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LESSONS IN PRICE STABILITY FROM THE U.S. REAL ESTATE MARKET COLLAPSE

Andrea J. Boyack[*]

2010 MICH. ST. L. REV. 925

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* Visiting Professor at George Washington University Law School. This Article grew out of a descriptive piece on U.S. real estate pricing that I presented at the 9th Annual Conference on Portuguese and American Law held on March 8, 2010, in Lisbon. Thanks to my research assistant, Robert Law, and to Angela Angelovska-Wilson for her helpful comments.

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ABSTRACT

The U.S. residential housing market collapse illustrates the consequences of ignoring risk while funding mortgage borrowing. Collateral over-valuation was a foundational piece of the crisis. Over the past few decades, secondary markets, securitization, policy, and psychology increased the flow of funds into real estate. At the same time, financial market segmentation divorced risk from reward. Increased mortgage capital availability, unmitigated by proper risk allocation, led to real estate price inflation. Social trends and government policies exacerbated both the mortgage capital over-supply and the risk-valuation disconnect.

The Dodd-Frank Act inadequately addresses the underlying asset valuation problem. Federal regulation may support market stability systemically, but micro-level oversight and private rights of action more efficiently and effectively secure responsible mortgage pricing.

INTRODUCTION

In 1959, long before his heralded "irrational exuberance" speech,[1] Alan Greenspan warned about irresponsible market pricing of stocks.[2] If

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1. Alan Greenspan, Chairman, The Challenge of Central Banking in a Democratic Society, Remarks at the Annual Dinner and Francis Boyer Lecture of The American Enter-

Greenspan's caution regarding stock over-valuation is rephrased in terms of real estate, it provides a concise explanation for the asset pricing component of the current crisis: "*Once [real estate] prices reach the point at which it is hard to value them by any logical methodology, . . . [real estate] will be bought as [stocks] were in the late 1920s—not for investment, but to be unloaded at a still higher price. The ensuing break could be disastrous.*"[3]

This Article examines the effect of money and risk-allocation on market pricing of real estate and mortgages, in particular the role of funding, trending, and segmenting as inflationary fuel. After noting particularities of real estate valuation practices, and in the context of the current financial crisis, this Article discusses the interaction of (a) increased capital availability, (b) the risk-reward disconnect of over-leverage and market segmentation, and (c) policies and psychology regarding homeownership and financing. The article then describes "macro-level" and "micro-level" systemic changes that will result in more accurate pricing of mortgages and underlying assets. An improved method of determining collateral valuation in mortgage lending will aid in stabilizing prices of mortgages in the secondary market as well as mortgage-backed securitization products and related derivatives. Some necessary changes shoring up our financial system must occur at the mortgage transaction stage. Improvements to primary market valuations will, in turn, support federal regulatory efforts to encourage responsible pricing at the later capital market stage. Federal regulation of securities markets is inadequate if market players on the ground floor of real estate finance fail to accurately account for risk.

I. THE REAL ESTATE CAPITAL VALUATION CONNECTION

The late Lord Harold Samuel popularized the expression: "There are three things that matter in property: location, location, location."[4] Though oft-repeated, this formula has never really been true. Even though real estate's value is always relative to the unchangeable factor of location, value

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prise Institute for Public Policy Research (Dec. 5, 1996), *available at* http://www.federalreserve.gov/boarddocs/speeches/1996/19961205 (describing the asset over-valuation of the dot-com bubble, Greenspan rhetorically asked, "How do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions[?]).

2. Gilbert Burck, *A New Kind of Stock Market*, FORTUNE, Mar. 1959, at 120, 201 (quoting Alan Greenspan).

3. *Id.*

4. The 1987 obituaries of Lord Samuel in Britain's *Sunday Times* and *Financial Times* and a 2007 issue of *The Daily Telegraph* all identify Lord Samuel as the coiner of this expression, though William Safire of *The New York Times* disputes his authorship. William Safire, *On Language: Location, Location, Location*, N.Y. TIMES, June 26, 2009 (Magazine), *available at* http://www.nytimes.com/2009/06/28/magazine/28FOB-onlanguage-t.html.

is also strongly impacted by fluctuating factors, including the quality and cost of improvements, the availability of capital, and the legal framework for interests in property.[5]

Pricing of real estate reflects its financial, legal, and market context. But pricing not only shows market context, it drives it. Increasing real estate prices creates nominal wealth. When rising values are made liquid through finance structures, they generate capital to spend. Conversely, a decline in already-liquidated asset values can create a financial black hole. In the context of a global market for mortgage-backed securities, the aggregate of millions of such black holes can suck billions of dollars out of the world's economy.[6] Accurate and sustainable real estate pricing is therefore a crucial foundation for stable real estate capital markets. One could put it this way: the three most important things that matter in property are price, price, and price. And real estate prices, unlike locations, are easily skewed.

At its most basic level, the story of real estate finance starts with land valuation. Since mortgage finance frees trapped asset values, the price of land depends on the availability of capital.[7] The more funds available to finance mortgages, the more liquid the collateral asset, and the higher its market value.[8] Finance opportunities grow real estate values. Real estate price history over the past decade supports this conclusion: as money flooded real estate lending, real estate prices increased dramatically.[9] But

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5. *See generally* ROBIN PAUL MALLOY & JAMES CHARLES SMITH, REAL ESTATE TRANSACTIONS: PROBLEMS, CASES, AND MATERIALS 1-15 (3rd ed. 2007).

6. "The U.S. financial system is now dependent to an unprecedented degree upon one prop: the greatest housing-real estate bubble in human history. A hyperinflationary spiral has sent home prices shooting up . . . ." Richard Freeman, *'Fannie and Freddie Were Lenders': U.S. Real Estate Bubble Nears Its End*, EXECUTIVE INTELLIGENCE REV., June 21, 2002, at 12, 12. By 1990, capital finance was a global market. Rated securitization products backed by real assets were sold to investors worldwide. This vastly enlarged the effect of real property price downturn. *See* ANDREW DAVIDSON ET AL., SECURITIZATION: STRUCTURING AND INVESTMENT ANALYSIS (2003).

7. *See infra* Section II.A.

8. In financial terms, liquidity refers to the probability that an asset can be converted into an expected amount of capital within an expected amount of time. The higher the liquidity, the lower the risk of "frozen" wealth, and since risk negatively impacts value, lower risks increase valuation.

9. From 1996 to 2006, U.S. national average house prices rose between 93% and 137%. *See* Past House Price Index Reports, FEDERAL HOUSING FINANCE AGENCY, http://www.fhfa.gov/Default.aspx?Page=195 (last visited Apr. 11, 2011); STANDARD & POOR'S, S&P/CASE-SHILLER HOME PRICE INDICES 2009, A YEAR IN REVIEW (Jan. 2010), *available at* http://www.standardandpoors.com/indices/sp-case-shiller-home-price-indices/en/us/?indexId=spusa-cashpidff--p-us---- (follow "S&P/Case-Shiller Home Price Indices: 2009 A Year In Review" hyperlink) [hereinafter S&P/CASE-SCHILLER] (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%. Past House Price Index, *supra*; *see also* ROBERT J. SHILLER, IRRATIONAL EXUBERANCE 13 (2d ed. 2005) [hereinafter SHILLER, IRRATIONAL EXUBERANCE]; Jonathan R. Laing, *The Bubble's New Home*,

these inflated prices were unrealistic and unsustainable.[10] What caused them to rise too high, and how can we promote robust economic growth and real asset wealth without risking the same ultimate result?

A. Asset Pricing and the Financial Crisis

The current global financial crisis resulted from multiple factors acting in concert, sometimes termed a "perfect storm."[11] These elements include sophisticated financial products,[12] rating agency discretion,[13] investor rating mandates,[14] borrower credit assessments,[15] bank regulations,[16] and opaque

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BARRON'S, June 20, 2005, at 24, 24. In the *Barron's* article, Laing quotes Shiller as stating that "the home-price bubble" had the "feel" of "the stock-market mania in the fall of 1999, just before the stock bubble burst in early 2000, with all the hype, herd investing and absolute confidence in the inevitability of continuing price appreciation . . . . Tulipmania reigns." Laing, *supra* (quoting Robert Shiller).

10. *See, e.g.*, Graham Searjeant, *US Heading for House Price Crash, Greenspan Tells Buyers*, TIMES (London) (Aug. 27, 2005), http://business.timesonline.co.uk/tol/business/economics/article559641.ece; *see also* JUNE FLETCHER, HOUSE POOR: PUMPED UP PRICES, RISING RATES, AND MORTGAGES ON STEROIDS 2 (2005); Krishna Guha, *Greenspan Alert on US House Prices*, FIN. TIMES, Sept. 16, 2007; Sarah Max, *The Bubble Question: How will Rising Interest Rates Affect Housing Prices?*, CNNMONEY (July 27, 2004), *available at* http://money.cnn.com/2004/07/13/real_estate/buying_selling/risingrates/ (last visited Apr. 11, 2011).

11. *E.g.*, JOHAN NORBERG, FINANCIAL FIASCO: HOW AMERICA'S INFATUATION WITH HOMEOWNERSHIP AND EASY MONEY CREATED THE ECONOMIC CRISIS xi (2009).

12. *See infra* notes 29 and 90 and accompanying text. In addition to trading in mortgage-backed securities themselves, a substantial market developed for "insurance type derivatives, called credit default swaps, [that] guaranteed re-payment of these mortgages in case of default" and were independently traded as investment products (and subject to great speculation). Randolph C. Thompson, *Mortgage Backed Securities, Wall Street, and the Making of a Global Financial Crisis*, 5 BUS. L. BRIEF 51, 53 (2008).

13. *See, e.g.*, John Patrick Hunt, *Credit Rating Agencies and the "Worldwide Credit Crisis": The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement*, 2009 COLUM. BUS. L. REV. 109 (2009); Carol Ann Frost, *Credit Rating Agencies in Capital Markets: A Review of Research Evidence on Selected Criticisms of the Agencies*, J. ACCT., AUDITING, & FIN., July 2007; *see also infra* notes 166-78 and accompanying text.

14. Primarily pursuant to 12 C.F.R. § 362.11 (2009) (prohibiting state and local entities and fiduciary investors from investing in "corporate debt securities not of investment grade"). This essentially gave the ratings from credit rating agencies the force of law. The impact of agency ratings was further increased by barriers to entry into the credit rating business created by the Securities and Exchange Commission in 1975. Lawrence J. White, *The Credit-Rating Agencies and the Subprime Debacle*, *in* WHAT CAUSED THE FINANCIAL CRISIS 228 (Jeffrey Freidman ed., 2011). Note that, in spite of 12 C.F.R. § 362.11, and in spite of standard practice of relying on agency ratings, Standard & Poor's credit rating contains the following disclaimer: "[a]ny user of the information contained herein should not rely on any credit rating or other opinion contained herein in making any investment decision." Other rating agencies include similar disclaimers on their ratings. White, *supra* at 228; *see infra* note 373.

accounting practices.[17] But related in one way or another to each such factor is the volatile collateral pricing, which supported these extensions of credit in the first place.[18] Although lenders look primarily to a borrower's ability and willingness to pay in order to assess the likelihood of loan repayment, sufficient collateral values can offset secured lending risk.[19] This makes loans to riskier borrowers less risky. When borrower credit fails, market evaluation of risk hinges on accurate real estate pricing.[20] The "sharp corrections in housing markets" caused by over-estimation of property values provided a "trigger" for the financial crisis.[21]

Real estate pricing is a key element, both in the analysis of what went wrong and in the engineering of effective solutions.[22] Real property values have a potentially destabilizing effect on our capital markets. Although inherently valuable because of its permanence and productivity, real property has no direct economic effect when values are trapped by illiquidity or inalienability.[23] A readily available capital supply, however, can allow that trapped value to become liquid—creating usable wealth. The resulting mixture of land plus money causes real estate values to grow, creating a real

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15. *See, e.g.*, Creola Johnson, *Fight Blight: Cities Sue to Hold Lenders Responsible for the Rise in Foreclosures and Abandoned Properties*, 2008 UTAH L. REV. 1169.

16. *See* discussion of Basel II's capital requirements in *Developments in Banking and Financial Law: 2004*, 24 ANN. REV. BANKING & FIN. L. 1, 150-54 (2005).

17. *See* Robert H. Herz & Linda A. MacDonald, *Understanding the Issues: Some Facts About Fair Value*, FIN. ACCT. STANDARDS BD., May 2008, at 1, 1-2, *available at* http://www.fasb.org/articles&reports/uti_fair_value_may_2008.pdf; *see also* Jana Shearer, *Mark-to-Market: Delivering the Financial Crisis to Your Front Door*, 36 OHIO N.U. L. REV. 239 (2010) (arguing that accounting practices were more of a delivery mechanism for the crisis than its cause).

18. This volatility is supported by the housing and financial market crash over the past 3.5 years.

19. *See* GEORGE LEFCOE, REAL ESTATE TRANSACTIONS 215-18 (5th ed. 2005) (describing the "three C's" that mortgage lenders consider in underwriting their loan risk: capacity to pay, credit scores (willingness to pay), and collateral value).

20. *Id.*

21. *Commercial Real Estate Loans Facing Refinancing Risks: CMBS Only Part of a Growing Problem*, DEUTSCHE BANK RESEARCH, 1 (July 6, 2010) https://www.dbresearch.com/PROD/DBR_INTERNET_EN-PROD/PROD0000000000259822.PDF [hereinafter DEUTSCHE BANK RESEARCH].

22. In 2007, U.S. Treasury Secretary Henry Paulson called the problems in mortgage lending "the most significant current risk" to the U.S. economy. *Housing Woes Take Bigger Toll on Economy than Expected: Paulson*, AFP (Oct. 16, 2007), http://afp.google.com/article/ALeqM5hWSjWmGJ4YXTh3PM5kOC7csTT48g [hereinafter Paulson Statement]. Rather than focusing on culpability of individuals or companies, this Article discusses the basic ingredients of the real estate capital market and some essential micro-level changes to our pricing and risk allocation system needed to prevent repeated market collapse. Current proposals and reforms are discussed in Part IV *infra*.

23. *See* Jon Christensen, *Land Rich, but Cash Poor, in the West*, N.Y. TIMES, Nov. 23, 1997, at BU1; *Property Rich, Cash Poor*, TIME, Oct. 19, 1981 (Magazine), *available at* http://www.time.com/time/magazine/article/0,9171,924967,00.html.

estate capital market that has a tendency to self-inflate.[24] If left unchecked, the inflated prices lead to an unsustainable bubble.[25]

United States policies and financial structures fed a steady stream of capital into the real estate market mixture for years. Decades ago the U.S. government fashioned secondary market entities whose mission was to promote more home mortgage lending.[26] Wall Street designed tempting new investment products—packaging, rating, and selling asset-backed securities and their derivatives.[27] This robust secondary mortgage market increased the supply of mortgage capital, which fed asset value.[28]

Collateral price inflation offsets the importance of accurate credit analysis of secured borrowers.[29] At every level of the real estate financial markets, the risk of borrower default was underestimated in light of presumed adequate—and expanding—collateral values.[30] Expectations that real estate prices would continue rising unabated suggested a naturally developing de-leveraging over time. Had this hypothesis held, lenders' risk of non-payment would gradually decrease. The theoretically growing collateral cushion therefore encouraged riskier lending, both in terms of borrower credit assessments and leverage limitations, and this in turn encouraged riskier securitizations.[31]

Not only did capital from the government and Wall Street increase asset prices, but rising asset prices also attracted more capital.[32] Increasing real property values created a wealth effect for owners, fueling the demand

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24. *See infra* Part II.

25. *See infra* Part II.

26. *See infra* Subsection II.A.1.

27. *See infra* Subsection II.A.2. For example, in 1983, Salomon Brothers and First Boston pioneered a financial debt vehicle called a collateralized mortgage obligation (CMO). First, a separate, special purpose entity (SPE) was created for the sole purpose of holding a pool (set) of mortgages. This SPE would issue bonds to investors who would receive payments according to prescribed priority levels (classes or tranches). The tranching of the CMOs could be done in a nearly infinite variety of ways (for example, sequence, parallel tranching, schedule bonds, defined maturity, non-accelerating, coupon tranching, or some combination of these), and the risks of such instruments could be further mitigated through various credit enhancement tools. *See* Hunt, *supra* note 13, at 117-19. *See generally* BRIAN P. LANCASTER, GLENN M. SCHULTZ & FRANK J. FABOZZI, STRUCTURED PRODUCTS AND RELATED CREDIT DERIVATIVES: A COMPREHENSIVE GUIDE FOR INVESTORS (2008).

28. *See, e.g.*, Anthony Sanders, *The Subprime Crisis and its Role in the Financial Crisis*, 17 J. HOUSING ECON. 254 (2008); Freeman, *supra* note 6, at 13 ("Since 1995, the housing bubble has required between $400 to $600 billion per year in new mortgages to finance homeowners' purchase of new and existing homes at inflated prices.").

29. *See* LEFCOE, *supra* note 19 (217-218).

30. *See, e.g.*, Sanders, *supra* note 28 (257-58); Freeman, *supra* note 6, at 13-15; Paulson Statement, *supra* note 22.

31. *Paulson Statement*, *supra* note 22; *see also* PAUL MUOLO & MATHEW PADILLA, CHAIN OF BLAME: HOW WALL STREET CAUSED THE MORTGAGE AND CREDIT CRISIS (2008).

32. *See* NORBERG, *supra* note 11, at 8-9.

for mortgage loans.[33] Owners wanted to cash out appreciated value so that it could be put to work in other investments or be spent.[34] This wealth effect was intensified by government policies promoting homeownership for everyone.[35] When the anchors for real estate prices—namely credit risk assessments and leverage limits—fell away, real estate prices and the demand for real estate capital soared.[36] The cycle perpetuated itself: increase in demand for mortgage funds led to increased capital supply, and mortgage capital from investors fed real estate values, raising market prices. This in turn fueled even further demand for mortgage financing. When the breaking point was finally reached, real estate values and the mortgage market imploded, taking the financial system down with it.[37]

B. Difficulties in Pricing Real Property

1. *Real Estate and Pricing Methodologies*

In some ways, land is the ultimate source of wealth: it is required for residence, it is required for all traditional means of production, it can never be truly replaced, and it lasts forever. Assigning precise dollar figures to such value presents one of the great conundrums of secured finance—in a way, land is priceless. And that is just the problem—because land is plentiful, yet each parcel is unique, commodity pricing of real estate is always a bad fit.[38] But to capitalize real assets, we must arrive at some quantified appraisal.

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33. *See infra* Subsection II.C.2.
34. *See infra* Subsection II.C.2.
35. *See infra* Subsection II.C.1.
36. *See infra* Section II.B.
37. S&P/CASE-SCHILLER, *supra* note 9, at 3 (real estate prices tumbled after 2005, reaching a record low in real estate price decline at -19% through the first quarter of 2009); Heather Landy & Renae Merle, *A Record Fall on Wall St.: Stocks Dive as Bailout Bill Fails to Pass*, WASH. POST, Sept. 30, 2008, at D1 (noting that "[t]he 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."); *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), http://www.marketwatch.com/story/home-prices-off-record-18-in-past-year-case-shiller-says.
38. An economist might put it this way: real estate *prices* are inherently "noisy"—imperfect measures of *valuation*.

The market traditionally looks at one of three methodologies to do so.[39] Using the comparative sales methodology, price is determined by looking to similar nearby properties and adjusting for any distinguishing factors.[40] With today's easily available internet tools making sale prices and features of neighboring properties both transparent and accessible,[41] comparative sales values are fairly easy to calculate. But the comparative sales approach shows housing price trends rather than a valuation tied to tangible factors or fundamentals. The comparative sales method thus fuels speculation. Overpricing of neighboring parcels will lead to continued neighborhood overvaluation. During the past several decades, pricing for sales and mortgage transactions for residential property relied solely on comparative sales pricing.[42]

Exclusive reliance on the comparative sales method can put a housing market into disequilibrium: home values can grow far beyond values that could be supported—or paid for—through rental streams.[43] For example, in 2006, the Office of Federal Housing Enterprise Oversight (OFHEO) calculated the ratio of equivalent rents to home prices (comparing the amount for which a given home would rent to the home's purchase price) and found that nationwide, the average rental value of homes for 2005 was only 7% of the purchase price.[44] The ratio in 2005 was the lowest on record (since OFHEO began the index in 1985), and the next-lowest annual ratio (1989)

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39. ENCYCLOPEDIA OF REAL ESTATE APPRAISING 1095 (Edith J. Friedman ed., 3d ed. 1978) [hereinafter ENCYCLOPEDIA OF REAL ESTATE]; WILLIAM N. KINNARD Jr., INCOME PROPERTY VALUATION; PRINCIPLES AND TECHNIQUES OF APPRAISING INCOME-PRODUCING REAL ESTATE (1971).

40. For a description of comparative sales methodology, see James Kimmons, *The Sales Comparison Method of Real Estate Appraisal and Valuation*, ABOUT.COM, http://realestate.about.com/od/appraisalandvaluation/p/compare_method.htm (last visited Jan. 29, 2011).

41. *See, e.g.*, ZILLOW, http://www.zillow.com. (last visited Jan. 29, 2011). Local municipalities typically have real property assessments and other information (square footage of lots and improvements, age of improvements) publicly available on county and city websites. *See, e.g.*, LUBBOCK CENTRAL APPRAISAL DISTRICT, http://www.lubbockcad.org/Appraisal/PublicAccess/ (last visited Jan. 29, 2011) (Lubbock, TX). In addition, Google Earth shows property location and appearance. *See* GOOGLE EARTH, http://www.google.com/earth/index.html (last visited Apr. 15, 2011).

42. *See* Tommy Fernandez, *AFL-CIO Lines Up to Oppose GSE Creep*, AM. BANKER, Apr. 25, 2002, at 1.

43. The national median home price was about thrice the annual household income prior to 2000. Between 2004 and 2006 the median home price rose to over four times the annual household income. Ben Steverman & David Bogoslaw, *The Financial Crisis Blame Game*, BLOOMBERG BUSINESSWEEK, Oct. 18, 2008, *available at* http://www.businessweek.com/investor/content/oct2008/pi20081017_950382.htm.

44. Suzanne Stewart & Ike Brannon, *A Collapsing Housing Bubble?*, REG., Spring 2006, at 15, 16 fig.1 ("A reading well below or above 100 indicates a market that is out of equilibrium: if the reading is below 100, renting is a bargain . . . .").

was 91%.[45] The rental-sale price disequilibrium was far more pronounced in certain areas of the country, such as California, Nevada, Arizona, and Florida where home prices in the prior decade had increased by over 99%.[46]

Geography provides the one limiting factor for comparative sales methodology. Properties are compared with sales within a given neighborhood, which helps explain why the epidemic of overpricing was mostly contained. Even though federal homeownership and monetary policies affected the entire nation, and even though mortgage lending—which had become a national rather than local industry—was prone to the same deficiencies across the country, the real estate bubble was localized: certain metropolitan and newly developed suburban areas (Las Vegas, Phoenix, California's "inland empire," and southern Florida) experienced by far the greatest increase in price and by far the greatest losses.[47] It could be said that a housing crisis in four or five states caused a global financial system meltdown,[48] showing that in today's world of global asset-backed finance, the effects of micro-level mispricing can be widespread and deadly.

Builders of new improvements typically employ another methodology for valuing their finished product: cost-to-replace.[49] This methodology calculates the market price of vacant land and adds in the current costs of materials and labor required to construct the improvements.[50] Appraisers of residential or commercial properties rarely use this approach, and the price

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45. *Id.*

46. *See infra* notes 58-59 (discussing of regional home markets and "nationwide" home appreciations).

47. Shayna M. Olesiuk & Kathy R. Kalser, *The Sand States: Anatomy of a Perfect Housing-Market Storm*, 3 FDIC Q. 30, 30, 31, *available at* http://www.fdic.gov/bank/analytical/quarterly/2009_vol3_1/AnatomyPerfectHousing.html; *see also* Sanders, *supra* note 28, at 258 ("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.").

48. Carmen Reinhart and Kenneth Rogoff explain that "the current crisis is far more global than any seen since the '30s, when most countries took a decade to grow back to where they had started." *Don't Buy the Chirpy Forecasts*, NEWSWEEK, Mar. 21, 2009, *available at* http://www.newsweek.com/id/190340/output/print; *see also infra* notes 58-59.

49. ALVIN L. ARNOLD, REAL ESTATE INVESTOR'S DESKBOOK §2.2 (3d. ed. 2002); *Cost Approach in Appraising Real Estate*, PROPEX, http://www.propex.com/C_g_cost.htm (last visited Apr. 15, 2011); Note, *Federal Estate Tax and the Right of Publicity: Taxing Estates for Celebrity Value*, 108 HARV. L. REV. 683, 688 (1995).

50. The cost-to-replace methodology applies the concept of substitution. For a description of this pricing method, see *Cost Approach in Appraising Real Estate*, *supra* note 49.

of vacant land still relies on sales comparison.[51] In addition, there is an inherent weakness in the cost-to-replace methodology because while improvements can be rebuilt, there is no true replacement of land—each piece is different and there is a localized, finite supply.

Income-producing real property is typically subject to a third valuation methodology.[52] The stream-of-income method derives the present value of realty by calculating the income that a property produces.[53] The net operating income of a parcel is determined by subtracting operating expenses for a property from the revenue that property produces over a given period of time (revenue typically means annual rental receipts).[54] This net income is then divided by a number representing the expected rate of return on investment over that period of time, called the capitalization rate, resulting in the present value of the parcel.[55] This was traditionally an investor's approach to pricing real property since investors expected profits to be derived from rents. Once investors' expectations changed and property re-sales ("flipping") became the anticipated source of profits, investors turned to comparative sales as the basis for price calculations.[56] Alan Greenspan characterized investor reliance on future sale price predictions as perilous and illogical,[57] but the stream-of-income method is not itself immune from bubble psychology because the capitalization rate is derived from the returns of other market investment opportunities.

Land is not like other market goods. Real estate parcels are situate, so price fluctuations caused by over-supply in one locality and over-demand in another will not balance out.[58] Although real estate capital markets today

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51. *See* Leslie Kent Beckhart, Note, *No Intrinsic Value: The Failure of Traditional Real Estate Appraisal Methods to Value Income-Producing Property*, 66 S. CAL. L. REV. 2251, 2259-69 (1993).

52. *Id. at 2273-78*; *see also* ENCYCLOPEDIA OF REAL ESTATE, *supra* note 39; KINNARD, *supra* note 39.

53. Beckhart, *supra* note 51, at 273-78. For a description of how to derive present value from stream of property income, see James Kimmons, *The Income Method of Real Estate Appraisal and Valuation*, ABOUT.COM, http://realestate.about.com/od/appraisalandvaluation/p/income_method.htm (last visited Jan. 29, 2011).

54. Beckhart, *supra* note 51 at 2273-78; *see also* ENCYCLOPEDIA OF REAL ESTATE, *supra* note 39; KINNARD, *supra* note 39.

55. Beckhart, *supra* note 51, at 273-78.

56. *See* NORBERG, *supra* note 11, at 8-10.

57. *See* Burck, *supra* note 2 (quoting Greenspan's 1959 analysis of stock pricing); *see also supra* notes 24-30 and accompanying text.

58. In the last decade, many cities in Arizona, California, Florida, and Nevada have experienced both a double-digit rise in prices as well as a double-digit decline in prices. S&P/CASE-SHILLER, *supra* note 9, at 5; *see also supra* notes 46-47 and accompanying text. Conversely, cities such as Boston, Charlotte, Cleveland, Dallas, and Denver never experienced double-digit price increases nor have they experienced double-digit declines. S&P/CASE-SHILLER, *supra*, at 6.

speak in terms of the aggregate and operate on a national level; at bottom, land assets are inherently and unchangeably local. The current real estate crisis illustrates this perfectly: although media reports and popular conception may frame the housing bubble as a U.S. problem, in reality, it is a problem surprisingly concentrated in a very few states and, in even more local terms, a problem centered in only a handful of counties in those states.[59] A meltdown in real estate prices in California or a rash of mortgage defaults in Florida does not directly impact prices for real estate in, say, Tennessee, Missouri, or Kansas.

The law recognizes this difficulty in accurately pricing real estate. Although contracts for exchange of goods are typically enforced only in economic terms (by granting damages for breach),[60] courts routinely order specific performance for real estate transactions rather than try to calculate accurate money damages.[61] Aside from whatever price the market obtains, there is no legal benchmark for real estate value.[62]

2. *Market and Legal Variables*

Because market pricing is, at best, a good guesstimate, values attached to real estate necessarily remain fragile, broadly susceptible to market misapprehensions and temporal changes. The 2006 planned redevelopment of

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59. *See* Dina ElBoghdady, *Foreclosure Activity Rises in Most Metropolitan Areas*, WASH. POST, July 30, 2010, at A14, 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 . . . ."); Brad Heath, *Mortgage Collapse Started in Few Areas*, USA TODAY, Mar. 6, 2009, at 01A (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 about a quarter of the nation's foreclosures" in 2008). As of July 2010, 1 in 200 households in California are in foreclosure; 1 in 171 households in Florida are in foreclosure; 1 in 167 households in Arizona are in foreclosure; and 1 in 82 households in Nevada are in foreclosure. *States with the Highest Foreclosure Rates*, CNBC.COM, http://www.cnbc.com/id/29655038/States_with_the_Highest_Forclosure_Rates (last visited Aug. 12, 2010) (on file with author) (citing data from RealtyTrac's U.S. Foreclosure Market Report).

60. *See, e.g.*, George T. Washington, *Damages in Contract at Common Law*, 47 LAW Q. REV. 345, pt. 1 (1931).

61. At common law, land was subject to particular laws "simply because it was land—a favorite and favored subject in England." Kitchen v. Herring, 42 N.C. (7 Ired.) 137, 138 (1851). For an economic argument in support of special treatment of land, see William Bishop, *The Choice of Remedy for Breach of Contract*, 14 J. LEGAL STUD. 299, 305 (1985).

62. For example, the Supreme Court has refused to review the adequacy of a foreclosure sale price, focusing exclusively on the foreclosure process instead. B.F.P. v. Resolution Trust, Corp., 511 U.S. 531, 545 (1994) ("We deem, as the law has always deemed, that a fair and proper price, or a 'reasonably equivalent value,' for foreclosed property, is the price in fact received at the foreclosure sale, so long as all the requirements of the State's foreclosure law have been complied with.").

New York's Stuyvesant Town illustrates this problem on a grand scale.[63] By all rights and logic, if any real estate transaction should have been correctly priced, this was it: the buyer was a joint venture of Tishman Speyer and BlackRock, two of the world's most experienced real estate investment companies, and preeminent financial institutions (Wachovia and Merrill Lynch) provided the debt capital.[64] Stream-of-income analysis for this, the largest real estate deal ever, resulted in a $5.4 billion price.[65] But it turned out that the appraisal was 65% ($3.5 billion) too high.[66] There is nothing safe about real estate investments when the asset is so profoundly overvalued.

Adjustments in the applicable legal system regarding entitlements and liabilities can have drastic effects on a property's ultimate value.[67] While based on the transactional concept of freedom of contract, real estate finance operates in the context of numerous public laws, and many varied legal areas and authorities potentially impact property values. Federal law affects even local real estate deals, setting parameters for mortgage lending,[68] bankruptcy,[69] environmental liability,[70] securities regulation,[71] and tax

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63. Charles V. Bagli, *Megadeal: Inside a New York Real Estate Coup*, N.Y. TIMES, Dec. 31, 2006, http://www.nytimes.com/2006/12/31/business/yourmoney/31speyer.html (last visited Apr. 17, 2011).

64. *See* Tishman Speyer/BlackRock, Peter Cooper Village and Stuyvesant Town: Term Sheet for Investor Equity (2006) (unpublished manuscript) (on file with author). *See generally* Megan McArdle, *Capitalist Fools*, ATLANTIC, Jan./Feb. 2010, *available at* http://www.theatlantic.com/magazine/archive/2010/01/capitalist-fools/7824/.

65. *See generally* Raymond H. Brescia, *Line in the Sand: Progressive Lawyering, "Master Communities," and a Battle for Affordable Housing in New York City*, 73 ALB. L. REV. 715 (2010).

66. Dawn Wotapka, *Tishman, BlackRock Default on Stuyvesant Town*, WALL ST. J., Jan 8, 2010, http://online.wsj.com/article/SB10001424052748703535104574646611615302076.html. *See generally* DANIEL GROSS, DUMB MONEY: HOW OUR GREATEST FINANCIAL MINDS BANKRUPTED THE NATION, 25-33 (2009).

67. *See, e.g.*, Tahoe-Sierra Pres. Council, Inc. v. Tahoe Reg'l Planning Agency, 535 U.S. 302 (2002); Palazzolo v. Rhode Island, 533 U.S. 606 (2001).

68. GSEs have published uniform loan instruments used in 80% or more of residential loans. *See* Andrew Lance, Note, *Balancing Private and Public Initiatives in the Mortgage-Backed Security Market*, 18 REAL PROP. PROB. & TR. J. 426, 438 (1983).

69. Under 11 U.S.C. § 362(a) (2006), all foreclosure proceedings are automatically stayed by the filing of any of the three types of bankruptcy proceedings; *see, e.g.*, *In re* Ward, 837 F.2d 124 (3d Cir. 1988). Bankruptcy trustee may also avoid pre-bankruptcy dispositions of real assets if such dispositions are found to be preferential or fraudulent. 11 U.S.C. §§ 544, 548 (2006).

70. *E.g.*, 42 U.S.C. §§ 9601-75 (commonly known as "CERCLA"); 42 U.S.C. § 6901-92 (known as "RCRA"). State laws also create environmental-based liabilities under various acts, sometimes called "baby CERCLA" acts. *See, e.g.*, CAL. HEALTH & SAFETY CODE §§ 25230(a)(2), 25359.7 (West 2010); 35 PA. CONS. STAT. ANN. § 6018.405. (West 2010).

consequences.[72] But it is state common law that establishes the baseline property rights for all land in a particular state. This means that in the United States, real property is subject to one of fifty distinct and complex legal regimes, each with its own version of mortgage,[73] foreclosure,[74] ownership liability,[75] ownership privileges,[76] and so forth. In addition, in no other area of law do local municipal regulations play a larger role than with respect to real property.[77]

Accuracy in real estate valuation is directly connected to information. While certain negative impacts on value may be discovered and accounted

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71. Although the SEC has been charged with sales of securitized products, certain asset-backed products fell outside of SEC oversight because of private placement, safe harbors, etc.

72. For example, IRS regulations permit homeowners to deduct state property taxes, mortgage interest, and expenses allocable to a home office. *See* Tax Reform Act of 1976, 26 U.S.C. § 280A (2006). There are numerous other tax statutes that permit like kind exchanges, deferring gain on residence, etc. *See e.g.*, 26 U.S.C. §§ 1031, 1033, 1034 (§1034 repealed 1997).

73. *See* RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES § 4.1, cmt. a (1996) (discussing the differences between "lien theory" and "title theory" and the intermediate theory of mortgages among different states). States also differ in terms of lender liability and lender and seller disclosure requirements in real estate transactions.

74. In Vermont and Connecticut, strict foreclosure still exists. 12 V.S.A. § 4531; CONN. GEN. STAT. ANN. § 49-15 (West 2010). In many other states, some variation of judicial foreclosure is the method for disposition of the borrower's equity of redemption. *See* GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW 558-59 (4th ed. 2001). In about 60% of the states, lenders may include a power of sale in their mortgage instruments, permitting non-judicial foreclosure. NELSON & WHITMAN, *supra*, at 581-85; *see, e.g.*, N.Y. REAL PROP. ACTS. LAW §§ 1301-91 (Consol. 2010). While the 2002 Uniform Nonjudicial Foreclosure Act promulgated by the National Conference of Commissioners on Uniform States Law has the potential of bringing state foreclosure laws into greater conformity, states have not yet adopted such measures. *See* Grant S. Nelson & Dale A. Whitman, *Reforming Foreclosure: The Uniform Nonjudicial Foreclosure Act*, 53 DUKE L.J. 1399 (2004) [hereinafter Nelson & Whitman, *Reforming Foreclosure*].

75. For example, nuisance law application to owners varies widely among (and within) jurisdictions. *See* Matthew Saunig, Comment, *Rebranding Public Nuisance*: City of Cleveland v. Ameriquest Mortgage Securities, Inc. *as a Failed Response to Economic Crisis*, 59 CATH. U. L. REV. 911, 916-25 (2010).

76. For example, the public's right to access (and an owner's ability to exclude from) beachfront property varies widely based on geographic region within the United States. *See, e.g.*, Leydon v. Town of Greenwich, 750 A.2d 1122 (Conn. App. Ct. 2000), *aff'd on other grounds*, 777 A.2d 552 (Conn. 2001); Glass v. Goeckel, 703 N.W.2d 58 (Mich. 2005); Raleigh Ave. Beach Ass'n v. Atlantis Beach Club, Inc., 879 A.2d 112 (N.J. 2005); Greater Providence Chamber of Commerce v. Rhode Island, 657 A.2d 1038 (R.I. 1995).

77. Localities govern land use extensively and have the primary taxing authority over real property. Local regulations on zoning and use restrictions have sizeable impacts on property valuation. *Compare* Prince George's Cnty. v. Sunrise Dev. Ltd. P'ship, 623 A.2d 1296, 1304 (Md. 1993), *with* VA. CODE ANN. § 15.2-2307 (2010). *See generally* JULIAN CONRAD JUERGENSMEYER & THOMAS E. ROBERTS, LAND USE PLANNING AND CONTROL LAW § 5.28 (1998).

for in market pricing, it is not possible to foresee and manage all the unknowns *ex ante*.[78] And since values in real estate are at the mercy of so many market and legal changeable factors, an information gap or faulty prediction can lead to disastrous results.

II. MONEY, RISK, AND PSYCHOLOGY: PRICE INFLATION'S FUEL

A. Funding: Twentieth Century Capital Market Developments

Real estate's price fragility makes it particularly vulnerable to changes in capital availability and finance structures. Over the past decades, major changes to mortgage markets increased the flow of funds and simultaneously increased demand for real estate capital.[79] Ample capital supply plus rising demand for asset liquidity pushed real estate prices higher, while secondary mortgage markets and securitization structures broadened the pool of investors in U.S. real estate to include the entire globe.[80] At the same time, these market changes unbundled functions in real estate finance, divorcing pricing from risk allocation with disastrous results.

1. *The Secondary Mortgage Market*

a. Origins and Purposes

As part of an effort to promote residential mortgage lending during the Great Depression, the U.S. government established the Federal National Mortgage Association (Fannie Mae).[81] Fannie Mae and its later-established "sister" entity, Federal Home Loan Mortgage Corporation (Freddie Mac), are government sponsored enterprises (GSEs), chartered by Congress and regulated by federal agencies, but owned by private shareholders.[82] Fannie

78. *E.g.*, Rosique v. Windley Cove, Ltd., 542 So. 2d 1014 (Fla. Dist. Ct. App. 1989) (denying rescission even though property was down-zoned between contract and closing); Sanford v. Breidenbach, 173 N.E.2d 702 (Ohio Ct. App. 1960) (denying specific performance sought by seller when home on property was destroyed by fire prior to closing).

79. *See infra* notes 83-96, 123-25 and accompanying text.

80. *See infra* notes 123-25 and accompanying text.

81. National Housing Act of 1934, 12 U.S.C. § 1716 (2006).

82. Emergency Home Finance Act of 1970, 12 U.S.C. § 1451-59 (2006). For details on the structure and purposes of Fannie Mae and Freddie Mac, see Robert Van Order, *Understanding Fannie and Freddie*, RICHARD'S REAL ESTATE & URBAN ECONS. BLOG, (July 31, 2008), 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). In addition to Fannie and Freddie, there are twelve Federal Home Loan Banks (sometimes called the

and Freddie's mandate is to buy qualifying residential loans from mortgage originators.[83] To qualify for purchase by the GSEs, loans must meet certain standards: for example, a loan cannot be too big or too risky.[84]

The market role of the GSEs is to directly increase the flow of capital into home lending by replenishing home mortgage lenders' capital stores.[85] Because of GSE loan purchases, a lender can renew its lending funds almost immediately rather than waiting out the typical thirty-year residential mortgage term.[86] The GSEs also encourage increased real estate capital indirectly by (a) inducing more long-term mortgages to be made (encouraging borrowing) and (b) offering originators of mortgage loans security against default risk (encouraging lending).[87]

In the 1980s, Fannie and Freddie began raising capital to purchase qualifying mortgages by pooling hundreds and thousands of those loans and selling shares in the pool to private investors.[88] Mortgaged-backed securitization allows broader participation in the "lender" side of the real estate finance market.[89] It also spreads the risk of default among many people and many properties, hedging against default and prepayment losses posed by an individual borrower or a certain locality.[90] Investing in an asset-backed pool

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"mini-GSEs"). These banks perform similar functions as Fannie and Freddie (providing funds to originating lending institutions).

83. GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW 932-41 (5th ed. 2007).

84. *See About Fannie Mae: Loan Limits*, FANNIEMAE, http://www.fanniemae.com/aboutfm/loanlimits.jhtml (last revised Jan. 24, 2011) [hereinafter *About Fannie Mae*]; *see also* Gail Cohen, *How to Qualify for a Fannie Mae Loan*, EHOW, http://www.ehow.com/how_5107817_qualify-fannie-mae-loan.html (last visited Jan. 24, 2011).

85. *See* NELSON & WHITMAN, *supra* note 83.

86. *Id.*; *see also* Robert Van Order, *The U.S. Mortgage Market: A Model of Dueling Charters*, 11 J. HOUSING RES. 233, 233-39 (2000); FRANK J. FABOZZI & FRANCO MODIGLIANI, MORTGAGE AND MORTGAGE-BACKED SECURITIES MARKETS 19-20 (1992).

87. *See About Fannie Mae*, *supra* note 84.

88. *See* FABOZZI & MODIGLIANI, *supra* note 86. Fannie and Freddie only securitized a portion of their loans, however, much of their mortgage purchases were financed with debt.

89. *See* DAVIDSON ET AL., *supra* note 6. 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.

90. *See supra* note 12 and accompanying text. Securitization eliminates risk through splitting a group (pool) of mortgage loans into multiple classes (tranches) with a hierarchy of repayment rights (the top tranche has the least risky position in terms of credit and prepayment risk). The tranching of the pool will reduce risks for investors holding the top tier position who are buffered by lower-positioned investors bearing the first loss. Theoretically, this is true even if the entire pool is made up of risky mortgage loans: the lower tranches act as a risk shock absorber. Wall Street opined that pooling and tranching can be done successively, reducing the top-tiered securities risk with each re-tranching. This theory, widely accepted in the dawn of the Twenty-First Century, seems to work less well under real market stress. Ultimately, valuation models for securitized products proved more problematic than

was considered safe, not just because debt obligations were collateralized, but because the securitization process minimized each investor's risk.[91] GSE guaranties further secured returns, and the ability of the GSEs to make good on their commitments was implicitly supported by the federal government.[92] Credit rating agencies endorsed the system's stability, awarding GSE debt securities the highest rating.[93]

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.[94] Increased capital to loan originators made financing cheaper, spurring lenders to increase borrower demand creatively by offering mortgage products promising little or no equity investment and small initial monthly payments.[95] The ample supply of funds and rising demand for asset liquidity put upward pressure on real estate prices.[96] The majority of all U.S. residential mortgage loans are now components of huge securitized pools of debt,[97] with about 40-50% of total

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securitization itself. For an overview comparison of securitization and traditional bank lending, see Gerald Hanweck, Anthony B. Sanders & Robert Van Order, *Securitization Versus Traditional Banks: An Agnostic View of the Future of Fannie Mae, Freddie Mac and Banks*, FINREG21 (Sept. 28, 2009), http://www.finreg21.com/lombard-street/securitization-versus-traditional-banks-an-agnostic-view-future-fannie-mae-freddie-ma. A concise description of the development of mortgage-backed securitization can be found at 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).

91. *See* DAVIDSON, ET. AL, *supra* note 6; *see also* Eggert, *supra* note 90 (describing the benefits of securitization to investors and lenders).

92. *See* Van Order, *supra* note 86.

93. *Debt Securities: Understanding Fannie Mae Debt: Fannie Mae Credit Ratings*, FANNIEMAE (July 27, 2006), http://www.fanniemae.com/markets/debt/understanding_fm_debt/credit_ratings.jhtml?p=Debt (last revised Jan. 15, 2009) (describing Fannie's senior debt as Aaa/AAA from each of the major ratings agencies: Moody's, S&P, and Fitch). Although Freddie's preferred stock was downgraded to Baa3 (the lowest investment grade rating) in August 2008, Freddie's senior debt credit rating remains at Aaa/AAA from the ratings agencies. *See Freddie Mac Courts Investors, Buffett Passes*, TAIPEI TIMES, Aug. 24, 2008, at 11, *available at* http://www.taipeitimes.com/News/biz/print/2008/08/24/2003421257.

94. *See* Van Order, *supra* notes 82, 86.

95. *See infra* notes 137-144 and accompanying text. In the first half of 2005, for example, the market for would-be borrowers was "ultra-competitive" and interest-only loans made up 28.5% of all mortgage loans, according to the mortgage data company Loan Performance. Stewart & Brannon, *supra* note 44, at 16.

96. Increase in ability to pay for homes raises home prices. Elizabeth Warren and her daughter Amelia Warren Tyagi claim that the two-income trend drove home prices up and may have decreased the overall standard of living. *See* ELIZABETH WARREN & AMELIA WARREN TYAGI, THE TWO INCOME TRAP (2003). Robert Shiller agrees that two-income trends expanded the availability of mortgage credit, which has "propel[led] home prices." SHILLER, IRRATIONAL EXUBERANCE, *supra* note 9, at 36.

97. *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/ in-

residential mortgage debt serviced through Fannie and Freddie and another ten to 15% through similar "private label" systems.[98] In terms of both market share and actual dollars, GSE securitized debt is huge: when Fannie Mae and Freddie Mac were put into conservatorship in September 2008, they had $5.4 trillion of guaranteed mortgage-backed securities debt between them.[99]

The GSEs advance politically popular goals: broaden access to mortgage financing and increase real estate liquidity. In theory, Fannie and Freddie were established to provide counter-cyclical stability, and GSE securities were designed to be safe investment products.[100] One thing is very clear: the existence of Freddie and Fannie enabled large sums of money to flow into home mortgage lending.[101] Until the crisis, that was seen—on balance—to be a good thing.[102]

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dex.htm (indicating that "half the mortgage debt in the country" was owned by Fannie and Freddie as of September 2008).

98. *Id.*; Van Order, *supra* note 86, at 237; *see also* STAFF OF H. COMM. ON OVERSIGHT & GOV'T REFORM, 111TH CONG., THE ROLE OF GOVERNMENT AFFORDABLE HOUSING POLICY IN CREATING THE GLOBAL FINANCIAL CRISIS OF 2008 12 (Comm. Print 2009).

99. *See* Press Release, James B. Lockhart, Dir., Fed. Hous. Fin. Agency, Statement on Behalf of Federal Housing Finance Agency, 1 (Sept. 7, 2008), *available at* http://www.fhfa.gov/webfiles/23/FHFAStatement9708final.pdf; *see also Hearing Before the H. Comm. on Fin. Servs.* (March 23, 2010) (statement of Anthony B. Sanders, Member, Mercatus Center's Financial Markets Working Group), *available at* http://mercatus.org/video/housing-finance-reform ("[T]he combined debt load for Fannie Mae, Freddie Mac, and the Federal Home Loan Bank [currently] stands at $8 trillion.") [hereinafter Statement of Anthony Sanders].

100. *See generally Oversight Hearing to Examine Recent Treasury and FHFA Actions Regarding the GSEs: Hearing Before the H. Comm. on Fin. Servs.*, 110th Congress (Sept. 25, 2008) (statement of Herbert M. Allison, Jr., President and Chief Executive Officer, Fannie Mae), *available at* http://www.fanniemae.com/media/speeches/2008/index.jhtml?p=Media&s=Executive+Speeches&t=2008+Executive+Speeches [hereinafter Statement of Herbert M. Allison].

101. 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* Paul Krugman, Op-Ed, *Fannie, Freddie, and You*, N.Y. TIMES, July 14, 2008, at A17.

102. For example, on Sept. 25, 2003 at the House Financial Services Committee hearing, in a debate about whether the GSE's capital reserve requirements should be increased from a mere 2.5%, Representative Barney Frank in a now-infamous quote, said: "I do think 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 towards subsidized housing. . . ." *See* Op-Ed, *What They Said About Fran and Fred*, WALL ST. J., Oct. 2, 2008, at A19 (quoting Representative Barney Frank). This was a conscious policy choice to take on more governmental risk in order to promote broader homeownership. On the other hand, the Congressional Budget Office's 1996 report, expressing frustration over the inability of government to limit GSE scope, concluded by saying: "Once one agrees to share a canoe with a bear, it is hard to get him out without obtaining his agreement or getting wet." Binyamin Applebaum, Carol D.

b. Private Label Securitization

Fannie and Freddie had been pioneers in secondary mortgage market purchasing and securitizing, but by the 1990s, private market players had followed suit, buying mortgages in the secondary market and using securitization to reduce risk.[103] The securitization trend spread to non-qualifying residential mortgages and shorter-term commercial mortgage financing.[104] Pooling and tranching allowed custom-selection of risk-return level[105] and created easy diversification opportunities for lenders and investors.[106] And because secondary mortgage market products could be readily sold, they were liquid sources of investment capital, attracting more money into real estate. While real estate itself cannot move, funds from New York or Europe can easily flow into California.

c. Mortgage Lenders: New Roles and Customers

This growing secondary mortgage market fundamentally changed the structure of mortgage lending. Previously, borrowers were the lending banks' customers: banks earned profits by collecting interest payments from homeowners. Since the borrowers were purchasing capital from the bank with payments made over time, lenders were motivated to consider long-term needs of loan applicants.[107] But by the mid-1990s, most originating banks no longer intended to acquire mortgages for their own portfolios.[108] They were acting as intermediaries—buying mortgages in order to sell them on the secondary market in turn. The banks' customers became the secondary market purchasers, including Fannie, Freddie, and private label mortgage-backed securitizers.[109] Today, banks no longer look to interest payments as their source of profits (interest payments now make up secondary market profits instead); rather, mortgage lenders' profits are generated by

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Leonnig & David S. Hilzenrath, *How Washington Failed to Rein in Fannie, Freddie*, WASH. POST, Sept. 14, 2008, at A1 (quoting the Congressional Budget Office Report).

103. Lower originating lender risk led to lower incentives by loan originators to fully assess risk in terms of likelihood and impacts. *See infra* notes 107-11 and accompanying text.

104. *See generally* NELSON & WHITMAN, *supra* note 83, at 483-92.

105. *See* discussion *supra* notes 90-91.

106. "In this way lenders became better able to smooth out their profit expectation by creating investment 'baskets' with 'eggs' gathered from many different markets." MALLOY & SMITH, *supra* note 5, at 381.

107. *See* Van Order, *supra* note 86, at 233-39.

108. *Id.*

109. This is true for the vast majority of residential lenders. Commercial lenders have not fully made this transformation, as more commercial loan originators still retain ownership of all or a significant portion of their originating loans. *See supra* notes 85-86 and accompanying text.

"churning paper and money between borrowers and secondary market investors."[110] Loan volume and origination fees provide bank returns. Akin to mortgage brokers, originating lenders became more incentivized to close (and sell) the mortgage to recoup their investment rather than ensuring borrower credit and long-term suitability of loans.[111]

The structure of the secondary market makes home prices, which are already vulnerable to difficulties inherent in pricing real estate,[112] even more volatile. Prices for mortgage-backed securities rise and fall on the winds of the financial markets, driven by interest rates, the availability of other investment opportunities, and financial capital supply. Perversely, the fluctuation of discount rates on the secondary market started driving loan pricing by originators and, ultimately, the flow of financial capital to homebuyers. Mortgage-backed securities are especially vulnerable to interest rate falls because a fall in rates not only reduces an investor's expected stream of income (and therefore current value of the securities) but will also increase the risk that loans will be refinanced—prepaid earlier than expected (again reducing the stream of income value).[113]

2. *Securitization, Nationalization, and Globalization*

The transformation of local U.S. real estate markets into global finance opportunities increased available capital by widening the scope of potential investors.[114] Before the Savings & Loan crisis in 1980, local thrifts

110. MALLOY & SMITH, *supra* note 5, at 382.

111. *Id.*; *see also* Van Order, *supra* note 86, at 233-39.

112. *See supra* notes 22-35 and accompanying text.

113. *See* United States v. Harris, 246 F.3d 566, 573 (6th Cir. 2001) (explaining the costs imposed on a lender by prepayment); *see also* RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES § 6.2 cmt. a (1997); Dale A. Whitman, *Mortgage Prepayment Clauses: An Economic and Legal Analysis*, 40 UCLA L. REV. 851, 871-72 (1993); MALLOY & SMITH, *supra* note 5, at 383. Most states hold that absent a constraining statute or contractual provision, borrowers have no inherent right to pay off a mortgage debt prior to maturity. Nevertheless, Fannie and Freddie form notes both expressly permit prepayment of all types of residential mortgage loans and many states create borrower repayment rights by statute. *Compare* FLA. STAT. ANN § 697.06 (West 1994) ("Any note which is silent as the right of the obligor to prepay . . . may be prepaid . . . without penalty."), *with* 41 PA. STAT. ANN. § 405 (West 1998) (prohibiting all prepayment penalties in residential mortgages), *and* DEL. CODE ANN. tit. 5, § 2234 (2001) ("A borrower may prepay a loan in full at any time."). Federal law requires explicit disclosures of any prepayment penalties. 12 C.F.R. § 226.18(k) (2010). In most commercial mortgages, prepayment risk is managed through prepayment penalties or other yield maintenance premium provisions. *See* NELSON & WHITMAN, *supra* note 83, at 483-87. For an extensive discussion of the judicial treatment of prepayment penalty clauses, see NELSON & WHITMAN, *supra*, at 487-503.

114. *See This American Life: Giant Pool of Money Wins Peabody*, (Public Radio International radio broadcast Apr. 5, 2009), *available at* www.pri.org/business/giant-pool-of-money.html (broadcast transcript on file with author) [hereinafter *This American Life Broad-*

(saving/lending institutions) dominated residential home finance in the United States.[115] Until the 1980s, deposits by local residents into savings accounts formed the source of mortgage capital.[116] Because of the narrow geographic focus of these home lenders, lending decisions were made in the familiar context of the applicable locality. In addition, since the lenders were smaller shops, loans were more likely to be individually vetted and tailored. This geographically symmetrical finance system—funds in and funds out within the same community—has now been almost completely replaced by global sources of capital.[117] The broadened mortgage funding system has increased potential volume and dollar amount of loans, but has decreased lender locality expertise and individual borrower and property attention.

Changes in individual mortgage transaction structure contributed to the pace and ease of securitization and worldwide effect of local U.S. mortgage markets. When national mortgage lending institutions took over home financing, they pushed for nationally standardized finance structures, legal forms, and insurance throughout the country.[118] While this lowered costs for the national lenders and ultimately made pooling and securitizing residential mortgages easier,[119] uniform instruments did not reflect identical state laws.[120]

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cast] (describing the growth in the "global pool of money," namely fixed income securities that from 2000 to 2006 grew from $36 trillion to $70 trillion).

115. For a concise description of how the primary mortgage market dominated home lending prior to the 1970s and securitization, see Thompson, *supra* note 12, at 51-52.

116. *See* Van Order, *supra* note 86; *see also The Downturn in Fact and Figures*, BBC NEWS (Nov. 21, 2007), http://news.bbc.co.uk/2/hi/business/7073131.stm [hereinafter BBC NEWS REPORT].

117. Van Order, *supra* note 86; Thompson, *supra* note 12, 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."). In addition to foreign investment in U.S. real estate, "[m]any foreign markets copied the United States model by creating similar debt instruments based on their housing markets." *Id.*; *see also* Pelma Jacinth Rajapakse, *Issuance of Residential Mortgaged-Backed Securities in Australia—Legal and Regulatory Aspects*, 29 U. NEW S. WALES L.J. 173 (2006) (describing similar securities in Australia).

118. Michael H. Schill, *The Impact of the Capital Markets on Real Estate Law and Practice*, 32 J. MARSHALL L. REV. 269, 269-79 (1999).

119. It is by far easier to securitize loans represented by uniform mortgage instruments. This is one reason that commercial mortgage-backed securitization has lagged so significantly behind residential MBS. *See supra* note 85 and accompanying text.

120. *See supra* notes 47-51 and accompanying text. Typically, multi-state lenders and purchasers use standardized forms with state-specific riders prepared by local counsel. Unlike credit card debt (which is also securitized), there is no ability to use contractual choice of law provisions to opt out of the jurisdiction in which the real estate is located, at least with respect to the underlying mortgage or deed of trust and assignment of rents. Fan-

The commercial mortgage-backed securities (CMBS) market lagged residential both in terms of securitization volume and as a source of lending capital.[121] Not only was there no GSE to jump-start commercial securitization, but the increased dollar amounts of commercial loans and their vastly greater complexity makes pooling them more cumbersome. Because commercial loans are individually larger, more complex and diverse (secured by various types of real estate product types, not just homes), securitization transaction costs are larger and risk spreading is more challenging.[122] Even so, the CMBS market experienced significant growth over the past few decades, reaching record highs in 2005, 2006, and even early 2007.[123] This dramatic growth in commercial real estate lending and CMBS played a large role in entangling world financial markets with U.S. real estate values.

National mortgage lending, securitization and global capital markets attracted new capital into the bond markets, increasing the flow of debt capital to real estate secured lending.[124] From 2000 to 2008, capital invested in real estate more than doubled.[125] The massive influx of capital made lending cheaper and easier, growing real estate prices and creating a series of internationally interwoven financial and asset markets. Investors from around the globe hastened to join "the mortgage backed securities bonanza,"

nie and Freddie have also had a profound influence on the document standardization trend. *See* Lance, *supra* note 68, at 438.

121. DEUTSCHE BANK RESEARCH, *supra* note 21, at 7-9. The report also notes that housing markets in Europe "follow developments in U.S. markets with a time lag." *Id.* at 3.

122. Schill, *supra* note 118, at 273-74.

123. 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 the following year to $25 billion in 2008—only about 10% of its value just the year before. DEUTSCHE BANK RESEARCH, *supra* note 21, at 8; *see also* John B. Levy, *CMBS Volume Hits Record High*, NAT'L REAL ESTATE INVESTOR (Aug. 1, 2005), http://nreionline.com/commentary/finance/real_estate_cmbs_ volume_hits/. In 2008, 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), http://www.reuters.com/article/2008/04/03/mortgages-commercial-volume-idUSN0342726520080403; Jim Clayton, *P&Ls: Pricing, Liquidity and Leverage*, PREA QUARTERLY, Winter 2009, at 46-52. The decline has been so dramatic that pricing for CMBS products is now unreliable due to lack of comparables.

124. *See* Schill, *supra* note 118, at 271 ("The growth in residential mortgage-backed securities has been phenomenal . . . . [There was] more than a 500% increase over the thirteen year period [between 1984 and 1997].").

125. *See* Karen Yourish & Laura Stanton, *Anatomy of the Housing Collapse*, WASH. POST, June 15, 2008, at A11 (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." Alec Klein & Zachary Goldfarb, *The Bubble, Part 1: Boom*, WASH. POST, June 15, 2008, at A1.

seeking safe investments with large returns.[126] The international scope of mortgage-backed securities investment enlarged the impact of the U.S. housing market crash: the crisis reached beyond Main Street's mortgage lending and beyond securities sold on Wall Street to become a global panic.

B. Segmenting: Increasing (and Avoiding) Risk

While commercial and residential mortgage lending are quite different in some ways, lenders and borrowers in both spheres practiced market behavior, which significantly increased financial risk.[127] As borrowers and investors bought into the idea that the higher the leverage, the better the deal, probable return calculations began ignoring asset depreciation risk. In addition, unbundled financial market functions and risk trading and spreading techniques allowed debt capital providers to downplay, defer, and delegate ultimate potential costs.[128]

1. *Addicted to Leverage*

a. Mortgage "Affordability"

Unsurprisingly, the first cracks in the housing market began to show with respect to the riskiest class of loans—subprime mortgages.[129] In 2006, nearly three million of these subprime mortgage loans were originated, and outstanding subprime loan amounts totaled in aggregate over one trillion dollars.[130] Although a strong collateral safety net could theoretically offset borrower credit risk, these subprime loans did not rely on leverage limits to protect lenders. In 2006, over 40% of the subprime loans had loan-to-value

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126. Thompson, *supra* note 12, at 55; *see also* Steven Pearlstein, *With Bubbles Popping Worldwide, No Wonder the Economy's Gone Flat*, WASH. POST, Oct. 7, 2008, at D1. Thompson also refers to the mortgage-backed securitization craze as an "unchecked feeding frenzy." Thompson, *supra*, at 54.

127. *See supra* notes 125-126 and *infra* notes 128-147.

128. *See infra* Subsection II.B.2.a.

129. "Subprime" lending 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 with a high coupon interest rate. Alt-A loans include prime mortgages for borrowers with no or limited documentation of income or assets. *See* Howard Lax, Michael Manti, Paul Raca & Peter Zorn, *Subprime Lending: An Investigation of Economic Efficiency*, 15 HOUSING POL'Y DEBATE 533, 540, 542 (2004), *available at* http://content.knowledgeplex.org/kp2/cache/documents/58731.pdf.

130. *See 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* Yuliya Demyanyk & Otto Van Hemert, *Understanding the Subprime Mortgage Crisis*, REV. FIN. STUD., May 4, 2009, *available at* http://rfs.oxfordjournals.org/content/early/2009/05/04/rfs.hhp033.full.pdf+html?sid=dbc20d22-4f10-46e7-93ae-6eae04207f2b.

ratios (LTVs) greater than 90%.[131] With respect to purchase money mortgages, "the median subprime borrower put no money down, borrowing 100 percent of the purchase price of the house."[132] Economist Stan Leibowitz opined that 100% leverage loans created more market risk than the poor borrower credit assessment and standards in the subprime sector.[133] As leverage and credit risk grew, collateral value speculation increased: lenders and borrowers both relied on asset value increases to mitigate the risk of default.

Together, subprime lending and increased leverage made home purchasing more "affordable" (at least initially). The biggest hurdle typically faced by a would-be homebuyer is a lack of income to sufficiently cover debt obligations, in terms of saving for a "downpayment" and making monthly mortgage payments thereafter.[134] Traditionally, buyers made at least a 20% equity contribution to a home's price at closing.[135] But over the past several years, newly popular and more risky mortgage products such as adjustable rate mortgages and interest-only loans, along with more aggressive combinations of senior and junior debt, enabled more borrowers to increase their leverage.[136] High leverage—in many cases 100% LTV

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131. The LTV is the percentage of the home value that is provided by debt capital. In an 80% LTV loan, a buyer would pay 20% of the purchase price and borrow the remainder. In a 100% LTV loan, the buyer would not have to pay anything—the house would be purchased with the bank's money alone.

132. Oren Bar-Gill, *The Law, Economics and Psychology of Subprime Mortgage Contracts*, 94 CORNELL L. REV. 1073, 1076 (2009). For an explanation of LTV ratios, see *supra* note 131.

133. Stan Liebowitz, Op-Ed., *New Evidence on the Foreclosure Crisis*, WALL ST. J., July 3, 2009, at A17, http://online.wsj.com/article/SB124657539489189043.html ("[T]he focus on subprimes ignores the widely available industry facts . . .51% of all foreclosed homes had prime loans, not subprime, and that the foreclosure rate for prime loans grew by 488% compared to a growth rate of 200% for subprime foreclosures. (These percentages are based on the period since the steep ascent in foreclosures began—the third quarter of 2006—during which more than 4.3 million homes went into foreclosure.").

134. Lack of income can both reduce a borrower's FICO score and lessen a borrower's ability to save enough money to make a substantial down payment.

135. For borrowers unable to put 20% of the purchase price down on a home, lenders typically demanded that borrowers pay insurance over the increase of depreciation risk that the lower equity percentage created. Some mortgage insurance was offered by the government and other insurance was offered by private mortgage insurance companies (PMIs). Mortgage bankers who ultimately sold their loans to the GSEs were traditionally strong participants in the government-insured markets. Savings associations have generally relied on PMI. In more recent years, all lenders shifted toward PMI and uninsured loans. *See* NELSON & WHITMAN, *supra* note 83, at 927.

136. Although popularly termed "new mortgage products," most of the products popularized in the past decade were not truly new. Negatively amortizing loans, variable interest rate loans, loans with balloon payments, and so-called hybrid ARMs (fixed interest rates followed by a period of variable interest rates) have all existed since the 1980s. However, these more exotic products became more and more the norm during the era of escalat-

loans—helped borrowers scale the first hurdle in home-buying: saving a downpayment. Interest-only loans and "teaser-rate" loans helped borrowers overcome the second homeownership hurdle—lack of income to support monthly mortgage payments—at least in the short run.[137]

Mortgages with no equity cushion and monthly payments that defer principal amortization leave collateralized debt completely at the mercy of asset depreciation. This allows no margin of error for real estate pricing: any property value decrease puts the loan "underwater."[138] In the long run, over-leverage and low monthly payments hurt, rather than helped, vulnerable populations who are increasingly losing their homes.[139] These products also ultimately stripped lenders' collateral support, leaving them partially unsecured and vulnerable to borrower strategic default.[140] The falling value of mortgages reflected this new reality and caused significant losses for formerly exuberant buyers of mortgage-backed securities.[141]

As if high leverage loans were not risky enough in terms of collateral support, lenders assumed still more risk by relaxing credit underwriting standards and offering low or no documentation loans.[142] These loans are

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ing housing prices as a way for people to afford mortgages on higher and higher priced homes with stagnant salary levels. *See* Sanders, *supra* note 28 (discussing the changing market for home loan products).

137. *See* Kimberly Blanton, *Adjustable-Rate Loans Come Home to Roost*, BOSTON GLOBE, Jan. 11, 2006, at D1. Greenspan endorsed the adoption and expansion of adjustable-rate mortgage products in 2004 when short-term rates were near historic lows. Greenspan also lulled investors, asserting that "securitization by Fannie and Freddie allows mortgage originators to separate themselves from almost all aspects of risk associated with mortgage lending." Bill Mann, Seth Jayson, Tim Hanson, Nate Weisshaar & Keith Beverly, *The People Responsible for Fannie Mae and Freddie Mac*, THE MOTLEY FOOL (Sept. 10, 2008), http://www.fool.com/investing/dividends-income/2008/09/10/the-people-responsible-for-fannie-mae-and-freddie-.aspx (quoting Alan Greenspan).

138. Thompson, *supra* note 12, at 55 ("Some estimate that now millions upon millions of homes in the United States have negative equity."); *see also* Karen Blumenthal, *'Underwater' Need Not Mean Foreclosure; Why Most People Who Owe More Than a Property's Worth Will Still Keep Their Homes*, WALL ST. J., Nov. 5, 2008, at D1.

139. *See* CREDIT SUISSE, MORTGAGE LIQUIDITY DU JOUR: UNDERESTIMATED NO MORE 1 (2007), *available at* http://www.recharts.com/reports/CSHB031207/CSHB031207.pdf.

140. Borrowers who owe more to a lender than a home is worth are vastly more likely to abandon both home and mortgage, particularly if the debt obligation is non-recourse (the lender cannot seek recovery from borrower personally).

141. *See, e.g.*, Andrew Frye, *Insurer Losses Trigger Most Regulator Intervention in a Decade*, BLOOMBERG (July 19, 2010), http://www.bloomberg.com/news/2010-07-19/insurer-losses-in-u-s-trigger-most-regulator-intervention-in-a-decade.html (explaining that the two biggest life insurance companies reported billions of dollars in quarterly losses from mortgage-backed securities investments).

142. *This American Life Broadcast*, *supra* note 114; *see also* George W. Bush, President of the United States, Address to the Nation, (Sept. 24, 2008), *available at* http://www.nytimes.com/2008/09/24/business/economy/24text-bush.html [hereinafter President Bush's Speech]; Noelle Knox, *43% of First-Time Home Buyers Put No Money Down*,

variously termed Alt-A, NINA (no income no asset loans) or stated income loans ("liar loans").[143] Anecdote[144] and data[145] show how all players in the primary mortgage market engaged in reckless market behavior with respect to such loans: mortgage brokers sold loans to borrowers who could ill afford the obligations, funding banks failed to perform basic credit diligence, and borrowers falsified their credit applications.

Documented earnings and equity requirements had previously anchored real estate prices.[146] Freed from these constraints, prices could soar as high as demand and money supply would allow, and policies and attitudes provided no restraint. In addition, creative structuring and financial fragmentation allowed for risks to be off-loaded. In 2008, based on analysis of loans currently sixty days or more in default, industry experts predicted that loans originated in 2006 and 2007 will be the most foreclosure-prone in history.[147]

USA TODAY, Jan. 18, 2006, at A1; BBC NEWS REPORT, *supra* note 116; Demyanyk & Hemert, *supra* note 130.

143. 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 (pay stubs, W-2 forms, tax returns, etc.) and borrowers simply certify to their own ability to pay.

144. *See, e.g.*, *This American Life Broadcast*, *supra* note 114. The author of Dr. Housing Bubble Blog relates the following:

> When I worked as an agent, I would constantly hit heads with brokers that [sic] laughed about creative financing they were able to pull on buyers. I would look at financial statements and shake my head as buyers fudged numbers encouraged by brokers to get into overpriced homes. "*Don't worry, banks never check especially if we go stated income. All we need is your signature here stating you make $100,000.*"

Why the Housing Market Has Failed You; 5 Major Failures of the Housing Market, DR. HOUSING BUBBLE BLOG (June 23, 2007, 12:01 PM), http://drhousingbubble.blogspot.com/2007/06/why-housing-market-has-failed-you-5.html.

145. 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 an overstated income by more than 50%. Steven Krystofiak, President, Mortgage Brokers Association for Responsible Lending, Statement to the Federal Reserve (Aug. 1, 2006), *available at* http://www.federalreserve.gov/secrs/2006/august/20060801/op-1253/op-1253_3_1.pdf; *see also* Mark Gimein, *Inside the Liar's Loan: How the Mortgage Industry Nurtured Deceit*, SLATE (Apr. 24, 2008), http://www.slate.com/id/2189576. Speaking of "liar loans," Slate Magazine opined, "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." Gimein, *supra*.

146. *This American Life Broadcast*, *supra* note 114; *see also* President Bush's Speech, *supra* note 142; Knox, *supra* note 142; BBC NEWS REPORT, *supra* note 116; Demyanyk & Hemert, *supra* note 130.

147. JOINT CTR. FOR HOUS. STUDIES AT HARVARD UNIV., *America's Rental Housing: The Key to a Balanced National Policy* 4 (2008) [hereinafter HARVARD HOUSING REPORT].

b. Tempting Returns and Other People's Money

Economically speaking, higher leverage means greater rates of return when appreciation is held constant: if you put down less money for the same return, your percentage gain is far greater. All market participants were lured by the return rate in high-leveraged financing.[148] Leverage also increases property prices, based both on anticipated rates of return and the so-called "other people's money" effect.[149] Although an investment's capital structure should not much affect the value of the underlying asset, in reality, people act as though it does. It is far easier to pay a higher price when such increase is funded by an outside source.

Although high leverage leavens higher prices through expected greater returns (and the relative ease of spending another's funds), greater potential risk in highly leveraged investments should theoretically temper price inflation. Lenders who hold mortgages for their own accounts recoup costs of increased risk by charging their borrowers higher interest rates and/or fees (within the limits of applicable usury and other laws). But the modern mortgage lender passes such risk on to secondary market buyers, who in turn sell the risk to investors via mortgage-backed securities. Modern market structures split risk off from the return calculation at every step of the financing, and the risk so far removed provides no real anchor to property appreciation.

2. *Capital Market Segmentation*

a. Unbundling Functions in Mortgage Lending

Before 1980, all the major real estate finance functions were performed by the entity making the loan,[150] but today, loan origination, funding, servicing, and allocation of credit risk are performed by different market actors.[151] Mortgage brokers originate loans, motivated by their fee structure

148. Although 260,000 subprime mortgages defaulted in 2004, the number of seriously delinquent conventional mortgages increased more than 143% between 2004 and 2007. *Id.* at 1. Taking greater risk in the face of greater reward reflects basic economic theory. *See* RICHARD A. POSNER, A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION 78-79 (2009).

149. *See generally* RICHARD A. POSNER, THE CRISIS OF CAPITALIST DEMOCRACY (2010) (discussing how the profit motive causes companies to take undue risks when the money they gamble is not their own); Russell Roberts, *Gambling With Other People's Money: How Perverted Incentives Caused the Financial Crisis*, MERCATUS CENTER, GEORGE MASON UNIVERSITY (May 2010), http://mercatus.org/publication/gambling-other-peoples-money (last visited Apr. 22, 2011). The 1991 movie "Other People's Money" by Alvin Sargent, based on the play by Jerry Steiner of this same title, illustrates this concept.

150. *See* Van Order, *supra* note 86, at 233.

151. *Id.*

to focus on loan size and quantity.[152] Brokers then sell loans to the funding mortgage banks.[153] After closing, a servicer (typically a bank that did not fund) handles borrower issues.[154] Credit risk is assumed by the secondary market purchaser and aggregated through pooling with other loans.[155] The risk is then repackaged and sold as shares in the pool. Investors provide the actual funds through purchasing mortgage-backed securities,[156] often with insurance companies providing credit enhancement to the mortgage pool.[157]

Unbundling finance functions allows for specialization and division of labor and promotes market competition, but it creates some problems as well. There are informational asymmetries, both for investors, who rely on credit agencies to assess risk exposure, and for secondary market purchasers, who buy loans from originators better-situated to assess and manage risk.[158] Although information technology has changed this dynamic to some extent, allowing secondary market buyers to exercise greater control over loan originators, informational asymmetries still present a challenge to correct pricing of secondary market products.[159]

By significantly removing the ultimate risk holders from the mortgage transaction, modern securitized asset financing effectively divorces risk assessment from the money source. Lack of accountability for primary market actors removed risk from the finance equation for the very entities that determine what loans to make and on what terms. When risk is deferred, it is both harder to manage and measure, and easier to ignore. Without internalizing the full costs of risk, financing decisions were made based on potential upside alone, which enabled increased leverage, greater loan demand, and soaring asset prices. Rather than warn of market instability, the rapid real estate appreciation actually encouraged more demand for mortgage-backed securities.[160] Prices at every step of the way (properties,

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152. As mortgages became more commoditized, attorneys became more marginalized in the home finance transaction context. Brokers have assumed the *de facto* role of borrower advisor, without owing legal duties to borrowers.

153. *See* NELSON ET AL., REAL ESTATE TRANSFER, FINANCE, AND DEVELOPMENT: CASES AND MATERIALS 916-1011 (8th ed. 2009).

154. *See generally* Van Order, *supra* note 86.

155. *Id.*

156. *See supra* notes 12, 89-93 and 103-06.

157. *See supra* notes 12, 89-93 and 103-06.

158. *See* Van Order, *supra* note 86, at 234. The subprime market suffered "asymmetric information on steroids." Hanweck, Sanders, & Van Order, *supra* note 90.

159. *See* Van Order, *supra* note 86, at 234.

160. Perceived real estate appreciation may have outpaced reality. Home prices grew at an annual 4.53% rate nationwide from 1995-2005, while market prices for mortgage-backed securities grew more rapidly. Also, it is misleading to talk in terms of a nationwide housing market, because in reality markets are quite localized. Property appreciation rates were the highest in the Pacific region (99.33% over the decade) and New England (83.66%),

mortgages, and securities) were set according to market valuations, multiplying the bubble effect.

The secondary market and securitization encouraged greater risk-taking on all accounts. The concept of securitization was sound, but the creativity of Wall Street stretched the credit enhancing properties of the structure too far, and somehow no one soberly recalled that risk spreading does not mean risk elimination (there can be no true loan alchemy performed: bad loans aren't really made into gold.).[161] After passing the "hot potato" of credit risk and collecting fees, the securitization gurus ultimately faced a day of reckoning when asset values depreciated, triggering borrower defaults and impossible reserve requirements.[162] As Tony Sanders of George Mason University put it, "'[t]he rocket scientists [at financial institutions] managed to create a missile that landed on themselves.'"[163]

b. Credit Rating Agencies and Faith in Prices

Investor demand for unproven mortgaged-backed securitization was not completely irrational or reckless, even though buyers of debt securities bore significant default and interest rate risk. First of all, conventional wisdom held that securitized products were less risky investments because of the very process of securitization.[164] Second, the prevailing world view at the time was that real estate values were safe bets because the value of real estate "would always go up."[165] In addition, before marketing these products for sale, the securities were virtually all rated by one of the three major New York credit rating agencies, Duff & Phelps, Moody's, or Standard &

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but in the center of the country, property prices grew at a modest 2% per annum. Stewart & Brannon, *supra* note 44, at 15 (citing data from OFHEO); *see also supra* notes 30, 32-33.

161. *See generally* Van Order, *supra* note 86; *see also This American Life Broadcast*, *supra* note 114.

162. 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* Porter Stansberry, *How AIG's Collapse Began a Global Run on the Banks*, DAILY WEALTH, Oct. 4, 2008, http://www.dailywealth.com/506/How-AIG-s-Collapse-Began-a-Global-Run-on-the-Banks [hereinafter *AIG's Collapse*].

163. Valerie Bauerlein & Carrick Mollenkamp, *Wachovia Write-Downs Deepen: Bank of America Issues a Warning as Debt Toll Widens*, WALL ST. J., Nov. 10-11, 2007, at A3 (quoting Anthony B. Sanders).

164. *See* discussion *supra* notes 61-62.

165. A widely distributed Powerpoint called "The Subprime Primer" mocks the now discredited but previously relied-upon mantra that "real estate values will always go up." A copy of this Powerpoint can be viewed at *The Subprime Primer*, SLIDESHARE, http://www.slideshare.net/guesta9d12e/subprime-primer-277484 (last visited Apr. 25, 2011). *See generally* NORBERG, *supra* note 11.

Poor's.[166] The "big three" credit rating agencies played a particularly essential role in this market model of risk unbundled.[167] Not only did the credit rating agencies "appear to have been recklessly, if not knowingly," misrating the mortgage-backed securities,[168] but investors from around the world acted in explicit reliance on such ratings.[169]

Between 1970 and 1990, the credit rating industry went through a business model shift.[170] Previously, rating agencies were hired by investors who wished to contract out assessment of potential investments. Under this structure, the rating agencies were investor agents, with associated fiduciary duties.[171] But this model became cumbersome, hobbled by inherent collective action problems.[172] The current business model emerged in response. Today, the issuer of securities pays credit rating agencies to rate its product. But this structure is fraught with conflicts of interest[173] and resulted in systematic over-rating of securities. Whether this was primarily due to conflicts of interest, industry negligence, or group-think regarding risks of securitized mortgage-backed products in general is unclear.[174] When there are only three market players, outlying behavior is rare, and no one pointed out dangers the industry had chosen to ignore.

Credit rating agencies were largely unregulated until the 2006 Credit Rating Agency Reform Act,[175] but fiduciary investors had been required by

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166. *See* NELSON ET AL., *supra* note 153, at 943; *see also supra* note 9.

167. *See, e.g.*, Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 620, 648 n.139 (1999).

168. Timothy E. Lynch, *Deeply and Persistently Conflicted: Credit Rating Agencies in the Current Regulatory Environment*, 59 CASE W. RES. L. REV. 227, 234 (2009); U.S. SEC. & EXCH. COMM'N, SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMMISSION STAFF'S EXAMINATION OF SELECT CREDIT RATING AGENCIES 23, 23-26 (2008) (quoting from an analytical manager's email calling a rated CDO a "house of cards" and quoting from other internal agency emails that reference inflated ratings in order to avoid negatively impacting business).

169. Mauro Bussani, *Credit Rating Agencies' Accountability: Short Notes on a Global Issue*, 10 GLOBAL JURIST 1 (2010). *See also supra* notes 13 and 28.

170. Lynch, *supra* note 168, at Section I.C.

171. *Id.* at Section I.B.

172. Without proprietary limits, there was little incentive for investors to pay for product ratings. In addition, ratings became increasingly used in public regulation and in private contracting. *See id.* Section I.C.

173. Jeffrey Manns, *Rating Risk After the Subprime Mortgage Crisis: A User Fee Approach to Rating Agency Accountability*, 87 N.C. L. REV. 1011 (2009); *see* Bussani, *supra* note 169.

174. "The herd instinct among forecasters makes sheep look like independent thinkers." Edgar R. Fieldler, *The Three Rs of Economic Forecasting-Irrational, Irrelevant and Irreverent*, CONF. BOARD MAG., June 1977, at 62, 63; *see also* Lynch, *supra* note 168, at 283-87 (discussing "behavioral finance and bounded rationality"). For a description of lack of credit rating agency diligence and problems with industry modeling and issuer disclosures, see *id.* at 246-49.

175. 15 U.S.C. § 78*o*(a) (2006).

law to base investment decisions on agency ratings for decades.[176] The 2006 Act prohibited undisclosed conflicts of interest and required internal separation of function between fee-negotiating divisions and rating analysts. But issuer-pays conflict of interest remains.[177] The concept that industry reputation constrains the activities of the credit rating agencies has been largely discredited due to the crisis and information about credit rating agency mindset during the bubble.[178]

C. Trending: Homeownership and the Wealth Effect

1. *The American Dream*

The aggressively pro-homeownership stance of the U.S. government grew real estate demand which encouraged rising prices.[179] Promotion of homeownership is politically popular, crosses party lines, and gets votes. Helping people buy homes when they may not otherwise be able to and helping people keep homes when they would otherwise face foreclosure are seen as legitimate policy and social welfare goals.[180] Through tax incentives, homeowner legal protections and public housing programs, the U.S. government not only creates opportunities to buy a home, but also encourages universal homeownership as good for society and as the fulfillment of every individual's "American Dream."[181] An ownership society arguably

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176. 12 C.F.R. §§ 362.10-.11 (2000) requires fiduciary investors to invest only in securities rated investment grade by "nationally recognized" agencies; *see* Hunt *supra* note 13 , at Part II.B.3 (explaining that regulations requiring certain ratings for investments vested ratings with the force of law).

177. *See* Lynch, *supra* note 168, Section V.A.

178. *See* Lynch, *supra* note 168; Hunt, *supra* note 13; *see also* Manns, *supra* note 173; Bussani, *supra* note 169.

179. *See, e.g.*, Applebaum, Leonnig & Hilzenrath, *supra* note 102 (quoting HUD Secretary Henry Cisneros' statement that Fannie and Freddie were "part of [the] equation" for the policy that "stress[ed] homeownership as an explicit goal for this period of American history").

180. Senator John Sununu 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: HOW AMERICA'S INFATUATION WITH HOME OWNERSHIP AND EASY MONEY CREATED THE ECONOMIC CRISIS, CATO INSTITUTE (Sept. 1, 2009), http://www.cato.org/event.php?eventid=6419 (featuring event video and a downloadable MP3).

181. The federal government has stated that "[o]wning a home is part of the American dream." BD. OF GOVERNORS OF THE FED. RESERVE SYS., INTEREST-ONLY MORTGAGE PAYMENTS AND PAYMENT-OPTION ARMS—ARE THEY FOR YOU? 1 (2006), *available at* http://www.federalreserve.gov/pubs/mortgage_interestonly/mortgage_interestonly.pdf; *see also* NORBERG, *supra* note 11, at 5 ("The U.S. political establishment had actually paved the way for a real-estate boom . . . . Homeownership is viewed as part of the American dream, as a route from poverty and social exclusion to independence and responsibility.").

increases civic participation and political freedom.[182] Building equity in a home theoretically grows wealth and incentivizes saving.[183] In addition, ownership of real property is strongly linked to individual autonomy. Professor Richard Pipes went so far as to say that legal structures supporting real property ownership are prerequisite to true political freedom.[184]

Some systemic pro-homeownership legal developments have been clearly salutary. For example, in the 1970s, every state in the nation passed laws allowing multi-family dwelling units to be individually owned.[185] Because of the statutory innovation of the condominium, apartments could be sold—not just leased—and urban dwellers could join the ranks of homeowners.[186] The protective stance of U.S. courts and legislation toward mortgagors represents another aspect of homeownership promotion. The law mandates various disclosures in making home loans,[187] and in foreclosing on defaulted mortgage debt, the law mandates specific protective procedures.[188] This increases lender costs but guards against unfair borrower victimization.[189]

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182. *See, e.g.*, JB McCombs, *Refining the Itemized Deduction for Home Property Tax Payments*, 44 VAND. L. REV. 317, 325-26 (1991).

183. *See, e.g.*, George McCarthy, Ford Foundation, Remarks at A New Way Forward: Center for American Progress (Feb. 4, 2010), *available at* http://www.americanprogress.org/issues/2010/02/sustainable_homeownership_event.html (click "full event video"); *cf.* SHILLER, IRRATIONAL EXUBERANCE, *supra* note 9, at 37 (calling saving through real estate appreciation an "illusion").

184. *See generally* RICHARD PIPES, PROPERTY AND FREEDOM (1999).

185. Condominium ownership structure became popular in the United States after the 1961 amendment to the National Housing Act permitting FHA-insured mortgages on condominium units. The FHA promulgated a model statute which was adopted or adapted by every state by 1969. *See* GERALD KORNGOLD & PAUL GOLDSTEIN, REAL ESTATE TRANSACTIONS: CASES AND MATERIALS ON LAND TRANSFER, DEVELOPMENT AND FINANCE 589 (5th ed. 2009).

186. *See* Stephen D. Teaford, *Homeownership for Low-Income Families: The Condominium*, 21 HASTINGS L.J. 243 (1970); Comment, *Condominiums and the 1968 Housing and Urban Development Act: Putting the Poor in Their Place*, 43 S. CAL. L. REV. 309 (1970); *cf.* Michael Diamond, *Rehabilitation of Low-Income Housing Through Cooperative Conversion by Tenants*, 25 AM. U. L. REV. 285 (1976).

187. Lenders must make disclosures to the government under the Fair Housing Act, The Civil Rights Act of 1968, 42 U.S.C. § 3605 (2006), the Equal Credit Opportunity Act (ECOA), 15 U.S.C. § 1691f (2006), the Home Mortgage Disclosure Act, 12 U.S.C. § 2803 (2006), and the Community Reinvestment Act of 1977 (CRA), 12 U.S.C. § 2904 (2006), in order to ensure non-discriminatory lending practices. Under the Home Ownership and Equity Protection Act and the Truth in Lending Act of 1994, 15 U.S.C. §§ 1601-1677f (2006), and under the Real Estate Settlement Procedures Act (RESPA), 12 U.S.C. §§ 2601-2617 (2006), lenders must make explicit disclosures to borrowers regarding all costs of finance (fees, charges, interest) and risk of loss. State laws usually mandate additional mortgage lender disclosures.

188. *See* NELSON & WHITMAN, *supra* note 83, at 600-95.

189. Since foreclosure is a creature of equity, judicial treatments and statutory requirements with respect to such proceedings focus on fairness to the borrower. During the

Some market-intrusive promotions of homeownership have been criticized, as either too costly (measured in terms of lost tax revenue) or unfair—allocating government resources away from the truly needy.[190] By granting homeowners tax relief, for example, the U.S. government effectively subsidizes the costs of homeownership, distorting the market by increasing demand at a given price.[191] Owner-occupants can deduct mortgage interest from owed federal income tax[192] and state and local real estate taxes,[193] and there are many ways to decrease and defer capital gains tax liability.[194] In an effort to lure buyers back to the market, the government offered first-time homebuyers an $8,000 tax credit on purchases closing by September 2010.[195]

Fannie and Freddie's mandate to promote "housing affordability" and government guaranties of mortgage debt for certain populations translates into another sort of "subsidy" of home-buying.[196] There are many government policies and programs making it easier for people to qualify for home loans, particularly targeting lower-income and first-time would-be home-

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Great Depression, additional statutory protections for borrowers facing foreclosure became common. *See id.* at 568-850 (discussing foreclosure law development and judicial and statutory limits on foreclosure proceedings).

190. *See* McCombs, *supra* note 182; Mark Andrew Snider, *The Suburban Advantage: Are the Tax Benefits of Homeownership Defensible?*, 32 N. KY. L. REV 157 (2005); Roberta F. Mann, *The (Not So) Little House on the Prairie: The Hidden Costs of the Home Mortgage Interest Deduction*, 32 ARIZ. ST. L.J. 1347 (2000).

191. *See* McCombs, *supra* note 182, at 325-29; KORNGOLD & GOLDSTEIN, *supra* note 185, at 578.

192. I.R.C. § 163(h) (2006). Interest deductions are not allowed for consumer loans (credit cards, car loans, etc.). In 1994, however, 68% of home loans were actually used to pay down consumer debt. *See* KENNETH TEMKIN ET AL., U.S. DEP'T HOUS. & URBAN DEV, SUBPRIME MARKETS, THE ROLE OF GSES, AND RISK-BASED PRICING (2002), *available at* http://www.huduser.org/publications/pdf/subprime.pdf.

193. I.R.C. § 164(a).

194. I.R.C. § 27. For example, if investment real estate is "exchanged" for a like-kind property under Section 1031 of the tax code, gain from the sale is not recognized at the time of sale. *See* Treas. Reg. § 1.1031(a)-1(b) (2009).

195. American Recovery and Reinvestment Act of 2009 (Pub. L. 111-5) (2009). Although legislators argued this tax credit would stimulate the real estate market, the statistics show just the contrary. *Falling Again*, ECONOMIST (June 23, 2010), http://www.economist.com /blogs/freeexchange/2010/06/housing_markets_2; *see, e.g.*, Martin Hutchinson, *Don't Be Fooled by the Housing Market's False Bottom*, MONEY MORNING, Dec. 31, 2009, http://www.moneymorning.com/2009/12/31/housing-market-false-bottom (boosting housing "by just about every artificial means you can imagine," keeps housing prices unrealistically high and skews housing indicators from representing actual market fundamentals).

196. *See supra* notes 71-72, 97 and accompanying text. Even before the crisis, some called for a reassessment of the underlying purposes and methods of the GSEs. *See, e.g.*, Freeman, *supra* note 6, at 12, 22-23 (A real estate bubble endangers the economy. Fannie and Freddie "are the linchpin of the housing bubble; without them, it could not exist.").

buyers.[197] Some such programs, like the Community Reinvestment Act (CRA),[198] have been blamed for contributing to the subprime crisis,[199] though current studies have failed to show a convincing link between CRA loans and delinquency rates.[200] It may be hard to measure the true impact of pro-homeownership policies because effects can be subtle. For example, government home-buying assistance may indirectly promote an entitlement culture with respect to property ownership that encourages riskier purchasing, borrowing, and lending.[201]

So do all these efforts work? Has U.S. homeownership increased? In 1940, 40% of Americans owned their own homes.[202] This figure was up to 62% by 1960.[203] By 2006, homeownership hit a record level of 69%,[204] but homeownership rapidly fell back as the market cooled. At the end of 2009, homeownership had declined to 67.2%—the same level it was in early

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197. For example, the federal government provides mortgage insurance to qualifying homebuyers. *See supra* note 135.

198. 12 U.S.C. §§ 2901-2908 (2006). The CRA was strengthened by FIRREA in 1989 and the Housing and Community Development Act in 1992. A 1995 resolution promulgated tests to ensure that home mortgage lenders were meeting the needs of low and moderate income neighborhoods. Community Reinvestment Act Regulations, 60 Fed. Reg. 22156 (May 4, 1995); *see* David Schon, *The Community Reinvestment Act in Today's Markets*, 7 J. AFFORDABLE HOUS. & COMMUNITY DEV. L. 270, 271-73 (1998). The CRA is a regulatory agency instruction and provides no private right of action. *See* Lee v. Bd. of Governors of the Fed. Reserve Sys., 118 F.3d 905 (2d Cir. 1997).

199. *See, e.g.*, CONGRESSIONAL OVERSIGHT PANEL, FORECLOSURE CRISIS: WORKING TOWARD A SOLUTION 73 (2009) [hereinafter CONGRESSIONAL OVERSIGHT REPORT] (statement of Representative Jeb Hensarling: "[M]andates like the CRA ended up becoming a significant contributor to the number of foreclosures that are occurring because they required lending institutions to abandon their traditional underwriting standards in favor of more subjective models to meet their government-mandated CRA objectives."); *see also* Raymond H. Brescia, *Part of the Disease or Part of the Cure: The Financial Crisis and the Community Reinvestment Act*, 60 S.C. L. REV. 617 (2009).

200. *See, e.g.*, CONGRESSIONAL OVERSIGHT REPORT, *supra* note 199, at 83 (statement of Richard Neiman, Damon Silvers, and Elizabeth Warren: "[M]ost disturbing is the suggestion that CRA has been a factor in the current financial meltdown, when the facts demonstrate just the opposite."); *see also* Brescia, *supra* note 199.

201. *See generally* NORBERG, *supra* note 11.

202. *Historical Census of Housing Tables: Homeownership*, U.S. CENSUS BUREAU, http://www.census.gov/hhes/www/housing/census/historic/owner.html (last revised Dec. 2, 2004) [hereinafter *Census of Housing*].

203. *Id.*

204. 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." *The Housing Finance Regulatory Improvement Act-Part I: Hearing on H.R. 3703 Before the Subcomm. on Capital Mkts., Sec., & Gov't Sponsored Enters. and the H. Comm. on Banking & Fin. Servs.*, 106th Cong. 267 (2000) (statement of Leland C. Brendsel, Chairman and Chief Executive Officer, Freddie Mac).

2000.[205] This decline is particularly significant because it is concurrent with demographic factors predicting increase of American homeownership—namely the baby boomer population moving into prime owning years.[206] It appears that despite the real estate heyday pre-2008 and in spite of all the government programs, policies, incentives for homeownership, the result of the past decade's policies promoting homeownership has been a net zero impact. Attitudes, policies, and products that extended homeownership to lower-income households ultimately led to increased foreclosures and evictions.[207] The housing bust washed away all the ownership gains during the housing boom.

2. *Stay Poor by Acting Rich*

The precipitous rise in property values in the early few years of the twenty-first century created what *The Economist* called "the biggest bubble in history."[208] Total value of residential property in developed countries rose by more than $30 trillion over those five years, equivalent to 100% of those countries' combined GDPs.[209] By way of comparison, the United States' stock market bubble of the late 1920s which lead to the Great Depression was equivalent to 55% of GDP.[210] The increase in perceived property values leading up to our current financial crisis was enormous, in both real and relative terms.

During the boom years, real estate markets were hyperactive, and nearly everyone saw real estate as a safe bet.[211] Through the mechanism of secured finance, homeowners "traded up" for bigger and more expensive houses and/or "cashed out" the asset value increase.[212] Others sought to

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205. *Housing Vacancies and Homeownership*, U.S. CENSUS BUREAU, http://www.census.gov/hhes/www/housing/hvs/annual06/ann06t20.html (last revised Feb. 12, 2007); *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.

206. Chris Isidore, *Home Ownership in Record Plunge*, CNNMoney.com, Jan. 29, 2008, http://money.cnn.com/2008/01/29/news/economy/home_ownership_vacancies/?postversion=2008012913. Of course, one could argue that without government subsidies and other homeownership promoting policies, the decline in ownership rates would have been even more precipitous.

207. HARVARD HOUSING REPORT, *supra* note 147, at 1.

208. *In Come the Waves: The Global Housing Boom*, ECONOMIST (June 16, 2005), http://www.economist.com/node/4079027 [hereinafter ECONOMIST ARTICLE].

209. *Id.*

210. *Id.*

211. *See supra* note 117; *see also Breaking New Ground in U.S. Mortgage Lending*, FDIC, http://www.fdic.gov/bank/analytical/regional/ro20062q/na/2006_summer04.html (last visited Jan. 14, 2011) [hereinafter *Breaking New Ground*] (assuring that mortgage outlook was "favorable" and that increases in asset values and volume of mortgage lending was due to successful homeownership policies and actors).

212. *See* S&P/CASE-SHILLER, *supra* note 9; *Breaking New Ground*, *supra* note 211.

profit from property appreciation by purchasing homes as short-term investments, hoping to resell—or "flip"—them after a matter of months.[213] Loan originations increased, funded by the now-global real estate capital market.[214] As the number of capital market investors increased, perceptions about mortgage-backed securities attracted more money into home finance.[215] Ironically, these developments supported the market's new characterization of mortgages and mortgage-backed securities as liquid commodities rather than paper backed by an illiquid, non-fungible asset.[216]

The investment and finance website The Motley Fool warned of a real estate bubble in 2005 and catalogued evidence of a runaway wealth effect.[217] Some indications included high compensation for housing industry executives[218] and reality television shows documenting home "flipping."[219] At the same time, mortgages had become riskier,[220] and consumer spending and household debt climbed to record levels.[221] In 2005, Greenspan admitted that "home prices seem to have risen to unsustainable levels."[222]

Yet dramatically increasing real estate prices led both owners and investors to pursue more real estate financing opportunities, relying on ex-

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213. For a description of the popularity of television "reality" shows with respect to speculative real estate see NORBERG, *supra* note 11, at 8-9; *see also* Buck Hartzell, *Real Estate Bubble? You Bet!*, FOOL.COM (Oct. 26, 2005), http://www.fool.com/personal-finance/retirement/2005/10/26/real-estate-bubble-you-bet.aspx [hereinafter MOTLEY FOOL BUBBLE ARTICLE].

214. *See supra* note 117.

215. *See* SHILLER, IRRATIONAL EXUBERANCE, *supra* note 9, at 57-60 (arguing that increase in press coverage of, and advertisements for, investment opportunities grew real estate investment).

216. *See, e.g.*, Schill, *supra* note 118, at 271-74.

217. MOTLEY FOOL BUBBLE ARTICLE, *supra* note 213; *see also* ECONOMIST ARTICLE, *supra* note 208.

218. Robert Toll, CEO of Toll Brothers (a national builder of luxury homes), earned fifty million dollars in 2005, making him the thirteenth most highly compensated CEO in the world. *See*, *Forbes List of Executive Pay*, FORBES.COM, http://www.forbes.com/static/execpay2005/rank.html (last visited Jan. 26, 2011).

219. The first show was *Property Ladder*, which aired June 23, 2005. A month later, no less than three shows on house "flipping" were on the air, including *Flip This House* and *Flip That House*. NORBERG, *supra* note 11, at 8-9.

220. In 2005, "42% of all first-time buyers and 25% of all buyers made no down-payment on their home purchase." ECONOMIST ARTICLE, *supra* note 208.

221. Consumer spending accounts had risen above the seventy-five year average of 65.5% to a high of 70% of US GDP—80% of which was mortgage debt. *The* Value *Investor*, CENTURY MGMT. NEWSL. (Dec. 31, 2004), at 17, 20, http://www.centman.com/PDF/ValueInvDec2004.pdf.

222. *The Economic Outlook: Hearing Before the Joint Econ. Comm.*, 109th Cong. 5 (2005) (statement of Hon. Alan Greenspan, Chairman, Board of Governors, Federal Reserve System), *available at* http://www.federalreserve.gov/BOARDDOCS/TESTIMONY/2005/200506092/default.htm.

pected appreciations to justify liquidated values and extensions of credit.[223] By 2008, however, the appreciation trend of U.S. real estate had started to reverse. Where margins were thin and leverage was high, depreciations led to increasing numbers of defaults, foreclosures, and write-offs.[224] The previously frenzied pace of real estate transactions and the torrents of capital flowing from financial markets simultaneously "froze up"—making it harder to sell or finance properties.

Since 2008, U.S. real estate values have fallen by $4.2 trillion, the largest decline in history.[225] Although the vanished value doesn't represent mass destruction of assets (it is not as if $4 trillion worth of real estate has been wiped off the planet), this is no mere "paper loss."[226] In many cases—where needed mortgage de-leveraging depended on asset appreciation or where borrowers refinanced to cash out equity—the dollars representing this lost value have already been spent.[227] It was our reaction to the wealth increase during the boom that hamstrings our ability to bounce back from the bust. All that borrowed wealth will eventually need to be repaid, but without robust finance markets and untapped real estate equity holdings, there is no value to fill the void.

My 95-year-old grandmother posits that "[t]he rich stay rich by acting poor, and the poor stay poor by acting rich."[228] In the years precipitating the crisis, homeowners certainly were acting rich.[229] But since their fortune was in perceived asset values, spending on reliance of this wealth led them to the financial brink.

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223. *See* discussion *supra* note 160.

224. From July 2007 to August 2009, 1.8 million homes were lost to foreclosure and 5.2 million more residential foreclosures were begun. *See* CONG. OVERSIGHT PANEL, MAY OVERSIGHT REPORT: REVIVING LENDING TO SMALL BUSINESSES AND FAMILIES AND THE IMPACT OF THE TALF 3-5 (2009).

225. *See* S&P/CASE-SHILLER, *supra* note 9; *see also* INT'L MONETARY FUND, EXECUTIVE SUMMARY, *available at* http://www.imf.org/external/pubs/ft/weo/2009/01/pdf/exesum.pdf (last visited Feb. 11, 2011).

226. *See This American Life Broadcast*, *supra* note 114 (discussing trillions of dollars of fixed income deposits allocated to mortgage-backed securities and other real estate investments); BBC NEWS REPORT, *supra* note 116.

227. *See* Andrew Laperriere, *Housing Bubble Trouble: Have We Been Living Beyond Our Means?*, WEEKLYSTANDARD.COM (Apr. 10, 2006), http://www.weeklystandard.com/Content/Public/Articles/000/000/012/053ajgwr.asp.

228. Gladys B. Wise, herself a veteran of the Great Depression.

229. *See* MOTLEY FOOL BUBBLE ARTICLE, *supra* note 213; *see also* ECONOMIST ARTICLE, *supra* note 208.

III. GOVERNMENT RESPONSES TO THE CRISIS

"The nine most terrifying words in the English language are 'I'm from the government and I'm here to help . . . .'"
-Ronald Reagan[230]

Congress and industry experts have spent much of the last two years debating and drafting legislation to cure current economic woes by reforming regulations and enhancing government oversight.[231] In response to the crisis, Congress passed a series of laws, including the Economic Stimulus Act of 2008,[232] the Emergency Economic Stabilization Act of 2008 that created the Troubled Asset Relief Program (TARP),[233] and the American Recovery and Reinvestment Act of 2009 (or "Stimulus Act").[234] Recently, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act).[235]

These reforms and programs focus on many "macro" issues involved in the broader financial crisis, but much could be gained by supplementing these with some changes at the "micro" or mortgage transaction level as well. Appraisal and capitalization methods of the underlying real asset drive investor pricing and perceptions and, together with credit assessments,

230. ASHTON APPLEWHITE, WILLIAM R. EVANS, III & ANDREW FROTHINGHAP, AND I QUOTE: THE DEFINITIVE COLLECTION OF QUOTES, SAYINGS, AND JOKES FOR THE CONTEMPORARY SPEECHMAKER 275 (1992).

231. *See infra* notes 232-35.

232. Pub. L. No. 110-185, 122 Stat. 613 (2008) provides 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* H.R. Rep. No. 5140, at 1 (2008).

233. TARP is a program permitting 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. Paritosh Bansal, *US Bailout Cost Seen Lower at $89 Bln*, WALL ST. J. (Apr. 11, 2010), http://reuters.com/article/idUSN1116401920100412.

234. Pub. L. 111-5, 123 Stat. 115 (2009). This legislation 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 GENERAL THEORY OF EMPLOYMENT INTEREST AND MONEY (1936); John Maynard Keynes, *The Maintenance of Prosperity is Extremely Difficult*, *in* NEW DEAL THOUGHT, 403, 403-09 (Howard Zinn ed., 1966).

235. "The Dodd-Frank Act" is thus far the most comprehensive of the legislation passed in response to the crisis. It attempts to close gaps and strengthen vulnerabilities in the financial regulatory system by enhancing government financial market oversight. The Senate Banking Committee assures that it will "restore responsibility and accountability in our financial system." *See Brief Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act*, U.S. SENATE COMMITTEE BANKING, HOUSING, & URB. AFF., http://banking.senate.gov/public/_files/070110_Dodd_Frank_Wall_Street_Reform_comprehensive_summary_Final.pdf (last visited Jan. 26, 2011) [hereinafter *Dodd-Frank Brief Summary*]. The Dodd-Frank Act is discussed in more detail at *infra* Section III.C.

are key to managing lender and investor risk. Rather than revisiting all the details of macro-level legislation, this Article focuses on some regulatory gaps and important micro-level tweaks—local regulation and privately enforceable allocation of risk. In addition, this Article offers critiques and queries regarding broader government goals and programs that contributed to the housing bubble. If left unchecked, such policies could stymie ultimate economic recovery.

A. Somebody to Blame

Twin objectives seem to have driven the government's response thus far to the financial crisis: use public money to save the victims of market freefall while making those who caused the problem pay. In theory, this concept makes sense and tracks civil law concepts—wrongdoers should compensate victims for the harms their negligence caused. But applied to the capital market meltdown, the model is inapt. First, it has proved exceedingly difficult to determine who is a victim and who is a perpetrator of this crisis.[236] Second, efforts to save those who were "victimized" (homeowners facing foreclosure, failing banks, and securitizers) have in many cases been ineffective,[237] or even economically harmful.[238] Third, even if we can use hindsight to determine who should be blamed for the crisis, the majority of losses occurred outside the then-applicable definition of liability.[239]

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236. For one example, subprime borrowers are variously seen as victims and as perpetrators of the subprime crisis of 2007. Ditto for the subprime lenders. Secondary market purchasers of subprime loans are either labeled clever but greedy or stupid with greed. *See* Jeff Madrick, *How We Were Ruined & What We Can Do*, N.Y. REV. OF BOOKS, Feb. 12, 2009; *see also* Ronald J. Colombo, *A Crisis of Character*, HUFFINGTON POST (May 12, 2009), www.huffingtonpost.com/ronald-j-colombo/a-crisis-of-character_b_202562.html; Robert T. Miller, *Morals in a Market Bubble*, 35 U. DAYTON L. REV. 113, 121-30 (2009).

237. More than 436,000 borrowers have dropped out of the Obama Administration's Home Affordable Modification Program (HAMP)—its flagship for foreclosure assistance (more than a third enrolled). *See* Alan Zibel, *Borrowers Exit Troubled Obama Mortgage Program*, YAHOO!FINANCE (June 21, 2010), http://finance.yahoo.com/news/Borrowers-exit-troubled-Obama-apf-887634101.html?x=0. For more discussion of HAMP and other attempted assistance programs, see *infra* note 460.

238. *See infra* notes 472 and accompanying text.

239. For example, SEC efforts to hold Goldman Sachs responsible for investor losses quickly ended in a settlement. SEC v. Goldman, Sachs & Co., 10 Civ. 3229 (S.D.N.Y Apr. 16, 2010), *available at* www.sec.gov/litigation/litreleases/2010/lr21592.htm (Litigation Release No. 21592). Goldman executives have publicly said that they "did nothing wrong" and many industry experts agree. *See, e.g.*, Peter M. Sandman & Jody Lanard, *What Did Goldman Sachs Do Wrong?*, THE PETER SANDMAN RISK COMMUNICATION WEBSITE, http://www.psandman.com/col/GoldmanSachs.htm (last visited May 15, 2011) (something is "badly awry" when the government attempts to punish companies for "violating" laws that haven't been promulgated).

Finally, focusing on symptoms fails to adequately address some underlying causes of the crisis.

The government has responded to public outcry following the financial crisis by promising increased regulation.[240] One theory motivating increased oversight is that such industries or individuals did something wrong that caused the crisis. In the frenzied quest to find somebody to blame,[241] the view emerges that had market players only been more tightly regulated, everyone would still be as prosperous as they were in the boom years of the past couple decades.[242] Some blame Wall Street's unrestrained greed and lack of social conscience as the root problem.[243] Similar pictures of dishonesty, greed, and culpability have been painted with respect to each market industry: unscrupulous borrowers, devious mortgage brokers, reckless mortgage lenders, sneaky secondary market securitizers, dishonest broker-dealers, incompetent market analysts, irresponsible credit rating agencies, and naive investment managers.[244]

Some commentators on the crisis have gone so far as to blame the underlying structure of capitalism itself for the crisis.[245] Free market critics point to the crisis as proof that unrestrained markets do not create prosperity,[246] and even prominent defenders of the market's invisible hand have paused to consider if eventual market equilibrium is worth short-term pain.[247] At the very least, the current downturn has caused a severe crisis of confidence in an unregulated economy and in our government and financial systems in general.

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240. *See supra* notes 231-35 and accompanying text.

241. Much effort has been expended in discovering who the perpetrators of this economic harm were. Testimonies of banking executives "called to account for the financial crisis" included both "mea culpa" and finger-pointings. *See* Eric Dash, *So Many Ways to Almost Say "I'm Sorry,"* N.Y. TIMES, Apr. 18, 2010, at WK4.

242. *See, e.g.*, *Dodd-Frank Brief Summary*, *supra* note 235.

243. *See, e.g.*, MICHAEL LEWIS, THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE 20 (2010).

244. Some degree of culpability likely falls on each segment, and making sure that our liability system reflects proper incentives to limit dishonest and dangerous market behavior in the future is a crucial piece of solving the financial crisis puzzle. *See infra* Section IV.B.

245. *See generally* JOHN BELLAMY FOSTER & FRED MAGDOFF, THE GREAT FINANCIAL CRISIS: CAUSES AND CONSEQUENCES (2009); *see also* ROBERT HEILBRONER, THE FUTURE AS HISTORY: THE HISTORIC CURRENTS OF OUR TIME AND THE DIRECTION IN WHICH THEY ARE TAKING AMERICA 94 (1959) ("Traditional capitalism throughout most of the world has been thrown on a defensive from which it is doubtful that it can ever recover.").

246. FOSTER & MAGDOFF, *supra* note 245, at 17.

247. *See supra* notes 148-49 and accompanying text (citing Richard A. Posner). After all, as John Maynard Keynes put it, "in the long run, we are all dead." JOHN MAYNARD KEYNES, A TRACT ON MONETARY REFORM 80 (Prometheus Books 2000) (1924) (emphasis omitted).

But blaming the capital market downturn on lack of regulation is too easy and too superficial. The mere fact that we are still debating regulatory reforms—three years after the subprime crisis of 2007—suggests that there is no quick regulatory fix.[248] Much of the current finger-pointing ignores the realities of regulation, past and future. Rhetoric in the blame game has subtly morphed from "illegal" to "immoral,"[249] underscoring the point that nearly all regulatory reform is reactionary rather than prophylactic.[250] Regulatory reform only truly solves crises we have already faced (possibly contributing to crises to come). This is necessarily true, for there is no end to, nor ability to accurately forecast, human ingenuity.

B. The Rewards and Limits of "Macro" Regulation

Nevertheless, regulation seems to offer a quick and easy fix, compared to a more grassroots, nuanced solution. Federal legislation and funding can be achieved with a stroke of the pen,[251] while comprehensive changes to how transactions and people operate will require education and behavioral adjustments that occur only gradually, over time. Historically, regulation in reaction to market downturn is surely the norm. But regulation is inevitably imperfect, both in foresight and in implementation.[252] Regulation can be more effective, however, if underlying incentives reinforce regulatory goals instead of motivating a search for end-runs and loopholes.

Regulation has its downside. First, there is the problem of regulatory capture: the regulators are themselves drawn from the ranks of the industries they are regulating,[253] calling into question their independence and unbiased outlook. There is also evidence that highly regulated industries ironically (and symbiotically) benefit from government oversight of their industry

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248. While the Dodd-Frank Act is sweeping in its goals and purposes, it is not yet complete. Much of the meat of the reforms will be added to the bones of the Act after completion of extensive studies and rulemakings authorized and mandated by the Act. *See infra* note 257.

249. *See* Miller, *supra* note 236, at 123.

250. *See* Bradley J. Bondi, *Facilitating Economic Recovery and Sustainable Growth Through Reform of the Securities Class-Action System: Exploring Arbitration as an Alternative to Litigation*, 33 HARV. J.L. & PUB. POL'Y 607, 608-09 (2010).

251. Of course this means a stroke of the pen *after* months of deliberation and debate in committee and on the floor of the houses of Congress, lobbying, drafting and redrafting, and a series of votes.

252. *See, e.g.*, Hanweck, Sanders & Van Order, *supra* note 90 ("Guarantees invite moral hazard if, as is inevitable, they are imperfectly managed.").

253. The theory of regulatory capture was well-developed by the Chicago School of law and economics academics, in particular Richard Posner. *See, e.g.*, Richard A. Posner, *The Social Costs of Monopoly and Regulation*, 83 J. POL. ECON. 807-27 (1975).

because regulation creates barriers to entry that reduce competition.[254] The more regulated an industry is, the more the existing entities benefit from regulatory know-how and the steeper the learning curve that newcomers must scale.[255]

Nevertheless, increasing regulation of previously unregulated or under-regulated segments of the market is useful if those segments are otherwise prone to ignore risk. Regulation can align decisions with their true costs, creating industry incentives for efficient choices. By internalizing risk, value judgments will reflect downsides as well as potential upsides. Furthermore, if regulation promotes transparency and disclosure, then it furthers the ability of market players to protect themselves, solving problems of informational asymmetries. Legislation should (and does) also prohibit predatory practices, fraud, and victimization at all levels of the market.

C. The Dodd-Frank Act

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), lengthy and sweeping legislation that mandates and changes regulation and consumer protection in almost every segment of the financial markets.[256] The Dodd-Frank Act, the provisions of which will become effective in stages over the next three years, is not yet complete in its regulatory focus however. According to one count, the Act requires 243 more rulemakings and 67 further studies.[257]

Most of the provisions of the Dodd-Frank Act relate to a system of federal regulatory control of large financial institutions, and thus expands

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254. *See, e.g.*, Lawrence J. White, *A Brief History of Credit Rating Agencies: How Financial Regulation Entrenched this Industry's Role in the Subprime Mortgage Debacle of 2007-2008*, MERCATUS ON POL'Y, October 2009, at 1, *available at* http://mercatus.org/sites/default/files/publication/59_CRA_history_(web).pdf.

255. *See, e.g.*, Chi. Bridge & Iron Co. N.V. v. Fed. Trade Comm'n, 534 F.3d 410, 438 (5th Cir. 2008) (Noting that government regulation can be one of the "most insuperable barriers" to entry for an industry); *see also* PHILIP F. ZEIDMAN, LEGAL ASPECTS OF SELLING AND BUYING app. F, § 4.9 (3d ed. Supp. 2010).

256. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010), *available at* http://www.sec.gov/about/laws/wallstreetreform-cpa.pdf. The law has been called the most sweeping financial reform legislation since the Great Depression. *See, e.g.*, Damian Paletta & Aaron Lucchetti, *Law Remakes U.S. Financial Landscape: Senate Passes Overhaul That Will Touch Most Americans; Bankers Gird for Fight Over Fine Print*, WALL ST. J., July 16, 2010, *available at* http://online.wsj.com/article/SB10001424052748704682604575369030061839958.html.

257. *See Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Enacted into Law on July 21, 2010*, DAVIS, POLK & WARDWELL LLP (July 21, 2010), http://www.davispolk.com/files/Publication/efb94428-9911-4472-b5dd006e9c6185bb/Presentation/PublicationAttachment/efd835f6-2014-4a48-832d00aa2a4e3fdd/070910_Financial_Reform_Summary.pdf.

federal oversight of the country's financial and economic health in general, particularly with respect to monitoring systemic risks posed by institutions that may be "too big to fail."[258] The Act authorizes the Federal Reserve to control the growth and financial products offered by institutions the failure of which would pose a "grave threat" to the financial stability of the country,[259] and includes the so-called Volcker Rule disallowing certain proprietary trading or investing by banks or related institutions.[260]

The Act creates three important new federal agencies, including the Consumer Financial Protection Bureau (CFPB).[261] Operations of existing federal agencies are consolidated and coordinated through the operations of these new entities.[262] The authority, funding, and operations of the SEC are beefed up as well.[263] Federal oversight is enhanced with respect to hedge funds, large investment advisors,[264] insurance companies,[265] and security-based swaps.[266]

The Act also provides for federal oversight of the mortgage financing transaction.[267] The CFPB is given rulemaking authority with respect to all institutions offering financial services or products to consumers and, in particular, all mortgage-related business.[268] Five departments in the CFPB focus respectively on research, community affairs, complaint tracking, and collection, ensuring equitable access to credit and promoting financial literacy among consumers.[269]

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258. *See Dodd-Frank Brief Summary*, *supra* note 235.

259. Bank holding companies with total consolidated assets of $50 billion or more are subject to more stringent standards of reserve capital, liquidity requirements, and other prudential risk-controlling regulations. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act § 116. Nonbank financial institutions that meet the size/importance criteria are also subject to similar Federal Reserve oversight, as are savings & loan institutions. *See id.* § 201.

260. *See id.* §§ 606-628. The Volcker Rule also limits the size of liabilities of such institutions.

261. *See id.* §§ 300-302. The Financial Stability Oversight Council is made up of financial regulators from ten federal agencies and is tasked with identifying risks to the nation's financial stability and protecting economic stability. *See id.* §§ 111, 112(a)(1). The Office of Financial Research provides information to aid in the Council's function. *See id.* §§ 112(a)(2), 152-156.

262. *See id.* § 312.

263. *See id.* §§ 901-991.

264. *See id.* §§ 401-416.

265. *See id.* §§ 501-502. This provision was likely motivated by the key role played by AIG in the crisis.

266. *See id.* §§ 711-720 (repealing the Gramm-Leach-Bliley Act exemption for such products); Pub. L. No. 106-102, 113 Stat. 1338 (1999).

267. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act § 1001-1002.

268. This includes all mortgage lenders, companies, brokers, servicers and the like. *Id.* §§ 1001-2002.

269. *See Dodd-Frank Brief Summary*, *supra* note 235.

With respect to what is perhaps the single largest unsolved issue of the housing crisis—namely, the future role of the GSEs—the Dodd-Frank Act offers no real input, merely requiring a study on ending the conservatorship of Fannie and Freddie.[270] Although the GSEs pumped up collateral valuation, the government-sponsored secondary market is now such an integral part of our financial system that it cannot be summarily disbanded.[271] Although the Dodd-Frank Act promotes certain low-income loans,[272] it does not promote housing "affordability." To the contrary, the Act explicitly prohibits fee structures that create incentives for subprime loans.[273]

The Dodd-Frank Act is a tremendously important set of laws, particularly with respect to managing systemic economic risk through federal regulation and oversight, but it is not without its critics. For example, some bemoan the addition of still more layers of bureaucracy on the already-existing and complex system of federal regulation.[274] And since much of the substance of the Dodd-Frank Act will be filled in later after studies and rulemakings are finished,[275] the ultimate effect of the Act cannot yet be assessed.[276]

IV. ASSET PRICING: LESSONS LEARNED AND NEXT STEPS

A. Why Current Legislation Is Not Enough

> *"I can calculate . . . the motions of erratic stars, but not the madness of the multitude."*
>
> -Sir Isaac Newton[277]

Although the Dodd-Frank Act is ambitious in its reformatory scope, federal regulation is far removed from transaction-level issues. And while gaps in federal regulatory oversight may have contributed to the crisis, one

270. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act § 1074; *see also supra* Subsection II.A.1.

271. For discussion on possible solutions to this problem, see Hanweck, Sanders & Van Order, *supra* note 90; Statement of Anthony Sanders, *supra* note 99.

272. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act §§ 1201-1210.

273. *Id.*; *see also Dodd-Frank Brief Summary*, *supra* note 235.

274. *See* MICHAEL P. MALLOY, ANATOMY OF A MELTDOWN: A DUAL FINANCIAL BIOGRAPHY OF THE SUBPRIME MORTGAGE CRISIS 263-72 (2010) (creation of a CFPB is "just another duplicative federal supervisor waiting to be co-opted by the industry it regulates").

275. *See* DAVIS, POLK & WARDWELL LLP, *supra* note 257.

276. *See, e.g.*, *Dodd-Frank Financial Commentary from HBS Faculty*, HBS FACULTY, (July 20, 2010, 2:50 PM), http://blogs.hbr.org/hbsfaculty/2010/07/dodd-frank-commentary-from-hbs.html.

277. Attributed to Newton in H. R. FOX BOURNE, THE ROMANCE OF TRADE 292 (1876) (in response to the 1720 economic crash following the "South Sea Bubble").

interesting thing about this particular meltdown is how individual homebuyers, brokers, and properties played crucial roles—with large aggregate effects. The underlying mortgage pricing and risk causes of the crisis suggest a ground-up solution. Because of this, in addition to systemic macro-level changes, certain transaction-level rules and incentives are needed. These would help stabilize the entire real estate capital market system by shoring up its foundational asset values. Micro-level legislation and privately enforced changes to our risk allocation system could effectively supplement and implement the provisions and purposes of the Dodd-Frank Act.

1. *Down-to-Earth Appraisals*

Local regulators can improve primary mortgage lending standards by raising bank credit and collateral assessment thresholds. More reliable credit and collateral appraisals will increase mortgage-pricing accuracy. While sale prices for homes should continue to be set by arms-length bargaining,[278] more restrictive lending criteria would help stabilize housing prices and ensure more systemic stability. Lenders' risk positions are different than buyers, and purchase prices are inapposite measures of collateral values and mortgage risk.[279] Independent and realistic assessments of both borrower credit and collateral value should inform lending decisions.

First of all, a lender's degree of cynicism in appraising a piece of real property should be directly proportional to the loan's leverage. In the home-buying context, an industry-wide formula could be applied to mandate factoring in risk when the mortgage's loan-to-purchase price ratio is above a certain threshold. The leverage position and related risk exposure should be adequately disclosed on the secondary market.[280] Borrower credit requirements should be calculated on a sliding scale, with tighter underwriting standards for higher leveraged loans. This way, the greater percentage of value that a borrower wishes to obtain through debt, the more reliable credit background and/or the more bona fide credit enhancements a borrower must have.[281]

278. This is particularly true if the purchaser must pay some significant portion of the purchase price as equity capital at the closing of the sale.

279. *See* ENCYCLOPEDIA OF REAL ESTATE, *supra* note 39, at 1099; *see also* LEFCOE, *supra* note 19, at 484.

280. *See infra* Subsection IV.A.2.

281. Credit enhancement is provided in the form of mortgage insurance and will only perpetuate overpricing if the mortgage insurers do not accurately assess their risk. This is true at the securitization level as well: witness the broad and devastating effects of AIG's failure to accurately assess and plan for its risk exposure. *See AIG's Collapse*, *supra* note 162.

Lender appraisals for purposes of the LTV ratio must reflect independent assessments[282] using the most objective criteria. To make any lender collateral valuations meaningful to capital market investors, realty appraisals should be calculated based on something more substantial than comparative sales.[283] While a homeowner may employ subjective criteria to arrive at his higher valuation of a given property, a lender should consider rental values and/or raw land and building costs in combination with sales comparisons to arrive at a more legitimate valuation of the property for purposes of the loan.[284] A lender's appraisal, if not equal to the stream-of-income assessment, should be limited to some margin of that present value. The investment website The Motley Fool has a concise statement of objective investor valuation thresholds: "If a home is selling for 150 times the monthly rent (or less), it's generally a good deal. If it's selling for more than 200 times the monthly rent of a comparable property, you're better off renting."[285] This concept is particularly apt in terms of collateral assessment. Since a lender's prospective interest in the property is akin to that of the traditional investor, a proper valuation query for a lender is: for what amount could this property be rented?[286]

The Dodd-Frank Act addresses property appraisals by prohibiting "higher-risk" mortgage loans that are unsupported by an independent appraisal (and under certain circumstances, a second appraisal).[287] These provisions effectively codify and add to the appraisal independence standards

282. Freddie Mac's Home Valuation Code of Conduct requires that originating lenders keep appraisal functions completely independent of loan production functions, as a prerequisite for mortgage sales to Freddie. *See Home Valuation Code of Conduct*, FREDDIE MAC (May 2010), http://www.freddiemac.com/singlefamily/pdf/hvcc_746.pdf.

283. *See supra* notes 42-48 and accompanying text.

284. Investors buying property, however, would be well-served to consider rental values instead of comparative sales.

285. *See* MOTLEY FOOL BUBBLE ARTICLE, *supra* note 213. The article uses a house in Alexandria, Virginia as a test case. Based on comparative sales, the house is valued at approximately $2 million, but since the house would rent for no more than $3,900 per month, it is priced at 512 times over the monthly rent. *Id.* Based on "[t]he 150 to 200 rule," the $2 million purchase price would only be an accurate valuation if monthly rent payments could be set at $11,000. *Id.*

286. Mortgage lenders do not typically rent property acquired at a foreclosure sale; rather, they attempt to find a third-party purchaser as quickly as possible. But the increasing time horizon in selling even marked-down, bank-owned properties in the currently sluggish real estate market suggests that even if lenders do not establish some means of recouping their costs through short-term rental of their foreclosed properties, these properties should be priced so that an investor can buy to rent. *See* Stewart & Brannon, *supra* note 44 (discussing this ratio).

287. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 1471-72, 124 Stat. 1376 (2010) (adding a new § 129H and § 129E to Chapter 2 of the Truth in Lending Act (15 U.S.C. 1631)). "Higher-Risk Mortgage" is defined as a non-qualifying residential mortgage loan (for purposes of secondary market purchase by GSEs) with an interest rate higher than one of the designated thresholds. *Id.* § 129H(f).

previously announced by Freddie Mac.[288] Unlike the Home Valuation Code of Conduct, the Dodd-Frank Act provides for civil penalties (in the form of escalating fines) for appraisal requirement violations.[289] While independence of appraisers makes collateral estimates more reliable, it is not enough to ensure that valuations are sound. Independence requirements should be combined with multiple-methodology appraisals and/or leverage limits discussed above. This would ensure a sufficient equity cushion to support real property's inherent price uncertainty. Rather than prohibit lending without adequate collateral appraisals, regulations should instead foster market flexibility by requiring lenders who fail to conform with appraisal and/or leverage requirements to highlight that fact in disclosure to ultimate risk holders.[290]

The Dodd-Frank Act also prohibits yield spread premium broker compensation, which created incentives for steering borrowers to higher-interest loans.[291] Hoping to promote mortgage lending based on a borrower's ability to pay rather than fees or interest spreads, the Act requires lenders to determine a borrower's credit "based on verified and documented information."[292] If lenders violate the ban on irresponsible steering or otherwise fail to adequately assess borrower credit, the borrower can raise these lapses in diligence as defenses in foreclosure proceedings, without regard to any statute of limitations.[293] Importantly, however, these restrictions and requirements on mortgage lending apply only to "non-qualified mortgages."[294] If a loan meets enumerated criteria, including a cap on points and fees that can be charged, it will be "qualified" and lenders can avoid restrictions and borrower foreclosure defenses described above.[295] The increased oversight of and borrower defenses for unqualified mortgages—and the qualified mortgage safe harbor—will dry up secondary mortgage market demand for riskier, non-qualified mortgage products (to the extent it still exists). Thus, the default risks associated with most non-qualified mortgages will probably remain with the originating lender. This means that non-qualified mortgages will be rarer and will cost borrowers more.[296]

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288. *Id.* § 1472; *see Home Valuation Code of Conduct*, *supra* note 282.

289. Dodd-Frank Wall Street Reform and Consumer Protection Act §§ 1471.

290. *See infra* Subsection IV.A.2.

291. Dodd-Frank Wall Street Reform and Consumer Protection Act § 1403; *see infra* Subsection IV.B.3.

292. Dodd-Frank Wall Street Reform and Consumer Protection Act § 1411(a)(2). This would effectively end no-documentation and low-documentation loans, at least with respect to "non-qualified loans" to which this regulation applies. *See infra* notes 294-96 and accompanying text.

293. Dodd-Frank Wall Street Reform and Consumer Protection Act § 1413.

294. *Id.* § 1412.

295. *Id.*

296. This would be a fairer allocation of risk compared to passing on risky borrowing costs to unwitting investors.

The Dodd-Frank Act also bans residential mortgage loan prepayment penalties (other than qualified mortgages).[297] Unlike default risk, prepayment of a mortgage loan does not affect return on principal, but it does impact return on investment, particularly in the realm of investment in securitized products.[298] Without prepayment penalties, disallowed under the Dodd-Frank Act, this prepayment risk is more pronounced. A major function of tranching in traditional loan securitization was to allocate prepayment risk, although subprime mortgages allocated such risk to borrowers via prepayment penalties.[299] The Dodd-Frank Act will no longer permit a borrower allocation of interest rate risk. To the extent that non-qualified mortgages are securitized in the future, both default risk and prepayment risk would have to be managed through tranching or some other mechanism.

Tighter lending standards will ensure that collateral value risk is considered and managed at the mortgage transaction level, keeping home prices from reaching unrealistic and unsustainable levels. Tempering the market's expectation of rapid and continuing appreciation of real estate and controlling mortgage risk will in turn restrain mortgage-backed securitization bubbles from developing.[300] Because bank regulations for residential lending work in concert with GSE mortgage purchase requirements, GSE requirements can help align incentives with regulation.

2. *Comprehensible Disclosure Requirements*

There is doubtless some truth to the assertion that many investor and borrower decisions were made without full understanding by investors and borrowers of what they were getting into and what their risks were.[301] Richard Thaler and Cass Sunstein explain that the "bounded rationality" of humans limits their ability to comprehend risks—even if such risks are technically disclosed.[302] In addition to the general complexity and confusion surrounding mortgage terms and mortgage-backed products, the subtle peer pressure of the era of real estate investment optimism clouded the better judgment of many market participants.[303] Robert Shiller, who made a career out of tracking irrational behavior in markets, blames the culture of "quick

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297. Dodd-Frank Wall Street Reform and Consumer Protection Act § 1414.

298. *See* MALLOY & SMITH, *supra* note 5, at 9-11.

299. Frank J. Fabozzi & Vinod Kothari, *Securitization: The Tool of Financial Transformation*, 20 J. FIN. TRANSFORMATION 33 (Sept. 2007).

300. Such efforts would be successful only in combination with reassessment of mortgage lender and mortgage broker liability, as explained *infra* Subsection IV.B.3.

301. *See, e.g.*, LEWIS, *supra* note 243.

302. RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS 270 (2009) ("[C]ountless borrowers did not understand the terms of their loans.").

303. *See generally* NORBERG, *supra* note 11.

buck" investment, profit opportunity advertisement, overly optimistic forecasts, and increased investment funds as fuel for the "irrational exuberance" of the past decade.[304] Shiller explains that "irrational exuberance" is amplified by an infectious feedback loop: "As prices continue to rise, the level of exuberance is enhanced by the price rise itself."[305]

Is there any way to both cut through the complexity of market products in order to allow borrowers and investors to understand and assess risk and also detach the feedback loop that exacerbates bubble behaviors? Sometimes irrational human behavior is ameliorated by targeted education, and it is possible that a concerted effort to inform the public regarding risk assessment and market cycles will inoculate against the contagion of bubble psychology run amok. The very occurrence of the downturn cycle may accomplish this to an extent, although the persistence of cycles historically argues to the contrary.[306]

Another option is more protective legislation—going beyond mere informational disclosure requirements and taking proactive steps to actually prevent people from making imprudent financial choices. But while consumer protection through disclosure makes sense, it is improper to use governmental force to remove freedom of choice. "Ultimately, in a free society, we cannot protect people from all the consequences of their own errors. We cannot protect people completely without denying them the possibility of achieving their own fulfillment."[307]

The answer must be to increase the ability of investors and borrowers to make their own informed judgments.[308] Through mandated investor and borrower disclosures, the government can empower people to make better decisions on their own. Greenspan made a clear statement to this effect: "An informed borrower is simply less vulnerable to fraud and abuse."[309]

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304. *See generally* SHILLER, IRRATIONAL EXUBERANCE, *supra* note 9, at 33-47.

305. *Id.* at 81.

306. *See generally* CARMEN M. REINHART & KENNETH S. ROGOFF, THIS TIME IS DIFFERENT: EIGHT CENTURIES OF FINANCIAL FOLLY (2009).

307. SHILLER, IRRATIONAL EXUBERANCE, *supra* note 9, at 230. Police Chief Wiggum, from the television show *The Simpsons*, cites another (ironic) justification for favoring individual empowerment over government protection, namely the lack of government competence to adequately protect people. As Wiggum put it, "Can't you people take the law into your own hands? I mean, we can't be policing the entire city!" *The Simpsons: The Secret War of Lisa Simpson* (Fox television broadcast May 18, 1997).

308. Thaler and Sunstein would call this "nudging." *See generally* THALER & SUNSTEIN, *supra* note 302.

309. Alan Greenspan, *Financial Literacy*, FED. RES. BOARD (Feb. 5, 2002), http://www.federalreserve.gov/boarddocs/testimony/2002/20020205/default.htm (testimony before the Senate Committee on Banking, Housing, and Urban Affairs).

Thomas Jefferson went even further: "[W]henever the people are well-informed, they can be trusted with their own government."[310]

Several agencies currently mandate disclosures related to mortgage lending. The Federal Reserve Board (FRB) mandates various disclosures under TILA. The Department of Housing and Urban Development (HUD) has required certain disclosures at the closing of mortgage loans pursuant to the Real Estate Settlement Procedures Act (RESPA).[311] An important step toward adequate disclosure at the mortgage borrower level was taken when the FRB issued new regulations in July 2008 mandating disclosure of a mortgage loan's Annual Percentage Rate (APR).[312] TILA had created the APR concept in 1968 as a way to help consumers understand the true cost of credit.[313] The APR calculates all fees and borrower costs and expresses these costs as a part of the interest paid on a loan.[314] This allows "apples to apples" comparison of loans with different terms, rates, points and fees. Quantitative disclosure of actual borrowing costs—if sufficiently high-lighted and comprehensible—should help inform borrowers of mortgage terms.

The Dodd-Frank Act amends several mortgage lending disclosure statutes, including the Interstate Land Sales Full Disclosure Act and TILA.[315] Under the Dodd-Frank Act, lenders must disclose the maximum amount that a borrower could pay on a variable-rate mortgage loan.[316] In addition, adjustable rate mortgages now require a warning label that "payments will vary based on interest rate changes."[317] Under the Act, additional residential borrower disclosures must be made at closing and in monthly mortgage statements.[318]

Required disclosures under the securities laws in this country are already extensive and well-developed.[319] The Dodd-Frank Act adds to these

310. Letter from Thomas Jefferson to Richard Price (Jan. 8, 1789), *available at* http://en.wikisource.org/wiki/Letter_to_Richard_Price_-_January_8,_1789.

311. *See* Real Estate Settlement Procedures Act (RESPA): Rule to Simplify and Improve the Process of Obtaining Mortgages and Reduce Consumer Settlement Costs, 73 Fed. Reg. 68204 (Nov. 17, 2008) (to be codified at 24 C.F.R. pts. 203, 3500).

312. *See* Truth in Lending, 73 Fed. Reg., 44522 (July 30, 2008) (codified at 12 C.F.R. pt. 226); *see also* Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, § 2502(a), 122 Stat. 2654, 2855-57 (2008) (to be codified at 15 U.S.C. § 1638(b)(2)).

313. Truth in Lending Act, Pub. L. No. 90-321, § 107, 82 Stat. 146, 149 (1968) (codified as amended at 15 U.S.C. § 1606 and 163-49 (2006)).

314. *Id.*

315. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 1098-1100, 124 Stat. 1376 (2010).

316. *Id.*

317. *See Dodd-Frank Brief Summary*, *supra* note 235.

318. Dodd-Frank Wall Street Reform and Consumer Protection Act §§ 1419-20.

319. *See* Securities Act of 1933, 15 U.S.C.A. § 77 (West 2010) (amended through P.L. 111-229, approved Aug. 11, 2010); Securities Exchange Act of 1934, 15 U.S.C.A. 78

as well, requiring disclosures for investors in derivatives[320] and asset-backed offerings,[321] as well as public reporting of transactions in the swap markets.[322] The Dodd-Frank Act further directs that various studies be performed regarding investor advisors, investor information, advertisement, conflicts of interest and disclosures.[323] These will likely result in still more disclosure requirements for securities offering materials. Presumably the disclosure language in such documents will be subject to stricter scrutiny by the SEC as well, since that agency's budget and authority have been significantly increased under the Act.[324]

Increasing information available for financial decisions—be they investment or mortgage borrowing decisions—is laudable as it increases both freedom of choice and responsibility. But there is a crippling limitation on the effectiveness of information disseminated via required disclosure. The actual effect of mandated disclosures is watered-down or even eliminated by the form in which the information appears. This again shows "bounded rationality."[325] A number-heavy HUD-1 settlement statement and pages of fine print offer very little of value to an average home mortgagor beyond multiplying the borrower's confusion. Prospective investors may find tome-sized offering memoranda impossible to adequately review. The result of such unintelligible disclosure, then, is merely to shift the risk of loss to the consumer without effectively informing the consumer at all.

Efforts to promote free choice and responsibility through disclosure must focus on the form of the disclosure as much as its substance. Required disclosures should lay out costs and risks in concise, unambiguous terms. Information should be accessible in both quantitative and—if possible—qualitative terms. Unlike typical offering memoranda or other densely writ-

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(West 2010) (amended through P.L. 111-257, approved Oct. 5, 2010); Trust Indenture Act of 1939, 15 U.S.C.A. 77 (West 2010) (amended through P.L. 111-229, approved Aug. 11, 2010); Investment Advisers Act of 1940, 15 U.S.C.A. 80b (West 2010) (amended through P.L. 111-257, approved Oct. 5, 2010); Investment Company Act of 1940, 15 U.S.C.A. 80a (West 2010) (amended through P.L. 111-257, approved Oct. 5, 2010); Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15 U.S.C.). These are supplemented by numerous rules and regulations promulgated by the SEC, available at http://www.sec.gov/about/laws/secrulesregs.htm. For more information, see http://www.sec.gov/about/laws.shtml.

320. Dodd-Frank Wall Street Reform and Consumer Protection Act § 405.

321. *Id.* § 941.

322. *Id.* § 727.

323. *Id.* §§ 911-919D.

324. The Dodd-Frank Act preliminarily authorized a series of increases in SEC funding over the next five years, effectively doubling the SEC's budget over the five-year period. *See* Stephen J. Crimmins et al., *Financial Services Reform: Investor Protection Provisions of Dodd-Frank*, K&L GATES, LLP (July 1, 2010), http://www.klgates.com/ newsstand/detail.aspx?publication=6518.

325. The concept of "bounded rationality" is discussed in THALER & SUNSTEIN, *supra* note 302.

ten disclaimer language, risk disclosure—particularly with respect to a mortgage transaction and an unrepresented mortgage borrower—should be short and easy to understand. In addition to regulating the form and substance of mortgage disclosure, creating a method of ensuring borrower comprehension would further empower consumers. For the bulk of home borrowers, federal disclosure mandates achieve little in the absence of legal representation. But help could be provided, say by making a cadre of lawyers available to answer borrower questions (perhaps paid out of a lender-funded pool while owing lenders no fiduciary duties).

The Dodd-Frank Act takes steps toward increasing actual borrower comprehension of disclosures, in the form of creating the Office of Housing Counseling within HUD (charged with developing borrower counseling and education programs),[326] and also by requiring HUD to certify computer software programs to assist in borrower evaluation of loan proposals.[327] While mentioned in concept rather than in any detail, computer-assisted quantification of mortgage information recalls a suggestion made by Thaler and Sunstein in their book *Nudge*.[328]

In the realm of securities investment, comprehensible disclosure is just as crucial but far more challenging. Complex bond market products and their risk structures may not be describable in an easy-to-understand way. There should therefore be a reliable source entrusted with the job of assessing the risks involved. This is the current role of the credit risk agencies, albeit played poorly over the past decade or so. Since expert assessments of securitization products is essentially a public good, the credit risk industry should be restructured to limit conflicts of interest and create a backstop of liability for incompetence as well as willful blindness.[329]

Treasury Secretary Henry Paulson called for more regulatory scrutiny of credit rating agency practices in light of over-rated mortgage-backed securities.[330] "It is clear that we must examine the role of credit rating agencies including transparency and potential conflicts of interest," he said.[331] "We must also assess if regulations and supervisory policies are encouraging an over-reliance on ratings by financial institutions and investors."[332]

The Dodd-Frank Act addresses the role of credit rating agencies in some detail, attempting to simultaneously (a) back away from statutory requirements of basing investment decisions on ratings, and (b) enhance regu-

326. Dodd-Frank Wall Street Reform and Consumer Protection Act § 1442.

327. *Id.* § 1443(a).

328. *See* THALER & SUNSTEIN, *supra* note 302.

329. *See infra* Subsection IV.B.2 (discussing potential avenues of increasing credit rating agency responsibility through liability exposure).

330. Paulson Statement, *supra* note 22.

331. *Id.*

332. *Id.*

latory oversight and accountability of the credit rating agencies.[333] Perhaps in recognition of the inherent conflict of interest in the current credit rating agency model,[334] the Act also requires the SEC to study ways to strengthen credit agency independence and requires the Government Accountability Office to study alternative business models for rating agencies, including the possible creation of an independent analyst organization.[335]

3. *Micro Regulation and State Regulators*

Regulating securities offerings in national markets has long been the realm of federal agencies, but state agencies are better-suited regulators for mortgage transactions.[336] Although the secondary mortgage market is a piece of national finance, the primary mortgage market remains local, governed by varying state and county regulations and impacted by geographically specific factors.[337] State regulators are closer to those deals, and property rights in and debt obligations secured by situate assets are already subject to state oversight.[338] In addition, local consumer protection efforts are typically more responsive. Michael Malloy puts it this way: "Nothing is as effective at protecting consumers from fraud as unleashing state and local consumer protection agencies on the perpetrators."[339] Today, there are many types of transactions that take place in national (or global) markets—or even exclusively in cyberspace, and raise multi-jurisdictional coordination concerns. But mortgage lending does not. The cross-border and internet-reality issues that call for federal (rather than state-by-state) regulation in other spheres do not credibly apply to most aspects of real estate transactions.

In the two decades leading up to the financial crisis, the Office of Thrift Supervision (OTS) and the Office of the Comptroller of the Currency (OCC) successfully argued that federal regulatory authority preempted state supervisory jurisdiction for federal savings associations or national banks—and even local institutions affiliated with these.[340] Courts routinely interpreted the Home Owners' Loan Act (HOLA) and OTS regulations as broad-

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333. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 931-939H, 124 Stat. 1376 (2010). For one thing, the Dodd-Frank Act calls into question the widespread practice of corporate issuers referencing the rating of their securities in prospectuses.

334. *See* Manns, *supra* note 173.

335. Dodd-Frank Wall Street Reform and Consumer Protection Act § 939.

336. *See supra* note 319.

337. *See supra* notes 73-77 and accompanying text.

338. Again, the land does not move, and local laws are especially relevant in real property-related transactions. *See supra* notes 51-55 and accompanying text.

339. MALLOY, *supra* note 274, at 270.

340. *Id.*

ly preempting state laws regulating federal thrifts.[341] The result: states could no longer maintain authority over lending activities of federal thrifts occurring in or secured by property in their jurisdiction.[342]

Federal preemption of state authority over in-state banking activities grew as well. After the 1994 Riegle-Neal Interstate Banking and Branching Efficiency Act permitted national banks to establish local branches, the OCC issued an interpretive letter, which explicitly allowed banks to use the most favorable interest rate among those states where the bank operated.[343] In response, the number of state branches of national and out-of-state banks increased rapidly while state regulatory authority over banking activities waned.[344]

In 1996, the Supreme Court held that any state law which "prevent[s] or significantly interfere[s]" with a national bank's financial activities is preempted.[345] And in 2007, in *Watters v. Wachovia Bank, N.A.*, the Court ruled that the National Bank Act (NBA) preempted Michigan law governing Wachovia's mortgage lending affiliates.[346] Justice Ginsburg's majority opinion in *Watters* held that it "would significantly burden mortgage lending" to allow "duplicative state examination, supervision and regulation."[347] The Court further found that "[a] national bank has the power to engage in real estate lending through an operating subsidiary, subject to the same terms and conditions that govern the national bank itself; that power cannot be significantly impaired or impeded by state law."[348] Justice Stevens' dissent in *Watters* criticized the majority for upsetting the "federal-state balance" in the banking system,[349] pointing out that Congress did not explicitly immunize national bank subsidiaries from compliance with nondiscriminatory state laws.[350]

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341. *See e.g.*, Gade v. Nat'l Solid Wastes Mgmt. Ass'n, 505 U.S. 88, 98 (1992) (holding that courts will infer intention to preempt state law in areas where the federal regulatory scheme is so pervasive as to "occupy the field").

342. *See* MALLOY, *supra* note 274, at 145-72.

343. Pub. L. No. 103-328, 108 Stat. 2338 (1994) (codified in scattered sections of 12 U.S.C.). The passage of the Act inspired copious legal commentary. *See, e.g.*, Charlotte L. Tart, *Expansion of the Banking Industry Under the* Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994*: Is the Banking Industry Headed in the Right Direction?*, 30 WAKE FOREST L. REV. 915 (1995).

344. By 2005, 40% of all domestic banks were branches of national or out-of-state banks. Christian Johnson & Tara Rice, *Assessing a Decade of Interstate Bank Branching* (Federal Reserve Bank of Chicago, Working Paper No. 2007-03, 2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=981214.

345. Barnett Bank of Marion Cnty, N.A. v. Nelson, 517 U.S. 25, 33 (1996).

346. Watters v. Wachovia Bank, N.A., 550 U.S. 1, 21-22 (2007).

347. *Id.* at 17-18.

348. *Id.* at 21.

349. *Id.* at 22 (Stevens, J., dissenting).

350. *Id.*

Two years later, in *Cuomo v. The Clearing House Association, L.L.C*,[351] the Court, in an opinion by Justice Scalia, scaled back the holding of *Watters*, holding that even though the NBA preempted state administrative oversight for national bank subsidiaries, state attorneys general remained empowered to enforce state law.[352] The Court distinguished *Watters*, explaining that it turned on visitorial rather than enforcement preemption, even though the dissent in *Cuomo* criticized the majority for overruling *Watters* by stealth.[353] *Cuomo* is an important precedent for state regulator enforcement of consumer protections law in spite of claimed immunity due to federal preemption.[354]

The Dodd-Frank Act scales back federal regulatory preemption as well, explicitly preserving state enforcement powers over national bank affiliates, non-depository institutions and federal thrifts.[355] But the Act also perpetuates federal authority over state consumer protection laws. States must inform the CFPB of regulatory actions against federally chartered banks, and the CFPB has the ability to intervene in a state action, dismiss it, or remove it to federal court.[356] Under the Act, state laws are only preempted to the extent that they are "inconsistent" with federal law, providing that more extensive state consumer protection is not considered inconsistent.[357] The Act identifies three triggers of preemption: (a) if a state consumer protection law would have a discriminatory effect on federal banks (as compared with state-chartered banks); (b) if the OCC determines that the state statute significantly impairs bank activities; or (c) if the federal law expressly provides for preemption.[358]

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351. Cuomo v. Clearing House Ass'n, 129 S. Ct. 2710 (2009). This case has been heralded as a major victory for consumer protection by reactivating state watchdogs. *See, e.g.*, Arthur E. Wilmarth, Jr., Cuomo v. Clearing House*: The Supreme Court Responds to the Subprime Financial Crisis and Delivers a Major Victory for the Dual Banking System and Consumer Protection*, *in* LAWRENCE E. MITCHELL & ARTHUR E. WILMARTH, JR., THE PANIC OF 2008: CAUSES, CONSEQUENCES AND IMPLICATIONS FOR REFORM (2010).

352. *Cuomo*, 129 S. Ct. at 2717 (holding that "a sovereign's 'visitorial powers' and its power to enforce the law are two different things").

353. *Id.*

354. *See, e.g.*, Deming v. First Franklin, No. 09-5418RJB, 2010 WL 891009, at *3-54 (W.D. Wash. March 9, 2010) (holding that "[w]hen . . . a state attorney general brings suit to enforce state law against a national bank, he is not acting in the role of sovereign-as-supervisor, but rather in the role of sovereign-as-law-enforcer.") (quoting *Cuomo*, 129 S. Ct. at 2721).

355. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1041-1048, 124 Stat. 1376 (2010). Federal thrifts no longer enjoy a broad preemption presumption.

356. *Id.* § 1042(b).

357. *Id.* § 1041(a).

358. *Id.* § 1044. To find that a state regulation significantly impairs a bank's activities, the OCC must apply the standard announced in Barnett Bank of Marion Cnty, N.A. v. Nelson, 517 U.S. 25, 33 (1996).

While the Dodd-Frank Act reverses the broad preemption effect of HOLA and the NBA and purports to support state regulatory authority over mortgage lending, it also delegates case-by-case preemption decisions to the OCC and the courts.[359] Still, the Act suggests a move away from high-level judicial deference to federal preemption claims, mandating judicial assessment of the thoroughness, validity, and consistency of OCC preemption determinations. This is a step in the right direction, but it fails to give states enough freedom and flexibility in overseeing mortgage lending and reining in abusive practices. The ultimate authority of federal agencies (the OCC and the CFPB) still looms. More thorough legislative reversal of the federal preemption trend would give states the ability to handle ground-floor oversight of mortgage lending. This makes sense because, while the secondary mortgage market and mortgage-backed securities markets are national, real estate is unchangeably local. Because mortgages are created and enforced according to state laws, and because states already closely regulate mortgage and foreclosure procedures, state regulators are more likely to become aware of abusive and distorting lending practices. The consumer protection goals of the Dodd-Frank Act would be better served by allowing state regulators to play a bigger and better role.

B. Promoting Responsible Behavior Through Incentives and Liability

"The most important thing for a young man is to establish a credit, a reputation, character."
-John D. Rockefeller[360]

1. *Internalizing Risk and Seeking Recourse*

Fundamental to the concept of investment is the axiom that return is inextricably linked to degree of risk.[361] Prospective investors must continually weigh risk aversion and potential costs against profit possibilities. With the unbundling of functions in our segmented capital market system, and with the assurances the securitization process and credit rating agency blessings provided, return calculations came unhinged from risk appraisals.[362] This led to an inherently unrealistic valuation model: return without risk, or upside-only investing. Such risk avoidance eventually eroded consumer

359. Dodd-Frank Wall Street Reform and Consumer Protection Act § 1044.

360. John D. Rockefeller, ALLGREATQUOTES.COM, http://www.allgreatquotes.com/credit_quotes.shtml (last visited May 17, 2011).

361. *See, e.g.*, MALLOY & SMITH, *supra* note 5, at 1-15.

362. *See supra* Section II.B.

market confidence. Only reallocating costs to those engaging in risky behaviors will motivate risk management and restore market trust.[363]

When risk and return are borne by separate entities, risk externalities result. One example is the moral hazard created by government GSE guaranties—because costs are borne by the general public rather than by risk-taking entities, risky behavior is perpetuated in efforts to capture greater returns.[364] Another example is the risk-taking incentive inherent in the mortgage banks' originate-to-distribute model.[365]

Our legal system can bring the costs of risk back into the decision-making calculus for the entities best able to manage that risk. Close regulation can accomplish this for some industries. But if our legal system allocates more of the downside costs to decision-makers seeking upside returns, then valuations will naturally become more responsible without the need for constant monitoring. In this case, we should try a "belt and suspenders" solution: manage risk-taking both by regulation and by proper risk allocation.

While awaiting adequate regulatory risk reallocations, disgruntled market players have sought cost reapportionment through the courts.[366] Plaintiffs have claimed securities violations, predatory lending, breach of fiduciary duties, and the torts of fraud and misrepresentation.[367] These lawsuits are likely just the beginning. In addition to calls for liability on Wall Street, risk allocation at the mortgage transaction level can promote risk internalization in the primary mortgage market. Even though empirical

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363. The market cannot function without trust. The very word "credit" means trust, and without belief that other market participants will perform as promised, the entire system of finance breaks down.

364. *See* Van Order, *supra* note 82; Krugman, *supra* note 101.

365. *See supra* Subsection II.B.2.

366. *See, e.g.*, Jonathan Stempel, *Goldman Sued by Liberty Mutual Over Fannie Stock*, REUTERS (July 9, 2010), http://www.reuters.com/article/idUSTRE6684DT20100709; Michael J. Hassen, *Class Action Defense Cases—In re Fannie Mae: Judicial Panel on Multidistrict Litigation (MDL) Grants Defense Motion to Centralize Class Action Litigation in Southern District of New York*, CLASS ACTION DEFENSE BLOG (Mar. 13, 2009), http://classactiondefense.jmbm.com/2009/03/class_action_defense_casesin_r_137.html (discussing the 19 class actions brought against Fannie Mae alleging the GSE was undercapitalizied).

367. *See* Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039 (2007). Prosecutors are currently examining whether eight banks perpetuated fraud on credit rating agencies to inflate the grade of their securities, and the SEC and the Justice Department are investigating numerous alleged securities violations, fraud, and predatory loans. Nelson D. Schwartz & Eric Dash, *With Banks Under Fire, Some Expect a Settlement*, N.Y. TIMES, May 13, 2010, at B1. The FBI has also launched investigations of top financial firms. Steverman & Bogoslaw, *supra* note 43; *see, e.g.*, *In re* First Alliance Mortg. Co., 471 F.3d 977 (9th Cir. 2006) (suit by California borrowers against secondary mortgage market buyer for predatory lending practices of the loan originator).

evidence shows that troubled banks tend to originate riskier loans,[368] poorly vetted or irresponsibly acquired loans may not give rise to tort liability under applicable standards. Sloppily underwritten mortgages are gambles with other people's money and create a significant drag on the price of securitization products from pools in which those loans end up. Causation, however, is easier to prove than foreseeability here, and it is still more difficult to show adequate negligence or intent to have liability attach.

The costs and benefits of increasing the duty of care owed by parties to mortgage transactions should be examined closely. Widening the scope of liability potentially increases responsibility and mortgage diligence accuracy. Lender diligence would support more stable pricing in the primary mortgage market and beyond. While a full discussion of how adjustments in our tort liability system could encourage responsible financial behaviors merits its own article, some general considerations with respect to achieving proper market incentives are mentioned below with respect to credit rating agency liability (in the realm of mortgage-backed securities sales) and liability of mortgage brokers, mortgage lenders and mortgage borrowers (the three market players with the most direct effect on asset pricing).

2. *Credit Rating Agency Liability*

The question of credit rating agency culpability looms large in the current crisis.[369] The law endorsed rating reliance, and investors duly counted on rating agency oversight and gate-keeping functions.[370] Many risky securities were products that had earned high ratings by the reputable credit rating organizations, and many investors specifically relied on such ratings, as they were required by law to do.[371] Hindsight makes it clear that the agencies failed to perform their anticipated function. Does that mean that the costs of such failure should be allocated to the "big three"?[372]

Holding credit rating agencies liable for over-rated products has been problematic. Agencies include explicit language in their ratings disclaiming

368. *See* Sheridan Titman & Sergey Tsyplakov, *Originator Performance, CMBS Structures and Yield Spreads of Commercial Mortgages* (2007 Real Estate Symposium, Working Paper Series, 2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1106959.

369. *See, e.g.*, Lynch, *supra* note 168; Bussani, *supra* note 169; Manns, *supra* note 173.

370. *See* Manns, *supra* note 173.

371. *See supra* note 176 and accompanying text.

372. Part of the problem is the concentration of rating activity in the "big three" rating agencies that were designated by the SEC in 1975 as being "nationally recognized" (Moody's, S&P, and Fitch). *See supra* note 175 and accompanying text.

any right to rely on such ratings,[373] and the law treats the agencies as quasi-journalistic entities with associated First Amendment rights to freely express their opinions.[374] In one recent federal district court case, *Abu Dhabi Commercial Bank v. Morgan Stanley & Co., Inc.*,[375] Judge Scheindlin considered and rejected the credit rating agencies' claims that the First Amendment protected them from ratings-related liability. The court held that even though the First Amendment protects rating agency opinions expressed publicly, "where a rating agency has disseminated their ratings [only] to a select group of investors . . . , the rating agency is not afforded the same protection."[376] Moody's and Standard & Poor's also claimed that their ratings were non-actionable opinions, but this defense was similarly unavailing. An opinion may be actionable, stated the court, "if the speaker does not genuinely and reasonably believe it or if it is without basis in fact."[377]

Debate surrounding the proper way to reform the credit rating agency industry abounds. In addition to regulatory reform and potential tort liability treatment, Professor Jeffrey Manns of George Washington University Law School has proposed removing the systemic conflict of interest for credit rating agencies by using an SEC-administered user fee system in exchange for the right to seek (capped) tort damages.[378] International jurists have clamored for an international private right of action and/or international governing body to ensure more responsible credit rating agency as-

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373. Moody's securities come with a disclaimer of liability for "THE ACCURACY, TIMELINESS, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY SUCH . . . MOODY'S [RATINGS] INFORMATION" and specifically states that the ratings information is "provided 'AS IS' without warranty of any kind." *Moody's Copyright and Disclaimers*, TREPP, http://www.trepp.com/moodys_disclaimer.cgi?whichTrepp=m (last visited Jan. 18, 2011).

374. *See, e.g.*, Compuware Corp. v. Moody's Investors Servs. Inc., 499 F.3d 520, 529 (6th Cir. 2007); Jefferson Cnty. Sch. Dist. No. R-1 v. Moody's Investors Servs., Inc., 175 F.3d 848, 856 (10th Cir. 1999); First Equity Corp. v. Standard & Poor's Corp., 690 F. Supp. 256, 260 (S.D.N.Y. 1988). For critique of this judicial treatment, *see* JOHN C. COFFEE, JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE (2006); Arthur R. Pinto, *Control and Responsibility of Credit Rating Agencies in the United States*, 54 AM. J. COMP. L. 341 (2006); Lisbeth Freeman, Note, *Who's Guarding the Gate? Credit-Rating Agency Liability as "Control Person" in the Subprime Credit Crisis*, 33 VT. L. REV. 585, 598 (2009).

375. Abu Dhabi Commercial Bank v. Morgan Stanley & Co., 651 F. Supp. 2d 155 (S.D.N.Y. 2009).

376. *Id.* Note a similar holding in another recent case: *In re* Nat'l Century Fin. Enters., Inc., Inv. Litig., 580 F. Supp. 2d 630, 640 (S.D. Ohio 2008) (refusing to apply the First Amendment defense where Moody's ratings had been disseminated to a "select class of institutional investors").

377. *Abu Dhabi Commercial Bank*, 651 F. Supp. 2d at 176 (quoting *In re* IBM Corp., Sec. Litig., 163 F.3d 102, 109 (2d Cir. 1998); citing Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1095 (1991) (rejecting the argument that statements containing opinions could not be a basis for an action for securities fraud)).

378. *See* Manns, *supra* note 173.

sessments.[379] The bottom line for credit rating agencies is: if the conflict of interest unavoidable in the issuer-pays structure is not removed by changing the compensation system for the credit rating agencies (by Manns' user fee system or the creation of a public agency, for example), then credit rating agencies should be unable to claim immunity from—and thereby avoid consequences for—negligent assessments.

3. *Lender, Broker, and Borrower Liability*

Anecdotal evidence and the distinctive features of this particular capital crisis suggest that, at least in some part, housing price run-up was due to irresponsible behavior of mortgage borrowers, lenders, and brokers.[380] Mispricing and willful blindness to risk at the primary mortgage market level ultimately, and in the aggregate, led to securitization of overpriced, risky products in the secondary market.[381]

a. Defining Bad Acts

One problem with using tort claims to reallocate costs of the crisis is that "[c]urrent legal remedies were not designed to address the level of foreclosure and abandonment some cities are now facing[,] and pursuing certain remedies takes too long to prevent irreversible damage to the surrounding neighborhoods."[382] There are gaps in recourse for homebuyers and investors as well. Extending new civil liability retroactively interferes with expectations, but to some extent a more expanded standard of liability could be found through judicial interpretation of already existing legal duties. In reassessing duties to warn and disclose of risk, courts should consider whether losses were reasonably foreseeable, preventable and externalized.

Even in cases where tort or statutory liability already exists, collective action problems can inhibit recovery and weaken liability's impact. It is possible that individual lawsuits could give individual victimized borrowers recourse, but *ad hoc* complaints and resolutions are unlikely to have sufficient industry effect.[383] A class-action lawsuit against certain lenders might deter lender misbehavior, but the class-action system in this country is time-consuming, incredibly costly to companies and shareholders, and ultimately

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379. *See* Bussani, *supra* note 169.

380. Criminal penalties apply for certain types of fraud, which constrains behavior as well. News stories increasingly highlight prosecutions for fraud in relation to mortgage lending.

381. This is surely true for subprime loans. Similar issues existed, to a lesser degree, in the prime mortgage market.

382. Johnson, *supra* note 15, at 1172.

383. *See id.* at 1198.

garners little reward for individual plaintiffs.[384] While there have been some private investor lawsuits claiming securities fraud, relatively few such cases have ended in significant victories for the investor plaintiffs.[385]

SEC Counsel Bradley Bondi, while decrying the dangers of class-action lawsuits run amok, suggests an alternative: class-action arbitration as "a more efficient and cost-effective mechanism to resolve disputes with integrity while minimizing the burdens on our judicial system."[386] Bondi made this suggestion in the context of securities law, but arbitration could be employed quite usefully in the primary mortgage market context as well. Bondi offers guidelines to increase accessibility and effectiveness of arbitration,[387] which could inform arbitration efforts for all market segments.

Regulatory lawsuits brought by federal oversight agencies could be another avenue for loss allocation, although many such cases face significant legal hurdles. Settlements with Goldman Sachs for $550 million regarding the supposed material omissions in their ABACUS product disclosures[388] and with Citigroup Inc. for $75 million regarding their overly optimistic statements and failure to disclose the extent of its subprime mortgage holdings[389] are—in terms of issuer earnings—modest recoveries. State agencies should take advantage of a move away from federal preemption to bring similar proceedings, and state courts should consider reinterpretation of duties of care as applied to mortgage lending. Perhaps the aggregate threat of litigation would sufficiently moderate behavior.

The Dodd-Frank Act has much to say about lender liability for "unfair, deceptive, or abusive" mortgage lending practices.[390] The Federal Trade Commission Act and state laws have long prohibited "unfair" and "deceptive" market behavior. The addition of the word "abusive" in the Dodd-

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384. *See* Bondi, *supra* note 250, at 609-13. For a concise and compelling discussion of the weaknesses and dangers of the current class-action litigation system see *id.* at 614-22.

385. For example, in Plumbers' Union Local No. 12 Pension Fund v. Nomura Asset Acceptance Corp., 658 F. Supp. 2d 299 (D. Mass. 2009), investors alleged omissions and misstatements regarding lender underwriting standards and borrower creditworthiness, but the court dismissed, citing "numerous warnings flagging the permissive underwriting practices underlying the mortgage pools" backed by the securities. *Id.* at 306. Such warnings are legion in offering statements and would similarly bar recovery by other investors based.

386. *See* Bondi, *supra* note 250, at 613.

387. *Id.* at 634-38. Bondi frames his pro-arbitration arguments in terms of securities class actions, but the same arguments apply for borrower class actions as well as investor class actions.

388. *See supra* note 239 and accompanying text.

389. Jesse Westbrook & Bradkley Keoun, *Citigroup Said to Pay $75 Million to Settle SEC Subprime Case*, BLOOMBERG, Jul. 30, 2010, *available at* http://www.bloomberg.com/news/2010-07-29/citigroup-said-to-pay-75-million-to-settle-sec-subprime-case.html.

390. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1031, 124 Stat. 1376 (2010) .

Frank Act, however, suggests an expanded definition of liability. "Abusive" acts are described in the Dodd-Frank Act as those that interfere with a borrower's ability to understand a product or that take unfair advantage of a borrower's lack of understanding.[391] The CFPB can investigate potential violations of the consumer protection laws, bring a civil action, and conduct its own hearings. To bolster the effect of disclosure requirements, the Act provides for double monetary fines for TILA violations and extends the statute of limitations for federal prosecution of TILA violations to three years.[392] Although the CFPB has no authority to institute criminal proceedings, it can refer any potential criminal matters to the Department of Justice.[393]

b. Mortgage Broker Accountability

Accountability for poorly-conceived mortgage loans should track irresponsible risk-taking behavior. In some cases, lenders may have been perpetrators of market negligence. In others, lenders may have been misled by mortgage brokers anxious to close a deal and earn a commission check and/or borrowers falsifying their loan applications. Since mortgage brokers are lender agents,[394] their fiduciary responsibilities should include liability for originating predictably doomed loans. Brokerage contracts should detail the duty to perform basic credit diligence, but even without an express provision to this effect, a more expansive judicial reading of fiduciary duties would find a negligent breach when brokers launched irresponsible loans.[395]

Liability is needed here to constrain a broker's economic interest in making bigger and higher-interest-rate loans. Because mortgage brokers typically made their profits from origination fees and yield spread premiums paid by the lender,[396] the larger the mortgage and the higher the interest rate

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391. *Id.* § 1031(d).

392. *Id.* § 1416(a)-(b).

393. *Id.* §§ 1052-56.

394. Since 1990, the use of mortgage brokers to originate residential mortgage loans has grown. In 2003, 44,000 mortgage firms arranged about 65% of all residential mortgages in the United States. *See* NELSON & WHITMAN, *supra* note 74, at 924; *see also* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-06-1021, ALTERNATIVE MORTGAGE PRODUCTS: IMPACT ON DEFAULTS REMAINS UNCLEAR, BUT DISCLOSURE OF RISKS TO BORROWERS COULD BE IMPROVED 7 (2006).

395. GSEs could mandate this sort of explicit requirement in brokerage contracts for loans they purchase, thereby setting the residential mortgage industry standard for the same.

396. *See* NELSON & WHITMAN, *supra* note 74, at 924. HUD issued a policy statement in 2001 concluding no violation of Section 8 of RESPA occurs if a broker's commission is reasonable compared to "prices in similar markets." DEP'T OF HOUS. AND URBAN DEV., RESPA STATEMENT OF POLICY 2001-1: CLARIFICATION OF STATEMENT OF POLICY 1999-1 REGARDING LENDER PAYMENTS TO MORTGAGE BROKERS, AND GUIDANCE CONCERNING UNEARNED FEES UNDER SECTION 8(B), 24 C.F.R. PART 3500 (2001). Federal courts defer to

a borrower paid, the more the broker earned. While the Dodd-Frank Act has curtailed certain such incentives, it would be prudent to have liability exposure reinforce responsible origination as well.[397]

Since brokers are the market players who deal most directly with would-be borrowers (and are often the *only* market player who interacts with borrowers),[398] they are best suited to perform these assessments. In economic terms, they are the least cost avoiders of predictably bad lending decisions, and allocating to brokers at least some of the costs of negligently made loans will enhance loan quality without exclusive reliance on direct regulatory oversight.

Undoubtedly some borrowers suffered from mortgage broker steering and/or from lender efforts to sell unrealistic loans. Brokers are not traditionally viewed as borrower agents, nor do lenders typically owe borrowers fiduciary duties.[399] But borrowers significantly interact with and rely upon mortgage brokers, suggesting that courts or legislatures should protect borrower expectations by finding that certain legal duties do exist. Jurisdictions have already started moving in the direction of more protection for buyers with respect to real estate brokers.[400] This is needed in the context of borrower reliance on mortgage brokers as well. Although broker payment incentives have been tweaked by the Dodd-Frank Act,[401] the mortgage origination system will be fixed only when borrowers have some representation or at least have a clear understanding that the mortgage broker's goal is not finding them their "best" loan.[402]

HUD's policy statement. *See, e.g.*, Heimmermann v. First Union Mortg. Corp., 305 F.3d 1257 (11th Cir. 2002).

397. *See supra* note 235 and accompanying text.

398. *See* Gerald Korngold, *Legal and Policy Choices in the Aftermath of the Subprime and Mortgage Financing Crisis*, 60 S.C. L. REV. 727 (2009).

399. *See, e.g.*, Garrett v. BankWest, Inc., 459 N.W.2d 833, 838-39 (S.D. 1990); Denison State Bank v. C. C. Madeira, 640 P.2d 1235, 1242-44 (Kan. 1982); Union State Bank v. Woell, 434 N.W.2d 712, 721 (N.D. 1989); *see also* Cecil J. Hunt, II, *The Price of Trust: An Examination of Fiduciary Duty and the Lender-Borrower Relationship*, 29 WAKE FOREST L. REV. 719, 736-39 (1994).

400. *See* Lewis v. Long & Foster Real Estate, Inc., 584 A.2d 1325, 1330 (Md. Ct. Spec. App. 1991) (finding a question of fact as to whether an agency relationship arose between buyer and broker); Gerard v. Peterson, 448 N.W.2d 699, 702 (Iowa Ct. App. 1989) (finding a "general duty" to buyers "not to negligently cause them harm"). Currently, more than forty states mandate written disclosure by real estate (not mortgage) brokers to a buyer explaining that the selling broker represents the seller. *See, e.g.*, *In re* Op. No. 26 of the Comm. on the Unauthorized Practice of Law, 139 N.J. 323 (1995); *see also* MALLOY & SMITH, *supra* note 5, at 52-54; Joseph M. Grohman, *A Reassessment of the Selling Real Estate Broker's Agency Relationship With the Purchaser*, 61 ST. JOHN'S L. REV. 560, 560-63, 584-88 (1987).

401. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1031, 124 Stat. 1376 (2010).

402. *See* NELSON & WHITMAN, *supra* note 74, at 925.

It is unsurprising that borrowers rely on mortgage brokers to look out for their best interests. Mortgage brokers collect information and analyze borrowers' debt and income to "pre-qualify" them for a loan (determine what loan the borrower can afford). Mortgage brokers counsel borrowers with respect to loan options and complete loan packages for them. Mortgage brokers then present the loan application package to a lender (or lenders) and report back to the borrower that their loan has been approved.[403] In spite of their legal agency relationship with the lender, mortgage brokers effectively act as borrower representatives.[404] Very few states require disclosure to a borrower of lender-paid fees, and only Wisconsin requires a mortgage broker to give the borrower a statement explaining the parties' relationship.[405] More is needed to clarify what duties a mortgage broker owes and to whom. Either through an explicit disclosure regime or through implied agency or "general" fiduciary duties, brokers should bear the costs of any deliberate steering of borrowers to loans they can ill afford. In addition to regulatory oversight, borrowers should have recourse against the brokers themselves.

Recognizing the role of mortgage brokers in the origination of irresponsible mortgages, Paulson suggested, "a uniform national licensing, education and monitoring system for all mortgage brokers" to bring "a higher level of integrity to the mortgage origination process."[406] While more regulatory oversight for mortgage brokers might increase broker competence and improve broker ethics, such efforts are better employed by states, especially since nearly every state already has such a licensing system in place.[407] Local licensing regimes prohibit factual misrepresentation, misleading promises, and violations of state or mortgage regulations.[408] Most states also require brokers to post a surety bond with the local regulatory agency overseeing licensing, and these bonds could assist in obtaining compensation for broker misbehavior.[409] Again, real estate's locality and immo-

403. *See* REAL ESTATE SETTLEMENT PROCEDURES ACT (RESPA) STATEMENT OF POLICY 1999-1 REGARDING LENDER PAYMENTS TO MORTGAGE BROKERS, 64 Fed. Reg. 1008 (March 1, 1999) (to be codified at 24 C.F.R. pt. 3500) [hereinafter RESPA POLICY STATEMENT].

404. *Id.*

405. FLA. STAT. ANN. § 494.0038 (West 2010) (requiring disclosure of broker fees and commissions); WIS. STAT. ANN. § 224.79 (West 2010) (requiring mortgage brokers to provide a statement explaining the parties' relationship and broker compensation).

406. *See* Paulson statement, *supra* note 22.

407. Alaska and California do not require mortgage brokers to be licensed.

408. *See, e.g.*, COLO. REV. STAT. § 12-61-903 (2006); D.C. CODE § 26-1103 (LexisNexis 2001); NEV. REV. STAT. § 645B.670 (2005); MD. CODE ANN., § 11-504 (McKinney 2003); N.Y. BANKING LAW § 599-c (2003).

409. *See* Gary M. Case & Michelle Himes-Wiederschall, *Mortgage Broker Claims*, 13 FIDELITY L. ASS'N. J. 57, 67 (2007).

bility and the non-uniformity of state laws suggest that broker oversight should remain a local regulatory solution.[410]

Licensing and monitoring should be supplemented by private rights of action, placing responsibility for predictably unrealistic and mis-priced mortgages on those who can easily avoid (or quantify) that risk. In addition, better allocation of risk of loss will naturally improve valuation accuracy as market players self-police to maximize their own returns. The same cannot be said for the in-vogue proposal of assignee liability, or abrogation of the "holder in due course" doctrine. Under assignee liability, borrowers could recover from secondary market purchasers as well as the loan originator.[411] While secondary market liability provides an avenue for borrower recovery, this will have less impact on risk externalities since investors do not directly control mortgage risk.[412] Secondary market demands for responsible pricing might indirectly promote mortgage lender risk internalization, however.

c. Borrower Misrepresentations

There are also instances where mortgage borrowers themselves have acted improperly in the origination of overly risky loans. While the borrower need not determine loan underwriting criteria or perform credit risk assessments, a borrower should be responsible for damages caused by his failure to tell the truth.[413] Borrower misstatements were so prevalent that no-documentation loans were widely called "liar loans."[414] Borrowers who attested to the truth of fantastical earnings should be barred from any claim against brokers and lenders (who are co-conspirators rather than defrauders in such a case). It may seem trivial to look to individual borrower-level falsifications and impose liability, but the credit of the financial markets can be restored only if each market participant feels the effects of its own disregard of truth and consequences.

4. *Trickle-Up Liability*

Increasing borrower, broker, and lender responsibility for poorly conceived loans will only benefit the players in the primary mortgage market unless the originating lenders are also liable to their secondary market buyers, and those entities are, in turn, adequately liable to their investors. This

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410. *See supra* notes 73-77 and accompanying text.

411. *See, e.g.*, Engel & McCoy, *supra* note 367.

412. *See* James Carlson, *To Assign, or Not to Assign: Rethinking Assignee Liability as a Solution to the Subprime Mortgage Crisis*, 2008 COLUM. BUS. L. REV. 1021, 1026 (2008).

413. In addition to civil penalties, buyers falsifying loan applications could face criminal penalties.

414. *See supra* notes 143-45 and accompanying text.

is particularly true where the end-user investors ultimately bear the costs of rapidly declining values and increasing defaults. Again, the goal is to recapture risk externalities and allow costs to be redirected to their source.

Unless there is a violation of securities law requirements, affirmative misrepresentation or breach of an express warranty, willing purchasers of mortgage-backed securities have no viable legal claim against the issuer.[415] Securities regulation is extensive and detailed, and systems already exist for obtaining remedies for violations of such regulations. If an issuer was misled as to the nature and extent of mortgage risk, however, secondary market purchasers should have recourse to their sellers. Absent some sort of fraud, however, it is difficult for a willing buyer to recover from a willing seller. The secondary mortgage market essentially functions in the realm of *caveat emptor*.[416]

Because modern finance has commoditized mortgage loans, some parallels could be drawn between sale of mortgages in capital markets and sale of "goods" in commerce. Article 2 of the U.C.C. implies warranties of quality and of good faith.[417] Courts have already extended this concept beyond "goods" to apply it in sales of other commoditized products, including the construction and sale of new homes.[418] Courts are now willing to deem builder/vendors of new homes merchants and imply in the sale of new homes a warranty that the house was constructed in a skillful manner, free from material defects.[419] Today, a majority of jurisdictions imply such a warranty of quality in the sale of new homes by a builder/vendor, either through statute or judicial interpretation.[420] This warranty can be expressly disclaimed.[421]

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415. *See* Joseph Philip Forte, *Representations and Warranties—The Capital Markets Context*, SR048 ALI-ABA 1377 (Apr. 2010).

416. "Honesty was never a profit centre on Wall Street, but the brokers used to keep up appearances. Now they have stopped pretending. . . . Investors, beware." James Grant, *Talking Up the Market*, FIN. TIMES, July 19, 1999, at 12.

417. U.C.C. § 2-314 (2006) reads an "implied warranty of merchantability" into commercial contracts. A merchant is implicitly held to have promised that goods it produces are fit for ordinary purposes.

418. The earliest U.S. cases are Carpenter v. Donohoe, 388 P.2d 399 (Colo. 1964) and Bethlahmy v. Bechtel, 415 P.2d 698 (Idaho 1966), but the concept of implying warranties in new home sales derive from two earlier English cases regarding implied warranties in partially constructed homes. *See* Miller v. Cannon Hill Estates, Ltd., (1931), 2 K.B. 113 (Eng.); Perry v. Sharon Dev. Co., (1937), 4 All. E.R. 390 (Eng.).

419. Caceci v. Di Canio Constr. Corp., 526 N.E.2d 266, 267 (N.Y. 1988). In New York, the judicially created concept of implied warranty of quality for new homes was replaced/codified by statute. *See* N.Y. Gen. Bus. Law § 777-777b(4) (1996); Amy L. McDaniel, Note, *The New York Housing Merchant Warranty Statute: Analysis and Proposals*, 75 CORNELL L. REV. 754 (1990).

420. *See* Jeff Sovern, *Toward a Theory of Warranties in Sales of New Homes: Housing the Implied Warranty Advocates, Law and Economic Mavens, and Consumer Psychologists Under One Roof*, 1993 WIS. L. REV. 13, 15-21 (citing over 30 states that had recognized

This concept could be expanded to apply in the context of originating and selling mortgages. Rather than let secondary market buyers beware, legislation or judicial innovation could imply a warranty by primary market lenders with respect to loans founded on latent borrower or property risks. Like the U.C.C. implied warranty of merchantability, this warranty could be explicitly waived as long as the waiver adequately put the secondary mortgage buyer on notice that it—not the primary lender—would ultimately bear such risks.[422] An affirmative disclosure regime bolstered by a private right of action for undisclosed mortgage "defects" would reallocate risk to loan originators in cases where mortgage sellers unfairly took advantage of information asymmetries.

While implied warranties can create a contractual "trickle up" of liability between mortgage originators and their secondary market purchasers, privity would bar extensions of liability to buyers at the secondary market stage. Drawing a parallel to the law of products liability, however, suggests that ultimate losses could be linked in tort to their foundational cause.[423] The tort of product liability holds manufacturers of faulty goods liable to any end user for harms caused by such goods.[424] This liability arises from an *in rem* duty (attached to the good in question) that arises when a defective product is produced and put into the stream of commerce.[425] By analogy to this concept, some courts have found builders' liability to later home-

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an implied warranty of quality). Some states have enacted legislation achieving this same result. *Id.* at 22-23. Currently, over 42 states have recognized an implied warranty of quality. *See* KORNGOLD & GOLDSETEIN, *supra* note 185, at 230.

421. *See, e.g.*, Petersen v. Hubschman Constr. Co., 389 N.E.2d 1154, 1157-58 (Ill. 1979); *see also* David L. Abney, *Disclaiming the Implied Real Estate Common-Law Warranties*, 17 REAL EST. L.J. 141 (1988).

422. The U.C.C. does allow conspicuous disclaimer of such implied warranties. *See* U.C.C. § 2-316 (2009).

423. *See* RESTATEMENT (SECOND) OF TORTS § 402A (1965) (superseded by RESTATEMENT (THIRD) OF TORTS §402A (1997)). Nearly every state now recognizes tort liability for faulty products placed in the stream of commerce. *See also* RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY (1997). In a similar vein, courts have found appraisers liable to third parties who purchase loans based on faulty appraisals if the reliance of such third parties on the appraisals is foreseeable. RESTATEMENT (SECOND) OF TORTS § 552 (1965); *see, e.g.*, Superior Bank, F.S.B. v. Tandem Nat'l Mortg., Inc., 197 F. Supp. 2d 298, 311 (D. Md. 2000); Private Mortg. Inv. Serv., Inc. v. Hotel and Club Assoc., Inc., 296 F.3d 308, 315 (4th Cir. 2002); West v. Inter-Finan., Inc., 139 P.3d 1059 (Utah Ct. App. 2006). *But see*, Luri v. First Fed. Bank of Cal., No. B139294, B142137, 2001 WL 1656602, at *5 (Cal. Ct. App. Dec. 27, 2001) (holding that appraisers do not owe duties to third parties for negligence).

424. *See, e.g.*, Henningsen v. Bloomfield Motors, Inc., 161 A.2d 69 (N.J. 1960); Phipps v. General Motors Corp., 363 A.2d 955 (Md. 1976); Santor v. A & M Karagheusian, Inc., 207 A.2d 305 (N.J. 1965), *abrogated by* Alloway v. General Marine Indus., L.P., 695 A.2d 264 (N.J. 1997).

425. *See, e.g.*, *Ex Parte* Grand Manor, Inc., 778 So. 2d 173, 178 (Ala. 2000).

owners in spite of lack contractual privity.[426] If similar *in rem* liability attached to mortgages, the producers of such loans would be ultimately liable to investors for losses incurred because of undisclosed and foreseeable vulnerabilities.[427] This would allow the buyer of debt positions, in the proper cases, to recover for foreseeable losses, motivating risk management disclosure. Because mortgages have become commodities in the secondary market,[428] and because modern-day lenders do not typically buy for their own account but rather are producing loans specifically for sale in that market (the originate-to-distribute norm),[429] it makes sense for courts and legislators to draw these sorts of analogies and treat mortgages in the secondary market like other "goods" produced for sale.[430]

C. Rethinking Home Policies

> *"We need a new spirit of community, a sense that we are all in this together. . . . or the American Dream will continue to wither. Our destiny is bound up with the destiny of every other American."*
> -Bill Clinton[431]

1. *Home Mortgage Capital Flow*

Regulation and litigation are tools for moderating market behavior, ensuring risk effects are adequately felt by risk avoiders.[432] But this assumes that risks could have, and should have, been avoided in the first place. In spite of the finger-pointing in the media and society's collective

426. *See, e.g.*, Blagg v. Fred Hunt Co., Inc., 612 S.W.2d 321, 322 (Ark. 1981) (holding that a builder/vendor's implied warranty "extends to subsequent purchasers for a reasonable length of time"); Gem Developers v. Hallcraft Homes of San Diego, Inc., 261 Cal. Rptr. 626 (Cal. Ct. App. 1989) (holding that developer of a lot could be liable for sale of that "product" to a condominium builder purchaser); *c.f.*, Calloway v. Reno, 993 P.2d 1259 (Nev. 2000) (holding townhouses are not "products" for purposes of tort liability), *superseded by statute as stated in*, Olson v. Richard, 89 P.3d 31 (Nev. 2004).

427. In a way, this is precisely the reason for products liability: place the risk of harm on the least cost avoiding party.

428. *See supra* notes 81-84 and accompanying text.

429. *See* Wilmarth, *supra* note 351.

430. In addition to judicial or legislative extensions of *in rem* liability to residential mortgage originators, the GSEs could also mandate lender acceptance of some degree of product accountability.

431. William J. Clinton, Announcement of First Presidential Run at Old State House, Little Rock, AR (Oct. 3, 1991), *available at* http://www.4president.org/speeches/billclinton1992announcement.htm.

432. If rewards are sufficiently high, risk-taking still occurs. POSNER, *supra* note 148, at 78-79. Risk-taking itself is less problematic than risk-taking in an informational vacuum or when costs are externalized. Decisions should be made in the context of considering all costs, including externally imposed losses.

blame game, a significant segment of the bubble was not caused by overly greedy and reckless market behavior, but rather by rational responses to cheap and plentiful mortgage-directed dollars.[433] It was a macroeconomic failure of the first order, and those responsible for overall mònetary policy (*i.e.*, the Fed) and fiscal policy (*i.e.*, Congress) were culpable.

The government initially reacted to the 2008 financial crisis by adding more money to the financial system.[434] This slowed the descent of the market otherwise in freefall, but stimulus dollars cannot actually spur a market rebound nor prevent the future over-pricing cycles.[435] At best, policies funneling money into the market, whether by purchasing troubled assets, offering home-buying tax incentives or subsidizing short sales of defaulted home loans,[436] might prime the pump of a frozen capital market. But simultaneous clamp down of new regulations in lending and higher scrutiny of loans

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433. *See generally* Miller, *supra* note 236.

434. The Treasury Department placed Fannie and Freddie into conservatorship, reorganizing the enterprises and infusing them with new capital. Ellis, *supra* note 97; *see also* Krugman, *supra* note 101; Press Release, James B. Lockhart, *supra* note 99; FEDERAL HOUSING FINANCE AGENCY, FACT SHEET, QUESTIONS AND ANSWERS ON CONSERVATORSHIP, *available at* http://www.fhfa.gov/webfiles/35/FHFACONSERVQA.pdf; Statement of Herbert M. Allison, *supra* note 100. For information on GSE investigations conducted during conservatorship activities, see Press 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. At the time, this was the largest state rescue in history; to the tune of $100 billion dollars (though just a fraction of the amount earmarked some weeks later for the Wall Street bailout plan). 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 et al., *New Bank Bailout Could Cost $2 Trillion*, WALL ST. J., Jan. 29, 2009, at A4, *available at* http://online.wsj.com/article/SB123319689681827391.html. When the dust finally settles, however, the Fannie/Freddie bailout may end up costing the taxpayers far in excess of the original estimate. Bloomberg Business Week recently speculated that,

> The 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 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 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), http://www.businessweek.com/news/2010-06-14/fannie-freddie-fix-at-160-billion-with-1-trillion-worst-case.html.

435. Joseph Grundfest of Stanford University Law School compares stimulus packages to botox shots. "For a little while, everyone is going to be frozen into a grin, and then the shots are going to wear off." David Segal, *Debt Raters Avoid Overhaul After Crisis*, N.Y. TIMES, Dec. 8, 2009, at A1 (quoting Grundfest).

436. *See infra* notes 449-51.

likely counteracts such effects. At worst, stimulus spending will resurrect (and precipitate) fragile market pricing and incentives that led to the crash in the first place. Plus, the cost for unbounded government spending is staggering.

In June 2010, U.S. public borrowing passed $13 trillion for the first time, according to the Treasury Department.[437] The U.S. debt will likely soon be larger than U.S. gross domestic product—estimated at $14.2 trillion.[438] Forbes Magazine projects that the U.S. government will issue nearly as much new debt this year as the rest of the governments of the world combined.[439] The problem with the national debt (like home mortgage debt) is that it ultimately must be repaid. The prospect of paying off more than our national GDP is troubling, to say the least.[440]

Arnold Kling of George Mason University points out that stimulus spending continues irresponsible government-promoted market buoyancy.[441] He finds an ironic disconnect between government rhetoric and policies.[442] Congress bemoans the advent of unaffordable mortgages backed by unrealistically appraised homes, but federal policies seem to be trying to restore that very pre-crisis status quo.[443] Instead, the government should take the more difficult short-term, but more stable long-term, road by judiciously denying consumer and mortgage debt markets the fuel they needs for unlimited expansion.[444]

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437. On June 1, 2010, the Treasury Department announced that the national debt was $13,050,826,460,886.97. Stephen Dinan, *Federal Debt Tops $13 Trillion Mark*, WASH. TIMES, June 2, 2010, http://www.washingtontimes.com/news/2010/jun/2/federal-debt-tops-13-trillion-mark; *see* Garfield Reynolds & Wes Goodman, *U.S.'s $13 Trillion Debt Poised to Overtake GDP: Chart of the Day*, BLOOMBERG, JUNE 4, 2010, http://www.bloomberg.com/news/2010-06-04/u-s-s-13-trillion-debt-poised-to-overtake-weigh-down-gdp-chart-of-day.html.

438. *World Economic Outlook Database*, INTERNATIONAL MONETARY FUND (Apr. 2010), http://www.imf.org/external/ns/cs.aspx?id=28 (follow "World Economic Outlook Database: April 2010" hyperlink; follow "By Countries (country-level data)" hyperlink; follow "Major advanced economies (G7)" hyperlink; select "United States" and follow "Continue" hyperlink; select "Gross domestic product, constant prices: National currency" and "General government gross debt: National currency," then follow "Continue" hyperlink; select a date range and follow "Prepare Report" hyperlink) (last visited May 16, 2011).

439. *See* Daniel Fisher, *The Global Debt Bomb*, FORBES MAG., Feb. 8, 2010, at 62, *available at* http://www.forbes.com/forbes/2010/0208/debt-recession-worldwide-finances-global-debt-bomb.html.

440. Anthony Abear, *What's a Few Hundred Billion Between Friends?*, 21 DCBA BRIEF 8 (2009); *see also* Reinhart & Rogoff, *supra* note 48.

441. *See* Arnold Kling, *Deficit Spending: A Scenario Analysis*, TAX & BUDGET BULL. NO. 54, (CATO Institute, Washington, D.C.), Feb. 2009, *available at* http://www.docstoc.com/docs/68100102/Deficit-Spending-A-Scenario-Analysis.

442. *Id.*

443. *Id.*

444. *Id.*

Mortgage capital availability sets real estate liquidity, and more liquid real estate is more valuable.[445] Cheap debt capital also encourages higher leverage, and leverage further causes prices to rise. Lower interest rates directly lead to money flowing into debt. Federal monetary and pro-homeownership policies subsidized and promoted residential mortgage borrowing, unbalancing the market. The innovation of mortgage-backed securities added to this substantial flow of housing debt capital.

The challenge for today is to maintain economic growth in face of a debt-flooded market without completely shutting off the capital flow. Private markets have contracted to such an extent that their capital contribution is, relatively, a mere trickle.[446] New lender underwriting standards and attention to asset valuation risk has decreased the number of highly leveraged loans.[447] But in addition to risk management through oversight and allocation of loss, governments should examine and re-think housing capital support. It seems at first perverse to advocate limited government spending and tighter monetary policy in face of a crisis in foreclosures, bankruptcies, and unemployment. But the bloated capital markets need to be put on a diet. As the government steps in to save the market from purging, it must proceed cautiously to prevent another binge.

Instead of increasing GSE capital (directly funding mortgage markets) or lowering interest rates (indirectly increasing borrowing),[448] the government, like appraisers of homes, needs a return to fundamentals. Employment is fundamentally connected with ability to pay loans. Increasing debt without increasing employment merely "kicks the can down the road" with respect to debt defaults. Instead of focusing exclusively on blame and bailout, the government can and should address underlying economic vulnerabilities: unemployment and increasing household and governmental debt. We can no longer procrastinate, punt, and pray.

A massive publicly funded bailout may be beneficial in the short term, but is not sustainable and creates a huge future problem of public debt.

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445. *See supra* notes 7-8 and accompanying text.

446. Paul Muolo, *Fannie, Freddie, GNMA at Nearly 100% Share*, NAT'L MORTGAGE NEWS, May 31, 2010, at 1 ("Almost every single loan originated today is purchased by Fannie Mae, Freddie Mac, or winds up as collateral for a bond guaranteed by the Government National Mortgage Association. In short, the U.S. residential loan business continues to be on government life support and likely will remain that way for the next three years.").

447. Kenneth R. Harney, *Real Estate Speculation Worries Mortgage Insurers; PMI Tightens Underwriting*, REALTY TIMES, Mar. 21, 2005, http://realtytimes.com/rtpages/20050321_tighterrules.htm; *see also This American Life Broadcast*, *supra* note 114.

448. This assumes that interest rates could fall any further than the current record-low rates. *See* Elizabeth Razzi, *Low, Low Rates a Temptation to Refinance*, WASH. POST, Aug. 14, 2010, at E1, http://www.washingtonpost.com/wpdyn/content/article/2010/08/12/AR2010081207265.html ("This week rates fell to levels that many people in the mortgage business thought they would never see.").

Huge public debt perpetuates the boom-bust cycle,[449] and offers no real exit strategy.[450] The only logical consequence to ballooning government debt is an ultimate devaluation in national currency.[451] This in itself could have devastating effects for the financial community, investors, and depositors alike. Borrowing more when interest rates are low and lending more when the capital markets keep funds freely flowing are logical market behaviors. Even though the inflationary effects of increasing debt capital can be somewhat curtailed by risk and regulation, limiting debt capital supply is also crucial to keep markets in check and stabilize the economy.

2. *A New American Dream?*

Along with decreasing employment and income levels in the United States, home foreclosures and homelessness are on the rise.[452] Americans today face a declining quality of life in the near and long term. Not only is homeownership declining while mortgage defaults increase, but housing prices in this country are likely still inflated above market equilibrium. The difficulty in selling and in renting homes for adequate sums to cover mortgage payments suggests that prices have not yet decreased sufficiently.[453] Maybe it is time to rethink public policies promoting the so-called "American Dream" of homeownership and redirect funds allocated (or foregone) in this effort to achieve adequate nationwide housing and employment.

It is imperative that people have homes, but these homes do not need to be owner-occupied. Lowest income earners face an increasing, perhaps critical, problem of finding an affordable place to live.[454] Furthermore, since a lease is almost always subordinate to the owner's first mortgage lien,

449. *See* REINHART & ROGOFF, *supra* note 306.

450. A commentator at a recent George Washington University symposium on the crisis compared ever-increasing public borrowing in the face of a crisis born of debt to St. Augustine's famed prayer: *da mihi castitatem . . . sed noli modo* ("God, give me chastity . . . but not yet.").

451. Bloomerg reports that "Nations have reached a 'Keynesian endpoint' . . . Debt-fueled spending programs aimed at combating the global financial crisis of 2008 are among policy tools now 'being seen as a magic elixir that has morphed into poison.'" Wes Goodman & Garfield Reynolds, *Pimco's Crescenzi Sees 'Endpoint' in Devaluations*, BLOOMBERG BUSINESSWEEK (June 8, 2010), http://www.businessweek.com/news/2010-06-08/pimco-s-crescenzi-sees-endpoint-in-devaluations-update2-.html.

452. *See* HARVARD HOUSING REPORT, *supra* note 147.

453. *See, e.g.*, Emma L. Carew, *To Woo A Renter: Homeowners Who Punt on Selling Face Challenge as Tenants Get Choosier*, WASH. POST, Aug. 15, 2009, at E1, http://www.washingtonpost.com/wpdyn/content/article/2009/08/13/AR2009081304009.html; *see also* Stewart & Brannon, *supra* note 44.

454. *See generally* HARVARD HOUSING REPORT, *supra* note 147.

foreclosures result in eviction even for tenants meeting lease obligations.[455] Landlords who lack funds to make mortgage payments stop maintaining their investment properties, diminishing the quality of rental housing.[456] Simultaneously, as homeownership becomes a riskier and costlier prospect, the demand for rental housing grows.[457] Because high-risk loans are concentrated in low-income and minority communities, these communities feel the greatest fallout from the housing meltdown,[458] and thus far, we have no coherent government plan for rescuing populations in crisis.

It is time to critically assess the success and cost-effectiveness of our nation's homeownership policies. Such assessment should include (a) the mandate and market role of Fannie and Freddie;[459] (b) home-buying and foreclosure-preventing programs such as the Home Affordable Modification Program (HAMP);[460] and (c) general home mortgage promoting policies and subsidies, including the CRA and the mortgage interest tax deduction.[461] The costs of each such policy or program should be explicitly justified by its benefits.

In March 2010, the Obama administration launched a program to help defaulting homeowners walk away from their homes.[462] The program subsidized short sales to lenders in an effort to ease borrower losses in foreclosures and allow former owners to extinguish bad debts and start anew.[463] The proponents of this program also hoped that subsidizing short sales would apportion losses between borrowers and lenders and streamline fore-

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455. Commercial lenders and tenants agree in advance that leases will continue after default. But residential tenants are unprotected from post-foreclosure eviction. Tenants may not even receive sufficient notice of lease termination.

456. *See* Robin Shulman, *Renters Becoming Latest Victims as Foreclosure Crisis Widens*, WASH. POST, Nov. 23, 2009, at A3, *available at* http://www.washingtonpost.com/wpdyn/content/article/2009/11/22/AR2009112200927.html.

457. Sadie Dingfelder, *Rethinking the American Dream*, WASH. POST, Apr. 10, 2010, at E1.

458. High risk, subprime loans account for 45% of loans in low-income, predominantly minority communities. HARVARD HOUSING REPORT, *supra* note 147, at 3.

459. *See supra* Subsection II.A.1 and notes 270-71 and accompanying text.

460. For a discussion of the HAMP program and its successes and failures over the first year, see CONGRESSIONAL OVERSIGHT PANEL, APRIL OVERSIGHT REPORT, EVALUATING PROGRESS ON TARP FORECLOSURE MITIGATION PROGRAMS (2010) [hereinafter APRIL OVERSIGHT REPORT]; *see also supra* note 237.

461. *See* KORNGOLD & GOLDSTEIN, *supra* note 185, at 578; *see also supra* notes 146-151 and accompanying text. The home mortgage interest deduction alone costs more than $80 billion of foregone tax revenue annually.

462. David Streitfeld, *Program to Pay Homeowners to Sell at Loss*, N.Y. TIMES, Mar. 8, 2010, at A1.

463. Short sales are tri-party agreements amongst a defaulting mortgage borrower, the mortgage lender, and a third-party purchaser, whereby the purchaser agrees to buy the property for less than the outstanding loan amount, and the lender agrees to accept payment of the buyer's purchaser price in full satisfaction of the borrower's mortgage loan.

closures, wiping out bad mortgages and putting downward pressure on inflated home prices.[464] Real estate agent Chris Paul explained how this program is unrealistic: "In a perfect world, this would work . . . . But because estimates of value are inherently subjective it won't. The banks don't want to sell at a discount."[465] The bigger the disparity between the collateral's current value and the outstanding loan amount, the larger the discount that would be required in a short sale. In addition, this proposed solution is unworkable for homes secured by both senior and junior mortgages because short sales extinguishing senior loans are still made subject to the junior mortgage lien.[466]

In April 2010, the Congressional Oversight Panel estimated that more than three-quarters of the mortgage loans which were modified under HAMP are still underwater.[467] Even with payment reductions and government assistance, these borrowers still owe more on their mortgage than their house is worth. Chronic over-leverage and the increased complexity of multiple lending layers have also hamstrung the Obama administration's efforts to use interest rate modifications to help borrowers avoid default. Junior mortgage liens create a significant barrier to modifications: modified first-lien loans can lose priority unless junior lenders give explicit permission to new terms. Junior liens are very common. The administration estimated in April 2009 that "up to 50 percent of at-risk mortgages currently have second liens."[468] Current programs do not address the increased workout complexity that this simple fact creates.

The Joint Center for Housing Studies at Harvard University suggests the government allow foreclosures to occur and losses to accrue while using money that otherwise would be spent on bailing out various market participants to establish a mission-driven public entity which could buy homes at foreclosure sales and manage them as "affordable rental housing."[469] Providing rental assistance to the neediest Americans, in the form of more public housing or rental vouchers, for example, is more justifiable than using government funds to encourage mortgage debt. A recent Washington Post article suggests that the Obama administration anticipates a critical exami-

464. Streitfeld, *supra* note 462.

465. *Id.*

466. *See* Nelson & Whitman, *supra* note 74, at 273-75.

467. APRIL OVERSIGHT REPORT, *supra* note 460.

468. Shahien Nasiripour, *75% of Homeowners in Obama's Loan Modification Plan Still Owe More Than Their Homes*, HUFFINGTONPOST (April 14, 2010), http://www.huffingtonpost.com/2010/04/14/obamas-home-loan-modifica_n_536801.html.

469. HARVARD HOUSING REPORT, *supra* note 147, at 4, 23. The study also decries restrictive land use regulations which artificially inflate the cost of construction for multi-family homes. *See id.* at 12, 20, 22.

nation of the effectiveness of current housing policies.[470] Raphael Bostic, a senior official at HUD, confirms that the underlying homeownership policy has indeed been reopened for debate: "In previous eras, we haven't seen people question whether homeownership was the right decision. It was just assumed that's where you want to go . . . .You're not going to hear us say that."[471]

The evidence shows that government involvement in the housing market over the past two decades has possibly done more harm than good.[472] Not only have homeownership policies resulted in no net increase in ownership, but funding mortgage borrowing—at an enormous cost to taxpayers—contributed to increasing home prices and, eventually, soaring foreclosure rates. Today homes are both less affordable to buy and easier to lose.[473]

Even if homeownership is preserved as a policy goal, the laws and programs implementing this goal should better target exactly what the policy hopes to achieve. Do we really want people to have lower equity interests in their homes as compared to debt? Do we want to encourage people to keep their most significant net worth in their homes? Perhaps some form of direct subsidy for home purchases or for rentals (perhaps limited to certain segments of the population) is more justifiable, both in terms of transparency and quality of life improvements. The government could give equity financial assistance rather than subsidize and encourage greater mortgage debt obligations, for example. The mortgage interest tax deduction as currently constituted encourages high-leveraged loans, but perhaps the deduction should be limited or could be capped to keep the deduction from factoring into a homebuyer's debt/equity allocation decision-making. In lieu of promoting mortgage borrowing, the government could directly subsidize homeownership by simply paying a portion of a buyer's equity contribution or by linking downpayments with a tax deduction. Subsidizing borrower equity contributions at closing would help borrowers lacking a sufficient downpayment to reduce their leverage below the required underwriting thresholds while still keeping home-buying cash outlays low.[474]

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470. Zachary A. Goldfarb, *Next Up for Reform: Housing Finance*, WASH. POST, Jul. 21, 2010, at A14.

471. *Id.* Bostic also said that while homeownership is valuable, there is an "underside" to homeownership as well.

472. *See, e.g.*, HARVARD HOUSING REPORT, *supra* note 147.

473. *Id.* at 19 ("[J]ust as many mortgage brokers and loan officers aggressively marketed high-risk mortgage products to vulnerable borrowers, many federal, state, and local officials also oversold the benefits of homeownership—especially to low-income and low-wealth households. The recent rise in mortgage delinquencies and foreclosures has now exposed the tragic flaw in this single-minded strategy.").

474. Reducing a borrower's out-of-pocket contributions may reduce a borrower's commitment to the property and encourage property abandonment (strategic default) upon depreciation, particularly if there are limits on a mortgage recourse to a borrower personally. This is a huge issue in over-leveraged loans.

The Obama administration reportedly will formulate a housing reform proposal in 2011.[475] This proposal will likely include restructuring the GSEs and unwinding massive government programs supporting homeownership.[476] Regardless of the precise parameters of the reforms, the net impact of changing government policy on homeownership priority should be less government money and incentives propping up the residential mortgage market. Such a revised "American Dream" will ultimately help stabilize housing prices and the economy.

CONCLUSION

Asset-pricing bubbles imperil our financial system.[477] Increasing debt capital supply and fractured risk allocation inflate real estate prices, and this trend self-perpetuates due to market information gaps and human nature. One stated goal of the new Dodd-Frank Act is closer regulatory oversight, which will force both primary lenders and secondary mortgage issuers to behave more circumspectly.[478] Although we can mandate reporting and disclosure and provide for protective government oversight, this is not enough. We must combat price inflation at its source.

Only by ensuring risk internalization will mortgage debt and securitized debt products be correctly priced. In recognition of the natural cycle of cheap money, asset over-pricing, and the wealth effect, and in the face of current real needs for homes and security, the government should reexamine our financial incentive system and re-engineer it for a better future product. Hopefully analyzing what went wrong will lead not just to a frenzy of blames and "what ifs" but will help craft sustainable and market-stabilizing responses now rather than postpone ultimate solutions and perpetuate the problem.

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475. Goldfarb, *supra* note 470.

476. *Id.*

477. *Learning from the Past: Lessons from the Banking Crises of the 20th Century: Hearing Before the Cong. Oversight Panel*, 111th Cong. 18 (2009) (opening statement of Elizabeth Warren, Chair, Congressional Oversight Panel) ("Financial crises tend to follow asset bubbles.").

478. *See Dodd-Frank Brief Summary*, *supra* note 235.