4-1-2009

Bailouts, Buy-Ins, and Ballyhoo

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The bailout strategy now being pursued by Treasury under the recently authorized Troubled Asset Relief Plan, if "strategy" it can be called, remains obscure and erratic at best. All the while markets remain jittery and credit remains tight, as the underlying source of our present financial jitters—continued decline in the housing market and still mounting foreclosures—goes unaddressed. This piece proposes an interesting and novel approach to solving the financial problem. If it works out, it would eventually minimize the cost to the government.

After a number of heady false starts, against the backdrop of threatened financial catastrophe, Congress and the White House enacted a stopgap financial "bailout" plan early in October 2008.[1] The "Troubled Asset Relief Plan" (TARP, "the Plan") is remarkable in a multitude of respects. As a fiscal matter, for one

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Challenge, vol. 52, no. 2, March/April 2009, pp. 36–54.

ISSN 0577–5132 / 2009 $9.50 + 0.00.
DOI: 10.2753/0577–5132520202

thing, the Plan's sheer size—$700 billion, with no assurance that this will be all—appears to be unprecedented. It dwarfs even the costs of the S&L cleanup nearly two decades ago, remarkable as these were in their own day. As a legal matter, for another thing, the sheer breadth of barely reviewable discretion that the TARP confers upon Treasury presses hard against constitutional limits on executive branch authority. Indeed, lawyers seem largely agreed that the original three-page version of the Plan might well have delegated authority in excess of what the Constitution permits, while the amended 400-page version squeaks by at best.

At least as striking as the TARP's fiscal scale and delegated executive scope, however, has been the remarkably *restless* character of Treasury's actions taken under the Plan since enactment. Fed chairman Ben Bernanke, President George W. Bush, and Treasury Secretary Henry Paulson originally projected the TARP, late in September 2008, as a proposed "buy-up" of mortgage-backed securities (MBSs) said to be clogging the credit markets. Next Treasury began speaking instead, about mid-October 2008, of "buying *in*" to financial institutions. This, it was said, would make lendable funds more immediately available to lenders, hence restoring liquidity to credit markets more expeditiously.

By early November, Treasury was reporting that the buy-in plan would entirely supplant the earlier buy-up plan. About mid-November, however, Treasury abruptly announced it would enter the short-term debt markets as well, once again "buying up," to get commercial paper circulating again. Then, near the end of November, the plan changed again. Now, we were told, Treasury would resume purchasing "toxic" assets, but more kinds than MBSs. Finally, in early December, talk had turned toward employing some of the TARP moneys to tide over automakers as well, a course of action that by the new year had indeed begun to be taken. The term "erratic," it seemed, could be used to describe more than presidential candidates in those days.

Throughout all the on-a-dime pivots and changes of direction, a few voices softer than Treasury's have been offering proposals aimed at the primary *cause* of our present financial worries. That is the ongoing mortgage foreclosure crisis afflicting our post-bubble real estate markets. With time and continued tumult, these proposals have gradually come to be more widely heard. Now it is not only Sheila Bair, Republican chair of the FDIC, who can be added to the list of those arguing that mortgage foreclosures lie at the core of our woes—a list that since autumn has included not only progressive housing advocates but also financiers and economists as ideologically diverse as Democrats George Soros and Joseph Stiglitz and Republican Glenn Hubbard. No, now even Fed Chair Bernanke and Treasury Secretary Paulson acknowledge the need to stabilize free-falling mortgage markets.

It is very good news that so many at last are now looking to stem the foreclosure crisis as the best means of addressing the present financial crisis. However badly needed the “transfusion” supplied by the first half of Treasury’s new $700 billion might have been to keep the “patients” that are our national and global financial systems alive on the table, the fact is that these patients—and the public fisc—will continue to hemorrhage until we stanch the flow of foreclosures that is still under way. The only real question is how best to do that.

A brief bit of forgotten institutional history, I believe, supplies our answer: The most effective—as well as the most constitutionally sound—way to solve the mortgage crisis, and thereby a looming national and indeed global financial crisis as well, is to direct the new Treasury, as of January 21, 2009, to administer the TARP through twinned institutions we already have. They both were originally established decades ago precisely to deal efficiently with low-end mortgage finance and refinance, which remains their purpose. Indeed they were founded to do so precisely in order to deal with the real estate crisis that immediately preceded (one shudders to say it) a certain notorious Wall Street contraction—one that commenced in October 1929. Our present woes, moreover, stem directly from intrusions upon these institutions’ original missions by underregulated private firms, first in the lead-up to, then during, the near-decade-long housing bubble that grew from the late 1990s to about 2006.

What institutions? you might now be asking. I am referring to the Federal Housing Administration (FHA), working in tandem with its originally government-sponsored and recently re-federalized sibling enterprises (GSEs), Fannie Mae and Freddie Mac. Any properly focused plan for financial bailout will critically involve what amounts to these institutions' original, and now recently restored, bailiwick. To see why and how this is so, we should begin with a brief refresher on the cause of the problems we are presently dealing with. I will then briefly reprise the founding and functioning of our newly restored team of mortgage finance institutions. Then I close with a sketch of how TARP now should be channeled through these institutions.

Where We Are and How We Got Here

Let us begin by noting two salient components of the present crisis. The first, what I will call "core," component is the doubtful value of an uncertain number of "subprime," "Alt-A," and "jumbo ARM" MBSs. These are held in varying quantities by a large number of financial institutions (FIs) worldwide, many of which appear not as yet to have fully reported the sizes of their holdings. These securities, moreover, underlie financial derivative commitments on the part of yet more FIs worldwide, with notional values that appear likewise as yet to be underreported. The MBSs, for their part, are now widely perceived to be "toxic" because many—though certainly not all and indeed not even a majority—of the mortgages backing them are troubled.[2]

Now many of the mentioned mortgages are troubled, in turn, because they were imprudently or in some cases "predatorily" extended by participants in the shadow industry of scarcely regulated "mortgage banks" that developed and then grew in the vacuum left by those S&Ls lost in the 1990s.[3] These institutions, most of which are not, legally speaking, banks at all—they take no deposits and are not regulated as depository institutions—proliferated rapidly with, while indeed helping to fuel, our recent Fed-enabled real estate bubble.[4] Naive, non-credit-checked, and in some cases clearly uncreditworthy borrowers not only received loans from these institutions but often were lured with offers of newfangled adjustable rate mortgages (ARMs) featuring low front-end "teaser" payments that later "ballooned."

Understanding how this could have happened will take us straight to the second penumbral component of our present crisis—as well as to how we will best solve it.

Now ordinarily, neither borrowers nor lenders would likely have expected anything good to come of loans on such terms as those I have just mentioned. But fees, risk transferability, and especially speculative asset bubbles have a funny way of changing people's calculations. Borrowers not unreasonably assume they can regularly refinance inexpensively, on the strength of the underlying collateral's apparently inexorable appreciation. Primary and secondary lenders naturally assume likewise. And again, such assumptions seem far from far-fetched while the bubble is growing. The Fed chairman himself said as much at the time, saying the buyers would be irrational *not* to take up ARMs.[5]

Borrowers, then, need not be profligate to "get in" what later proves "too deep" when it comes to levered asset purchases. And lenders, for their part, need not be venal: They can reasonably endorse borrowers' best hopes, even when lured by origination and loan servicing fees, and by the easy sale of resultant mortgages to secondary holders. The secondary holders, for their part, indeed add to the pressure. Often they prod loan originators on, as seems to have happened quite widely this time. Why? Perhaps partly because they assume the originators have done the due diligence. But they are lured in any event by the returns on investments that are there to be had while a bubble's inflating, even if there be defaults here and there. The highest rewards *always* are associated with some risk, after all.

For a time in these cases—often for years—everyone does indeed win. The process takes on a self-fulfillingly prophetic, spontaneous "chain letter" or Ponzi-like character. More are drawn into the market as prices keep rising. Some hope to clear speculative profits by "flipping" the assets they borrow to buy. Others—more innocently, perhaps—reasonably judge they can prudently purchase to hold, but on more highly levered terms than they might otherwise have accepted. And still others are mixed cases of holder-cum-speculator.[6] In all cases, in any event, as the new entrants keep entering, the prices do keep rising, in effect validating the judgments of those who act upon the expectation of continued ascent.

As this process continues, some begin to believe, while others perhaps labor to convince themselves, that we have entered upon some permanent "new era," from which point onward asset values quite generally "can only go up." Others, somewhat more modestly, convince themselves simply that the particular asset in question—land or petroleum, say—is in finite supply. Since populations and long-term demand know no limits, they conclude not implausibly that *this* one "can only go up." Others, finally, remain fairly certain that all that goes up can come down. But they know that they cannot know when the descent will begin, so they keep hanging on anxiously, day by day, in hopes of gleaning just that much more profit before exiting. It is in each participant's rational interest, after all, to ride the thing up to that asymptote which is the very inflection point. So most keep on riding.

But, of course, bubbles never grow indefinitely; the inflection point always *is* reached. The Ponzi growth rate slows at some point in the indefinite medium term, whatever the more definite, long-term trend lines might be.[7] When that happens, the spontaneous Ponzi process abruptly halts and then quickly reverses. The buildup of worry—"how long can this last?"—discharges at last. A "Minsky Moment" is reached.[8] Now many erstwhile winners, having been nervously mindful all along that a peak followed by mass exit must at some point be reached, seek to salvage gains or cut losses by being first to jump ship. "Sauve qui peut," "Die Letzen beissen die Hunde," or "Devil take the hindmost," as used to be said on the French, German, and English markets, respectively. But in modern, electronically traded markets, the time span between first and last is paper thin. Prices plunge very quickly, and with them the reliability of those repayment obligations associated with the credit extensions that fueled the rise.

This is the fate that befell our own housing bubble quite recently. Prices leveled off, then began falling in mid-2006. The ensuing slump quickly began to throw ill-structured, bubble-time mortgages into default, as market valuations of underlying assets began falling below nominal debt obligations. Default rates, not surprisingly, have since grown steadily. And as they have grown, the market values of mortgages, mortgage-backed securities, and associated derivative obligations have dropped yet further. In effect, the same feedback loop structure that characterized the buildup now characterizes the comedown.

The second penumbral component of our mortgage-rooted financial crisis accordingly is, no pun intended, derivative. It is mass-psychological, simply the flip side of the just described Ponzi process: A proverbial "market for lemons" of the sort known to macroeconomists since at least the time of Akerlof's and Stiglitz's canonical articles of the early 1970s (for which, of course, both won Nobels), and to financiers since Gresham first postulated the "Law" bearing his name, follows many a burst bubble.[9] The prevailing mood changes, tendencies toward risk aversion are heightened, and uncertainties are resolved by assuming the worst.

In the present iteration of this depressingly familiar story, no institutions or persons know precisely what portions of their own MBS holdings will prove "underperforming" in consequence of the mortgage industry's post-crash troubles. That is partly because no one knows precisely which mortgages will foreclose, thus which securities will prove underperforming or how much. And it is partly because no one knows how low particular property values, or property values more generally, will fall. And finally it is partly because property values, hence mortgage and thus MBS values, are themselves partly determined by whatever action we collectively take or do not take to prevent defaults. There is a significant element of self-fulfilling prophecy in whatever we do here, just as there was self-fulfilling prophecy in the growth of the Ponzi-like bubble itself. And so until action on the part of the collectivity is taken by some agent authorized to act in the name of all, each private party assumes the worst and seeks exit.

This self-fulfilling–prophecy part of the story steadily radiates outward: The market grows ever more jittery over the just enumerated uncertainties. The longer these jitters endure, the more prone investors become to undervalue affected financial institutions' MBS—including portfolios, and hence ultimately those institutions' own issuances.

The more they consequently shed their stakes in these institutions, the more quickly the remaining such stakes lose *their* short-run values. In effect, there is a "run on the banks," in this case by shareholders rather than depositors, as used to happened before there was federal deposit insurance. The negative feedback loop found in the market for MBSs accordingly spreads beyond those securities. The familiar financial "contagion" ensues.

The process, of course, is aided and abetted by mark-to-market accounting rules that require institutions to value their assets as the market values them—even when, thanks to the panic psychology at work here, the market arguably is grossly undervaluing them. And with affected institutions in turn interlinked by collateralized debt obligations, credit-default swaps, and other derivative risk-sharing arrangements, even those *not* holding MBSs end up affected. The "downward spiral" winds steadily downward. But what goes down can be turned back up and be brought to a much more sustainable stratum.

Enter the FHA and its GSE siblings: We can quickly reverse the widening downward spiral that is this crisis's penumbral component, as Treasury's original late–September 2008 plan itself contemplated, by directly addressing the cause at its core—the bad mortgages and the securities they back. And this is precisely what the FHA and its newly renationalized GSEs originally were and are *for*. Let us look, then, a bit further back than the heady early and dismal later 2000s, to the heady mid- and dismal later 1920s and 1930s.

Where We Were and How We Got There

Public memory of the era immediately preceding the New Deal features three gaps that we would do well now to fill. One such forgotten fact is that, before there was a "World War II," "World War I" was called "The Great War." The second forgotten fact is that the 1929 stock market "crash" commonly singled out as having initiated the Depression that, thank goodness, we still can call "The Great" was in fact but a stage in a longer-term decline. It was immediately *preceded* over that course, moreover, by a crash in the *real estate* market—most notably, perhaps, in Florida, in which none other than Charles Ponzi himself had loomed large.[10]

Finally, the third fact that we have forgotten is that the system of home mortgage finance that has made America "a nation of home owners," as well as introducing the financial innovation known as "securitization" itself, was actually designed and then instituted over the course of the 1930s and 1940s—precisely *in response* to the just mentioned real estate crisis.[11] Before that time, less than 40 percent of American families owned their own homes, while since that time, more than 70 percent have come to enjoy that status. Where homes are concerned, in other words, the "ownership society" is a New Deal invention. That society, however, along with the mentioned statistic, is now under threat—as are, in consequence, our and the world's financial systems—just as they were in the early 1930s.

It is a matter of some urgency rather than mere antiquarian interest, then, to recollect this history—as well as to see how our present problems take root in our having forgotten and departed from it. We must act quickly to ensure that the Great Depression remains "Great," rather than becoming just "I." A bit, then, on the mentioned history.

Early in the twentieth century as now, most who purchased residential real estate did so at least partly on credit. What was different was that fewer, for that reason, purchased housing at all. Housing credit markets were more fragmented, mortgages in consequence much less liquid investments than they have since become. Home loans in consequence were extended for much briefer terms—generally two to three years—at the end of which they would "balloon" to come due in full.

Loan-to-value ratios before the 1930s, in turn, were very low by modern standards. As little as 50 percent was considered high, and it was rare. Financing on such terms not surprisingly fell short of most would-be buyers' capacities. And so second mortgages, junior liens, and rollover refinancings were the norm. This was not terribly problematic for those who dared buy, so long as real estate values continued to rise, as they did—very rapidly—through most of the 1920s. Refinancing then, as more recently, was not difficult when the value of one's collateral—the home itself—continued to rise in the real estate boom of the twenties.

When real estate prices leveled off and then began falling in 1928, however, short-term mortgages no longer could be refinanced in full. Again things were much as they are today. Resultant forced sales and foreclosures, which reached the rate of over 1,000 per day once some 50 percent of all home mortgages in the country had gone into default, brought prices steadily lower. The real estate market fell into the familiar "downward spiral."[12] The parallel with today could not be more striking.

Indeed the parallels proliferate. For then also, as today, the crisis that afflicted the real estate market spread much more widely, ultimately reaching the stock market itself. The reasons were obvious: For one thing, upward of 30 percent of the American labor force was employed either in the home-building industry itself or in industries that were bound to lose business as home builders went out of business. For another thing, of course, disemployed labor, like fearful and foreclosed mortgagees themselves, spent less money, feeding yet further contraction. The vortex of contraction, recession, and then depression was on.

The programs instituted to address this widening real estate–rooted crisis—begun in the last year of the Hoover administration, broadened through the Roosevelt years, and continuing in but minimally altered form today—cannot fail to impress in their innovativeness and comprehensiveness. The process began with the Federal Home Loan Bank Act (FHLBA) of 1932,[13] which authorized establishment of a system of Regional Federal Home Loan Banks roughly parallel to that of the Federal Reserve's system of Regional Federal Reserve Banks. The Regional Banks provided standards and supervision to member institutions—the private mutual savings banks (MSBs) then responsible for most mortgage lending—and in return supplied added lines of credit on the security of mortgage loans that they held (in effect "monetizing" those mortgages).

The new Congress that took office in 1933 built upon Hoover's well designed initiative. It did so first with a Home Owners' Loan

Act (HOLA) in 1933,[14] which temporarily established a Home Owners Loan Corporation (HOLC) for refinancing foreclosed loans on favorable terms to enable erstwhile home owners to recover their homes. It also laid the groundwork for a steady spread of more MSBs by directly affording national charters even where state authorities might have barred entry.

One year later, the National Housing Act (NHA) of 1934[15] afforded a system of deposit insurance for the MSBs analogous to that newly instituted for depositors in commercial banks, further boosting the availability of lendable deposits. More critically, the NHA instituted a system of insurance for the *MSBs themselves,* against defaulting *mortgagors*: Section 203 of the Act established a nationwide "mutual mortgage insurance system" through which a newly created, and in this case now permanent, Federal Housing Administration could insure first-mortgage loans made for the construction, purchase, or refinancing of one-to-four-bedroom family homes. In effect, the FHA took over and discharged indefinitely the functions of the HOLC, which from its inception had been conceived as ad hoc and temporary.

FHA still operates today, guaranteeing and, in many cases, originating or refinancing mortgages that conform to the standards that it imposes ("conforming" mortgages). It also affords financial counseling to borrowers. And it does all of this at no cost to the public fisc—the only federal agency to do so.

The FHA and its insurance scheme fundamentally altered the régime of home financing in the United States. It effectively replaced traditional collateralization requirements with national default-risk pooling, rendering home loans more affordable. The uniform requirements upon which FHA conditioned its insurance fostered the development of a standardized home mortgage *instrument* marketable throughout the country. That is the familiar thirty-year, fixed-rate mortgage so common to low-end mortgage finance until recently. This in turn opened the door to securitization and hence yet more complete risk-pooling, more on which presently. The housing *quality* requirements upon which FHA *conditioned* its insurance also ensured the financial rationality of federally facilitated home-finance investments. And FHA's requirements of (a) actuarial soundness, and (b) risk classifying and separate pooling ensured that the system retained the traditional efficiencies of a private insurance market. That is why it still operates in the black.

Congress effectively completed its ad hoc discovery of our now familiar method of financially engineered homeownership spreading in 1938 by chartering the first modern "government sponsored enterprise" (or GSE). The Federal National Mortgage Association—FNMA, or "Fannie Mae"—was charged with making a national market in FHA-insured mortgage instruments themselves, i.e., with "securitizing" those mortgages. In effect, Fannie Mae along with later progeny (in particular Ginnie Mae and Freddie Mac, to say nothing of the *higher-education* loan securitizers like Sallie Mae, expressly patterned after the Fannie Mae model) closed the proverbial circle, separately completing the markets for housing credit and credit-risk bearing, thereby optimizing the availability of such credit to home buyers in the manner described earlier.

Fannie Mae proved sufficiently successful, even on market terms, to privatize in 1968. (Sallie Mae did so in late 2004.) Freddie, for its part, was instituted in 1970 specifically to compete with the newly privatized and gargantuan Fannie. Both Fannie and Freddie subsequently came to offer a multitude of home finance services, and operated effectively, as well as profitably, in spreading home ownership until recently.[16]

What, then, went wrong? In essence, the story is just that told in the previous section, albeit now with an added wrinkle. On the one hand, Fannie and Freddie were caught up in bubble psychology like so many others, including the Fed chairman. It was very *profitable* to buy ever more risky, non-FHA-conforming mortgages so long as property values kept growing at the rates they grew in the late 1990s and early 2000s. Global investors in Fannie and Freddie, including many a large sovereign wealth fund or treasury, insisted that these profits be sought.

On the other hand and at the same time, in view of their original missions as engines of our American home-ownership society, members of Congress and other officials during the Clinton and Bush years alike, themselves evidently caught up in the belief that real estate "could only go up," in some cases actively pressured the old GSEs to take on more risky mortgages. *Why not* pursue the original salutary mission all the more aggressively, if even the Fed chairman was convinced that real estate would just keep rising in value? Finally, in view of Fannie's governmental lineage, Fannie's and Freddie's "implicit" federal guarantees, and both institutions' associated "too big to fail" status, Fannie and Freddie were all the more able to attract plenty of purchasers of their securities.

Ultimately, of course, all of this landed Fannie and Freddie in very hot water. The real estate slump that commenced in the summer of 2006 hit them especially hard, for they held the great bulk of low-end mortgages. We know where it led: Fannie and Freddie were ultimately renationalized in September 2008. Many took this for an ominous sign, on all fours with the totterings of Bear Stearns, Countrywide, Lehman Brothers, Merrill Lynch, AIG, and Washington Mutual, among others. What we ought *really* to see in the renationalization of Fannie and Freddie, however, is *opportunity.* And restoration of home values, homeownership, and finance. That takes us on to the solution of our present crisis.

Bringing It All Back Home

With the FHA still in operation as the sole federal agency that operates at no cost to the public fisc, and with its prodigal siblings now back in the family, we are actually now very well situated to address the mortgage crisis at the core of our imminent global financial crisis. Indeed we can easily set the team to work in a manner a lot like the manner in which it operated in solving that real estate crisis that prompted its founding in the first place. Here is how to do it.

First, *through the now newly refederalized GSEs,* employ TARP moneys to purchase and repurchase MBSs perceived as "toxic" or "troubled" from key financial institutions now holding them. Pay more than currently undervalued market, but less than discounted cash-flow value. That way, value will be recouped as MBSs rise back to less panic-depressed values. And that way, we will also ensure that financial institutions that overinvested in MBSs incur some cost, thereby mitigating the moral hazard concerns occasioned by any bailout. In effect, we will be taking a "deductible," or conferring the attributes of "coinsurance" on the bailout.

How much more than currently undervalued market, but lower than discounted cash-flow value, should we pay out? Many methods have been proposed, best known among them probably the "reverse auction" first suggested by Treasury in September 2008. Reverse auctioning certainly seems the most efficient means of dividing the surplus that we will be recouping. But we shall do best to prescind here from fine-tuned accounting and valuation matters, as there is surely a range of reasonable possibilities from which to choose. What matters for the present is that MBSs are certainly much undervalued at present by a spooked market, for the same psychological reasons as for their having been overvalued by our erstwhile euphoric market. And this fact itself, if there is more or less symmetry between, first, the euphoric and then the dejected "animal spirits" at work in the MBS market this decade, suggests somewhere near the mean between peak and trough rates as a good working benchmark against which to check observed auction rates, perhaps marginally adjusted in recognition of any asymmetry thought to be worked by endowment or related effects.

Will the MBSs rise back to higher values as suggested? Yes, for reasons rooted in the "market for lemons" and "self-fulfilling prophecy" phenomena noted above. The problem in this case is that, while we know that only a small minority of mortgages will actually default and only a minority of MBSs will actually prove to be "toxic," we do not know *which* ones. During those periods of irrational despair that follow periods of irrational exuberance, individuals irrationally fear that they are holding the *underperforming* investments *disproportionately.* Let us call it a "reverse Wobegon" problem: Each individual worries, "*I* might have only the *bad* ones."[17] Fearing this individually, they then in effect *make* it so collectively, by stampeding to sell what they irrationally undervalue. In short, we have a classic collective-action problem, one that in this case artificially deflates value.

Concentrate ownership of the full affected portfolio, then, and you address this collective action problem head-on and entirely solve it. Each security then can effectively be valued at the mean, without anyone's having to know which particular securities in fact possess more or less than mean value. The problem of individuals' all fearing that they hold securities possessed of less than mean value—the "reverse Wobegon problem"—is immediately solved. We restore full portfolio value, in short, precisely by concentrating ownership of the full portfolio, booking the difference between that and the current irrationally depressed market value of dispersed securities. Concentrating ownership also, it happens, will facilitate smooth operation of the second part of the FHA/GSE plan that I am proposing, the part that restores value to underlying mortgages themselves. On, then, to that.

The second and complementary part of the plan is, in this case through the FHA, simultaneously to arrange refinancing and financial counseling for those mortgagees who, owing to poorly structured or misleadingly packaged mortgages, are now going under. Make a priority of first-time single-home buyers who have purchased the homes to occupy them and who might realistically pay for them if only their payment structures are smoothed. Show less solicitude for "second" or "*n*th" homes that clearly are speculative properties purchased for "flipping," unless there is a good chance of saving foreclosure costs by refinancing. Show intermediate solicitude for those who, though not strictly speculators, have nonetheless grossly overreached, helping to refinance some while gradualizing workouts and foreclosures on others. The FHA is quite experienced with all of these options and more.

Note that all of this can be done at a reasonable, unforced pace once FHA's sibling GSEs have purchased or repurchased the great bulk of MBSs per the first part of the plan. For the newly renationalized GSEs do not face the same short-term financial imperatives as private lenders. Nor do they face the bargaining problems that confront dispersed classes of creditors in more garden variety insolvency situations. For, yes, debt workouts also are familiarly a collective action problem, as any bankruptcy expert will readily attest. This is yet another benefit of concentrating ownership of these now troubled assets in the hands of our GSEs. And it will enhance the value of the assets themselves, precisely by preventing massive foreclosures and their associated costs and thus preserving the value of those mortgages that underlie the presently "toxic" MBSs.

It bears noting here that the FHA can effect mortgage refinancings much more efficiently than judges or any new cadre of bankruptcy trustees of the sort that some are proposing would do. For one thing, again, refinancing is already an FHA specialty. But for another, it is because the GSEs' repurchasing of MBSs will eliminate the usual holdout problems that afflict ordinary debt workouts in the vicinity of court-administered bankruptcy. I think that this renders the paired FHA/GSE plan superior, moreover, to Professor Shiller's proposal for a new HOLC.[18] For the latter would not only just recreate an agency that the FHA was itself instituted to replace and make permanent, but also it would not yield the concentrated MBS-ownership advantages that this plan involves.

Offer to buy troubled MBSs, then, and most who now hold them will sell. Then we can refinance mortgages with speed, but with *deliberate* speed—without pressure. As for any who do not sell their MBSs per the plan, note first that they would have to constitute one-third of the mortgage credit outstanding on any one home if they wished to block refinancing. That seems unlikely. Note finally that if, improbably, they were to constitute such a bloc and then seek to obstruct refinancing arrangements by FHA, there would surely be sufficient ground for the government to exercise its eminent domain power and pay the amount paid to the last—or indeed even the first—voluntary sellers of MBSs to the holdouts. A securities covenant is no more a suicide pact than is the Constitution, and there is no reason whatever to honor exploitative holdout power in times of exigency like the present. If anything, there is reason to shame holdouts publicly, along with the worst of that comparative minority of borrowers and lenders who were grossly negligent in the midst of the bubble.

So how much will all of this cost? That is, of course, hard to say, in view of the feedback-effect-rooted indeterminacies that we have noted to be at work in the present crisis. The best we can reasonably expect at the present, I think, is to take cognizance of the range of reasonably anticipated possibilities. At one end of this range is the possibility that the FHA and its renationalized GSE siblings will actually come out in the black. Certainly that is what happened from the late 1930s onward, when the original package was first put into place. And indeed it is why Fannie was ultimately privatized, and it is why the FHA has operated at a profit since its inception. It also bears noting that Bernanke, Bush, and Paulson themselves argued that TARP, even *without* the salvaging of MBS values that refinancing mortgages would effect, could well bring a net gain to the fisc in the end.

How about the less rosy end of the range of possibilities? That one is just a bit harder to estimate, in part because of the aforementioned feedback-effect-rooted indeterminacies. It owes also to the countervailing effects of the aforementioned MBS appreciation apt to be wrought by concentrated ownership on the one hand, and the MBS depreciation apt to be wrought by continued home-value decline and foreclosures on the other. Worst-case scenario would be that the full amount spent purchasing troubled MBSs would be lost. At present, under the TARP, that would be about $350 billion—the remaining amount now available—plus whatever increment of the first half of funds Treasury has already spent upon MBSs. One hastens to add, however, that this worst-case scenario seems far from plausible, for all of the reasons adduced above.

Concluding Thoughts

To our detriment we have long since forgotten how effective FHA and its GSE siblings were, upon their founding during the Roosevelt era, in ending our last mortgage "meltdown." At literally no ultimate cost to the public fisc—none—they cured that real estate crisis, and in so doing transformed us from a nation in which less than 40 percent owned their homes to a nation in which 70 percent do.

Since FHA remains both self-funding and best at what it does, and since the GSEs now have been refederalized in keeping with their original, pre-privatization mandates, their complementary original missions can now be restored. Their mandates are clear, are constitutional, and still can be accomplished more or less without cost. They exist to spread and maintain nonspeculative home ownership on Main Street. Set them to work on that now, and we will save Wall Street—and the global financial system as well. At least until the next bubble.[19]

Notes

1. Emergency Economic Stabilization Act of 2008, Public Law 110–343, October 3, 2008.

2. To be more fine-grained, MBSs associated with a particular pool of mortgages are typically divided into three or more tranches. The largest tranch generally comprises the least risky, hence lowest-return, stream of payments, often accounting for 70 percent of a pool's nominal value. The next tranch typically comprises a slightly more risky, hence slightly higher-return, stream of payments, and accounts for 20 percent of the pool's nominal value. The final tranch, typically accounting for 10 percent of the pool's nominal value, comprises the most risky, but also highest-yield, stream of payments. This tranch is colorfully said to include the pool's "toxic waste." The "toxic" MBSs are, of course, principally associated with this tranch of most pools. But as I shall note further below, as confidence is lost, one tranch's "toxicity" comes to taint, in perception, other tranches as well.

3. The network of S&Ls, fostered by President Hoover in the early 1930s to revitalize real estate markets and further developed by President Roosevelt thereafter to the same end, was done in by the LBO-fueling junk bond craze of the later 1980s, made possible by the Reagan administration's and Congress's elimination of previously tight regulation of S&L investment practices.

4. There seems to be growing consensus that the Fed kept lending rates too low in the early 2000s. A charitable interpretation is that it overshot in addressing the slowdowns first threatened by the Asian financial crisis and Russian debt default of the late 1990s, then occasioned by the deflation of the tech bubble in 2000 and the 9/11 attacks of 2001. There are, of course, also less charitable interpretations.

5. The allusion here is to Chairman Greenspan's now notorious speech given in February 2004. See, e.g., "Greenspan Says Personal Debt Is Mitigated by Housing Value," *New York Times*, February 24, 2004, available at www.nytimes.com/2004/02/24/business/24fed.html?ex=1231131600&en=8882db4e0fc674da&ei=5070.

6. Those who borrow with a view to buying homes they will actually occupy buy more expensive homes, for example, their down payments in turn constituting smaller portions of the total to be paid. Others borrow with a view to purchasing homes they

intend all along to "flip" at a profit. Still others are actuated by motives that combine the first two, perhaps planning to continue residing in the home if appreciation rates slow, and to "flip" the home or "trade up" should appreciation continue apace.

7. This seems the right place to trot out the inevitable quotation of Keynes, to the effect that "in the long run, we're all dead." We might also liken things here to a sort of reversal of Al Gore's frequent observation that this year's being cooler than last year constitutes no refutation of long-term global warming. The trend line's sloping upward over the long haul does not prevent its being jagged over long enough periods to be either misleading (in the case of climate-change skeptics) or devastating (in the case of investment naifs).

8. The reference is, of course, to Hyman Minsky, *Stabilizing an Unstable Economy* (New Haven: Yale University Press, 1986), a work that seems unsurprisingly to be enjoying a bit of a rediscovery.

9. George Akerlof, "The Market for Lemons: Quality Uncertainty and the Market Mechanism," *Quarterly Journal of Economics* 84, no. 3 (1970): 488–500; Joseph Stiglitz and Andrew Weiss, "Credit Rationing in Markets with Imperfect Information," *American Economic Review* 71, no. 3 (1981): 393–410.

10. The tale is well told in Frederick Lewis Allen's *Only Yesterday* (New York: Harper and Row, 1931), a forgotten work that bears rediscovery today.

11. See, e.g., J. Paul Mitchell, "Historical Overview of Federal Policy: Encouraging Homeownership," in *Federal Housing Policy and Programs: Past and Present,* ed. Paul Mitchell (New Brunswick, NJ: Rutgers University Center for Urgan Studies, 1985); D. Barlow Burke Jr., *Law of Federal Mortgage Documents* (New York: Little, Brown, 1989); K.T. Jackson, *Crabgrass Frontier: The Suburbanization of the United States,* 2d ed. (New York: Oxford University Press, 2008). See generally Robert Hockett, "A Jeffersonian Republic by Hamiltonian Means: Values, Constraints and Finance in an American 'Ownership Society,'" *Southern California Law Review* 79, no. 1 (2005): 45–164.

12. Milton P. Semer et al., "Evolution of Federal Legislative Policy in Housing: Housing Credits," in Mitchell, *Federal Housing Policy and Programs;* Hockett, "A Jeffersonian Republic."

13. 12 U.S.C.A. § 601 ff.

14. 12 U.S.C. § 1464 ff.

15. 48 Stat. 1246, June 27, 1934.

16. See www.fanniemae.org.

17. The allusion, of course, is to Garrison Keillor's proverbial town of Lake Wobegon, where "all the children are above average."

18. Professor Shiller's proposal is made in Robert Shiller, *The Subprime Solution* (Princeton University Press, 2008). A similar plan, proposed by Representative Barney Frank (D-MA) and Senator Christopher Dodd (D-CT), was put forth in 2007 but withdrawn in the face of opposition by industry groups, Republicans in Congress, and the now outgoing Bush administration. The Dodd-Frank plan would have employed the FHA but, proposed as it was before Fannie and Freddie had been renationalized, did not involve GSEs' sweeping troubled MBSs from the market. Now that we have the full team together again, prospects look better.

19. More on how to prevent that one I will leave for another day. See Robert Hockett, "A Fixer-Upper for Finance," working paper, 2009, available at http://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=602726.