dream of homeownership for America's working families can prepare our nation to embrace the rich possibilities of the twenty-first century."). There is a wealth of scholarly literature expositing the many positive social externalities that a high homeownership rate creates, from better maintained communities and higher participation to promoting savings in the form of equity. *See, e.g.*, JB McCombs, *Refining the Itemized Deduction for Home Property Tax Payments*, 44 VAND. L. REV. 317, 325-26 (1991); *Sustainable Homeownership*, CTR. FOR AM. PROGRESS (Feb. 26, 2010), http://www.americanprogress.org/issues/2010/02/02/sustainable_homeownership_event.html; *see also infra* notes 59 and 68. *See generally* RICHARD PIPES, PROPERTY AND FREEDOM, xiii (1999) (pointing out that the repressive regimes of Communist Russia and Nazi Germany were only possible because private property had been undermined. "While property in some form is possible without liberty, the contrary is inconceivable.").

43. *See* FABOZZI & MODIGLIANI, *supra* note 21. For discussion of how loan qualification standards are created by the Office of Federal Housing Enterprise Oversight (OFHEO) and the history of qualifying loan purchases by Fannie Mae and Freddie Mac, *see* JOHN WIEDEMER, REAL ESTATE FINANCE 44, 78-86 (8th ed. 2001). Historical dollar limits of conventional loans can be found on Fannie Mae's website, *see Fannie Mae Historical Conventional Loan Limits*, FANNIE MAE (2011), http://www.fanniemae.com/aboutfm/pdf/historicallimits.pdf. For a discussion of recent developments (and lack of complete systemic reform), *see Fannie Mae and Freddie Mac: Unfinished Business*, THE ECONOMIST (July 22, 2010), http://www.economist.com/node/16640249.

44. *See Loan Limits: 2011 Single-Family Mortgage Loan Limits*, FANNIE MAE, http://www.fanniemae.com/aboutfm/loanlimits.jhtml (last visited Apr. 9, 2011) (outlining the conforming loan limitations on first mortgages); *see also* Gail Cohen, *How to Qualify for a Fannie Mae Loan*, EHOW.COM, http://www.ehow.com/how_5107817_qualify-fannie-mae-loan.html.

45. *Loan Limits: 2011 Single-Family Mortgage Loan Limits*, FANNIE MAE, http://www.fanniemae.com/aboutfm/loanlimits.jhtml (last visited Apr. 9, 2011). In 2010, the loan-to-value ratio of qualifying mortgages for GSE purchase was 97%; *see also News Release: Fannie Mae Implementing New Loan-to-Value Ceiling for Home Affordable Refinance Program; Loans Eligible for Delivery September 1*, FANNIE MAE (July 1, 2009), http://www.fanniemae.com/newsreleases/2009/4743.jhtml?p=Media&s=News+Releases (stating Fannie Mae is temporarily increasing permitted loan-to-value ratio to over 100% for loan re-financings). This ratio is almost certainly going to decrease in response to efforts to shore up GSE underwriting standards.

credit support of private mortgage insurance).[46] The loan-to-value ratio for conforming mortgage decreased over the past few years, and currently is at 97%, although this amount will be soon lowered to 90%.[47] The maximum size of conventional first mortgages (those qualified for GSE repurchase) ranged from $93,750 in 1980 to $417,000 in 2007.[48] In 2008, the Economic Stimulus Act increased GSE loan limits to $729,750;[49] this change was renewed in the Housing and Economic Recovery Act of 2008[50] and the American Recovery and Reinvestment Act of 2009.[51] These size increases were finally allowed to expire in 2010, decreasing the maximum dollar amount of conventional mortgages to $650,000.[52]

Beginning in the 1980s, the GSEs began raising private capital to fund purchases of mortgages on the secondary market.[53] Under this

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46. The charters of Fannie Mae and Freddie Mac technically prohibit the acquisition of new mortgages with loan-to-value ratios in excess of 80%, but amendments to the charter allowed for lower ratios in combination with second mortgages or insurance. The Federal National Mortgage Association Charter Act, as amended through Oct. 28 1992, Title III of Nat'l Housing Act, 12 U.S.C. 1716 et seq., § 302(b), *available at* http://www.fanniemae.com/aboutfm/pdf/charter.pdf. The loan-to-value ratio cap was originally set at 75% and was changed in 1974. Pub. L. 93-383, § 806(c). *See also* Dawn Kopecki, *Obama's Mortgage Plan for Fannie, Freddie May Face Legal Snag*, BLOOMBERG, Feb. 24, 2009, *available at* http://www.bloomberg.com/apps/news?pid=newsarchive&sid=alIg4Jsp56Vw. The trend of decreasing loan-to-value ratios in conforming loans was criticized back in 1997. Vern McKinley, *The Mounting Case for Privatizing Fannie Mae and Freddie Mac*, Cato Policy Analysis No. 293, Dec. 29, 1997, *available at* http://www.cato.org/pubs/pas/pa-293.html#N_73_.

47. *National Mortgage Network*, FREDDIE MAC GUIDELINES, http://www.nationalmortgagenetwork.org/pdfs/market_conditions/Freddie-Mac-LL-increase.pdf (last visited May 14, 2011). In 2008, the GSEs set the loan-to-value limits based on whether the home was located in a distressed or declining state. *See Guidelines for Housing Finance Agencies*, GENWORTH MORTGAGE INSURANCE CORPORATION (Oct. 6, 2008), http://www.michigan.gov/documents/mshda/mshda_genworth_underwriting_guidelines_239205_7.pdf.

48. *Fannie Mae Historical Conventional Loan Limits*, FANNIE MAE (2011), http://www.fanniemae.com/aboutfm/pdf/historicallimits.pdf. The dollar cap of loan amounts is somewhat variable depending on geography. For example, high cost areas (Hawai'i, New York, etc.) have higher limits based on an index maintained by the FHA.

49. Economic Stimulus Act of 2008, Pub. L. No. 110–185, §§ 201-02, 122 Stat. 613, 619–21 (2008).

50. Housing and Economic Recovery Act of 2008, Pub. L. No. 110–289, § 1124(a)–(b), 122 Stat. 2654, 2691–93 (2008).

51. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115, 217, 220 (2009).

52. The Federal Housing Finance Agency maintained the heightened conforming loan maximum of $417,000 for single family homes and up to $729,750 in certain high cost areas for Fannie Mae and Freddie Mac. *See* Lender Letter LL-2010-13, EFANNIEMAE.COM (Nov. 19, 2010), https://www.efanniemae.com/sf/guides/ssg/annltrs/pdf/2010/ll1013.pdf. In general, larger loans cost more and involve greater credit risk by concentrating finance capital among fewer borrowers.

53. *See Basics of Fannie Mae MBS,* FANNIE MAE,

structure, qualifying mortgages purchased by Fannie Mae and Freddie Mac were put in a pool with hundreds and thousands of other loans, and private investors would buy shares of the mortgage-backed pool (mortgage-backed securities or MBS), which would fund Fannie Mae and Freddie Mac's purchase of still more mortgages.[54] The investors in GSE securities took on the interest rate and prepayment risks associated with the corresponding mortgages, but the GSE retained the credit risk by guarantying its investors that the principal on the underlying mortgage loans would be recovered.[55] Securitization of the secondary mortgage market completed the full transformation of the U.S. housing finance market. The erstwhile community savings and loan model all but disappeared from mortgage lending and was replaced by a national (or even international) capital markets system, unlimited by geography or originating lender interest rate constraints. With securitization, finance capital would naturally flow to where it was in greatest demand. This new nationalized system of home finance not only made still more capital available for mortgage lending, as geographic constraints ceased to be a factor, but it also standardized home finance and all its elements (loan document terms, title insurance, credit and collateral appraisals, etc.). In theory, this replaced a localized relationship-based system for assessing likelihood of borrower default with a system of more objective underwriting criteria such as credit scores, credit history, salary and employment data and data regarding a borrower's other financial obligations.

The modern capital markets also offered new opportunities for investors. Mortgaged-backed securitization allows broader participation in the "lender" side of the real estate finance market.[56] Indeed, capital flocked to the U.S. housing market that offered safe investment options offering good returns. This further increased the

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http://www.fanniemae.com/mbs/mbsbasics/index.jhtml (last visited Apr. 10, 2011) (providing brief overview of mortgage-backed securities).

54. *See* FABOZZI & MODIGLIANI, *supra* note 21. Fannie Mae and Freddie Mac only securitized a portion of their loans; much of their mortgage purchases remained financed by corporate debt.

55. *See* Ingrid Gould Ellen, John Napier Tye & Mark A. Willis, *Improving U.S. Housing Finance through Reform of Fannie Mae and Freddie Mac: Assessing the Options*, FURMAN CTR. FOR REAL ESTATE & URBAN POL'Y, N.Y.U SCHOOL OF LAW 30–31 (May 2010), 30-31. *See generally* W. Scott Frame & Lawrence J. White, *Fussing and Fuming over Fannie and Freddie: How Much Smoke, How Much Fire?* 19 J. OF ECON. PERSPECTIVES 159 (2005).

56. *See* DAVIDSON ET AL., *supra* note 34 at 3-4, 19-21, and 29-33. Investor risk arises from various sources, including risk of loan default and non-repayment as well as risk of interest rate change and prepayment of mortgages.

flow of funds into mortgage lending, growing the U.S. housing and finance sectors.

Investment in an asset-backed pool was considered safe for three reasons. First, the process of securitization itself allowed investment risk to be spread because a single investment represented a pool of diverse interests.[57] Securitization spreads the risk of default among many people and many properties, hedging against credit and prepayment risks posed by an individual borrower or a certain locality.[58] The number of loans in the pool spread the risk of one borrower's prepayment (or, if applicable, default) among the thousands of investors. The geographic diversity of the pooled mortgages mitigated against localized risks, caused by fluctuations in asset value in one market or a certain community's employment downturn.

Second, the credit risk of mortgages generally was considered very low. Originating lenders were expected to have conducted basic credit diligence on their borrowers by assessing the borrowers' ability and willingness to meet their mortgage obligations. In addition, even in the event of borrower default, the backup of collateral value underscored the ability of the lender to recover the value of the loan. During the boom years at the turn of the millennium, real property values were considered tremendously solid and ever-appreciating.[59] Indeed, mortgages had historically experienced a fairly low default rate and a valuable asset would cover all unpaid loan amounts in the unlikely event of default. Securities sold by Fannie Mae and Freddie Mac were guaranteed by the GSEs, so the credit risk associated with a pool of mortgages was retained by the issuer and not even passed on to investors.

Finally, even if the entire system failed and the GSEs failed to cover the risk they had assumed and were unable to pay their investors, it

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57. *Id.*; *see also* Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 535–50 (2002) (describing the benefits of securitization to investors and lenders).

58. The structure of securitization in the abstract was not the problem; rather, it was the valuation model for securitized products that was inadequate. For an overview comparison of securitization and traditional bank lending, *see* Gerald Hanweck, Anthony Sanders & Robert Van Order, *Securitization versus Traditional Banks: An Agnostic View of the Future of Fannie Mae, Freddie Mac and Banks*, FINREG 21 (Sept. 28, 2009), http://www.finreg21.com/lombard-street/securitization-versus-traditional-banks-an-agnostic-view-future-fannie-mae-freddie-mac (providing an overview comparison of securitization and traditional bank lending). A concise description of the development of mortgage-backed securitization can be found at Eggert, *supra* note 57, at 535–49 (2002).

59. *See generally* JONATHAN NORBERG, CATO INST., FINANCIAL FIASCO: HOW AMERICA'S INFATUATION WITH HOMEOWNERSHIP AND EASY MONEY CREATED THE ECONOMIC CRISIS (2009).

was widely believed that the federal government would step in and meet the payment obligations of these entities. If such governmental backup existed (and we now know it did), then the GSE guaranties were implicitly supported by the full faith and credit of the U.S. government.[60] Unsurprisingly, GSE debt securities acquired the highest credit rating.[61]

The GSE secondary market and securitization system significantly sped up the flow of mortgage finance capital, making real estate values more liquid and keeping interest rates low.[62] More capital flowing to the loan originators increased homeowner access to funding. Increasing the supply of real estate capital also made financing cheaper, spurring lenders to increase borrower demand creatively by offering a broad spectrum of mortgage products, many of which promised little or no equity investment and small initial interest-only monthly payments.[63] The ample supply of funds and rising demand for asset liquidity put upward pressure on real estate prices.[64] As real properties appreciated, individual and aggregate asset wealth grew.[65]

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60. *See* Van Order, *supra* note 20.

61. *See Understanding Fannie Mae Debt*, FANNIE MAE, http://www.fanniemae.com/markets/debt/understanding_fm_debt/credit_ratings.jhtml?p=Debt (last visited Apr. 9, 2011) (describing Fannie Mae's senior debt Aaa/AAA from each of the major ratings agencies; Moody's, S&P, and Fitch). Although Freddie Mac's preferred stock was downgraded to Baa3 (the lowest investment grade rating) in August 2008, Freddie Mac's senior debt credit rating also remains Aaa/AAA from the ratings agencies. *See* Associated Press, *Freddie Mac Courts Investors, Buffett Passes*, TAIPEI TIMES, Aug. 24, 2008, http://www.taipeitimes.com/News/biz/archives/2008/08/24/2003421257.

62. *See* Van Order, *supra* note 20.

63. In the first half of 2005, for example, interest-only loans made up 28.5% of all mortgage loans, according to the mortgage data company Loan Performance. Suzanne Stewart & Ike Brannon, *A Collapsing Housing Bubble?*, 29 REGULATION 15, 16 (Spring 2006) (calling the mortgage market of 2000-2005 "ultra-competitive" in terms of marketing loans to would-be borrowers); *see also* Jeff Madrick, *How We Were Ruined & What We Can Do*, *in* N.Y. REV. OF BOOKS Feb. 12, 2009, *available at* http://www.nybooks.com/articles/archives/2009/feb/12/how-we-were-ruined-what-we-can-do/; Ronald Colombo, *A Crisis of Character*, HUFFINGTON POST (May 12, 2009, 4:58 PM), www.huffingtonpost.com/ronald-j-colombo/a-crisis-of-character_b_202562.html; Robert T. Miller, *Morals in a Market Bubble*, 35 U. OF DAYTON L. REV. 113, 113-37 (2009).

64. An increase in ability to pay for homes seems to create a pricing increase trend in homes. This is true regardless of the source of the increase in capital. Ample debt capital availability due to the development of the secondary mortgage market and securitization has been supplemented by increased household salary earnings due to the increase of two-income earning families. Elizabeth Warren and her daughter Amelia Warren Tyagi claim that the two-income trend drove home prices up, and ironically may have decreased the overall standard of living as well. ELIZABETH WARREN & AMELIA WARREN TYAGI, THE TWO INCOME TRAP: WHY MIDDLE-CLASS MOTHERS AND FATHERS ARE GOING BROKE (2003). According to Warren and Tyagi, today's two-income family earns on average 75% more money than its single-income counterpart of a generation ago, but actually has less discretionary income

The securitized secondary market, then, served popular and reasonable goals: creating a predictable source and predictable costs of mortgage capital, making real estate values more liquid, and increasing homeownership. These outcomes worked in tandem to build what politicians have long called "the American Dream."[66] Greater capital availability and access made homeownership increasingly realizable for all segments of society.[67] The secondary market allowed banks to make long-term fixed-rate fully-amortizing loans, allowing homeowners to build equity over time. Reliable credit availability preserved the value of homes as well.[68] The appreciation of real estate and opportunity to build equity wealth through stable, fixed payments grew savings for millions of Americans, creating a nest egg of equity and appreciated value in their home.[69]

In addition, the securitized secondary market encouraged profitable private investment in real estate, allowing the public goal of homeownership to be funded by private dollars (and pounds,

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after paying fixed monthly bills (with the biggest single expenditure being housing). *Id.* at 50–52. Robert Shiller agrees that the trend of two-income couples has expanded the availability of mortgage credit which has "propel[led] home prices." ROBERT SHILLER, IRRATIONAL EXUBERANCE (2d ed. 2005). Interestingly, Shiller also credits the declining crime rate as a factor in home price increases, since "One can more comfortably flaunt wealth today, and so wealth has become more attractive." *Id.* at 36.

65. The total value of residential property in developed countries rose by more than $30 trillion from 2000 to 2005, which was equivalent to 100% of those countries' combined GDPs. *See In Come the Waves: The Worldwide Rise in House Rrices is the Biggest Bubble in History. Prepare for the Economic Pain when it Pops*, THE ECONOMIST (June 16, 2005) [hereinafter *In Come the Waves*], *available at* http://www.economist.com/node/4079027?story_id=4079027. The investment and finance website The Motley Fool warned of a real estate bubble in 2005 and catalogued evidence of a runaway wealth effect. Buck Hartzell, *Real Estate Bubble? You Bet!*, THE MOTLEY FOOL.COM (Oct. 26, 2005), http://www.fool.com/personal-finance/retirement/2005/10/26/real-estate-bubble-you-bet.aspx. From 1996 to 2006, U.S. national average house prices rose between 93% and 137%. *See Office of Federal Housing Enterprise Oversight (OFHEO), House Price Appreciation Slows Further: OFHEO House Price Index Shows Declines in Five States, Continued Deceleration in Others*, (2006), *available at* http://www.fhfa.gov/Default.aspx?Page=195; MAITLAND & BLITZER *supra* note 3, at 3 (illustrating that real estate prices dramatically rose between 1991 and 2005). From 2001 to 2006, real estate values in seven metropolitan areas increased more than 80%. *Id.*

66. *See supra* note 42 and accompanying text.

67. *See supra* note 13 and accompanying text.

68. Mortgage capital availability sets real estate liquidity, and more liquid real estate is more valuable. Andrea J. Boyack, Lessons in Price Stability from the U.S. Real Estate Market Collapse 68 (Aug. 2010) (unpublished manuscript), http://works.bepress.com/cgi/viewcontent.cgi?article=1002&context=andrea_boyack.

69. David Min, *Why the 30-Year Fixed-Rate Mortgage Is an Essential Part of Our Housing Finance System*, CTR. FOR AM. PROGRESS (Nov. 19, 2010), *available at* http://www.americanprogress.org/issues/ 2010/11/housing_reform.html. *But see* Sanders & Lea, *supra* note 11 (arguing that a self-amortizing loan is an inefficient way to build wealth).

Euros, yen, etc.) and permitting individuals, municipalities, and companies to share the wealth of real estate appreciation. The modern capital market also conquered geographical limitations on credit and investment in real estate.

The majority of all U.S. residential mortgage loans today are components of these huge GSE-securitized pools of debt,[70] with over 50% of total residential mortgage debt being serviced through Fannie Mae and Freddie Mac investment structures.[71] In terms of both market share and actual dollars, GSE securitized debt is huge: at least $4.5 trillion, 83% of which is held by private investors.[72]

The goals of the GSEs are politically popular ones: broaden access to mortgage financing, particularly focusing on extending credit to under-served populations, and increase liquidity in real estate credit markets. Fannie Mae and Freddie Mac were established to provide counter-cyclical stability, and GSE securities were designed to be safe investment products.[73] One thing is very clear: the existence of Freddie Mac and Fannie Mae enabled large sums of money to flow into home mortgage lending. Until the crisis, that was seen—on balance—to be a good thing.

In addition to their huge contribution to the growth of homeownership in America, the GSEs played—and continue to

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70. *See* David Ellis, *U.S. Seizes Fannie and Freddie*, CNNMONEY.COM (Sept. 7, 2008, 8:28 PM), http://money.cnn.com/2008/09/07/news/companies/fannie_freddie/index.htm (indicating that "half the mortgage debt in the country" was owned by Fannie Mae and Freddie Mac as of September 2008).

71. *Id.*; *see* Van Order, *supra* note 20, at 235; *see also Staff of H.R. Comm. on Oversight & Gov't Reform, the Role of Government Affordable Housing Policy in Creating the Global Financial Crisis of 2008*, 111th Cong. 12 (2009). Some 10–15% of outstanding residential mortgage debt is being serviced through similar "private label" systems. STAFF OF H.R. COMM. ON OVERSIGHT & GOV'T REFORM, 111TH CONG., THE ROLE OF GOVERNMENT AFFORDABLE HOUSING POLICY IN CREATING THE GLOBAL FINANCIAL CRISIS OF 2008, at 12 (Comm. Print 2009).

72. According to James Lockhardt, Director of the regulatory oversight agency OFHEO. *See Subprime Lending and Securitization and Government-Sponsored Enterprises: Hearing Before the Financial Crisis Inquiry Commission*, (Apr. 9, 2010) [hereinafter James Lockhardt Statement] (testimony of James B. Lockhardt), *available at* http://fcic.gov/hearings/pdfs/2010-0409-Lockhart.pdf. Other estimates put the debt as high as $5.4 trillion. *See* Ellis, *supra* note 70. Professor Anthony Sanders of George Mason and Member of Mercatus Center's Financial Markets Working Group highlighted that the combined debt load for Fannie Mae, Freddie Mac, and the Federal Home Loan Bank currently stands at $8 trillion. *See Hearing on Housing Finance—What Should the New System be Able to do?: Part I—Government and Stakeholder Perspectives, H.R. Comm. on Financial Services*, 111th Cong. 58 (2010) (Testimony of Anthony Sanders), *available at* http://mercatus.org/video/housing-finance-reform.

73. *See generally Oversight Hearing to Examine Recent Treasury and FHFA Actions Regarding the Housing GSEs Before the H. Comm. on Financial Services*, 110th Cong. 36 (2008) [hereinafter Testimony of Herbert Allison] (statement of Herbert M. Allison, Jr., President and CEO of Fannie Mae).

play—crucial roles in supporting the market for multifamily rental housing. The GSEs are the primary lender for development of multifamily housing in the United States to the tune of $27 billion.[74] By attracting enormous amounts of private capital and allocating this capital to multifamily housing, the GSEs have contributed to the production of millions of units of market-rate rental housing.[75] In fact, the United States has the best and most stable rental housing sector in the world,[76] thanks in large part to the role of the GSEs. Other sources of long term investment capital, including banks, pension plans, and life insurance companies, have never been the predominant lenders for multifamily housing.[77]

The multifamily housing sector financed by the GSEs has been—and likely will continue to be—a critical part of our housing market. The number of Americans requiring rental housing is predicted to increase dramatically over the next few decades, due to changing demographics and immigration trends,[78] and a stable and affordable supply of rental housing is critical to quality of life for median-income and lower-income populations. People who cannot or do not desire to own a home still require housing, and it is far better for the taxpayer that this housing be supplied through an affordable market scheme rather than subsidized directly through government direct grants. The GSEs achieved this tax-neutral outcome by providing sufficient capital to multifamily projects so that these units could be

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74. *National Multi Housing Council Housing Finance Reform: The Multifamily Perspective*, [hereinafter NMHC Perspective] *available at* www.nmhc.org/Content/ContentList.cfm?NavID-435. In 2008, Fannie Mae and Freddie Mac provided capital for 84% of multi-family mortgage loans. Nick Timiraos, *Fannie, Freddie Woes Hurt Apartments*, THE WALL ST. J., Nov. 18, 2009, at C1. Proposals regarding the GSEs have generally neglected to consider this aspect of Fannie Mae and Freddie Mac's market contribution, and it seemed unlikely (until the Treasury/HUD Report, *supra* note 16), that this role would be endangered. Timiraos, *supra* note 74 (quoting Richard Campo, CEO of Camden Properties Trust as saying "[t]he idea that the government is going to do something negative to affordable housing in this interim period . . . seems pretty far-fetched").

75. NMHC Perspective, *supra* note 74.

76. *Id.*; *see also* Letter from National Multi Housing Council, National Apartment Association and American Seniors Housing Association to Timothy F. Geithner, U.S. Treasury Secretary, and Shaun Donovan, HUD Secretary, dated July 21, 2010, Re: Public Input on Reform of the Housing Finance System, eDocket Number: Treas-DO-2010-001 and HUD-2010-0029.

77. *A Responsible Market for Rental Housing Finance: Envisioning the Future of the U.S. Secondary Market for Multifamily Residential Rental Mortgages*, CTR. FOR AM. PROGRESS (Oct. 2010) [hereinafter, Rental Housing Finance], *available at* http://www.americanprogress.org/issues/2010/10/pdf/multifamilyhousingreport.pdf.

78. *See State of the Nation's Housing 2010*, JOINT CTR. FOR HOUS. STUDIES OF HARV. U. (2010) [hereinafter 2010 Harvard Housing Study]; *America's Rental Housing: The Key to a Balanced National Policy*, JOINT CT. FOR HOUS. STUDIES OF HARV. U. (2008) [hereinafter 2008 Harvard Housing Study]; Rental Housing Finance, *supra* note 77.

rented to middle- and low-income families without any government subsidy.[79] About 90% of the units financed through Fannie Mae and Freddie Mac provide such good housing options at zero taxpayer cost.[80] The vast bulk of below-market housing costs, on the other hand, are provided through the FHA.[81]

Not only is providing market liquidity for multifamily housing of vital societal import, but it carries little taxpayer risk as well. To date, there have been very few defaults in the multifamily sector; less than 1% of Fannie Mae and Freddie Mac's guarantied multifamily loans have defaulted.[82] While some of the loans made to multifamily rental housing projects have been securitized in pools similar to single family home loans, most of the multifamily loans purchased by the GSEs remain in their portfolios.[83] Multifamily loans are usually individually bigger than single-family home loans, and the transactions are more idiosyncratic than residential mortgages. Larger individual loans make the risk harder to spread through pooling (multifamily loan pools typically have fewer, larger mortgages), and lower uniformity of these transactions increases the costs of credit and collateral due diligence as well as the cost of pricing and underwriting the loans.[84]

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79. *See* Rental Housing Finance, *supra* note 77.

80. *Id.* The multifamily housing sector was "holding up the best" even at the height of the crisis, but industry experts worried that if the GSEs focused on their single family problems and ignored multi-family lending, that could change. Michael Stoler, *Fannie, Freddie, and the Multifamily Market*, THE N.Y. SUN, Sept. 18, 2008.

81. Anthony Pennington-Cross and Anthony M. Yezer, *The Federal Housing Administration in the New Millennium*, 11 J. OF HOUSING RESEARCH 357 (2000).

82. NMHC Perspective, *supra* note 74; Rental Housing Finance, *supra* note 77, at 10-12.

83. NMHC Perspective, *supra* note 74; Ellen et al., *supra* note 55, at 6.

84. Commercial loans generally share these characteristics as well: they are larger, more idiosyncratic and less uniform. In addition, there is no federal or quasi-federal agency guaranty for commercial loans, so all commercial mortgage lending operates outside the GSE sphere. This is why commercial lending lagged residential mortgage backed securitization both in terms of timing (starting later historically) and in terms of volume (lower amounts of CMBS). Deutsche Bank Research, COMMERCIAL REAL ESTATE LOANS FACING REFINANCING RISKS: CMBS ONLY PART OF A GROWING PROBLEM 7–9 (July 6, 2010), *available at* http://www.dbresearch.com/PROD/DBR_INTERNET_EN-PROD/PROD0000000000259822.pdf. The only time CMBS volume represented significant market share was in the five to ten years prior to the housing crisis, suggesting it was fueled by over-speculation rather than stable investment capital choices. Global CMBS issuance hit its highest point ever in 2007 at a volume of $324 billion—five times the volume of 2000. Then the CMBS market plummeted over the following year to $25 billion in 2008—only about 10% of its value just the year before. *Id.* at 8; *see also* John Levy, *CMBS Volume Hits Record High*, NAT'L REAL ESTATE INVESTOR (Aug. 1, 2005), *available at* http://nreionline.com/commentary/finance/real_estate_cmbs_volume_hits/. In 2008, however, CMBS volume fell dramatically and has yet to recover. *See, e.g.*, Al Yoon, *CMBS Volume Now Seen Plunging to Six-Year Low*, REUTERS (Apr. 3, 2008),

B. Systemic and GSE Failures

As soon as the dust from the housing and financial crises had settled in 2009, the world began trying to find somebody to blame. The GSEs had helped to create the modern mortgage market system of secondary purchases of loans, which were pooled, securitized and sold as investments. The private market built upon this foundation, securitizing increasingly risky mortgages and inventing insurance products that freed more capital to create more loans.[85] Without the secondary market, there would be no capital to create the volume of mortgages that were originated in the decades before the collapse. Without Wall Street, the insurers of securities, and credit rating agencies, there would have been no market for risky mortgage-backed securities. And without the huge global growth of capital markets since the 1980s, there would have been insufficient investment funds to significantly increase the quantity of lending. While Fannie Mae and Freddie Mac did not market the risky securities themselves, they did help engineer the MBS concept and context, allowing the private issuers eventually to do so. Furthermore, toward the end of the boom years, the GSEs began to partake of increased credit and market risk themselves.

After four decades of providing safe, well-underwritten loans for single family and multifamily housing, something went wrong with the GSE model and the housing market in general. The failure of the GSEs to remain solvent was caused by a combination of four factors: (1) the GSEs' loss of the protection of reliable mortgage underwriting standards; (2) the moral hazard of implicit government guaranties, coupled with a profit structure that rewarded quantity rather than quality, which encouraged risk-taking; (3) the significant market presence of the GSEs, which made them more vulnerable to general economic downturns; and, (4) the GSEs' lack of adequate capital reserves to cushion a significant market downturn. Interestingly, however, none of these factors were unique to Fannie Mae and Freddie Mac—other large institutional players in the home

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http://www.reuters.com/ article/idUSN0342726520080403; Jim Clayton, *P&Ls: Pricing, Liquidity and Leverage*, PREA QUARTERLY 46–52 (Winter 2009), *available at* http://www.cornerstoneadvisers.com/_pdf/P&Ls.pdf. The drop in volume has been so dramatic that comparative sales pricing for CMBS products is currently unreliable—there simply is not enough liquidity for any reliable market pricing of the real-estate-backed securities to exist. Multifamily housing has not suffered (yet), since it is still supported through GSE secondary market purchasing.

85. *See* Eggert, *supra* note 57, at 535–36 (describing how the private sector's ability to securitize separately from the GSEs was bolstered by the investor confidence resulting from credit rating agencies assigning ratings to securities produced).

mortgage capital markets suffered the same sorts of failings. Nearly every depository institution in the United States is subject to an explicit guaranty in the form of FDIC insurance,[86] and the government's bailout of investment banks and insurance companies proves that these institutions had the benefit of a somewhat implicit guaranty as well.[87] Since both accounting rules and banking regulations have since adjusted in reaction to a presumption that private label entities lacked sufficient capital cushion,[88] that factor held true for private issuers as well. In some ways, the failings of the GSEs were actually less extreme: Fannie Mae and Freddie Mac held far less risky securities and guaranties than their private label MBS-issuer counterparts, and private issuer lapses persisted over a longer period of time.[89]

1. Lack of Adequate Underwriting

Starting in the 1990s, Fannie Mae and Freddie Mac started delegating the underwriting of the loans they would purchase, guaranty, and securitize to the originating lenders. Given that losses on qualified mortgage lending were historically small, it made sense to save costs on underwriting by delegating this task, designating an originator as an "approved lender," and relying on that originator's credit diligence to support the loan's viability.[90] Under the delegated

86. Hanweck et al., *supra* note 58.

87. The initial 2008 Wall Street bailout plan was for $700 billion, though later estimates suggest that the true cost may be hundreds of billions more. *See* Deborah Solomon, David Enrich & Jon Hilsenrath, *New Bank Bailout Could Cost $2 Trillion*, THE WALL ST. J., Jan. 29, 2009, *available at* http://online.wsj.com/article/SB123319689681827391.html; *see also* Goldfarb & ElBoghdady, *supra* note 10.

88. Private label securitization "promoted the riskiest mortgages" and consistently have experienced default rates twice that of Fannie Mae and Freddie Mac. Robert Van Order, *Privatization Won't Reduce Risk,* THE N.Y. TIMES, March 8, 2011.

89. *See supra* notes 84-88 and accompanying text; *see also* Susanna Montezemolo, *Wall Street, Not Fannie Mae & Freddie Mac, Created & Led the Toxic Mortgage Market*, CTR. FOR RESPONSIBLE LENDING HILL BRIEF, Jan. 25, 2011 [hereinafter CRL BRIEF] (explaining that the GSEs "were *followers*, not leaders, in the events leading up to today's foreclosure epidemic").

90. Fannie Mae's automated underwriting system, Desktop Underwriter, and Freddie Mac's system, Loan Prospector, became fully operational in 1997. Theresa R. DiVenti, *Fannie Mae and Freddie Mac: Past, Present and Future*, 11 CITYSCAPE: A J. OF POL'Y DEV. & RESEARCH 231 (2009); *see also* Susan Wharton Gates, Vanessa Gail Perry & Peter Zorn, *Automated Underwriting in Mortgage Lending: Good News for the Underserved?* 13 HOUS. POL'Y DEBATE 369 (2002). When Fannie Mae and Freddie Mac expanded their purchases to include Alt-A and other poorly documented loans, Fannie Mae implemented the Expanded Approval system and Freddie Mac expanded its Loan Prospector system to accommodate these offerings. DiVenti, *supra* note 90, at 236. FHA went to delegated underwriting under the Direct Endorsement Lender Review and Approval Process (DELRAP) program in 2010. HUD ML 2009-46B. Recent audits of FHA loans raise doubts as to the efficacy of

underwriting model, approved lenders performed their own underwriting according to enumerated GSE underwriting criteria; Fannie Mae and Freddie Mac did spot checks.[91] This delegated underwriting system worked fairly well until 2006, but as risky lending became more frequent and widespread in the broader housing market, poorly underwritten loans began moving into GSE portfolios and pools as well.[92] In this way, Fannie Mae and Freddie Mac slowly—but eventually—followed market trends. Ironically, their delayed adoption condemned them to participating in the worst abuses of credit diligence in history.[93]

Even with delegated underwriting, the GSEs had managed to stay away from overly risky mortgage loans for decades. In fact, until 2005, it appears that Fannie Mae and Freddie Mac had stayed true to their original business model: buying and guarantying fully documented, high quality mortgages.[94] During the first decade of the twenty-first century, however, Fannie Mae and Freddie Mac lost market share as more and more mortgages were originated for resale to private label MBS issuers on the secondary market.[95] Many of these underlying mortgages were unqualified for purchase by the GSEs. Some were "jumbo loans," too big for Fannie Mae and Freddie Mac's loan amount cap—then around $400,000.[96] Some were subprime

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delegated underwriting: 49% of FHA loans today do not meet underwriting standards. Joy Leopold, *HUD Losses From Noncomplying FHA Loans Top $11M*, DSNEWS.COM (Mar. 9. 2011), http://www.dsnews.com/articles/hud-losses-from-noncomplying-fha-loans-top-11m-2011-03-09.

91. Peter Mahoney & Peter Zorn, *The Promise of Automated Underwriting: Freddie Mac's Loan Prospector*, HOUS. FIN. INT'L 13, *available at* http://www.housingfinance.org/uploads/Publicationsmanager/ 9706_Aut.pdf. Automatic underwriting was heralded as a huge step forward to increasing homeownership particularly among underserved populations. *See* Peter Zorn, Susan Gates & Vanessa Gail Perry, *Automated Underwriting and Lending Outcomes: The Effect of Improved Mortgage Risk Assessment on Underserved Populations*, FISHER CTR. FOR REAL ESTATE AND URBAN ECONS., U. CAL., BERKLEY, C01-008 (Aug. 2001).

92. *See Conservator Report*, FED. HOUS. FIN. AGENCY (August 26, 2010) [hereinafter Conservator Report], *available at* http://www.fhfa.gov/webfiles/16591/ConservatorsRpt82610.pdf.

93. *See supra* note 65; *infra* note 133 and accompanying text.

94. The Treasury/HUD Report explains that not only did the GSEs insist on high quality, fully documented loans prior to 2006, but by establishing "appropriate benchmarks for conforming loans" they were able to "improve [underwriting] standards within the broader mortgage industry." Treasury/HUD Report, *supra* note 16, at 4.

95. The GSEs purchased 70% of new mortgage originations in 2003, but by 2006, GSE purchases represented only 40% of the market for new mortgage secondary market sales. Ellen et al., *supra* note 56; James B. Lockhart III, *Speech at the American Securitization Forum,* Las Vegas, NV, Feb. 9, 2009, *available at* www.fhfa.gov/webfiles/823/ASFSpeech2909.pdf.

96. *See supra* notes 39-43 and accompanying text. The jumbo market, representing loans for larger, more expensive homes, remains in grave peril, lacking sufficient capital. *See* Robert Frank, *Foreclosures on Million-Dollar Homes Surge*, THE

loans, which by definition were too risky for resale to the GSEs.[97] The loss of market share inspired Fannie Mae and Freddie Mac shareholders to put pressure on the companies to increase their mortgage purchases; one way they did so was to expand mortgage purchasing for low documentation loans.[98] Shareholders of Fannie Mae and Freddie Mac hoped to share in the widespread money-making from the inflated mortgage market. Meanwhile, the government signaled that wide access to housing finance credit remained a priority for the institutions, and even pushed for greater access to credit for lower income would-be owners.[99]

WALL ST. J. (Sept. 27, 2008), http://www.msnbc.msn.com/id/26869897/ns/business-real_estate/.

97. From 2001 to 2006, the volume of Subprime and Alt-A loans quintupled, from $0.2 trillion in 2001 to $1.0 trillion in 2006. By 2008, volume had contracted to only $0.1trillion. *See* Inside Mortgage Finance data.

98. Alt-A loans were not technically subprime because mortgage borrowers had sufficient down payments and Fair Isaac Corporation ("FICO") scores. The biggest failing of Alt-A loans was lack of income and asset documentation. In 2008, Charles W. Calomiris and Peter J. Wallison condemned Fannie Mae and Freddie Mac in the pages of The Wall Street Journal for "aggressively buying of subprime and Alt-A mortgages and mortgage-backed securities" motivated by "desperate attempt to recover market share from the investment banks." Charles W. Calomiris & Peter J. Wallison, *Blame Fannie Mae and Congress for the Credit Mess*, THE WALL ST. J. (Sept. 23, 2008), http://online.wsj.com/article/SB122212948811465427.html. While Fannie Mae and Freddie Mac did buy some top-tranche securities from subprime pools, the loss from such holdings have been less significant than losses due to guarantied Alt-A loans, and interestingly the purchases of subprime MBS top tranches may have been motivated by an attempt to fulfill their low housing investment requirements.

99. In 2003, former House Financial Services Committee chair Barney Frank, for example, effectively instructed the GSEs to concentrate on affordable housing and implied that Congress would support this mission in spite of potential credit loss risks. *See H.R. 2575, The Secondary Mortgage Market Enterprises Regulatory Improvement Act, Sep. 25, 2003, Hearing before the Committee on Financial Services*, Serial No. 108-54. Frank argued for broader credit availability spearheaded by the GSEs. *Id.* ("Fannie Mae and Freddie Mac do very good work, and they are not endangering the fiscal health of this country."). Frank argued for greater attention to affordable housing by the GSEs as well as downplaying any risk for extending more housing credit. *Id.* ("[W]e, as the Federal Government, have probably done too little rather than too much to push them to meet the goals of affordable housing . . . people exaggerate a threat of safety and soundness, the more people conjure up the possibility of serious financial losses to the Treasury, which I do not see . . . . I do not want to see any lessening of our commitment to getting low-income housing."). In addition, scholars in the 1990s and early 2000s had argued for reduced credit and down payment barriers to entry for homeownership, citing data generated by the Home Mortgage Disclosure Act (HMDA) reporting requirements on low income credit availability to indict the banking industry for implicitly discriminating against minority populations. The Home Mortgage Disclosure Act of 1975, 12 U.S.C. 2801; *see also* www.ffiec.gov/hmda. For a detailed description of the HMDA data *see* Glenn Canner & Dolores Smith, *Home Mortgage Disclosure Act: Expanded Data on Residential Lending*, 77 FED. RESERVE BULLETIN, 859 (November 1991). For scholarly interpretation of this data and calls for lowering barriers to credit availability, *see, e.g.,* Alicia Munnell, Geoffrey Tootell, Lynn Browne & James McEneaney, *Mortgage Lending in Boston: Interpreting HMDA Data*, 86 THE AM. ECON. REV. 25 (1996); *What We Know About Mortgage Lending Discrimination in America*, U.S. DEP'T OF HOUS. & URBAN DEV., OFFICE OF POL'Y DEV. & RESEARCH (1999), *available at*

There were several significant failings in the mortgage market in the first decade of this millennium, and by ramping up purchases of loans and MBS, Fannie Mae and Freddie Mac joined in and suffered from the system's failures. First, actors at each stage of the mortgage finance system were being compensated based on loan volume rather than loan performance. Sometimes this failing is phrased as "having no skin in the game."[100] Volume-based compensation created financial incentives for each market player that encouraged more and riskier loans rather than quality, well-underwritten mortgage products. For example, brokers and originators were paid based on loan size and loan volume and, in particular, yield spread.[101] The more loans that were originated, the bigger the brokers' paychecks and the more originators profited, in terms of fees as well as resale costs. The originate-to-distribute model motivated the primary mortgage market participants to focus on churning paper rather than accurately underwriting credit risk.[102] Ironically, the riskiest loans sometimes yielded the biggest payouts for originators who charged and retained larger upfront fees and incentivized mortgage brokers to do the same.

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http://archives.hud.gov/news/1999/newsconf/intro.html; Margery Turner & Felicia Skidmore, *Mortgage Lending Discrimination: A Review of Existing Evidence*, THE URBAN INST. (1999), *available at* http://www.urban.org/url.cfm?ID=309090; John Goodman, Jr. & Joseph Nichols, *Does FHA Increase Home Ownership or Just Accelerate It?* 6 J. OF HOUS. ECON. 184 (1997). The House Banking Committee cited such data in calls for greater moves to increase credit access by reducing credit and collateral requirements. Stuart S. Rosenthal, *Eliminating Credit Barriers To Increase Homeownership: How Far Can We Go?*, JOINT CTR. FOR HOUS. STUDIES OF HARV. U. (Aug. 2001), at 6. There were, however, calls to reign in the GSEs even at a cost to credit accessibility. In 2005, the Senate Banking Committee adopted a bill introduced by Sens. Elizabeth Dole, John Sununu and Chuck Hegel, The Federal Housing Enterprise Regulatory Reform Act of 2005, S. 190, that would have beefed up prudential regulation of the GSEs. Every Democrat voted against this bill and it failed to pass. *See* Stephen Labaton, *New Agency Proposed to Oversee Freddie Mac and Fannie Mae*, THE N.Y. TIMES, Sept. 11, 2003; Charles Calomiris & Peter Wallison, *Blame Fannie Mae and Congress for the Credit Mess*, THE WALL ST. J., Sept. 23, 2008.

100. *E.g.*, Christopher M. James, *Mortgage Backed Securities: How Important is "Skin in the Game?"* FRBSF ECON. LETTER 2010-37 (December 13 2010); Stan Liebowitz, *New Evidence on the Foreclosure Crisis,* THE WALL ST. J., July 3, 2009. Although H.R. 4173, § 1403, et seq. mandates a 5% risk retention piece for originators of non-qualified residential mortgages, any originators of mortgages meeting the qualified residential mortgage requirements will be exempt from the risk retention requirement. *See* Ronald D. Orol, *FDIC's Plan for 'Skin in the Game' Loans*, MARKETWATCH.COM (March 28, 2011), http://www.marketwatch.com/story/fdics-plan-for-skin-in-the-game-loans-2011-03-28?siteid=rss&rss=1.

101. GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW 558–559 (4th ed. 2001). The Dodd-Frank Act now prohibits yield spread premium broker compensation which created incentives for steering borrowers to higher-interest loans. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-517, § 1403, 124 Stat. 1376–2223 (2010).

102. MALLOY & SMITH, *supra* note 133, at 382.

Volume-based compensation was mirrored in the secondary market as well. Churning paper into securitized mortgage-backed pools attracted more investment funds, and Fannie Mae, Freddie Mac, and the private label securitizers all stood to profit from increased quantity in U.S. mortgage backed securities. Issuers of MBS were paid based on volume of securities produced rather than the quality of the loans pooled.[103]

In the securitized secondary market, risk of loss was segmented, deferred, and shifted, which essentially caused market participants to operate without recognizing any potential downside anchor. Because originators did not retain mortgages in their portfolio, they incurred no direct risk for originating mortgages with higher-than-typical credit risk.[104] Secondary market purchasers who were able to pass along credit risk to their investors were similarly unconcerned with ultimate loan repayment.[105] The GSEs retained credit risk, but fell prey to the same market thinking of other securitizers: that mortgage lenders bore very little risk of principal repayment because of (a) underwriting and (b) ever-appreciating collateral backing up the obligation.[106]

After some internal debate as to the wisdom of aggressively pursuing market share by lowering underwriting standards,[107] Fannie Mae and Freddie Mac finally started to increase market share by

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103. Prior to 2007, credit risk for mortgages was widely seen as minimal in all MBS, whether that risk was retained by Fannie Mae and Freddie Mac in the GSE-securities model or passed on to investors under the private label securities model. Historically, losses had been quite low, and credit rating agencies blessed the concept of securitization as a risk-spreading tool by granting such securities the highest ratings. Risk of loss was further mitigated through extensive insurance and re-insurance offerings for the securitizers. The combination of history, insurance and credit ratings painted a risk-free picture for investors, securitizers and lenders alike.

104. *See* MALLOY & SMITH, *supra* note 13 at 381-82; *see also* LAWRENCE E. MITCHELL & ARTHUR E. WILMARTH, THE PANIC OF 2008: CAUSES, CONSEQUENCES AND IMPLICATIONS FOR REFORM (2010); Boyack, *supra* note 68.

105. Interest rate and prepayment risks in loans sold and securitized through the "private-label system" were passed on to investors who thus "required a higher yield to absorb this risk." Jaffe, *supra* note 9. The private secondary market promoted riskier mortgages and felt greater losses. Van Order, *supra* note 88. In addition, it was the private-label market (in particular the run on the shadow banking system issuing "deposit-like instruments (e.g., repurchase agreements and commercial paper securitization)" that was the "source of the panic and subsequent credit crunch." *Id.*

106. *See, e.g.*, Norberg, *supra* note 59.

107. For example, Freddie Mac's former chief risk officer, David A. Andrukonis reportedly warned the company that it was buying bad loans that "would likely pose an enormous financial and reputational risk to the company and the country," but this warning went unheeded. Charles Duhigg, *At Freddie Mac, Chief Discarded Warning Signs*, THE N.Y. TIMES, Aug. 5, 2008. Andrukonis left the company over this dispute.

pursuing riskier business investments in late 2005/early 2006.[108] The GSEs began to guaranty new and riskier mortgage products, including in particular Alt-A loans that lacked traditional credit documentation.[109] By aggressively pursuing Alt-A loans—those with sufficient loan-to-value ratios but little or nothing in the way of documented borrower earnings and assets—the GSEs exposed themselves to a significant increase of credit risk.[110] Commentators,

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108. This resulted from delegated underwriting as well as an expansion of what mortgage products would be eligible for purchase (especially Alt-A). Involvement with loans falling below underwriting standards has exposed Fannie Mae executives to a massive class action lawsuit for "accounting fraud". *See* In re Fannie Mae Securities Litigation, Consolidated Civil Action No.: 1:04-CV-01639 (D.C. Dist. Ct.), *available at* http://securities.stanford.edu/1032/FNM04-01/200534_r03c_04cv01639.pdf. There is evidence that non-eligible products also snuck in to GSE pools or portfolios through the backdoor. In addition to buying questionable mortgages, Fannie Mae and Freddie Mac invested in questionable mortgage backed securities. Investigations are currently underway regarding to what extent Fannie Mae and Freddie Mac were misled with respect to the mortgage-backed securities they purchased at the height of the boom. Nick Timiraos, *U.S. Queries 64 Issuers of Mortgage Securities, Others*, THE WALL ST. J. (July 13, 2010), http://online.wsj.com/article/SB10001424052748704288204575362882033038278.html. Many in government (including now-government-outsiders John Sununu and Elizabeth Dole) have called Fannie Mae and Freddie Mac drivers of the crisis by their purchase of Alt-A securities, allowing such loans to be securitized. For a brief description of these loan types, *see supra* note 98. The culpability of Fannie Mae and Freddie Mac is debatable. *See* Christopher Lewis Peterson, *Fannie Mae, Freddie Mac, and the Home Mortgage Foreclosure Crisis*, 10 LOY. J. PUB. INT. L. 149 (2009); *see also* Hanweck et al., *supra* note 58. In addition, even if credit risk was appropriately included in pricing, since debt securities represent a future stream of income rather than a currently available liquid—or even liquidatable—asset, there is a liquidity risk factor as well. As we see today, the lack of liquidity lessens the ability to price securities (lack of comparable sales) as well.

109. Alt-A loans are loans that have characteristics of prime loans (for example, high FICO scores, adequate down payments) but have less than full documentation of income and wealth. Alt-A loans may be "stated income," meaning there is no independent verification of borrower income (pay stubs, W-2 forms, tax returns, etc.) and borrowers simply certify to their own ability to pay.

110. While at the time, the risk of Alt-A loans was not well understood, data since the housing crisis supports the allegation that stated income loans were significantly more risky than their verified income counterparts. In August 2006, Steven Krystofiak, president of the Mortgage Brokers Association for Responsible Lending, in a statement at a Federal Reserve hearing on mortgage regulation, reported that his organization had compared a sample of 100 stated income mortgage applications to IRS records, and found almost 60% of the sampled loans had overstated their income by more than 50 percent. Steven Krystofiak, Statement at the Federal Reserve 4 (Aug. 1, 2006), *available at* http://www.federalreserve.gov/secrs/2006/august/20060801/op-1253/op-1253_3_1.pdf; Mark Gimein, *Inside the Liar Loan: How the Mortgage Industry Nurtured Deceit*, SLATE (Apr. 24, 2008), http://www.slate.com/id/2189576. Speaking of "liar loans," *Slate* magazine opined that the "simplest aspect of the crisis to understand" is also the "most troubling, because it's not about complicated financial dealings and can't be fixed with bailouts. It's about an astounding breakdown of social norms." *Id.* The GSEs also increased their loan size limits by nearly two-fold, but this increase was only truly significant in increasing volume after the housing meltdown began. Mark Calabria of the Cato Institute estimates that a quarter of all loans purchased by Fannie Mae in 2005, and 10% of all loans purchased by Freddie Mac in 2005, was

such as Robert M. Diamond and Clifford J. Treese, called for a return to traditional underwriting standards for the GSEs as early as 2006,[111] but such prophets of reason were unheeded in the mad rush to grow company profits during the peak of the housing boom.

In retrospect, we now know that the GSEs grew market share at the worst possible time. Residential mortgages originated in 2006 and 2007 were the most poorly underwritten loans in history.[112] This was partially in response to mortgage lender efforts to pump up new loan originations to feed the secondary market and investor demand for securities backed by these loans. The massive increase in volume of mortgages originated during this time represents some shockingly risky and unrealistic loans, including numerous types of non-documented financings (so-called "liar loans").[113] In addition, many of these originations represented re-financing rather than new home purchasers, since lenders were quantity-driven and allowed and encouraged homeowners to take out new or additional loans in order to "cash out" their equity. Investor demand and the originate-to-distribute model sped the decline in underwriting, as did the willingness of mortgage borrowers to enjoy cheap and easy credit and to take out loans they had no realistic prospect of repaying, blinded by trust in mortgage brokers and originators and by the overly optimistic hope of eternal market expansion.[114]

Fannie Mae and Freddie Mac were among the largest consumers of these bad-vintage mortgages.[115] During these last two years of the

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from Countrywide. Kerri Panchuk, *GSEs Inflated Subprime Balloon Before it Popped*, CATO INST. (March 15, 2011), http://www.housingwire.com/2011/03/15/gses-inflated-subprime-balloon-before-it-popped-cato-institute.

111. Clifford Treese, Robert Diamond & Katherine Rosenberry, *Changing Perspectives on Community Association Mortgage Underwriting and Credit Analysis*, RESEARCH INST. FOR HOUS. AM. REPORT, Nov. 1, 2001; Ross Guberman, *Fannie Mae Projects a Happy Image. But as Its Debt Grows Bigger and Its Executives Get Richer, Should Taxpayers Start to Worry?* THE WASHINGTONIAN, Aug. 2002.

112. *Thematic Review on Mortgage Underwriting and Origination Practices, Peer Review Report*, FIN. STABILITY BD., Mar. 17, 2011, *available at* http://www.financialstabilityboard.org/publications/ r_110318a.pdf, 17-22.

113. As no-document and no-income loans became so common even their acronyms enjoyed widespread comprehension (NINA and NINJA loans, for example). Alt-A loans are loans that have characteristics of prime loans (e.g., good credit history) but have less than full documentation of income and wealth. A stated income loan occurs where there is no independent verification of borrower income (no examination of pay stubs, W-2 forms, tax returns, etc.) and borrowers simply certify to their own ability to pay.

114. *See* Boyack, *supra* note 68, at 125-28.

115. In 2008, Charles W. Calomiris and Peter J. Wallison condemned Fannie and Freddie in the pages of The Wall Street Journal for the "aggressive buying of subprime and Alt-A mortgages and mortgage-backed securities" by the GSEs). Charles W. Calomiris & Peter J. Wallison, *Blame Fannie Mae and Congress for the Credit Mess*, THE WALL ST. J. (Sept. 23, 2008), http://online.wsj.com/article/NA_WSJ_PUB:

housing bubble—2006 and 2007—the GSEs aggressively pursued mortgage purchases for securitization and for their own portfolio holdings.[116] This was at the height of the housing bubble, a time when warnings of over-inflated mortgage-backed products began to be more insistent and the most knowledgeable investors and lenders were getting out while they still could.[117] Investment guru and icon Warren Buffett once described the cycle of market bubbles as successively attracting three "I"-categories of investors: first, "innovators" (who imagine and take advantage of new market products); second, "imitators" (who recognize a new opportunity and perfectly catch a market swell); and finally "idiots" (who get into the market at the worst possible time, just before the crash).[118] Poor timing led the GSEs to try their hand at surfing the risky mortgage wave only to end up in a spectacular wipeout.

The fragility of the subprime mortgage market was apparent by 2007,[119] and by 2008, the multiplication of mortgage defaults and the

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SB122212948811 465427.html. Dean Baker has also condemned Fannie and Freddie for "jumping into junk mortgages near the end of the bubble," a move which, he says, has little to do with extending credit to would-be homebuyers and rather was all about market share. Dean Baker, *Opposing View on Housing Finance: Go Back to the Old Design*, USA TODAY, June 4, 2010. Washington Post reporters concur with this assessment. Binyamin Applebaum, Carol D. Leonnig & David S. Hilzenrath, *How Washington Failed to Rein In Fannie, Freddie*, THE WASH. POST, Sept. 14, 2008, at A1 The testimony of President and CEO of Fannie Mae lends support to this as well. *See Opening Statement by Daniel Mudd to the U.S. House Committee on Financial Services*, Apr. 17, 2007, *available at* http://www.fanniemae.com/media/ speeches/printthispage.jhtml?repID=/media/speeches/2007/ speech_267.html.

116. Calomiris, *supra* note 115. Dean Baker has also condemned Fannie Mae and Freddie Mac for "jumping into junk mortgages near the end of the bubble," a move which, he says, has little to do with extending credit to would-be homebuyers and rather was all about market share. Dean Baker, *Opposing View on Housing Finance: Go Back to the Old Design*, USA TODAY (June 4, 2010), http://www.usatoday.com/news/opinion/editorials/2010-06-04-editorial04_ST1_N.htm. Washington Post reporters concur with this assessment. *See* Binyamin Appelbaum, Carol D. Leonnig & David S. Hilzenrath, *How Washington Failed to Rein In Fannie, Freddie*, THE WASH. POST, Sept. 14, 2008, at A1. The testimony of President and CEO of Fannie Mae lends support to this as well. *See Opening Statement by Daniel Mudd to the U.S. House Committee on Financial Services*, Apr. 17, 2007, *available at* http://www.fanniemae.com/media/ speeches/printthispage.jhtml?repID=/media/speeches/2007/ speech_267.html.

117. *See, e.g., In Come the Waves*, *supra* note 65; Andrew Laperriere, *Housing Bubble Trouble: Have We Been Living Beyond Our Means?*, THE WEEKLY STANDARD (Apr. 10, 2006), http://www.weeklystandard.com/Content/Public/Articles/000/000/ 012/053ajgwr.asp.

118. In an October 1, 2008 televised interview, Warren Buffett explained that there is a "natural progression" to boom-bust business cycles and a typical trend in market bubble investment. He called the progression the "three I's"—namely (in chronological order), innovators, imitators and idiots. *See Charlie Rose* (Oct. 1, 2008), *available at* http://www.charlierose.com/view/interview/9284.

119. *See* Sanders, *supra* note 29. The "subprime" segment of the market typically refers to mortgage loans made to borrowers with FICO credit bureau scores below 620 or 660 or loans originated by a lender specializing in subprime loans or loans

collapse of inflated home values in several key markets put the entire housing market in crisis. As MBS values plummeted along with collateral values, the housing finance market imploded, taking Fannie Mae and Freddie Mac down with it.[120] In cases where originator breach of representations and warranties to the GSEs might have justified "putting" the mortgages back to the primary lenders (e.g., Countrywide) in order to offset credit losses, Fannie Mae and Freddie Mac refrained because many such originators lacked the assets and stability to compensate secondary purchasers.[121]

2. Moral Hazard

With the hindsight available in 2011, many wonder why competent capital providers allowed so much credit risk to be created without accounting for its cost or assessing its risk. Mortgage lending became overly risky because under the modern housing market system structure, each party rationally did not care about credit risk. Mortgage brokers did not care about ultimate loan performance, as they were paid based on total loan amount and yield-spread premiums.[122] Originating lenders did not care about underwriting since they were not going to hold poorly conceived loans in their portfolios anyway; they were going to immediately sell them to Fannie Mae and Freddie Mac (or a private label securitizer).[123] The GSEs and other MBS issuers did not care about underwriting because of the huge investor demand for their securities.[124] Plus, the issuers had

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with a high coupon interest rate. *See* Howard Lax et al., *Subprime Lending: An Investigation of Economic Efficiency*, 15 HOUS. POL'Y DEBATE 533, 536–537 (2004), *available at* http://content.knowledgeplex.org/kp2/cache/documents/58731.pdf.

120. *See supra* note 7 and accompanying text.

121. Ronel Elul, Nicholas S. Souleles, Souphala Chomsisengphet, Dennis Glennon, & Robert Hunt, *What "Triggers" Mortgage Default?* (Fed. Reserve Bank of Philadelphia, Working Paper No. 10-13, April 2010). Bank of America, as successor to the prolific second mortgage lender Countrywide, has recently been sued (again) for failing to disclose the existence of second mortgages on loans sold on the secondary market Dexia Holdings v. Countrywide Fin. Corp., No. 650185/2011 (N.Y. Sup. St.), *available at* https://iapps.courts.state.ny.us/fbem/DocumentDisplayServlet?documentId=tirVQewp3WuiTF+/gZlMUw==&system=prod.

122. *See* Boyack, *supra* note 68, at n.126, 145-50 and accompanying text.

123. *Id.* at 25.

124. From 2000 to 2008, investor capital in mortgage backed securities more than doubled. *See Anatomy of a Meltdown, The Credit Crisis: A Three-Part Series on the U.S. Housing Bust*, THE WASH. POST, June 15-17, 2008 (chart showing global investments 2000-2008). "Wall Street had no shortage of customers for subprime products, including pension funds and investors in places such as Asia and the Middle East, where wealth had blossomed over the past decade." *Id.*; Alec Klein & Zachary Goldfarb, *The Bubble*, THE WASH. POST, *available at* http://www.washingtonpost.com/wp-srv/business/credicrisis.

obtained insurance to cover any losses.[125] MBS investors likely did not care as well: they were getting a great deal because these investments had low historical losses and because GSE securities came with a company guaranty implicitly backed by the federal government, making the chance of default-based losses minute.[126] Any investor doubts as to the safety of mortgage backed securities were assuaged by credit rating agencies who blessed these investments—both GSE-issued and private label—as safe.[127] Unsurprisingly, these safe bets yielding higher returns attracted more and more investors, who demanded more and more securities, which in turn grew demand for secondary market mortgages. This increased lender motivation for volume, which made underwriting seem less and less essential as time went on.

The implicit and cost-free federal guaranty of GSE securities both buoyed investor valuation of such securities and created a moral hazard for Fannie Mae and Freddie Mac directors. Because of government implicit (and later explicit) underwriting of Fannie Mae and Freddie Mac, the losses accruing to those pools of securitized debt are socialized (ultimately paid for by taxpayers), while the profits are privatized.[128] Incidentally, an explicit federal guaranty also underwrites commercial banks: federal deposit insurance prevents banks from "going under," thus spreading the risks and costs of bank failures over the entire public.[129] The Wall Street bailout has been criticized for extending this same system retroactively, on a huge scale, to failed investment banks.[130] Socializing losses while privatizing

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125. *See* Porter Stansberry, *How AIG's Collapse Began a Global Run on the Banks*, DAILY WEALTH (Oct. 4, 2008), http://www.freerepublic.com/focus/f-news/2097802/posts.

126. *See supra* note 60 and accompanying text.

127. *See* Boyack, *supra* note 68 at n. 223-33 and accompanying text.

128. Paul Krugman, *Krugman: Fannie and Freddie*, INT'L HERALD TRIBUNE, (July 14, 2008), http://*www.iht.com/*bin/ printfriendly.php?id=14480831; *see also* Bill Mann et al., *The People Responsible for Fannie Mae and Freddie Mac*, THEMOTLEYFOOL.COM (Sept. 10, 2008) [hereinafter Fannie/Freddie Motley Fool Article], http://www.fool.com/investing/dividends-income/2008/09/10/the-people-responsible-for-fannie-mae-and-freddie-.aspx.

129. *See* Van Order, *supra* note 20.

130. *See* Carmen Reinhart & Kenneth Rogoff, *Don't Buy the Chirpy Forecasts*, NEWSWEEK.COM (Mar. 21, 2009), http://www.newsweek.com/id/190340/output/print; *see also* Ben Rooney, *Bank failure tally passes 100 for the year*, CNNMONEY.COM, (July 23, 2010, 6:55 PM), http://money.cnn.com/2010/07/23/news/economy/bank_failures/index.htm. Deeming banks "too big to fail" (TBTF) has been "ubiquitous" during this financial crisis, drawing much criticism. The ultimate result was that, in terms of government guaranty and moral hazard, "virtually all major financial institutions (banks included) and systems of institutions are GSEs" in effect. Hanweck et al., *supra* note 58, at 1.

profits encourages lender risk-taking.[131] This moral hazard is implicit in governmental guaranties and underwriting, whether this underwriting results from federal conservatorship, government insurance, or direct bailout of entities deemed "too big to fail." In each case, risks borne by such entities are subsidized by tax dollars. A taxpayer risk subsidy undercuts the *raison d'être* for the GSEs in the first place: to increase market liquidity to encourage capital to flow to under-served borrowers. Instead of public support paying for a public good (increased market liquidity), taxpayer funds ended up being allocated to prop up individual market players.

Supposedly, systemic disincentives created by taxpayer-funded guaranties can be corrected through regulation, and thus government prudential regulation would theoretically limit risk-taking.[132] Yet, loan purchase criteria and other regulatory restraints ultimately failed to insulate the GSEs from inordinate risk. Faced with the pressures and temptations to expand mortgage purchases, and poised in the context of a bloated mortgage market, Fannie Mae and Freddie Mac ended up taking on far more risk than their meager capital reserves could ever hope to absorb.[133]

3. Relative and Absolute Size

The losses incurred by Fannie Mae and Freddie Mac—now estimated at $220 billion—were massive, far beyond anyone's previously anticipated "worst case scenario."[134] These losses were surprisingly large not just because of the GSEs' bad timing and moral hazard. The sheer size of Fannie Mae and Freddie Mac's market share increased their general vulnerability to economic downturns.[135]

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131. *See* Krugman, *supra* note 128.

132. *See* Appelbaum et al., *supra* note 115 (discussing the Office of Federal Housing Enterprise Oversight and other regulatory efforts with respect to the GSEs).

133. Fannie Mae and Freddie Mac's government regulator, the OFHEO was essentially "fired" by the Federal Housing Finance Regulatory Reform Act of 2008, Division A of The Housing and Economic Recovery Act of 2008, Public Law 110-289, which set up a new federal oversight agency for the GSEs, the FHFA. *See* DiVenti, *supra* note 90, at 231-232.

134. GSE losses have been calculated at $226 billion, about 3/4 from Alt-A loans and less than 10% from subprime mortgage backed securities purchased by the GSEs. Conservator Report, *supra* note 92. By 2007, the GSEs owned $170 billion of subprime mortgages in AAA tranches of private label securities (11% of total outstanding subprime debt). James B. Lockhardt III, *"GSE Challenges: Reform and Regulatory Oversight," Speech at MBA's National Secondary Market Conference and Expo*, May 21, 2007, *available at* www.mortgagebankers.org/files/CREF/docs/2007/RegulatoryandLegislativeRoundup-JamesB.LockhartIII.pdf.

135. When Fannie Mae and Freddie Mac were put into conservatorship in September 2008, they had $5.4 trillion of guarantied mortgage backed securities debt between them. *See Statement of Federal Housing Finance Agency Director James B. Lockhardt III*, Sept. 7, 2008, *available at*

Because the GSEs had assumed the credit risk with respect to an enormous percentage of home mortgage loans, when mortgage defaults increased and home values fell, the GSEs felt the drop in the market more any other player.[136] In relative terms, Fannie Mae and Freddie Mac were among the most exposed of financial housing market actors. In absolute terms, their losses were staggering: to repay taxpayer monies already funneled to Fannie Mae and Freddie Mac, the companies would have to jointly pay the government over $360 million dollars every month for the next thirty years (and that without any interest or inflation rate included).[137]

4. Inadequate Loss Buffers

The housing market that rewarded risky, high-volume lending and disincentivized prudent underwriting also operated in the absence of adequate "buffers" or safeguards against issuer meltdowns. When defaults and devaluations outpaced projections, insurance and capital reserves proved completely inadequate. Commercial banks are required by bank regulations to retain a certain amount of capital in reserve as a cushion against losses or unforeseen demands to release deposits.[138] Prior to the financial crisis, Basel II regulated these levels, and the regime for capital reserve regulation (and other banking regulation aspects) has recently been changed (some would say upgraded) under Basel III.[139] Essentially, the concept of capital reserves is the same under both regimes: the riskier the loans that a financial institution makes, the larger reserve cushion of capital the bank must keep. Because financial institutions use money to make money, they lose potential profits for any reserve capital that cannot be used to generate profits. But operating without sufficient reserves

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http://www.fhfa.gov/webfiles/23/FHFAStatement9708final.pdf. These GSEs were by far the largest secondary mortgage market player, holding more loans than all other secondary market players put together. They were definitely too big to fail. *See also* Krugman, *supra* note 128.

136. Although the investors in mortgage backed securities had successfully spread their risk across multiple loans, Fannie Mae and Freddie Mac, as holders of the aggregate risks of default, ended up with all of their eggs in one basket. If mortgage loans are valued based on faulty assumptions (about market values, rates of repayment/default), then even a little drop could mean a huge decrease in profits for an aggregate credit risk holder.

137. There are 360 monthly payments in 30 years, and $130 billion divided by 360 is $361,111,111.

138. Peter Miu, Bogie Ozdemir & Michael Giesinger, *Can Basel III Work? Examining the New Capital Stability Rules by the Basel Committee–A Theoretical and Empirical Study of Capital Buffers* (Feb. 2010), *available at* http://ssrn.com/abstract=1556446.

139. *Id.* For a discussion of Basel II's capital requirements, *see* Eric Y. Wu, *Basel II: A Revised Framework*, 24 ANN. REV. BANKING & FIN. L. 150 (2005).

puts depositors and the institution at risk.[140] The concept of reserves as protection against unforeseen capital demands is common among all financial market participants: originating lenders, secondary market buyers, guarantors and MBS issuers, and anyone who expects, but cannot guaranty, a certain flow in/flow out of capital. Each of these parties were constrained by capital reserves and motivated by faulty risk-assessments to keep less money back "for a rainy day."[141]

Companies like AIG and Mortgage Guaranty Insurance Company (MGIC or "Magic") recognized that financial institutions wanted to free up capital reserves and offered a solution. These insurers offered to pay for an institution's unforeseen capital needs by selling products such as "credit default swaps" to banks around the world.[142] Credit default swaps, which were essentially unregulated insurance contracts, freed up more of an institution's funds to be used to generate profits and allowed banks to use greater leverage in investing in the secondary market and to get around the Basel rules.[143] Ironically, these insurers lacked their own reserves and assets

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140. United States banks are further protected from over-extension by FDIC insurance over deposits. *See Deposit Insurance*, FDIC, http://www.fdic.gov/deposit/ (last visited April 26, 2011) (discussing the FDIC insurance system).

141. *See generally* Hanweck et al., *supra* note 58 (comparing the moral hazard of FDIC insurance to that of the implicit government guaranty of Fannie Mae and Freddie Mac investor obligations).

142. In this way, the mortgage-backed securities had been moved off balance sheet. If they were held on balance sheet, Basel II banking regulations required the institution to hold 8% cash reserves to support the risk represented by the securities. But by building conduits, the securitizers were able to give just a credit line (0.8%) reserve. Once the securities were moved back on the balance sheet, the institutions were immediately and desperately in need of capital. *See* Stansberry, *supra* note 125.

143. An example helps to illustrate how credit default swaps worked: There is a hypothetical European bank ("EB") that has surplus deposits and wants to maximize the spread between what it must pay for deposits and what it can earn from making loans. EB would like to find reliable investments that would allow its capital to earn the best returns. One option would be to buy a pool of high-yielding (but high-risk) subprime mortgages, but under Basel II, EB would have to keep a significant capital reserve to support such a risky investment. AIG would offer to insure the subprime securitization investment for BE. AIG would use statistical analysis of anticipated values, default rate and other risk factors to calculate the anticipated rate of return on the securities and insure the securities against this risk for some percentage of the securities' face value. Although called a "credit default swap," this was really an unregulated insurance contract. AIG would be paid a lump sum in return for guarantying the securities, and AIG's own AAA rating would deem the insured securities safe, requiring a much lower Basel II capital cushion. EB could put more of its capital into the market to make higher profits under this arrangement. Furthermore, due to mark-to-market accounting, AIG would immediately book the profit on the credit default swap based on the payment received, discounted by the expected default rate. The credit default swap was a win-win for the insurer and the holder of the swap: EB would get a guaranteed return on a risky investment, allowing it a higher profit with lower reserves, and AIG could immediately book profits from the swap. Of course, once AIG's rating fell and its own lack of assets meant it could not make good on its swap promises, the risk holdings of banks

to back up their promised payouts. When it became apparent that AIG and other insurers lacked the capital to back up the insurance they sold, and when the profits these companies had booked never actually materialized, the insurers failed. This resulted in the undercapitalization of the financial institutions (aka the financial crisis of 2008).[144] The massive amounts of capital "created" through these types of market innovations ended up disappearing in the face of greater-than-anticipated defaults and falling collateral values. The over-leveraged deposits of financial institutions were insufficient to support their actual market risks, and only the 2008 government bailouts prevented the complete meltdown of the world's financial system.[145]

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increased, leaving them in violation of Basel II and unable to support their own capital needs.

144. On September 15, 2008, all major credit agencies downgraded AIG, leading to soaring losses in the financial sector. Once AIG was downgraded, it suddenly had to come up with billions of dollars of reserve funds that it did not have, leaving the world's largest insurance company effectively bankrupt. AIG's failure started a frightening domino effect: Lehman Brothers failed on the same day, and Merrill Lynch was sold to Bank of America. Although the federal government stepped in, promising to lend AIG $85 billion and to facilitate an "orderly" sell-off of assets, the fractured system was too far gone to completely save. AIG's largest trading partner was Goldman Sachs, and when AIG went bankrupt, Goldman lost $20 billion. Although Goldman was able to recoup half these losses by offering shares to Warren Buffett ($5 billion) and the public ($5 billion), it still experienced a massive capital drain from AIG's failure. The collapse of the credit default swap market led to a liquidity freeze for the investment banks. Without viable insurance for bank obligations, no additional capital could be released: all available capital had to be used to fund required reserves. Even daily operation costs had to be funded by the Federal Reserve through bailout funds.

145. The federal government provided $348 billion to financial institutions in just one month in 2008. Stansberry, *supra* note 125. Much of this money has since been repaid. Jeff Bater & John Kell, *With Fifth Third Out, Banks Have Repaid 99% of TARP*, THE WALL ST. J., March 17, 2011; *see also* Zachary Kouwe, *As Banks Repay Bailout Money, U.S. Sees a Profit*, THE N.Y. TIMES, Aug. 30, 2009. The U.S. government had no choice but to fund a bailout of AIG and the financial institutions. For example, Sen. Chris Dodd described meeting with U.S. Secretary Henry Paulson, Federal Reserve Chairman Ben Bernanke and others in Congress as the government decided whether to provide bailout funds to AIG and Wall Street, "The Federal Reserve Chairman announced that unless we acted within a matter of days, the entire financial system in the entire world could meltdown." *Chris Dodd Offers Glimpse into Financial Reform Bill,* THE GW HATCHET (Jan. 14, 2011), *available at* http://blogs.gwhatchet.com/newsroom/2011/01/14/chris-dodd-offers-glimpse-into-financial-reform-bill; *see also* Jamie L. Freedman, *Examining Financial Reform*, GEORGE WASHINGTON UNIVERSITY LAW (Jan. 24, 2011), http://www.law.gwu.edu/News/newsstories/Pages/ExaminingFinancialReform.aspx Financial expert and talking head Suze Orman put it succinctly, "Thank God, they bailed out AIG." Suze Orman, *Thank God, They Bailed Out AIG*, CNN LIVING (Sept. 17, 2008), http://articles.cnn.com/2008-09-17/living/lkl.suze.orman_1_aig-bailout-suze-orman-stock-markets?_s=PM:LIVING. A half year after the bailout, some questioned whether it had, in fact, been as necessary as it had seemed at the time. *See, e.g.*, *Did We Need to Bail Out AIG?*, THE ECONOMIST (Apr. 14, 2009), http://www.economist.com/blogs/freeexchange/2009/04/did_we_need_to_bail_out_aig.

The people quantifying the risks posed by mortgages and securitization of mortgages did not accurately estimate the risks, in part because they were limited by their own historical lack of experience. The generation of analysts that were operating on Wall Street and in the GSEs in the first decade of the twenty-first century simply had no personal knowledge of a time when real estate values significantly declined and mortgage default was common.[146] Their models and their experience failed to recognize any possibility that there would be significant credit failures or significant collateral failures when in fact, there were both.[147] Mortgage defaults have increased so rapidly that in 2010, lenders commenced as many foreclosures in a month as they previously had in a year,[148] and home values have fallen across the country by 30% since 2006.[149] In some markets, home devaluation has been vastly greater.[150] Falling home values led to more mortgage defaults—directly through valuation motivated ("strategic") defaults, and indirectly by increased levels of unemployment due to decreased housing and finance demand, leading to greater inability to make mortgage payments.[151]

The GSEs were unprepared to absorb losses of this magnitude. Fannie Mae and Freddie Mac's lax capital reserve requirements made their position even more precarious. Notwithstanding some earlier legislative efforts to consider increasing the GSEs' cash reserve, their capital reserve requirements in 2008 remained a mere 2.5%.[152] In a 2003 House Financial Services Committee Hearing, for example, Representative Barney Frank expressed the prevailing policy choice to free up more capital to encourage market liquidity. In the debate about whether the GSEs' capital reserve requirements should be beefed up, Frank infamously said, "I do not want the same kind of focus on safety and soundness that we have in OCC [Office of the Comptroller of the Currency] and OTS [Office of Thrift Supervision]. I want to roll the dice a little bit more in this situation."[153] Today, this statement is both ironic and telling:

146. Thompson, *supra* note 11, at 52.
147. *Id.*
148. *See supra* note 2. Each month, approximately 100,000 homes nationwide are lost in a foreclosure sale, a rate comparable to the number of homes lost in foreclosure in an entire year pre-crisis. Viega, *supra* note 2.
149. *See supra* note 3.
150. *See* MALLOY & SMITH, *supra* note 13, at 380-82.
151. Gail Marks-Jarvis, *Ethics of Strategic Default are Really Hitting Home*, CHICAGO TRIB., Oct. 7, 2010. ("Morgan Stanley recently estimated that about 18 percent of defaults will be strategic.").
152. Frame & White, *supra* note 55, at 170.
153. *See* Opinion, *What They Said About Fran and Fred*, THE WALL ST. J., Oct. 2, 2008, at A19, *available at* http://online.wsj.com/article/SB122290574391296381.html.

Congress made a conscious policy choice to take on more governmental risk in order to promote broader home ownership.[154] Congress was telling Fannie Mae and Freddie Mac to take risks, to spend more capital to help originate still more mortgages, and to promote homeownership and home borrowing.[155] Thus, the capital reserve cushion for the GSEs remained 2.5% of the value of securitized loans, and by 2008 it was clear that this amount was woefully inadequate.[156]

In July 2008, the U.S. Treasury indicated that the government would bail out Fannie Mae and Freddie Mac if necessary.[157] By September 2008, it was. The Treasury Department placed Fannie Mae and Freddie Mac into conservatorship, reorganizing the enterprises and infusing them with new capital.[158] The Treasury Department pledged to guaranty the GSEs' debts, bring in new

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According to investment website MotleyFool.com, Frank may have been under a chronic misapprehension regarding the true nature of the GSE's risk portfolio. Less than a month before Fannie Mae and Freddie Mac went into conservatorship, on Aug. 25, 2008, Frank told *Money* magazine that "Fannie and Freddie are better off than the market thinks . . . . Part of the problem is rumor-mongering by short-sellers." *See* Mann et al., *supra* note 128.

154. Sen. John Sunnunu explained that part of the housing boom was caused by a political problem since no one wanted to appear to be anti-housing. *Financial Fiasco: The U.S. Infatuation with Homeownership*, CATO INST. (Sept. 1, 2009), http://www.cato.org/event.php?eventid=6419.

155. Comments such as Representative Frank's, *see supra* note 153, suggest that some in Congress may have confused the role of Fannie Mae and Freddie Mac with that of the FHA. FHA provides subsidies in the form of rental or mortgage borrowing assistance—providing publicly funded support for lower income housing. The GSEs were designed to be budget neutral, providing merely a mechanism to assist private capital flow to support middle-income home borrowing and rental projects. The GSEs' goals of market promotion and liquidity generation were not intended to be direct government subsidies of housing, but rather a policy that would keep homeownership (and renting) affordable to middle-class Americans.

156. *See* Appelbaum et al., *supra* note 116 (discussing failed efforts by Gary Gensler, current Chairman of the Commodity Futures Trading Commission and then undersecretary of the Treasury, to rein in the GSEs in March 2000 and the policies underlying the expansion of the GSEs during the following eight years). In 1996, the Congressional Budget Office reported that Fannie Mae and Freddie Mac were likely using government support to increase their profits rather than reduce mortgage rates, but concluded that it was impossible to control this abuse of government support. The Congressional Budget Office's report concluded with a surprisingly folksy idiom: "Once one agrees to share a canoe with a bear, it is hard to get him out without obtaining his agreement or getting wet." *Id.*

157. Ellis, *supra* note 70; *see also* Krugman, *supra* note 128.

158. Ellis, *supra* note 70; *see* James Lockhardt Statement, *supra* note 72; *see also* Press Release, United States Department of Treasury, Fact Sheet, Questions and Answers on Conservatorship, (Sept. 7, 2008), *available at* http://www.treasury.gov/press-center/press-releases/Documents/fhfa_consrv_faq_090708hp1128.pdf; Testimony of Herbert Allison, *supra* note 73. For information on GSE investigations conducted during conservatorship activities, *see* News Release, Federal Housing Finance Agency, FHFA Issues Subpoenas for PLS Documents (July 12, 2010), *available at* http://www.fhfa.gov/webfiles/15935/PLS_subpoena_final_7_12_10.pdf.

management, and provide fresh liquidity to the declining housing market. At the time, this was the largest state rescue in history: $200 billion.[159] The amount of federal funds earmarked to back up GSE securities was increased to $400 billion and then pledged without limit.[160] To date, well over $130 billion of taxpayer money has been paid on behalf of the GSEs, and the pledge of federal support could very well be billions more.[161] This means that the GSE conservatorship will likely end up being the largest single piece of the financial crisis bailout.

Rescuing Fannie Mae and Freddie Mac in 2008 was necessary to keep the residential mortgage market machinery from grinding to a halt and to mitigate the impact of the crash on homeowners and homebuyers.[162] By allowing Fannie Mae and Freddie Mac to continue providing market liquidity, would-be buyers could continue to get mortgage loans, which permitted some degree of market normalcy.[163] In addition, without credit availability for housing finance, even more defaulted mortgages would remain in economic limbo, either as foreclosure pending or post-foreclosure sale real estate owned by the lending banks (REO properties). Today, 90% of mortgage loans are originated either with FHA insurance supporting credit risk or

159. The initial 2008 Wall Street bailout plan announced just weeks later was much larger—$700 billion. Some later estimates suggest that the true cost of the private label bailout may be hundreds of billions more. *See* Deborah Solomon et al., *New Bank Bailout Could Cost $2 Trillion*, THE WALL ST. J. (Jan. 29, 2009), http://online.wsj.com/article/SB123319689681827391.html. When the dust finally settles, however, the Fannie/Freddie bailout may well end up costing the taxpayers far in excess of the original estimate and the Wall Street bailout funds may be more likely to be reimbursed. Bloomberg Business Week recently speculated that, "[t]he cost of fixing Fannie Mae and Freddie Mac, the mortgage companies that last year bought or guaranteed three-quarters of all U.S. home loans, will be at least $160 billion and could grow to as much as $1 trillion. Fannie Mae and Freddie Mac, now 80% owned by U.S. taxpayers, already have drawn $145 billion from the currently-unlimited line of government credit granted to ensure that home buyers can get loans while the private housing-finance industry is moribund. That surpasses the amount spent on rescues of American International Group Inc., General Motors Co. or Citigroup Inc., which have begun repaying their debts." Lorraine Woellert & John Gittelsohn, *Fannie-Freddie Fix at $160 Billion With $1 Trillion Worst Case*, BLOOMBERG.COM (June 14, 2010), http://www.businessweek.com/news/2010-06-14/fannie-freddie-fix-at-160-billion-with-1-trillion-worst-case.html. Other estimates of the cost expended to maintain the GSEs thus far put the figure around $130-135 billion. Applebaum, *supra* note 12; Treasury/HUD Report, *supra* note 16.

160. Corbett Daly, *Treasury Uncaps Credit Line for Fannie, Freddie*, REUTERS, Dec. 24, 2009.

161. *See supra* note 7.

162. *See* Testimony of Herbert Allison, *supra* note 73; *see also* Van Order, *supra* note 88 ("That is the paradox of guarantees. They produce incentives to take on too much risk, as they did with Fannie and Freddie after 2004 and with the savings and loans in the 1980s, but they also limit systemic risk and panic. It's hard to have one without the other.").

163. *See* Treasury/HUD Report, *supra* 16; Van Order, *supra* note 20.

originated specifically for GSE resale,[164] and the only positive mortgage cash flows are in the realm of GSE purchases.[165]

Most if not all of the "bailout" monies allocated to Fannie Mae and Freddie Mac have been used to cover the bad vintage loans from 2006 and 2007 (particularly the Alt-A loans).[166] After decades of superlative market performance, two abysmal years of secondary market purchases coupled with lack of capital reserves crippled these housing finance giants. Fannie Mae and Freddie Mac remain on government life support. Now, politicians and taxpayers alike cry for their total eradication.[167]

II. REFORMING AMERICA'S HOUSING MARKET: A REPORT TO CONGRESS

Almost immediately after billions of dollars were earmarked to save Fannie Mae and Freddie Mac in 2008, proposals began proliferating recommending GSE reform or elimination. In October 2009, Credit Suisse produced a research analysis report titled "GSEs—Still the Best Answer for Housing Finance."[168] The paper stresses the need to preserve Fannie Mae and Freddie Mac in order to save the fragile residential mortgage market from further disruption, to preserve the market's ability to guaranty mortgage capital costs prior to loan origination (known as the "TBA market"), and to take advantage of the structures already in place at the GSEs, including human capital, technology and infrastructure.[169] Credit Suisse proposed that the current GSEs be segued into issuers with a "clean slate" by transferring non-performing portfolio assets and high credit risk guaranties to a "bad bank" to hold while retaining healthy assets and guaranties in a "good bank" supported by explicit government reinsurance.[170]

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164. *See infra* notes 218-220 and accompanying text; *A Responsible Market for Housing Finance: A Progressive Plan to Reform to Reform the U.S. Secondary Market for Residential Mortgages*, CTR. FOR AM. PROGRESS (Jan. 2010) [hereinafter Secondary Market Report], http://www.americanprogress.org/issues/2011/01/pdf/responsiblemarketforhousingfinance.pdf.

165. *See* Jim Clayton, *P&Ls: Pricing, Liquidity and Leverage*, PREA QUARTERLY 46-52 (Winter 2009).

166. Treasury/HUD Report, *supra* note 16 at 23; Conservator Report, *supra* note 92.

167. *See supra* note 9.

168. Qumber Hassan & Mahesh Swaminathan, *Mortgage Market Comment, GSEs—Still the Best Answer for Housing Finance, Credit Suisse*, CREDIT SUISSE (Oct. 6, 2009), *available at* http://www.zigasassociates.com/images/uploads/GSEs_-_Still_the_best_answer_for_housing_finance.pdf

169. *Id.* at 1-3

170. *Id.* at 1; *see also* Ingrid Gould Ellen et al., *Improving U.S. Housing Finance through Reform of Fannie Mae and Freddie Mac: Assessing the Options*, FURMAN CTR. FOR

The Center for American Progress (CAP) produced a proposal recommending that the government offer an explicit guaranty of regulated mortgage-backed securities issued by various entities.[171] The proposal outlines a structure where several "charter mortgage issuers" would issue government guaranteed mortgage backed securities, backed by mortgages on both single and multifamily housing.[172] The CAP proposal claims to promote market liquidity through supporting mortgage-backed securitization and to ensure market stability through comprehensive regulation. Further, the CAP proposal would support fair housing by requiring that all guarantied issuers ensure capital flows to underserved communities.[173] CAP also issued an October 2010 paper focusing on the critical need to preserve funding for multifamily mortgages.[174]

The Mortgage Bankers Association (MBA) issued a report in August 2009 proposing the creation of new, privately-owned, and chartered mortgage credit-guarantor entities that would be covered with an explicit government guaranty and would step into the liquidity-promoting role formerly occupied by Fannie Mae and Freddie Mac.[175] Under the MBA proposal, the government guaranty would only apply to securities of pools of qualified loans, not portfolio losses or corporate debt in general, with profits of the issuing entities set at a modest level like that of a public utility.[176] To protect against moral hazard, a strong prudential regulator would ensure compliance with underwriting criteria, pricing of securities, and adequacy of capital reserves.[177] A similar "good bank/bad bank

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REAL ESTATE & URBAN POL'Y, 30–31 (2010), *available at* http://www.urban.org/UploadedPDF/1001382-fannie-mae-freddie-mac-reform.pdf.

171. *A Responsible Market for Housing Finance: A Progressive Plan to Reform the U.S. Secondary Market for Residential Mortgages*, CTR. FOR AM. PROGRESS 30-32 (2010), *available at* http://www.americanprogress.org/issues/2011/01/pdf/responsiblemarketforhousingfinance.pdf.

172. *Id.*

173. *Id.* at 30-33; *see also* Ellen et al., *supra* note 170 at 28-30.

174. *A Responsible Market for Rental Housing Finance: Envisioning the Future of the U.S. Secondary Market for Multifamily Residential Rental Mortgages*, CTR. FOR AM. PROGRESS (2010), *available at* http://www.americanprogress.org/issues/2010/10/pdf/multifamilyhousingreport.pdf.

175. *Recommendations for the Future Government Role in the Core Secondary Mortgage Market*, MORTG. BANKERS ASS'N 6 (2009), *available at* http://www.mortgagebankers.org/files/Advocacy/2009/RecommendationsfortheFutureGovernmentRole.pdf.

176. *Id.*; *see also* Ellen et al., *supra* note 170, at 32-34.

177. *Recommendations for the Future Government Role in the Core Secondary Mortgage Market*, MORTG. BANKERS ASS'N 7 (2009), *available at* http://www.mortgagebankers.org/files/Advocacy/2009/RecommendationsfortheFutureGovernmentRole.pdf.

resolution of the GSEs" would aid in transitioning the current system to the one the MBA proposes.[178] After the Obama Administration issued its February 2011 proposal, the MBA issued a press release claiming that their proposal had been included as one of the three options outlined by the administration.[179]

The Housing Policy Council has also been involved in the debates and planning surrounding the future of Fannie Mae and Freddie Mac. In July 2010, it issued a proposal advocating an explicit government guaranty for mortgage-backed securities meeting enumerated underwriting criteria.[180] The proposal by the Financial Services Roundtable suggested supporting successor secondary market mortgage backed issuers with privately capitalized and regulated insurance companies, subject to underwriting regulation, but not supported by any governmental guaranty. The government would provide backup insurance over issued securities (at a cost charged to the issuers) in case the private insurance system should fail.[181] In the Obama Administration's February 2011 press release, the Financial Services Roundtable endorsed the third option ("Privatized system of housing finance with . . . catastrophic reinsurance behind significant private capital").[182]

This flurry of debate and political demands for a plan for the GSEs' future in the wake of the conspicuous absence of any guidance on the issue in the Dodd-Frank Act eventually led to the Obama Administration's own proposal, a report to Congress titled "Reforming America's Housing Finance Market" (the "Treasury/HUD Report" or "Report"), in February 2011.[183] The

178. *Id.*

179. Press Release, Michael D. Berman, Chairman, Mortgage Bankers Association, MBA's Comment on Administration's White Paper on Government Role in the Secondary Mortgage Market (Feb. 11, 2011), *available at* www.mortgagebankers.org/NewsandMedia/PressCenter/75650.htm ("We are gratified to see that one of the concepts they articulate closely tracks MBA's proposal, released eighteen months ago . . . . Our proposal directly addresses the problems that caused the failure of the Fannie Mae/Freddie Mac system.").

180. Letter from Housing Policy Council, The Financial Services Roundtable, to Timothy Geithner, Treasury Secretary, and Shaun Donovan, HUD Secretary 5 (July 21, 2010), *available at* http://www.fsround.org/housing/pdfs/pdfs2010/HousingPolicyCouncilCommentsonReformofHousingFinanceSystem7-21-10.pdf.

181. *Id.*; *see also* Ellen et al., *supra* note 170, at 34-35.

182. Press Release, Housing Policy Council, The Financial Services Roundtable, Housing Policy Council Statement on Administration's Proposal for GSE Reform (Feb. 11, 2011) (quoting Treasury/HUD Report, *supra* note 16, at 29), *available at* www.fsround.org/media/htm11/HPC_statement_on_admin_proposal_for_GSE_Reform.html.

183. Treasury/HUD Report, *supra* note 16, at 1-3 (discussing the government's proposed role as providing oversight and limited, targeted assistance).

Treasury/HUD Report cited several "fundamental structural flaws" in the GSEs that led to their failure.[184] The Report blames the profit motive inherent in a privately capitalized structure, saying it "undermined the[] public mission" of Fannie Mae and Freddie Mac (*i.e.*, promoting market stability and access to credit) by encouraging excessive risk-taking in seeking excessive returns.[185] Such risk-taking was not tempered by proper risk assessment because of the "perceived government backing" that gave the GSEs an unfair market advantage.[186] In particular, the Report says the preferential tax treatment of Fannie Mae and Freddie Mac, their low capital reserve requirements, and their implicit (and unpaid-for) government guaranty allowed the GSEs to price their securities lower and to dominate the market, as well as take on "irresponsible risks."[187] In addition to the profit motive/risk avoidance tendencies enabled by the structure of the GSEs, the Report notes that the capitalization requirements for Fannie Mae and Freddie Mac proved woefully inadequate and that their regulating entity (the Office of Federal Housing Enterprise Oversight) was "structurally weak and ineffective."[188]

Recognizing the obvious failures of the GSEs, the Report explained that significant systemic reform is needed to achieve two policy goals maintaining good housing choices while dramatically reducing the role of government in the housing market.[189] The Report explains that although access to credit to buy a home and maintenance of quality rental options is essential for quality of life (and the ability to "achieve the American Dream"), the housing finance market should become "predominantly private."[190]

In a logical non sequitur, however, the report goes on to argue that the only way to achieve these outcomes is to "dramatically transform the role of government in the housing market" and to wind down the GSEs.[191] In this way, the Treasury/HUD Report provides a frightening example of when good intentions improperly

184. *Id.* at 7-9.
185. *Id.* at 8.
186. *Id.*
187. *Id.*
188. *Id.* at 8-9. The OFHEO has since been replaced with the FHFA . Whether or not this change in regulatory authority amounts to more than "changing the sign on the door" remains to be seen.
189. *Id.* at 12, 18-19.
190. *Id.* at 1-2.
191. *See id.* at 1-2, 12-13 (noting that the Report still advocates for a large role for government by providing oversight, protection, and strategic support while also apparently advocating for a decrease in government's traditional role of providing incentives to buyers).

implemented could have unforeseen, and possibly disastrous, consequences. While the goals of the Report are laudable, eliminating Fannie Mae and Freddie Mac would not effectively achieve the housing finance system envisioned by the Report.

A. The Good: Necessary Reforms

Reforms of Fannie Mae and Freddie Mac are vital, as their spectacular failure proves. The Treasury/HUD Report references some of the in-progress changes to underwriting that must be implemented in order to restore the soundness of the originated, purchased, and pooled mortgages,[192] an effort that started with the Dodd-Frank Act and impacted the mortgage finance market generally,[193] rather than simply those loans bought and guarantied by the GSEs. In addition to these ongoing efforts, the Report advocates steps to promote GSE independence from taxpayer risk-coverage.[194] Such changes to the GSEs' mortgage guaranties would foster greater market competition and less systemic risk.[195] Finally, the report mentions, but does not detail, the crucial immediate need for coordination among government and other regulated underwriting standards in order to resuscitate the wounded housing finance market.[196]

The critical first step for restoring a well-functioning financing system, including originated mortgages and secondary market investments in mortgage backed securities, is to improve underwriting standards. Poor underwriting of mortgages, including huge loan-to-value ratios and inadequate (or non-existent) credit assessments for borrowers, has been widely cited as a major cause of the increase in mortgage default and foreclosures.[197] The Dodd-

192. *See id.* at 5, 7, 15-16 (discussing government initiatives currently being implemented).

193. The Dodd-Frank Act mandated that new underwriting standards be set by the government for "qualifying residential mortgages" (QRMs). Efforts to define and implement such enumerated standards are underway. *See infra* note 198. The rules for QRMs will be finalized in 2011 and be implemented in 2012. Treasury/HUD Report, *supra* note 16, at 16.

194. Treasury/HUD Report, *supra* note 16, at 12-13.

195. *Id.* at 15-16.

196. *Id.* at 15.

197. *See, e.g.*, Boyack, *supra* note 68; *State of the U.S. Economy and Implications for the Federal Budget: Hearing Before the H. Comm. on the Budget*, 110th Cong. 10 (2007); Oren Bar-Gill, *The Law, Economics and Psychology of Subprime Mortgage Contracts*, 94 CORNELL L. REV. 1073, 1074 (2009). In August 2006, Steven Krystofiak, president of the Mortgage Brokers Association for Responsible Lending, in a statement at a Federal Reserve hearing on mortgage regulation, reported that his organization had compared a sample of 100 stated income mortgage applications to IRS records, and found almost 60% of the sampled loans had overstated their income by more than 50

Frank Act anticipated underwriting improvements as a cornerstone of any systemic fix, and set out parameters whereby new underwriting standards for "Qualified Residential Mortgages" and "Qualified Mortgages" would be promulgated in 2011 and become effective in 2012.[198] The GSEs have recently announced a decrease in loan-to-value ratio requirements for loans they will purchase. During the housing crisis, the GSEs announced that a mortgage with a 97% loan-to-value ratio would be eligible for sale to Fannie Mae and Freddie Mac. [199] The Treasury/HUD report mirrors other current proposals

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percent. Mark Gimein, *Inside the Liar Loan: How the Mortgage Industry Nurtured Deceit*, SLATE (Apr. 24, 2008), *http://www.slate.com/id/2189576* (quoting Statement of Steven Krystofiak, Aug. 1, 2006, *available at* http://www.federalreserve.gov/secrs/2006/august/20060801/op-1253/op-1253_3_1.pdf); *see also* Yulia Demyanyk & Otto Van Hemert, *Understanding the Subprime Mortgage Crisis*, 22 REV. FIN. STUD. (2009); Alan M. White, *Reboot an Absurd System,* THE N.Y. TIMES, March 8, 2011 ("The absurdity of the pre-crisis home finance system was that the most marginal borrowers, first-time buyers, immigrants, young people with minimal savings, were likely to get funding through the nongovernmental subprime securitization channel, while the government-sponsored enterprises funded the middle class and well-heeled.").

198. *See* Pub. L. 111-203, § 1400 et seq. The 2,000+ page text of the Dodd-Frank Act is *available at* http://banking.senate.gov/public/ and http://thomas.loc.gov/cgi-bin/bdquery/z?d111:H.R.4173. It is widely predicted that the new QRM rule will make mortgage capital more expensive and less accessible to borrowers. *See, e.g.*, Tamara Keith, *Mortgage Rule Raises Doubts for Banks, Borrowers*, NATIONAL PUBLIC RADIO (Mar. 29, 2011), http://www.npr.org/2011/03/29/134960865/FDIC-Unveils-New-Mortgage-Rules; Dina ElBoghdady & Zachary Goldfarb, *Making a Mountain Out of a Mortgage?*, THE WASH. POST, Apr. 10, 2011, at A1; *Twenty Percent Downpayment Rule Would Disrupt First-Time Home Buyer Market*, Nat'l Ass'n of Home Builders (Mar. 29, 2011) [hereinafter NAHB QRM Response], www.nahb.org/news_details.aspx?sectionID=148&newsID=12402&print=true.

199. Down payment requirements have now increased for GSE-purchased mortgages. *See, e.g.*, Fannie Mae Announcement SEL-2010-13. In March 2011, the Federal Reserve announced that a 20% down payment would be required for qualified residential mortgages. Federal Reserve Press Release, *available at* http://www.federalreserve.gov/newsevents/press/bcreg/20110329a.htm.
The National Association of Home Builders (NAHB) and the National Association of Realtors (NAR), among others, have decried a 20% down payment requirement as unduly restrictive of homeownership. *See* NAHB April Statement, *supra* note 10 ("By mandating a 20% downpayment on qualified residential mortgages, the Administration and federal regulators are excluding those without huge cash reserves—which constitutes most first—time home buyers and many middle-class households—from a chance to buy a home," said NAHB Chairman Bob Nielsen); NAR Statement of March 20, 2011, *available at* http://www.realtor.org/press_room/news_releases/2011/03/downpayment. NAR President Ron Phipps opined that "[a] narrow definition of QRM, with an unnecessarily high down payment requirement, will increase the cost and reduce the availability of mortgage credit, significantly delaying a housing recovery. *Id.* Although generally available low-equity loan options have expired, Fannie Mae has a new "HomePath Mortgage" program that provides up to 97% financing without mortgage insurance for designated homes owned by Fannie Mae as a result of foreclosure. Properties that are available can be viewed by at www.homepath.com.

for decreasing the loan-to-value ratio in prime mortgages to at least 90%.[200]

Any reform of the secondary market and the GSEs must be built upon a foundation of good underwriting in originating mortgage loans. For mortgage lending, underwriting has a dual focus: viability of the borrower and sufficiency of the collateral. Adequate down payment requirements are part of this, but borrower credit assessment mandates are even more vital.[201] "Credit" has been called "man's confidence in man" and measures a lender's confidence that a borrower will repay a loan.[202] The likelihood of borrower repayment of a debt is typically measured by factors impacting a borrower's ability to repay (income, other payment obligations) and a borrower's willingness to repay, typically based on historical repayments of debts (credit history, quantified as a FICO score).[203] Although lowering the loan-to-value ratio increases a lender's

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200. The Treasury/HUD Report addresses this indirectly, advocating a larger required down payment—of at least 10%—by borrowers as a way to increase the level of private capital ahead of Fannie Mae and Freddie Mac's guarantees. Treasury/HUD Report, *supra* note 16, at 13. The NAHB has consistently decried this move as shifting the middle-class away from non-subsidized home affordability. Nicholas J. Tennyson responded to an editorial in *The Washington Post*'s opinion page supporting an increased down payment requirement for qualified residential mortgages. "You said, 'It's probably best to draw the line at those who can make downpayments of 20%, and let low- and moderate-income borrowers who can still qualify in the private market turn to the Federal Housing Administration.' Marie Antoinette was much more economical in her use of language when she offered the same sentiment – 'let them eat cake.'" *See* NAHB April Report, *supra* note 10.

201. Bob Nielsen of the NAHB correctly pointed out that "[l]ow-down payments are not what drove this lending crisis. It was lax underwriting standards." NAHB April Statement, *supra* note 10. Government data shows convincingly that the size of the down payment, while a factor in predicting mortgage defaults, was much less significant a factor than credit history. ElBoghdady & Goldfarb, *supra* note 198 (borrowers who met strong credit underwriting standards but made small down payments defaulted at a rate of 2.3% while 80% LTV loans without good credit underwriting defaulted at a rate of 4.7%). Not only do lenders hope primarily to recover from a borrower rather than seek repayment from foreclosure sales, but pursuing collection through foreclosure is costly and uncertain in terms of timing and ultimate recovery. *See, e.g.*, John Y. Campbell et al., Forced Sales and House Prices 10 (Dec. 2009) (unpublished manuscript), *available at* http://econ-www.mit.edu/files/3914 (showing that foreclosure sales prices averaged 27% lower than the appraised value for the home). The losses incurred by Fannie Mae and Freddie Mac due to Alt-A loan default underscore this concept: the Alt-A loans typically had higher-than-average down payments (and consequentially lower loan-to-value ratios), but because borrower repayment ability had not been confirmed, default—and therefore loss—far exceeded expectations.

202. Senator Daniel Webster, Address to Congress Regarding Bank of United States Charter (May 7, 1834); *see* BLACK'S LAW DICTIONARY 424 (9th ed. 2009).

203. There are three FICO scores for each potential borrower, representing credit information kept by the three credit bureaus, Experian, TransUnion, and Equifax. *About Credit Scores*, MYFICO, http://www.myfico.com/crediteducation/creditscores.aspx (last visited Apr. 26, 2011); *see also* MALLOY & SMITH, *supra* note 13 at 367-69.

likelihood of ultimately recovering outstanding loan amounts from the asset in the event of default, the primary concern of a mortgage lender is avoiding default in the first place. Recovering the borrowed funds from loan collateral is merely a contingency plan.[204] Although the recent increase in strategic defaults of underwater mortgages proves the theory that increasing a mortgage's loan-to-value ratio also increases the risk of default,[205] it is certainly not the only factor. Belief in ever-increasing real estate values tempted many lenders to increase loan-to-value ratios and to ignore other credit fundamentals such as verified income and assets—the "ability to repay" piece of the underwriting equation. Abandonment of sound underwriting led to vastly increased rates of default.[206] Relying on real property values alone to ensure profit from mortgages is predictably foolish because foreclosures are costly and uncertain and values are unpredictable.[207] A stable mortgage market, therefore, must be founded on credit underwriting as well as adequate security.

The Treasury/HUD report enumerates some baby steps that will reduce GSE market share and wean the GSEs off of their current government support.[208] To some extent, many of these steps are necessary, even if the ultimate wind-down of Fannie Mae and Freddie Mac are not. For example, the Report advocates increasing the

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204. Strength of collateral values is akin to the strength of the safety net below a tightrope walker, while strength of borrower credit—akin to strength of the actual rope—is of even greater concern to lenders.

205. *See* Elul, *supra* note 121; David Streitfeld, *No Help in Sight, More Homeowners Walk Away*, THE N.Y. TIMES, Feb. 2, 2010.

206. CRL Brief, *supra* note 89 (citing the Alt-A loan failures as "the primary reason that the GSEs were placed into conservatorship); *see also Fannie Mae Investor Presentation, Fannie Mae 2008 Q2 10A Investor Summary*, 36, Aug. 6, 2008, *available at* www.fanniemae.com/media/pdf/webcast/080808transcript.pdf. By 2008, Alt-A loans accounted for 10% of GSEs' risk exposure but 50% of their combined loses. *U.S. SEC Form 10-Q, for Quarterly Period ending June 30, 2008*, FED. NAT'L MORTG. ASS'N 6, *available at* www.fanniemae.com/ir/pdf/earnings/2008/q22008.pdf; U.S SEC Form 10-Q, for the Quarterly Period ending June 30, 2008, FED. HOME LOAN MORTG. CORP. 71, *available at* www.frediemac.com/investors/. According to the Calculated Risk Blog Data Charts, default rates and foreclosure rates for Alt-A loans exceed all other types of non-subprime loans other than Option ARMs (adjustable rate mortgages) and are experiencing default at a rate some four times higher than other prime loan products. Calculated Risk, *Forex - MBA National Delinquency Survey: Delinquency rate declines in Q3*, FOREXTV.COM (Nov. 18, 2010, 11:29 AM) [hereinafter Calculated Risk Data], http://www.forextv.com/forex-news-story/forex-mba-national-delinquency-survey-delinquency-rate-declines-in-q3.

207. John Y. Campbell, Stefano Giglio & Parag Pathak, *Forced Sales and House Prices,* HARV. U. STUDY (Dec. 2009), *available at* http://econ-www.mit.edu/files/3914. The study showed that foreclosure sales prices averaged 27% lower than the appraised value for the home. *Id.*

208. Treasury/HUD Report, *supra* note 16, at 12-13 (listing recommendations to increase private capital while reducing Fannie Mae and Freddie Mac's involvement in housing finance).

capital reserve requirements of the GSEs and bolstering GSE independence through private insurance rather than a government guaranty.[209] The Report also argues that guaranty fee pricing should be increased as well, as a way to attract private capital back to the secondary market.[210] Artificial increases to guaranty fees will not be necessary if the level of government support is decreased and thereby the guaranty costs of the GSEs rise—in this case, guaranty fees will increase naturally and in the proper proportion to indicate true costs and market factors. Weaning the GSEs from their taxpayer-funded guaranties is ultimately a legitimate and wise policy goal, and measured steps toward this goal can and should be taken right away.

The Report also sets forth several short-term steps aimed at decreasing Fannie Mae and Freddie Mac's share of the secondary mortgage and mortgage backed securities markets.[211] Although these steps are justifiable to the extent they promote market efficiencies such as competition and consumer options, the resulting reductions may hurt rather than help mortgage borrowers and investors if reductions in GSE market share are aimed solely at efforts to wind down the entities. Traditionally, GSE mortgage loan purchases focused on a limited target: qualifying mortgages could not be too big or too risky. Risk was controlled through underwriting standards and size was controlled through conforming loan limits.[212] The market limitations placed on the GSEs were motivated by their mandates: providing capital liquidity and homeownership are goals specifically targeted at improving ownership potential of middle (and lower) income Americans whose unsupported ability to leverage home purchases were otherwise limited by the intersection of market factors (such as the cost of lending capital) and the reality of limited liquidity resources of most working Americans. This is true today as well, and explains why the GSE role remains necessary: while the FHA can focus on taxpayer-funded housing options for the poorest citizens and the private market responds well to the needs of the wealthiest, liquidity support is necessary to ensure stable, constant

209. *Id.* at 13.

210. *Id.* at 28. The FHA immediately raised their mortgage insurance premium by a quarter of a percentage point for all of its fifteen and thirty-year loans. *See* Coleman Wood, *The Future of Fannie/Freddie?*, S.E. REAL ESTATE BUS. (March 2011), http://southeastrebusiness.com/articles/MAR11/cover2.html.

211. Treasury/HUD Report, *supra* note 16, at 11-15.

212. *See supra* notes 39-44 and accompanying text. Some size limits have been subject to geographical adjustments from time to time to account for widely differing locality pricing in housing markets. *See* Lender Letter LL-2010-13, Nov. 19, 2010, *available at* https://www.efanniemae.com/sf/guides/ssg/annltrs/pdf/2010/ll1013.pdf.

access to funding for the huge percentage of middle-income Americans. Therefore, reducing conforming loan limits to their pre-crisis levels, in terms of dollar-caps on loans, makes sense. However, this concept could be taken too far. Loan size reduction should not be a tool to take the GSEs out of the market altogether, but rather a way to scale back GSE-supported lending to a more manageable and justifiable market sector.

The Treasury/HUD Report notes the necessity of "improving coordination among existing government housing finance programs."[213] Coordination of programs is long overdue and is one of the largest impediments to efficient market functioning today. Ironically, however, the meltdown in the housing and financial markets over the past few years has led to a decrease of cooperation and coordination among finance programs. Although the report validly points out that the "programs and borrowers will benefit from greater coordination of systems, information, and market standards,"[214] during the last few years, each agency has been allowed to promulgate its own qualification requirements, underwriting standards, and processes. The resulting mish-mash of regulations and ever-changing standards has made mortgage lending less predictable and, therefore, more costly.[215] Although many standards are somewhat duplicative across agencies and programs, some requirements are irreconcilable. Some are even so poorly conceived that they are internally inconsistent, making predictable satisfaction impossible. This is particularly true with respect to approved multifamily and condominium lending under FHA and Fannie Mae and Freddie Mac.[216]

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213. Treasury/HUD Report, *supra* note 16, at 13, 15.

214. *Id.*

215. *See* Letter from Loura Sanchez of Hindman Sanchez to Community Associations Institute, Nov. 23, 2010 (discussing internally inconsistent regulations that make it impossible for condominiums to ensure compliance with GSE and FHA approval requirements while not violating FHA's interpretation of 24 CFR 203.41); *see also* Andrea Boyack, *Community Collateral Damage: A Question of Priorities* (forthcoming Apr. 2011), *available at* http://ssrn.com/abstract=1811067.

216. *Condominium Approval Process for Single Family Housing*, DEP'T OF HOUS. & URBAN DEV. (2009), *available at* http://www.hud.gov/offices/adm/hudclips/letters/mortgagee/files/09-46bml.pdf. Condominium projects will not be approved for resale to the GSEs (or for FHA insurance) unless, inter alia, no more than 15% of the total units are in arrears (more than 30 days past due) of their association assessments and at least 50% of the units in the project are owner-occupied. HUD Mortgagee Letter 2009-19, June 12, 2009; HUD Mortgagee Letter 2009-46A, Nov. 6, 2009; HUD Mortgagee Letter 2009-46B, Nov. 6, 2009. The restrictions make it difficult to resell distressed units at a market price. *See* Lew Sichelman, *Lender Overlays Killing Home Sales*, NAT'L MORTG. NEWS, Nov. 19, 2010 ("[M]any condo units sit empty, not for a lack of demand, but for a lack of financing.").

B. The Bad: Worrisome Long Term Plans

While the Treasury/HUD Report outlines some short-term plans that would undoubtedly lead to market recovery and a more stable financing system prospectively, it does so only in the context of the long-term goal of "[i]mplementing a wind-down of Fannie Mae and Freddie Mac's future participation in the housing market."[217] Although it may make sense to take the U.S. government out of Fannie Mae and Freddie Mac (by removing the federal guaranty of those companies), it makes far less sense to take Fannie Mae and Freddie Mac out of the U.S. housing finance system. Historically, the GSEs have been responsible for many market and lifestyle benefits that would be eroded in the absence of Fannie Mae and Freddie Mac as market players.[218] Homeownership, access to mortgage financing, lending competition, and rental housing all would be adversely impacted by withdrawing the GSEs from the market.[219] Enormous resources developed over more than 40 years and currently part of the GSEs, in terms of human capital, connections, industry know-how and data, would be lost or devalued by the wind-down.[220] The wind-down itself would put tremendous pressure on a mortgage finance system already in the throes of its worst historic meltdown.[221] Furthermore, getting rid of Fannie Mae and Freddie Mac is unnecessary in order to achieve the very goals that the Report supposedly aims to advance.[222]

Throughout the report's descriptions of various methods whereby the mortgage finance market can be more privatized, there is no mention that Fannie Mae and Freddie Mac were actually privately held companies, financed by private capital from shareholders and sales of securities, until 2008 when the GSEs were put into conservatorship.[223] Rather than reinvent our complicated and typically well-functioning tiered mortgage market, perhaps all that is needed is restoration of the pre-2005 ownership structure along with some vitally important yet less costly reforms. We do not need to eliminate the GSEs to privatize the system—we just need to re-

217. Treasury/HUD Report, *supra* note 16, at 13.
218. *See supra* notes 11-14 and accompanying text.
219. *See infra* notes 220-79 and accompanying text.
220. *See* Hassan & Swaminathan, *supra* note 168, at 8 (noting that the MBA Model "[p]oses operational and logistical challenges related to the transfer of know-how and infrastructure of the GSEs to new guarantors.").
221. *See, e.g.*, *supra* note 10.
222. *See infra* Part III.
223. Treasury/HUD Report, *supra* note 16, at 5.

privatize the GSEs, return to sound underwriting, and provide for adequate reserves.

The Obama Administration outlined three possible pathways to privatization of the home finance market, all involving a trade off among four factors: access to mortgage credit, investment in the U.S. housing sector, taxpayer protection, and financial and economic stability.[224] For example, the report explains that a completely private secondary market, unsupported by any government guaranty, insurance, or market support, would provide maximum taxpayer protection, but would limit access to credit, investment in the housing sector, and likely financial and economic stability.[225] Other proposals involve shoring up economic and financial stability by having the government ultimately backstop a future secondary market meltdown, but would still adversely impact mortgage credit access and housing sector investment.[226] The Report presumes that it is virtually impossible to achieve all four of these factors simultaneously.[227]

Creating "skin in the game" can be achieved by permitting the GSEs to survive while gradually weaning them off of the government guaranty as capital reserves and private insurance are built up. Compensation and private market incentives are far more likely to ensure sound underwriting than are government regulators, and at lower taxpayer cost. Unsupported by taxpayer bailout, investors and shareholders would demand that the GSEs commit to better mortgage underwriting standards for purchased and pooled loans. Compensation for all market players reflecting loan quality rather than quantity would control against the risk of taxpayer bailout and systemic failure. With the GSEs intact, mortgage lending would continue to be assisted by the capital and liquidity support the secondary market and mortgage backed securitization provides. If GSE reform occurred within the context of wider market and systemic underwriting and risk assessment and allocation improvements, this continued access to capital could coexist with market stability and attractive investment options, all without sacrificing the taxpayers' interest.

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224. *Id.* at 24-27.
225. *Id.* at 27-28.
226. *Id.* at 28-30.
227. *See id.* at 31 (explaining that the three proposed options achieve some of the four factors at the expense of others); *see also* Michael Barr, *A Framework for Housing Finance Reform*, N.Y.U. FURMAN CTR., NAVIGATING UNCERTAIN WATER: MORTGAGE LENDING IN THE WAKE OF THE GREAT RECESSION, Feb. 4, 2011 (less than 1% of GSE losses have come from loans originated in 2009 and 2010).

The Report itself admits that "[t]he losses that the federal government has covered at Fannie Mae and Freddie Mac . . . are virtually all attributable to bad loans that those firms took on during the height of the housing bubble[,]" and goes on to state that with new and stricter underwriting, the loans guaranteed by the GSE today are "of much higher quality" and "unlikely to pose a significant risk of loss to taxpayers." [228] This itself highlights how the system itself is not irreparably broken; rather, there was a lapse in underwriting that caused enormous loss. Admittedly, there is still ample "bathwater" to be drained from the system—by ensuring poor underwriting is no longer appealing or even tolerable to investors or shareholders. But why throw out the "baby" of a secondary market system that not only works, but is involved in the majority of mortgages originated today? Yes, the market imploded and the GSEs are ailing. But they should be healed, not eliminated. The GSE-created housing finance system worked well for more than forty years, providing "efficient, cost effective lending and benefits to our economy . . . ."[229] Much of that system can be salvaged.

C. The Ugly: Unintended Consequences of Eliminating the GSEs

While there may be political reasons for casting blame on the GSEs for their costly, taxpayer-funded bailout, eliminating Fannie Mae and Freddie Mac altogether is only justified if it goes beyond a punitive impulse and prospectively would create a better market reality. Winding down the GSEs may solve the challenges posed by their erstwhile government implicit backup and market share, but without a better option it could create more problems than it would solve. In addition, focusing on certain issues that would go away with the demise of Fannie Mae and Freddie Mac ignores the reality that many risks this move aims to avoid would only be relocated.[230]

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228. *Id.* at 23.

229. The Securities Industry and Financial Markets Association (SIFMA) claims that we need to "fix the parts of the housing finance system which need attention without dismantling the aspects of the system that have provided efficient, cost effective lending and benefits to our economy for the last 30 years." Press Release, SIFMA Statement on Administration's Housing Finance Reform White Paper (Feb. 11, 2011), *available at* http://www.sifma.org/news/news.aspx?id=23305.

230. This is one of the themes explained in Gerald Hanweck, Anthony Sanders & Robert Van Order, *Securitization versus Traditional Banks: An Agnostic View of the Future of Fannie Mae, Freddie Mac and Banks*, FINREG 21 (Sept. 28, 2009), http://www.finreg21.com/ lombard-street/securitization-versus-traditional-banks-an-agnostic-view-future-fannie-mae-freddie-mac; Van Order, *supra* note 20, at 233-55; Robert Van Order, *The Economics of Fannie Mae and Freddie Mac*, 23 REGULATION 27, 27-33 (2000). Van Order bases his assessment of market health from varying institutional types on the classic theory of Franco Modigliani and Merton H. Miller.

Furthermore, getting rid of Fannie Mae and Freddie Mac could potentially cause dire unintended consequences for rental housing, communities, as well as the housing finance market in general. Reforming the GSEs' charters might capture the same benefits as winding down these institutions—namely, minimizing taxpayer risk—while avoiding some of the collateral damage that the elimination of the GSEs would likely entail.

1. Market Uncertainty

There are five categories of unintended consequences that must be factored into any accurate cost-benefit analysis of winding down the GSEs. First, the current significant dependence of the market on GSE-enhanced capital flow suggests that a too-rapid wind-down of Fannie Mae and Freddie Mac would increase market uncertainty. While the Treasury/HUD Report posits that private capital would materialize to fill a market gap left by the departing GSEs,[231] there is no true indication that this would happen. Since nine out of every ten loans today are either insured by the FHA or funded through GSE secondary market purchases,[232] reductions in GSE market activity would markedly increase uncertainty in the finance capital available for single family and multifamily residential mortgages.[233]

Unpredictability is costly for borrowers as well as lenders and investors, and unpredictability in the financial markets will stymie any true recovery from the financial crisis. Would-be buyers of real property—particularly distressed REO or foreclosure properties—

Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance, and the Theory of Investment*, 48 AM. ECON. REV. 261, 261-297 (1958).

231. Treasury/HUD Report, *supra* note 16, at 12-13. Chris Whalen of Institutional Risk Analytics calls it "childish" to predict the return of private capital to the mortgage finance market "at a time when the only loans being underwritten are for those with government guarantees." Tom Braithwaite & Suzanne Kapner, *White House seeks Wind Down of Fannie and Freddie*, FINANCIAL TIMES, Feb. 11, 2011; *see also* Barr, *supra* note 227.

232. Treasury/HUD Report, *supra* note 16, at 12; Secondary Market Report, *supra* note 164; *see also* Rick Newman, *Kill Fannie & Freddie? Not Likely!*, US NEWS & WORLD REPORT, Feb. 21, 2011; Marc Santora, *New Worries for Buyers Seeking Mortgages*, THE N.Y. TIMES, Mar. 10, 2011.

233. Treasury/HUD Report, *supra* note 16, at 23-24 (emphasizing that a winding down of the GSEs must happen gradually in order to be a "responsible transition."). Several commentators have reiterated the need for a cautionary pace because of the grave threat to the market that imminent credit shut-down would pose. *See, e.g.*, Ellen et al., *supra* note 55; Douglas J. Elliott, *The Middle Class Still Needs Help*, THE N.Y. TIMES, March 8, 2011 (arguing that the GSEs should be gradually phased out in "an intelligent transition plan"). Other commentators opine that slowing the wind-down of Fannie Mae and Freddie Mac will not prevent the resulting adverse market effects. *See, e.g.,* Press Release, Consumer Federation of America, Administration Proposal Could Threaten Consumer Access to Safe, Affordable Homeownership (Feb. 11, 2011) [hereinafter CFA Press Release].

cannot and will not proceed in the absence of clearly defined capital availability and costs. The GSE TBA market[234] allowed borrowers to lock in lending rates before a property conveyance, but that might not be true of a market without the gears of mortgage lending greased by a ready-made secondary buyer. Lenders will be wary of originating loans without a ready secondary market purchaser, and investors may be unable to assess credit risks of private label securities. The uncertainty of today's market has caused private capital to flee, and it is not at all certain that private capital will be enticed back into mortgage lending merely by the gradual wind-down of the GSEs. The U.S. News & World Report accurately assesses that "[w]ithout the government, in other words, hardly anybody would be able to buy a home today," and if mortgage financing is less available, the housing market could suffer still further declines that may "trigger another recession."[235] Furthermore, additional lending costs could price "[e]ven some middle-class families with good credit" out of homeownership, "leaving politicians to explain how they killed the American Dream."[236]

Capital availability is essential to recovery from the current mountain of bad mortgage debt.[237] Without capital, would-be foreclosure buyers will be unable to take title to distressed properties, prolonging the current foreclosure limbo. Real estate prices and valuation will continue to decline until foreclosure rates return to their former levels.[238] In the meantime, homeowners—particularly those with negative equity—lack any financial incentive to make payments on their debt (assuming the debt cannot be brought current or paid off) and further lack the motivation to maintain their

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234. The "TBA" market refers to the GSEs' ability to pre-sell loans (prior to origination) and therefore guaranty capital prior to loan origination. This pre-selling of loans to funding sources allowed originators to "lock in" mortgage rates, since their capital costs were known. The TBA market is essential to liquidity, says SIFMA. *See* SIFMA Statement on Administration's Housing Finance Reform White Paper, *supra* note 229.

235. Rick Newman, *Kill Fannie and Freddie? Not Likely*, U.S. NEWS & WORLD REP. (Feb. 21, 2011), http://money.msn.com/investing/kill-fannie-and-freddie-not-likely-usnews.aspx.

236. Rick Newman, *Why Fannie and Freddie May Never Die*, USNEWS.COM (Feb. 15, 2001(, http://money.usnews.com/money/blogs/flowchart/ 2011/02/15/why-fannie-and-freddie-may-never-die; *see supra* note 36 and accompanying text.

237. The Mortgage Bankers Association reported in November 2010 that approximately 14% of all mortgages, meaning nearly 4 million properties, are delinquent or in foreclosure. *See Lawler: How Many Folks Have "Lost Their Homes" to Foreclosure/Short Sales/DILs?*, CALCULATED RISK (Feb. 2, 2011, 5:30 PM) http://www.calculatedriskblog.com/2011/02/lawler-how-many-folks-have-lost-their.html; *see also* Calculated Risk Data, *supra* note 206.

238. Boyack, *supra* note 68, at 70.

homes.[239] Foreclosure limbo for negative equity properties is the worst possible reality, leading to deterioration of the housing stock, cost-shifting onto blameless neighboring owners, and increasing market uncertainty and investor flight.[240] Tightening the flow of capital exacerbates the huge costs that foreclosure delay imposes on communities, mortgage lenders and investors,[241] particularly until the inventory of bad loans is cleared out of the system.

Still, proponents of GSE wind-down maintain that private capital will move in to fill any vacuum left by Fannie Mae and Freddie Mac.[242] This faith in a seamless market solution to the capital liquidity problem seems ill-founded, particularly in light of private capital's behavior over the past few years. All we have seen since 2008 is widespread flight of private capital from the housing finance business.[243] It will take more than a theoretical market opportunity to bring private capital back, particularly for securities that carry credit risk. Even the Treasury/HUD Report admits that "[i]n the wake of the financial crisis, private capital has not sufficiently returned to the mortgage market," although the Report echoes this hope that private capital may reappear in the wake of a GSE wind-down.[244]

Even if private capital were to return to a stable mortgage finance market, recent experience has validated one fear that justified creation of the GSEs to begin with: private capital will not continue to exist during market downturns. Just when the flow of credit is most needed to keep a market from freezing up or panicking, most private capital sources dry up. While the Treasury/HUD Report recognizes this and suggests some system of emergency-only public

239. Boyack, *supra* note 215.
240. *Id.*
241. *Id.*
242. Treasury/HUD Report, *supra* note 16, at 12-13.
243. *See supra* note 235. Rescuing Fannie and Freddie was necessary to keep the residential mortgage market machinery from grinding to a halt and mitigated the impact of the crash on homeowners and homebuyers. *See* Testimony of Herbert Allison, *supra* note 73; Stuart Gabriel & Stuart Rosenthal, *Do the GSEs Expand the Supply of Mortgage Credit? New Evidence of Crowd Out in the Secondary Mortgage Market*, J. OF PUBLIC ECONS. (forthcoming). Commentators from all sides of the political spectrum reluctantly admit that 2008-2011 would be credit frozen years for housing had Fannie Mae and Freddie Mac not been taken over and compelled to keep capital flowing into housing finance. Barr, *supra* note 227. Barry Zigas of the CFA recently said that "the conservatorship has been a tremendous help in stabilizing the decline in the housing market, and has been one of the key reasons that the housing market has not crashed further." *Politics: Shattered Dreams: The End of Fannie and Freddie*, FOXNEWS.COM (Feb. 21, 2011), http://www.politics.foxnews.mobi/quickPage.html?page=23888&content=48532108&pageNm=-1.
244. Treasury/HUD Report, *supra* note 16, at 12.

capital to stabilize markets in times of need,[245] it is unclear how this sort of capital support system could be turned on and off like a faucet.

2. Higher Costs of Mortgage Capital

The cost of capital will increase as Fannie Mae and Freddie Mac leave the market.[246] Proponents and critics of the GSE system alike agree that capital costs are lower today because of the GSEs. While economists have modeled and estimated the degree to which mortgage capital costs will grow should Fannie Mae and Freddie Mac cease to play their market role, some increase in the cost of lending and borrowing is virtually certain. Raising the cost of housing finance capital will create other outcomes in sequence, and each of these spells adverse consequences for the economy. First, higher costs of borrowing will decrease access to mortgage finance, which will decrease access to homeownership and put downward pressure on real estate values. As the cost of capital increases, more and more would-be borrowers will be priced out of the market. This is particularly true if underwriting standards and loan-to-value ratio requirements increase—as they must.[247] While increased underwriting standards alone will disqualify some would-be borrowers, raising the cost of capital in addition will make homeownership unavailable to millions of Americans. In the past three years, homeownership levels have eroded to the pre-2000 range (while demographic changes in population suggest that in a neutral

245. *Id.* at 28-29.

246. This is a nearly unanimous opinion of commentators on the issue. John McIlwain, *Homeownership: Deferring the Dream*, URBAN LAND INST., Feb. 23, 2011 ("all proposals . . . will create a more costly mortgage market for consumers"). The only contested issue in is by how much the cost of capital will in fact increase. *See, e.g.*, Credit Suisse Report, *supra* note 168; Adam Quinones, *Risk Retention Reform is Top Priority: White Paper Winners and Losers*, MORT. NEWS DAILY (Feb. 11, 2011), www.mortgagenewsdaily.com/channels/198694/print.aspx (predicting a 2 percentage point cost increase for 30-year fixed rate loans if the GSEs are wound down); *Treasury Plan Admits to an Increase in the Cost of Housing*, NAT'L MORT. NEWS, Feb. 9, 2011; Michelle Singletary, *In Overhauling Fannie Mae and Freddie Mac, it's better to be Late than Sorry*, THE WASH. POST, Feb. 2, 2011; Edward Glaeser, *Reform Isn't Enough*, THE N.Y. TIMES, Mar. 8, 2011 (arguing that the increase in capital costs and decrease in home values would be "moderate rather than cataclysmic" and that "prices would probably drop by less than 2 percent."). Mark Zandi, economist and adviser to both political parties, estimated that mortgage rates would go up one percentage point and home prices would fall by 10% should the GSEs be eliminated. Zachary Goldfarb, *Bipartisan Support for Scrapping Fannie, Freddie Draws Criticism*, THE WASH. POST, Feb. 9, 2011; *see also* Goldfarb & ElBoghdady, *supra* note 10.

247. *See supra* Part II.A.; *infra* Part III.B.

market, homeownership would be increasing during this period).[248] Decreased mortgage access will exacerbate that trend.

Barry Zigas, director of housing policy for Consumer Federation of America, claims that the Treasury/HUD Report's proposals would lead to "the abandonment of a nearly 70-year commitment to affordable homeownership by working American families."[249] Zigas claims that the only beneficiaries would be "Wall Street banks and hedge funds" and that the elimination of the GSEs will end up "[m]aking consumers pay more in these troubled times."[250] The National Council of La Raza and NAACP released a joint statement decrying the Administration's proposal to eliminate the GSEs, saying that even in the best case, such proposals will "entirely fail" to meet the goal of ensuring access to credit and "will instead marginalize communities of color."[251] John Taylor, President and CEO of the National Community Reinvestment Coalition predicts that elimination of GSE-purchased loans will cause a "radical reduction in the number of working class and blue-collar people who can own homes" and could close "the window of opportunity for home ownership . . . for the next generation of homeowners."[252] Representative Maxine Waters expressed concern that the proposals would "radically increase the cost of homeownership, and housing in general," and therefore be to the detriment of her constituents.[253]

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248. *Housing Vacancies and Homeownership*, U.S. CENSUS BUREAU, *available at* http://www.census.gov/hhes/www/ housing/hvs/annual06/ann06t20.html; *see also* Haya El Nasser, *Drop in Homeownership Likely to Continue*, USA TODAY (Aug. 6, 2009), http://www.usatoday.com/news/nation/2009-08-05-rental_N.htm.

249. Press Release, Consumer Fed. of Am., Administration Proposals Could Threaten Consumer Access to Safe, Affordable Homeownership 1 (Feb. 11, 2011), *available at* http://www.consumerfed.org/pdfs/ Zigas-Response-to-Admin-Housing-Plan-PR-2-11-11.pdf.

250. *Id.* at 3. Zigas correctly points out that the financial crisis was authored and directed by Wall Street, not by the GSEs, who were merely among the largest individual victims of the culture of speculation and bad underwriting. *Id.* at 2. Zigas blames the housing bubble—and ultimate bust—on "regulators [who] turned their backs on consumers and allowed Wall Street banks and investors to wreck the world economy with expensive, unsafe and predatory loans that were outside the government's guarantee system to begin with," and concludes that "sticking it to consumers only to enhance Wall Street profits is unacceptable." *Id.* at 3.

251. Civil Rights Statement on the Administration's Report on Reforming the U.S. Housing Finance Market, Feb. 11, 2011, *available at* http://www.nationalfairhousing.org/Portals/33/Media%20Statement%20Housing %20funding.pdf; *see also* Edward Scanlon, *The Impact of Homeownership on the Life Satisfaction of African Americans*, WASH. U. CTR FOR SOCIAL DEV. (1999).

252. John Schoen, *White House wants Fannie, Freddie to Go*, MSNBC.COM (Feb. 11, 2011), http://www.msnbc.msn.com/id/41520586/ns/business-eye_on_the_economy/.

253. Zachary Goldfarb & Brady Dennis, *Administration Proposals to Overhaul Federal Housing Role Draw Fire from Left*, THE WASH. POST (Feb. 12, 2011),

Without a robust secondary mortgage market offering to assume interest rate and prepayment risk from mortgage loan originators, mortgage product offerings will likely change. Currently, the secondary market is an essential tool for lenders to hedge the risks inherent in a system that pairs short-term, flexible interest rate capital costs for lenders with what is, in the U.S., the conventional mortgage loan type: a long-term, fixed interest rate, prepayable loan.[254] Under this structure, the borrower not only can pay back a loan over a long period of time, but the borrower bears no interest rate risk at all. If interest rates rise over the life of the loan, the borrower is safely fixed at a lower, predictable interest rate set at the funding date. If interest rates drop, the borrower can prepay the debt at no penalty and refinance at the lower rate.[255] The only reason that mortgage originators are motivated to offer such a loan product is because the interest rate and prepayment risks are immediately passed on to the secondary market (which typically passes them on to investors). Saying farewell to the GSEs could well mean the demise of the thirty-year, fixed rate prepayable mortgage loan.[256] Some politicians and economists note that this may not be a bad result: no other country in the world offers long-term, fixed rate mortgage loans as a general rule.[257] Indeed, the only reason these offerings are widely available in the U.S. is because of the secondary market and securitization. Perhaps the borrowing public will adjust to a European-style mortgage lending system, and perhaps not.

Over the past three years, real estate values have fallen 30% in the United States.[258] Higher costs of mortgage financing and lower mortgage capital access will reduce borrowing power, depress housing demand, and further depress real estate values. While initial losses in housing values can be chalked up to correcting for bubble-era pricing, the current drag on property values indicates a more

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http://www.washingtonpost.com/business/left-blanches-at-administrations-housing-market-proposals/2011/02/11/ABJecqF_story.html.

254. Kling, *supra* note 11 ("I am skeptical that the 30 year fixed rate mortgage without a prepayment penalty would survive without [Fannie Mae and Freddie Mac]"). *But see* Jaffe, *supra* note 9 ("The 30 year fixed rate mortgage will flourish in a private market").

255. *See generally* Michael Schill, *The Impact of Capital Markets on Real Estate Law and Practice*, 32 J. MARSHALL L. REV. 269, 269-279 (1999); MALLOY & SMITH, *supra* note 13 at 379-83; Robin Paul Malloy, *The Secondary Mortgage Market–A Catalyst for Change in Real Estate Transactions,* 39 SW. LAW J. 991, 1003-1010 (1986); Barr, *supra* note 227.

256. *See, e.g.*, Applebaum, *supra* note 12; Borak, *supra* note 12 (noting that the conventional 30-year fixed, prepayable loan will likely not exist in the absence of the GSEs).

257. *See, supra* notes 11-12.

258. Economist Special Report, *supra* note 12 at 15; *see also supra* note 3.

serious and long-lasting trend and relates to increasing unemployment, lower wealth, and higher credit standards.[259] These factors already constrain housing demand and put downward pressure on prices. If credit costs increase, it will be even more difficult to get capital for housing and prices of homes will fall further still. Reducing the availability of mortgage capital also makes real estate less liquid, making it harder for people to sell homes, more difficult to own or buy a home, and incidentally making the population less mobile.

Falling property values also represent a destruction of wealth for Americans, amounting to trillions of dollars.[260] The U.S. savings rate is one of the lowest in the world.[261] The way many people build wealth and save for retirement is by building equity in their homes, through a combination of amortization and appreciation.[262] When home values plummet, retirement savings and the American homeowner's "nest egg" disappear. As we have already seen in the wake of the housing meltdown, this destruction of wealth has far-reaching consequences. The capital gap to cover disappeared wealth has already had far-reaching repercussions in the world's economy: in 2008, some four trillion dollars disappeared from the world's "balance sheet" (as if the GDPs of France, Spain and Italy had all vanished).[263]

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259. *See* discussion of underlying home valuation fundamentals in Boyack, *supra* note 68 at n.29-44 and accompanying text.

260. *See In Come the Waves*, *supra* note 65.

261. The average savings rate for Americans in the decade prior to January 2000 was a scant 3.5%, but this rate fell below 1.0% multiple times in the decade between 2000 and 2010. *Comparison of Personal Saving in the National Income and Product Accounts with Personal Saving in the Flow of Funds Accounts*, BUREAU OF ECON. ANALYSIS (March 25, 2011); *see also* NAHB April Statement, *supra* note 10.

262. *See Social Benefits of Homeownership and Stable Housing*, RESEARCH DIV., NAT'L ASS'N OF REALTORS, 2 (2006), *available at* http://www.realtor.org/research/research/homeownershipbenefits; Eric Belsky & Joel Prakken, *Housing Wealth Effects: Housing's Impact on Wealth Accumulation, Wealth Distribution and Consumer Spending* 3 (2004), *available at* http://www.jchs.harvard.edu/publications/finance/w04-13.pdf (explaining equity building as method to accumulate wealth); *Testimony of Julia Gordon, Center for Responsible Lending, Before the House Committee on Financial Services Subcommittee on Insurance, Housing and Community Opportunity, Are There Government Barriers to the Housing Market Recovery?*, Feb. 16, 2011 [hereinafter Gordon Testimony]; *see also* Economist Special Report, *supra* note 12 at 5. *But see* William Goetsmann & Matthew Spiegel, *The Policy Implications of Portfolio Choice in Underserved Mortgage Markets*, JOINT CTR. FOR HOUS. STUDIES OF HARV. U. (Aug. 2001) (alleging that when adjusting for inflation, homeownership does not increase wealth).

263. *See* MAITLAND & BLITZER, *supra* note 3. GDP per capita (PPP) as described in the Central Intelligence Agency's World Factbook, *available at* https://www.cia.gov/library/publications/the-world-factbook/fields/2195.html; *see also* Heather Landy & Renae Merle, *A Record Fall on Wall Street: Stocks Dive as Bailout Bill Fails to Pass*, THE WASH. POST, Sept. 30, 2008 (noting that the Dow Jones

Falling property values will also spell further reductions in property tax revenue for communities. Again, we have already seen the start of this trend as depressed values lead to decreased municipal revenues. Municipalities face budgetary gaps caused by lower-than-expected property tax inputs, which puts at risk the many public goods provided by localities, including schools, libraries, parks, emergency services and the like.[264] Correcting for this reduction in value by increasing millage rates will be politically difficult if not impossible.

3. Insufficient Rental Housing

Increased market uncertainty and higher costs of borrowing will make home-buying less available, which means that rental demand will increase. While there be many reasons to support an affordable market for rental housing as a viable alternative to homeownership,[265] ironically, without Fannie Mae and Freddie Mac acting to keep funds flowing to multifamily housing development, there will be insufficient rental housing to support this increasing demand. The multifamily housing loan portfolios of the GSEs did not create losses for the entities, perhaps because multifamily project mortgages continued to be well underwritten even in 2006-07.[266] Multifamily loans held or guaranteed by Fannie Mae and Freddie Mac have suffered almost no

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industrial average tumbled 7 percent, or 777.68 points, eclipsing the record point drop after the Sept. 11, 2001 terrorist attacks, to close at 10,365.45; the technology-heavy Nasdaq composite index slid 9.14 percent, or 199.61, to 1983.73, and the broader Standard & Poor's 500-stock index lost 8.79 percent, or 106.62, to close at 1106.39."); ROBERT J. SHILLER, THE SUBPRIME SOLUTION: HOW TODAY'S GLOBAL FINANCIAL CRISIS HAPPENED, AND WHAT TO DO ABOUT IT, 29-38, 87-113 (2008) (attributing the financial crisis to un-tempered increases in home prices); Ruth Mantell, *Home Prices Off Record 18% in Past Year, Case-Schiller Says,* MARKETWATCH (Dec. 30, 2008), http://www.marketwatch.com/story/home-prices-off-record-18-in-past-year-case-shiller-says.

264. William Selway, *U.S. Property Taxes Fall by Most Since Housing Market Crash,* BLOOMBERG, Mar. 29. 2011 (citing Census Bureau reports of a $5.3 billion drop in municipal real estate tax collections); Gordon Testimony, *supra* note 262, at 5; G. Thomas Kingsley, Robin Smith & David Price, *The Impact of Foreclosures on Families and Communities,* THE URBAN INST. fig. 3 (May 2009).

265. 2010 Harvard Housing Study *supra* note 78; 2008 Harvard Housing Study, *supra* note 78. One third of Americans today rent their residences; *see* Rental Housing Finance, *supra* note 77.

266. One reason that rental properties in general have fared better during the housing crisis is that revenue-producing properties are usually subject to a different pricing methodology, namely the stream-of-income method. Valuation based on the stream of income was linked to a less-manipulable variable, namely salary levels, and these provided some constraint in appraisals. The bubble did not grow as fast or as large in sectors where housing was priced according to the stream-of-income method, which meant the fundamentals upon which a loan was assessed and underwritten were more reliable and the loan less risky. *See* Boyack *supra* note 68, for an in-depth discussion of stream-of-income valuation and other more bubble-prone systems.

losses (less than a 1% default rate),[267] and are still bringing in a profit during conservatorship.[268] Unwinding the GSEs would change that, tightening credit availability not only for single family lending but for multifamily residential projects as well. Decreased credit availability to multifamily developers and landlords would be devastating to housing availability and costs, particularly as demand for rental options continues to rise.

It is doubtful that private capital would adequately fill a void in this sector,[269] even though defaults have been minimal. Had the GSEs not continued funding multifamily housing from 2008 to 2010, there would have been widespread foreclosures on performing apartment property loans as owners of these projects would have been unable to obtain capital to refinance at maturity.[270] The thousands of rental units that were at stake have thus far been saved. These renters would be imperiled in a future without predictable capital for multifamily mortgage lending.

During the next few decades, demand for rental housing is projected to increase significantly. In the next five years, two-thirds of all new households will be rentals, which means six million new rental households will enter the market, demanding housing options.[271] Professor Arthur Nelson of the University of Utah predicts that half of all homes built between now and 2030 will have to be rental units to meet this growing demand.[272] Since private capital for

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267. *See supra* notes 64-73 and accompanying text.

268. Up to $2 billion so far. NMHC Perspective, *supra* note 74.

269. Traditionally, the majority of multifamily home mortgages have been sold on the secondary market to Fannie Mae or Freddie Mac. NMHC Perspective, *supra* note 74; *see also* Rental Housing Finance, *supra* note 77 at 2. The Center for American Progress proposes that mortgage-backed securities issues be chartered specifically for multifamily housing mortgage lending. *See generally* Rental Housing Finance, *supra* note 77.

270. NMHC Perspective, *supra* note 64; *see also Policy Brief: Meeting Multifamily Housing Finance Needs During and After the Credit Crisis*, JOINT CTR. FOR HOUS. STUDIES OF HARVARD U. (Jan. 2009) (warning that without loan purchases by Fannie Mae and Freddie Mac, "apartment transactions could come to a near standstill").

271. Arthur C. Nelson, *The New Urbanity: The Rise of a New America*, 626 ANNALS AM. ACAD. OF POL. & SOC. SCIENCE, 192 (Nov. 2009) (predicting that the upcoming shift into rental households will be "as sweeping a change to America's metropolitan landscape as the half century after World War II"); *see also* Rental Housing Finance, *supra* note 77, at 1 (describing the "echo boom" generation entering the housing market during the next decade and predicting that "rents will in all likelihood rise, perhaps sharply, over the next 10 years"). The number of renters becoming home-owners has dramatically dropped off in the years since the financial crisis. *See* Economist Special Report, *supra* note 12, at 5.

272. Nelson, *supra* note 271; *see also* ARTHUR C. NELSON, DEMOGRAPHIC OUTLOOK FOR MULTI-FAMILY HOUSING (2009); Arthur C. Nelson, *Catching the Next Wave: Older Adults and the "New Urbanism,"* 33 J. OF THE AM. SOC'Y ON AGING 37 (Winter 2009-2010).

new apartment construction has essentially disappeared since the crisis began, how will there be sufficient financing to build the required 300,000 new rental units a year without Fannie Mae and Freddie Mac? Outside the GSEs, there is not sufficient capital to even replace units lost through demolition and obsolescence.[273] The growing rental demand projections make this shortfall even more acute.

Collateral damage to the multifamily housing market would be ironic as well as unfortunate because providing capital to this market has cost taxpayers nothing. Not only have these loans performed well and have earned the GSEs profits, but 90% of the apartments financed by the GSEs are affordable to families without government assistance.[274] In this way, the GSEs do precisely what they had been envisioned to do: allocate private funds to provide housing to those who can afford to pay reasonable housing costs while freeing up governmental funds to provide subsidies to people who cannot (through FHA and VA).

Constraining the rental housing supply while demand increases will of course mean rents will go up. This will make existing rental housing less affordable, particularly for the most vulnerable segments of society. In turn, this will lead to more dependence on government housing aid, putting more of a burden on the FHA. The FHA is already overwhelmed with the number of loans it is being asked to insure, its own market share having increased from less than 10% to almost 40% since the crisis began.[275] One of the immediate goals of the Treasury/HUD Report is to scale back FHA's market share,[276] but

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273. NMHC Perspective, *supra* note 74. The debate on the future of the GSEs has largely ignored the impact multifamily housing. Peter Lawrence, *Policy Points: Multifamily Finance: The Neglected Issue in the Fannie-Freddie Debate*, 11 J. OF TAX CREDITS 1 (2011) ("[W]hat may get lost in this vigorous and consequential GSE debate is ensuring that a well-performing, highly liquid capital market for multifamily rental housing continues.").

274. NMHC Perspective, *supra* note 64. Today 30 million of the 36.7 million rental units in America are not subsidized in any way by the federal government. Rental Housing Finance, *supra* note 77, at 9; 2008 Harvard Housing Study, *supra* note 78, at 12. Even so, the specter of un-affordability of housing hangs over rental housing as a whole, since renters spend a disproportionately higher share of their income to meet their housing needs. 2010 Harvard Housing Study, *supra* note 78; *see also* Gordon Testimony, *supra* note 262, at 6.

275. Robert Van Order & Anthony Yezer, *FHA Assessment Report: The Role and Reform of the Federal Housing Administration in a Recovering U.S. Housing Market*, GEO. WASH. CTR. FOR REAL ESTATE & URBAN ANALYSIS (Feb. 2011) (finding that the FHA "moved into uncharted, risky territory" by increasing its market share from 6% to more than 56%).

276. Treasury/HUD Report, *supra* note 16, at 14. Immediately following the release of the Treasury/HUD Report, the FHA raised its mortgage insurance

if the need for government housing assistance increases, that will prove impossible.

Efforts to reduce the number of FHA-insured loans have already essentially eliminated most FHA financing for condominium products, which ironically would normally have provided another source of affordable multifamily living. The first steps taken by the FHA to deliberately remove itself from segments of the mortgage finance focused on cutting off insurance for condominium unit financing.[277] Thousands of condominium sales have been chilled or frozen because of the lack of available capital due to changes in the FHA condominium approval process (changes that include internally inconsistent and sometimes incomprehensible requirements) and hugely widespread approval expiration without the possibility of spot-approval renewals.[278] Eliminating FHA-insured financing for condominiums and multifamily housing developments while winding down the GSEs would further undercut efforts to promote such vertical living arrangements as viable ownership and rental housing options.

The Treasury/HUD Report admits that Fannie Mae and Freddie Mac "developed expertise in profitably providing financing to the middle of the rental market, where housing is generally affordable to moderate-income families,"[279] but in advocating a wind-down of Fannie Mae and Freddie Mac, the Report offers absolutely no suggestions regarding possible alternative financing sources for this increasingly critical market sector. Until a reliable substitute for the GSEs in this context is found, winding down Fannie Mae and Freddie Mac would be irresponsible policy.

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premium by 0.25% in order to build up reserves in its Mutual Mortgage Insurance Fund and to deliberately reduce market share. Wood, *supra* note 15.

277. HUD Mortgagee Letter 2009-19, June 12, 2009; HUD Mortgagee Letter 2009-46A, Nov. 6, 2009; HUD Mortgagee Letter 2009-46B, Nov. 6, 2009).

278. While GSE support of mortgage financing for single family homes has been cited as one of the ways our legal system promotes sprawl (along with the biggest sprawl factor—zoning), the creation of the condominium ownership form in the 1960s permitted the twin goals of homeownership and re-urbanization/re-greening of housing to co-exist. It is surprising that the first housing product sector to suffer from government pullout is the very product sector that is most affordable, most likely to give rental housing alternatives, and typically most "green." It is even more surprising that most scholars condemning homeownership promotion as "push[ing] Americans away from urban density toward suburbia, leading to longer commutes, more energy use and the decline of urban centers," ignore the condominium homeownership model. *See, e.g.*, Glaeser, *supra* note 246.

279. Treasury/HUD Report, *supra* note 16, at 20.

4. Diversion of Investment Capital

The Treasury/HUD Report recognizes that the GSEs aided in attracting capital to U.S. mortgage capital markets.[280] Eliminating the GSEs will, in turn, likely divert capital away from the U.S. mortgage market. While the Administration notes that this diverted capital could be put to use in other productive segments of the U.S. economy, this optimistic assumption understates the magnitude of real estate and housing-related sectors in the economy today and ignores the fact that much investment capital in the U.S. housing market may be diverted away from the United States altogether.

American real estate capital markets currently attract money from investors worldwide,[281] which helps decrease mortgage costs for American homebuyers and stimulates employment in the finance, housing and construction sectors. The U.S. mortgage market is "one of the largest and most liquid of all fixed-income markets globally."[282] This well-functioning, liquid market option attracts "vast amounts of private capital."[283] If this market were to be disrupted, investment capital would find other homes. It is impossible to predict precisely where, but since capital in the real estate markets originates from all parts of the globe, it is likely that at least some of this capital will be diverted to other countries.

Less capital in the U.S. housing market will further increase unemployment. To date, the biggest job losses have been in construction, development and other fields related to the wrecked housing market as well as the $11 trillion housing finance system.[284] But other sectors have been—and will be—adversely impacted as well. Fewer home sales reduce employment in home furnishings, appliances, sales, home improvement, and a host of other related

280. *Id.* at 4, 25.

281. Thompson, *supra* note 11, at 52. ("As mortgage backed securities performed outstandingly and generated profits, Wall Street, and almost every other international player, became euphoric about these new debt instruments. Believing them to be reliable and safe investments, an array of world renowned financial institutions flocked to invest."); *see also Anatomy of a Meltdown, The Credit Crisis: A Three-Part Series on the U.S. Housing Bust*, THE WASH. POST, June 15-17, 2008 (chart showing global investments 200-2008). "Wall Street had no shortage of customers for subprime products, including pension funds and investors in places such as Asia and the Middle East, where wealth had blossomed over the past decade." *Id.* at pt. 1.

282. *See* SIFMA Statement on Administration's Housing Finance Reform White Paper, *supra* note 229.

283. *Id.*

284. The construction industry alone has suffered the loss of 1.9 million jobs since 2007, with the unemployment rate in that industry at more than 20%. *Employment Situation Summary*, BUREAU OF LABOR STATISTICS, Apr. 1, 2011, *available at* http://www.bls.gov/news.release/empsit.nr0.htm; *see also* Barr, *supra* note 227.

areas of the economy—and rising unemployment is currently the largest barrier to ultimate economic recovery.

5. Competition and Market Failures

One other ugly unintended consequence of winding down Fannie Mae and Freddie Mac is the reduction in market competition and accountability for mortgage originators that would result from the huge competitive advantage that would be enjoyed by the largest banking institutions in the absence of GSE underwriting and capital support to level the playing field. Four companies would be the biggest beneficiaries of winding down Fannie Mae and Freddie Mac: Bank of America, Wells Fargo, JP Morgan Chase and Citibank.[285] These "Big Four" would be the only institutions who would likely be able to take over the GSEs' market share and do what Fannie Mae and Freddie Mac do now. And without the GSEs, the smaller banks—the regional and mid-size community banks—would not be able to effectively compete. Eliminating the GSEs would likely spell the end of mortgage lending competition outside of this four-bank oligarchy, which would significantly reduce the consumer protections inherent in a competitive market.[286]

While the Treasury/HUD Report suggests that eliminating the GSEs would remove entities that have a market advantage and

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285. Some large national banks and major regional banks may benefit to some extent as well, but these four mega-banks would reap the largest gains. This is presumably what Barry Zigas of Consumer Federation of America meant when he referred to "Wall Street." *See supra* notes 249–251 and accompanying text; *see also* Sara Rosen Wartell & Barry Zigas, *High Stakes in Housing Finance Reform*, AM. BANKER, Aug. 11, 2010.

286. Currently, community banks have an alliance with Freddie Mac which ensures their access to the secondary mortgage market. Through this program, GSE expertise and support allows these smaller banks to compete in the mortgage lending market. News Release, PRNewswire, ICBA and Freddie Mac Renew and Enhance Alliance Agreement (Mar. 18, 2011). Refocusing secondary market share to large institutional lenders would not eliminate the problems for which Fannie Mae and Freddie Mac are now accused of foisting on the nation: moral hazard, bad underwriting and mortgage bubble psychology. In fact, while the GSEs crafted the secondary market and securitization for prime loans, the bulk of the risk, loss, and systemic peril was created at the hands of the securitizing investment banks. Ironically, to the extent that destroying Fannie Mae and Freddie Mac benefits banking giants, the "solution" to the mortgage crisis would actually sacrifice stable loans and reward the very authors of systemic risk. Moral hazard and underwriting problems were by far more imperiling in the private sector. *See* Gary B. Gorton, Slapped in the Face by the Invisible Hand: Banking and the Panic of 2007 39-40 (May 9, 2009) (unpublished manuscript, prepared for Fed. Reserve Bank of Atlanta's 2009 Fin. Mkts. Conference), *available at* http://www.frbatlant a.org/news/Conferen/09fmc/gorton.pdf.; Gary B. Gorton, *The Subprime Panic* (Nat'l Bureau of Econ. Research, Working Paper No. 14398, 2008), *available at* http://www.nber.org/papers/w14398.

thereby create an even playing field,[287] this is not the case. Community and regional banks lack the capacity to create large enough loan pools to obtain sufficient capital to compete with the "Big Four." In a system where the GSEs set underwriting standards for secondary market "conforming loan" purchases, all originators are required to play by the same underwriting rules. But since community banks are more vulnerable to individual loan failures because of their smaller size, bigger banks can leverage their volume in order to decrease underwriting standards and broaden customer base in order to push smaller players out of the mortgage lending market. After the dust settled from the 2008 financial meltdown and the associated acquisitions, mergers and failures, the Big Four banks were left collectively holding an astounding 57% share of the residential mortgage market.[288] Eliminating the GSEs would increase their market dominance and ensure that they remain, in effect, too big to fail.

Rendering smaller banks less able to compete in the mortgage market will hasten their irrelevance as mortgage originators. What does that mean for the residential housing finance market? Instead of a myriad of various-sized originating lenders, we would be left with four giant lenders and a small number of larger regional banks. The best case is that only the four giant lenders would effectively be too big to fail. In addition, unlike in the case of the GSEs that had a special charter-based mandate and oversight, there is no government input or control over these banking institutions other than through legislation.

Giving further market advantage to the Big Four banks is especially ironic because it was the private sector MBS that spawned and triggered the housing meltdown to begin with.[289] While perpetrators and victims of the crises of 2007-08 abound, the fact that private label securitization losses were more than double those of Fannie Mae and Freddie Mac, and the fact that underwriting was more absent and

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287. Treasury/HUD Report, *supra* note 16, at 8, 12-13. In fact, removing the GSEs could create an uneven playing field benefitting the big banks. *See supra* notes 274-277 and accompanying text. *But see* Mayer *supra* note 11 (arguing that smaller banks could organize into cooperatives to effectively compete with larger institutions and pointing out that this is what has happened in Denmark).

288. Wells Fargo originated 23.92% of residential loans in the 4th quarter of 2009, Bank of America originated 22.43%, Chase originated 9.02% and CitiMortgage originated 2.81%. Only five other lenders were above 2% market share, and no other lender was above 5%. *Top Residential Originators 4Q09*, NAT'L MORTG. NEWS (March 8, 2010), http://www.nationalmortgagenews.com/nmn_issues/34_23/-456249-1.html; *see also* Gordon Testimony, *supra* note 262, at 18.

289. *See supra* notes 88, 105, 286.

risk-management more out of control in the private sector, all argue against handing the Big Four the "keys to the kingdom" by eliminating their only true competitors: Fannie Mae and Freddie Mac. The Consumer Federation of America notes that taking the GSEs out of the equation would shift control of mortgage banking to "Wall Street banks and investors whose previous missteps have already caused massive foreclosures and losses for consumers."[290] As Rick Newman of U.S. News & World Report notes, "[t]hey kind of have a point."[291]

III. PATH TO PRESERVE FANNIE AND FREDDIE

A. Looking Forward

Eliminating the GSEs may be a good move politically and, ironically, is a goal that both Democrats and Republicans agree upon, though for different reasons. Politicians on the right have long been concerned with taxpayer support of housing in the form of the implicit guaranty of the secondary mortgage market, and argue that the presence of the GSEs sets up quasi-public entities as favored market players, costing taxpayers billions.[292] The failure of the GSEs, say those on the right, was their failure to remain truly private corporations and their attempt to advance housing goals, not just shareholder profit. Politicians on the left cite the opposite reason as the cause of Fannie Mae and Freddie Mac's failure: by bowing to profit-maximizing pressures of shareholders and management, the GSEs strayed from their public purpose and mandate to increase housing opportunities for lower-income Americans.[293] As Professor Robert Van Order of The George Washington University School of Business put it, "Republicans want to get rid of [Fannie Mae and Freddie Mac], and Democrats want them to become the FHA."[294]

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290. Newman, *supra* note 236 (quoting Barry Zigas); *see also* Barr, *supra* note 227.

291. Newman *supra* note 232; *see also* Adam J. Levitin, *More Openness on Mortgages*, THE N.Y. TIMES, March 8, 2011 (opining that "privatizing the housing finance system means increased financial vulnerability for homeowners and greater systemic risk from the housing sector" and pointing out that "the private securitization market has never provided transparency of credit risk to investors and will not do so on its own.").

292. *See supra* notes 7, 9, 60 and 128-133 and accompanying text; *see also* Goldfarb, *supra* note 246 ("Republicans want to accelerate the mortgage giants' demise, reflecting their view that Fannie and Freddie are government-created monstrosities whose victims have been the taxpayers.").

293. Goldfarb, *supra* note 246 ("Although Republicans and the administration agree that Fannie and Freddie have to go, that's where the agreement ends.").

294. Conversation with Professor Robert Van Order, Professor of Fin., Geo. Wash. U. (Mar. 10, 2011); *see also* White, *supra* note 197.

Interestingly, each side is both right and wrong. Profit-maximizing activities did lead to a significant portion of risk-taking behavior in 2006-2008, in the form of buying and guarantying Alt-A loans in particular.[295] And Congressional pressure to make mortgage capital more available in the hope of further raising homeownership rates was what made the GSEs even more vulnerable to market downturns.[296] The mission-focus of Fannie Mae and Freddie Mac combined with their profit seeking led them to buy AAA-rated tranches of subprime MBS offerings, which was the most cost effective way to meet affordable housing goals set by HUD.[297]

Regardless of the failings of the GSEs on both accounts, we need to look ahead to the best market and consumer result, not become reactionary in our legislation and legal systems, and elimination of the GSEs may harm both homeownership and a free market. Winding down Fannie Mae and Freddie Mac may be politically savvy in the short term by effecting a large superficial "solution" to the risk of yet another taxpayer bailout and may be appealing in allowing the government to assign blame and channel public discontent. But this political maneuver risks harming the home finance system in the long term to appease short-term calls for response and retribution.

In the 1980s, the mortgage market was transformed by the growth of the secondary market and securitization. That genie cannot be put back in the bottle. Therefore, our capital markets will still need entities that do what Fannie Mae and Freddie Mac do in order to continue to function—generate liquidity by providing a secondary market for mortgages. Keeping the GSEs alive avoids having to reinvent the wheel. These two companies have extensive personnel, technology and market expertise. Fannie Mae and Freddie Mac have established banking relationships with lenders, services, appraisers, engineers, and other service providers in the mortgage system. They are up and running today, taking advantage of their decades of experience in fulfilling the important intermediary function in the real estate capital market.

There are currently no good alternatives. The Treasury/HUD Report fails to even begin to describe adequate market substitutes,

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295. *Annual Report (Form 10-K)*, FANNIE MAE 25 (2007), *available at* http://www.fanniemae.com/ir/pdf/annualreport/2007/2007_annual_ report.pdf; *Annual Report (Form 10-K)*, FREDDIE MAC 42 (2005), *available at* http://www.freddiemac.com/investors/ar/pdf/2005 annualrpt.pdf.

296. James Lockhart, Dir., Fed. Hous. Fin. Agency, Address at the National Press Club: FHFA's First Anniversary and Challenges Ahead (July 30, 2009), *available at* www.fhfa.gov/web files/14715/FHFA1stAnnSpeechandPPT73009.pdf.

297. *Id.* at 6; *Annual Report (Form 10-K)*, FANNIE MAE (2007).

other than vaguely asserting that "private capital" will fill the void left by the GSEs,[298] or that some public utility sort of entity would step into the mission-based role of the GSEs.[299]It makes little sense to try to replace a system that actually works with something we cannot even describe except in aspirational terms. And while the system became dysfunctional for a few years, many of the systemic fundamentals, including the concept of Fannie Mae and Freddie Mac and their role, successfully bought and sold mortgages and securities for decades before.[300] Furthermore, the system never stopped working for multifamily housing loans, which continue to create company profits today.[301] Finally, the single-family mortgages being bought today are sufficiently underwritten so as to present very little risk of default and are projected to be revenue positive for the GSEs.[302]

The Administration must look forward, not backward, in order to solve the mortgage market problems of today. The elimination of the GSEs, whatever its political appeal, would freeze up mortgage lending and wring still more value out of the economy's housing sector.[303] The enumerated goals of the Administration can be achieved without these costs. Market reform must focus forward, taking into account which changes will create benefits while avoiding unintended consequences. Political scapegoating and retributive systemic changes will likely divert us from the best path and the best ultimate outcomes.

B. Incentives, Underwriting and Contingency Plans

It goes beyond the scope of this short article to make specific, detailed recommendations.[304] However, certain conceptual changes

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298. *See generally* Treasury/HUD Report, *supra* note 16.

299. Consider, for example, the idea of setting up a housing trust fund to provide financing for multifamily projects that has been mentioned by the Obama Administration. *Id.* at 21. While this may have some appeal conceptually, Robert Diamond estimates that the likelihood of this happening while Republicans have a majority in the House of Representatives "is between nil and none." Interview with Robert E. Diamond, Jr., Chief Exec., Barclays PLC (Mar. 1, 2011).

300. *See supra* notes 20-22,33-42, 62-69 and accompanying text.

301. *See supra* notes 74-80 and accompanying text.

302. Treasury/HUD Report, *supra* note 16, at 23 ("Over the last two years, Fannie Mae and Freddie Mac have implemented stricter underwriting standards and increased their pricing. As a result, the new loans being guaranteed by Fannie Mae and Freddie Mac today are of much higher quality than in the past and are unlikely to pose a significant risk of loss to taxpayers.").

303. *See supra* note 10 and accompanying text.

304. Many projects focusing on recommended solutions are in progress in the government, and at law schools, business schools, political science, and economics departments across the country, including the Mercatus Center at George Mason University and the Center for Responsible Lending.

should be present in any viable reform package. First, changes to the finance system must ensure that all players at every level in the market have sufficient "skin in the game" to accurately and responsibly assess and price risks. This means that all brokers, originators, secondary market purchasers, and issuers must profit based on mortgage loan *performance* rather than originating or securitizing *volume*.[305] The Dodd-Frank Act mandates a 5% credit risk retention for originating lenders *if* the loans originated are not qualified residential mortgages.[306] To limit irresponsible behavior, however, some risk retention is appropriate for all originated loans. Primary lenders, after all, are best able to assess and control borrower credit risk. If the compensation structure for primary lenders (and brokers) is based on loan quality, then the market will produce more quality loans. It is far better to regulate through such direct financial incentives than to rely exclusively on expensive and often ineffective oversight. By incentivizing quality rather than quantity, the concerns of loan originators and MBS issuers will align with the concerns of the capital providers—the investors (or whoever bears the credit risk).

Increased underwriting is also a vital part of consumer protection. While education and disclosure can assist borrowers in understanding their debt obligations and perhaps allow borrowers to refrain from assuming debt they are likely unable to repay, recent experience in the subprime market also indicates that credit underwriting and lending limits may be necessary to keep borrowers from losing their homes and damaging their credit by assuming unrealistic obligations. To be fully protected, consumers also must be protected from themselves.

Risk retention that motivates better underwriting will also ensure that mortgage capital flows at the right pace and to the right borrowers because risk will be evaluated and built into the cost of providing funds. The GSEs must have "skin in the game" as well, and the only way to avoid the moral hazard of the previously catastrophic implicit government guaranty is to back away from such an implicit backup completely: government support of GSE obligations should

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305. The Dodd-Frank Act and Federal Reserve compensation rules fail to accomplish this needed change, since compensation for loan originators and mortgage brokers is still volume-based. Alex Ulam, *Fed Rules Beget a (Mostly Volume-Based Mortgage Commission Model*, AMERICAN BANKER, April 1, 2011, *available at* http://www.americanbanker.com/issues/176_63/loan-officer-compensation-1035261-1.html?pg=2.

306. H.R. 4173, § 941; *see also* NAHB QRM Response, *supra* note 198.

be explicit and limited.[307] The concept, no matter how implemented, is the same: change market incentives so that oversight efforts work with, rather than against, financial motivation. Risk retention will also encourage market competition—which aids consumer protection as well, for both mortgage borrowers and investors.

Appropriate regulatory backup should support what realigned financial incentives are intended to achieve: better loan underwriting for mortgages.[308] For decades, the GSEs set the *de facto* standards for mortgage lending across the country by detailing which loans they were willing to purchase on the secondary market.[309] Fannie Mae and Freddie Mac can continue this role, creating a ready-made market for loans meeting enumerated underwriting criteria, and the GSEs must effectively ensure compliance with such standards as well, whether that means keeping underwriting in house or having better quality control ("spot checking") of delegated underwriters. GSE underwriting standards should emphasize safety and soundness of the credit risks undertaken by the companies rather than be left open to political outcome-based manipulation by Congress or a federal agency.

GSE underwriting criteria must appropriately cover credit analysis as well as loan-to-value ratios and loan size caps. Recent experience teaches that low-leverage, low-credit loans can still cause significant loss—for example, the tremendous Alt-A losses that Fannie Mae and Freddie Mac suffered.[310] The Treasury/HUD Report mentions that housing finance reform must occur in conjunction with consistent and coordinated standards.[311] This is, indeed, critical. Promulgating varying and inconsistent standards for underwriting conformity not only creates confusion and uncertainty but also increases compliance

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307. Some advocate a complete elimination of government guarantee of GSE obligations. Others advocate a limited backup of GSE guarantee of securities only. Either option is preferable to the prior unlimited and speculative government guarantee which motivated market gambling by GSE officials and their shareholders alike.

308. But regulation alone is not the answer. Regulation built on appropriate allocations of economic incentives work better than regulation alone, because regulation is imperfect and less flexible than market reactions. *See* discussion of Boyack *supra* note 68, at Part IV.B.

309. Originating lenders have long accustomed themselves to conforming mortgage underwriting and structuring to the demands of their secondary market customers, and Fannie Mae and Freddie Mac were their biggest and most reliable customers. *See* MALLOY & SMITH, *supra* note 13, at 382; *see also* Levitin, *supra* note 291 (pointing out the valuable role that the GSEs can have in ensuring "that the financing products are the ones that reduce, rather than create, risk" and explaining that a "complete privatization of housing finance would create systemic risk and therefore encourage bailouts, not prevent them").

310. *See supra* note 206 and accompanying text.

311. Treasury/HUD Report, *supra* note 16, at 15.

(and therefore lending) costs. Although historically these entities' standards were fairly uniform, unfortunately, current regulation-based changes have led to a highly inconsistent *status quo*. FHA, Fannie Mae and Freddie Mac today seem unable (or unwilling) to coordinate their approach to our standards for underwriting, and variance with HUD and VA further complicate government lending approvals and loan oversight.[312] Reexamining underwriting criteria with an eye to creating a standardized approach should be step one of this administration.

Finally, reforming underwriting is not enough without a viable contingency plan for market players and the market as a whole.[313] Basel III has already reacted to a dearth of capital reserves in the banking sector by changing reserve requirements.[314] Capital reserve requirements for the GSEs should also be increased. In addition, the risk of loss for Fannie Mae and Freddie Mac could be mitigated through a combination of other creative and effective privately-funded mechanisms. For example, private insurance coverage could reduce the companies' exposure caused by pulling back the unlimited governmental guaranty of GSE obligations.[315] Some have suggested using convertible bond funding to help reestablish independent financing for Fannie Mae and Freddie Mac.[316] As the GSEs are weaned from an unlimited government guaranty, their cost of capital will increase and their market share will be reduced. As their capital costs increase, the GSEs' current systemic dominance will erode an appropriate rate and to an appropriate extent, as determined by market pricing rather than based on some politically-set maximum percentage. Bringing capital costs into market alignment will create market opportunities for other capital providers if they can adequately protect their own risks in similar (or less costly) ways.

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312. *See supra* notes 213-216 and accompanying text.

313. The fate of the GSEs is tied to the rest of the market, and even perfect reform of Fannie Mae and Freddie Mac will not insulate the market from untempered and exploited risk of speculation if other finance providers are not subject to rules that prohibit risk-taking behavior. The banking and shadow banking industries must be regulated as well, especially since moral hazard risks unavoidably plague the entire housing finance market to some extent. *See* Treasury/HUD Report, *supra* note 16, at 29-30, for a discussion of the market stability role of guarantee or reinsurance.

314. [Cite discussion of this]

315. *See supra* notes 181-183

316. Such convertible bonds (sometimes called Coco bonds) would initially be debt issuances, but would convert to equity should losses in excess of a certain amount be realized, allowing the debt to be essentially written off if needed. *See* Robert Van Order, Some Thoughts on What to do with Fannie Mae and Freddie Mac 13 (July 2010) (unpublished manuscript) (on file with author).

Limiting (or eliminating) the government guaranty of GSE obligations also allows Fannie Mae and Freddie Mac to function independently, as privately funded institutions, rather than as entities susceptible to shifting political focus and short-term vote-seeking goals. Taking a step back from the government financially would allow the GSEs to take a step back politically as well. They can stop "rolling the dice" and start focusing on market stability and liquidity rather than housing subsidization (a role more properly assigned to FHA).

CONCLUSION

Promoting homeownership through creating a system of privately funded real estate capital markets is a wonderful idea that over decades created the best housing finance system in the world.[317] A combination of confused mandates, moral hazard and irresponsible underwriting caused the system to break, costing American taxpayers over $130 billion.[318] The system is indeed broken—but not beyond repair. Denmark, Canada and other countries have interesting financial systems, but none of them have provided their populations the liquidity that a well-functioning securitized secondary mortgage market has in the United States. Rather than reinvent our system from the ground up, the United States needs to preserve what is valuable while we fix what went wrong.

Keeping Fannie Mae and Freddie Mac alive can help achieve a positive outcome. After all, the same goals we had in the Great Depression remain good policy objectives today: increasing housing quality, stabilizing capital markets, and allowing for wealth building and realization of the "American dream" through homeownership and quality rental housing options. Ensuring stable housing alternatives, including homeownership for credit-worthy borrowers, remains a politically and socially attractive goal. Sufficient quality and quantity of rental housing is a critical need that should be supported by ensuring that lending funds continue to flow to multifamily development. And homeownership is, after all, a way of increasing the "skin in the game" of citizens themselves. Homeowners are more invested in their communities, take good care of their properties, are good citizens, build wealth, pay real estate taxes, and create spheres of autonomy. This is the achievement of an American Dream—for individuals and for the country as a whole.

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317. *See supra* note 11 and accompanying text.
318. *See supra* note 7 and accompanying text.