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Clifford V. Rossi

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CLIFFORD V. ROSSI*

Toward Comprehensive GSE and Housing Finance Reform

THE MUCH ANTICIPATED JOINT REPORT FROM THE TREASURY AND HUD on reforming mortgage markets ultimately was short on specific recommendations, but had a central theme of laying out options that would sharply limit government involvement in housing going forward in the short- and long-term.[1] The report also offered some introspection into the causes of the government-sponsored enterprises' (GSEs) demise, including a lack of credit discipline, particularly late in the housing bubble.[2] Reforming the two agencies is complicated by ongoing weakness in housing that requires a delicate policy balance between maintaining adequate liquidity in the mortgage market while not allowing it to stagnate long-term by extending the conservatorship of Fannie Mae and Freddie Mac.[3] A sweeping set of policy solutions to this problem are presented below that address key structural aspects of

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* Executive-in-Residence, Center for Financial Policy and Tyser Teaching Fellow, Robert H. Smith School of Business, University of Maryland.

1. *See* DEP'T OF THE TREASURY & U.S. DEP'T OF HOUS. & URBAN DEV., REFORMING AMERICA'S HOUSING FINANCE MARKET: A REPORT TO CONGRESS 12–15 (2011) [hereinafter JOINT REPORT], *available at* http://www.treasury.gov/initiatives/Documents/Reforming%20America's%20Housing%20Finance%20Market.pdf (discussing various short-term options to enable private capital to dominate the mortgage market, which include increasing the price of GSEs' guarantees to help private institutions "compete on a level playing field," reducing conforming loan lim ts so that larger loans are funded by the private sector, and increasing the price of FHA insurance to help ensure that the FHA does not obtain Fannie Mae's and Freddie Mac's market share as they wind down); *id.* at 24–30 (noting long-term options for the government's future role in housing finance, including suggestions for a privatized system with government assistance for a limited group of borrowers).

2. *Id.* at 7 ("[A]s their combined market share declined—from nearly 70 percent of new originations in 2003 to 40 percent in 2006—Fannie Mae and Freddie Mac pursued riskier business to raise their market share and increase profits . . . . [They] strayed farthest from their core business in 2006 and 2007—the very moment the housing market was extending credit to the riskiest borrowers and home prices were peaking.").

3. *See infra* p. 363 (discussing the use of the federal guarantee to enhance liquidity to mortgages), and *infra* p. 369(discussing the continued conservatorship of Fannie Mae and Freddie Mac as a transition period).

what should replace the agencies, how they should be regulated, how to limit the cost to the taxpayer and revive the moribund secondary market for mortgages.[4]

The scope of housing finance reform is vast and fraught with policy trap doors requiring a clear set of policy objectives to provide a comprehensive solution to the current crisis. First among these is to mitigate the potential for systemic risk and guard the taxpayer from future liability.[5] It was simply a matter of time before these two massive companies with a dual mission required a bailout.[6] The crisis surrounding these firms is the mortgage industry's equivalent of Chernobyl and the fallout from their demise will blanket the housing market for years to come.[7] Extending this analogy, lax regulation, poor controls and underlying weaknesses in infrastructure and incentives facilitated their collapse much as it did for the Chernobyl nuclear facility.[8] It is absolutely imperative that policy protect the taxpayers from future systemic risk events.

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4. *See infra* notes 5–25 and accompanying text (discussing objectives of policy reform), notes 27–69 and accompanying text (discussing a public utility model for structural reform), and notes 70–74 and accompanying text (discussing various financing methods for new regulatory regime).

5. *See* Ben S. Bernanke, Chairman, Fed. Reserve, Address Before the Independent Community Bankers of America's Annual Convention and Techworld, Honolulu, Hawaii: GSE Portfolios, Systemic Risk, and Affordable Housing (Mar. 6, 2007), *available at* http://www.federalreserve.gov/ newsevents/speech/bernanke20070306a.htm ("[T]he large presence of the GSEs in financial markets, the lack of market discipline exercised by investors in GSE senior debt, and the incentives for continued portfolio growth [] led the Federal Reserve Board to conclude that . . . [the GSEs'] portfolios continue to represent a potentially significant source of systemic risk."); *see also* JOINT REPORT, *supra* note 1, at 7 (noting that the since Fannie Mae and Freddie Mac have been placed into conservatorship, the Treasury Department has provided over $130 billion to these GSEs).

6. *See* Steven A. Holmes, *Fannie Mae Eases Credit to Aid Mortgage Lending*, N.Y. TIMES, Sept. 30, 1999, at C2 (warning that while Fannie Mae's decision to ease credit requirements may not pose any risk during stable times, the GSE "may run into trouble in an economic downturn, prompting a government rescue similar to that of the savings and loan industry in the 1980's"); *see also Proposals for Improving the Regulation of the Housing Government Sponsored Enterprises: Hearings Before the S. Comm. on Banking, Hous. & Urban Affairs*, 108th Cong. 374–75 (2004) [hereinafter *GSE Hearings*] (statement of Alan Greenspan, Chairman, Board of Governors of the Federal Reserve) (discussing the Federal Reserve's concern about the size and scope of the GSEs' portfolios and warning that "preventative actions are required sooner rather than later" to avert future systemic difficulties).

7. *See, e.g.*, Binyamin Appelbaum, *New Housing Era: 30-Year Mortgage May Fade*, N.Y. TIMES, Mar. 4, 2011, at A1 (discussing potential consequences of shutting down Fannie Mae and Freddie Mac, which could include limited access to the 30-year-fixed-rate mortgage, large increases in interest rates for borrowers, and lender-charged "lock in" fees). *See generally* Arthur E. Wilmarth, Jr., *Reforming Financial Regulation to Address the Too-Big-To-Fail Problem*, 35 BROOK. J. INT'L L. 707, 715–16 (2010) (explaining the "devastating losses on homeowners and investors" as a result of the financial crisis).

8. *Compare* David J. Reiss, *The Federal Government's Implied Guarantee of Fannie Mae and Freddie Mac's Obligations: Uncle Sam Will Pick Up the Tab*, 42 GA L. REV. 1019, 1033–42 (2008) (following accounting scandals in 2003 and 2004, Fannie and Freddie used their political strength to ward off efforts to increase the strength of an already limited regulatory regime), *and* Peter J. Wallison & Charles W. Calomiris, *The Last Trillion-Dollar Commitment: The Destruction of Fannie Mae and Freddie Mac*, AMERICAN ENTERPRISE INSTITUTE FOR

Another objective of policy reform must be to ensure adequate and ongoing liquidity to mortgage markets and access to credit under all market conditions in all locations. The fact that 95+ percent of mortgages today are securitized by the GSEs or FHA illustrates the depth of the current liquidity crisis in the mortgage market that impedes a recovery in housing.[9] Originating banks cannot solely provide sufficient liquidity by holding mortgages on balance sheets to revive the mortgage market. The complete disappearance of the private label security market for mortgages indicates a market failure that some form of government intervention can address. However, government intervention need not be equated with a bill to be presented to the taxpayer when the next mortgage crisis occurs. Limiting the buildup of toxic risk concentrations up front in the form of a set of standardized products with limited risk layering represents the first line of defense against future crises.[10]

A further objective is to strengthen core mortgage processes across the loan life cycle. The mortgage crisis clearly exposed severe weakness in underwriting, investment and servicing practices among most participants in the industry.[11] The cur-

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PUBLIC POLICY RESEARCH 5–6, 9 (2008), *available at* http://www.law.yale.edu/documents/pdf /cbl/Calomiris _Wallison_Last_Trillion.pdf (following the scandals, the GSEs shifted their attention towards affordable housing in order to maintain congressional support, which increased their exposure to subprime loans between 2005 and 2007), *with* John F. Ahearne, *Nuclear Power After Chernobyl*, 236 SCI. 673, 677 (1987) (finding "weaknesses in the approval of operating procedures" and noting that Chernobyl power plant operators ignored warnings, took steps to deliberately override the safety system, and lacked proper accident training and general knowledge of the plant).

9. *See January 2011 Mortgage Performance Observations: Data as of December, 2010 Month-end*, LENDER PROCESSING SERVICES, 20–21 (2011), http://www.lpsvcs.com/ NewsRoom/IndustryData/ Documents/2010%20-%2012%20Mortgage%20Monitor/LPSMortgageMonitorDecember2010.pdf (noting 95% government support of all new originations through December 2010); *see also* JOINT REPORT, *supra* note 1, at 12 ("[P]rivate capital has not sufficiently returned to the mortgage market, leaving Fannie Mae, Freddie Mac, FHA, and the Government National Mortgage Association ("Ginnie Mae") to insure or guarantee more than nine out of every ten new mortgages.").

10. *See generally* Thomas J. Pate, *Triple-A Ratings Stench: May the Credit Agencies be Held Accountable?*, 14 BARRY L. REV. 25, 26 (2010) ("Although, traditionally, regulators had seen [Credit Rating Agencies] as 'gatekeepers,' in the recent past, they have done more to allow financial products to access the market rather than keeping high-risk, or so-called 'toxic products,' out of the market."). *See* Roger Lowenstein, *Triple-A Failure*, N.Y. TIMES, Apr. 27, 2008, at MM36 (noting that so long as a pool of mortgages was given a triple-A rating, investors may believe that "it was just as safe, in theory, as other triple-A securities"); *see also infra* notes 47–51 and accompanying text (discussing the importance of setting product standards within new regulatory framework).

11. *See* Sheila C. Bair, Chairman, FDIC, Remarks at the Wharton School, University of Pennsylvania International Housing Finance Program, Philadelphia, Pa. (June 18, 2010), *available at* http://www.fdic.gov/news/news/speeches/chairman/spjun1810.html (proclaiming that the "financial crisis was triggered by a reckless departure from tried and true, common-sense loan underwriting practices" and that investors lacked market discipline by investing in poorly underwritten loans); Nick Timiraos et al., *U.S. Pushes Mortgage Deal—Obama Proposal Seeks Multibillion-Dollar Settlement of Loan-Servicing Cases*, WALL ST. J., Feb. 24, 2011, at A1 (noting allegations of improper foreclosure procedures among mortgage servicers because "bank employees routinely signed off on foreclosure documents without personally reviewing case details").

rent foreclosure crisis points to considerable deficiencies in mortgage servicing that to some degree reflect incentive conflicts among servicers and investors, as well as a servicing network that is unable to provide transparency and consistency in the application of default treatments to borrowers in trouble.[12] Greater efforts must be placed on fundamental reform of how mortgages are manufactured. The mortgage industry may find important clues from the nation's electric power generation industry for building transformative change.[13] A functioning power grid is considered a critically important public safety and national security issue.[14] The recent mortgage debacle painfully reminds us that a functioning housing market is, for financial markets and the economy, no less important.[15]

Finally, meaningful reform must address a host of incentive problems in the mortgage industry. Opportunities to adversely select the GSEs by lenders proliferated during the housing boom in many forms as exemplified by broker-originated loans.[16] Loans originated by mortgage brokers experienced losses for the agencies and banks that held these loans that were multiples above loans made in retail channels.[17] Nonstandard products coupled with lax oversight and limited risk retention by originators contributed to losses that were far larger than expected.[18] Re-

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12. *See* Peter S. Goodman, *Late-Fee Profits May Trump Plan To Modify Loans*, N.Y. TIMES, July 30, 2009, at A1 (illustrating how mortgage servicers are conflicted between collecting delinquency fees and recouping losses for investors); *see also* Gretchen Morgenson, *Banks' Flawed Paperwork Throws Some Foreclosures Into Chaos*, N.Y. TIMES, Oct. 4, 2010, at A1 (explaining that some mortgage servicers failed to provide defaulting borrowers with legal documentation of their right to foreclose and "[i]n some cases, documents have been signed by employees who . . . have not verified crucial information like amounts owed by borrowers").

13. *See infra* notes 31–32 and accompanying text.

14. *See, e.g.*, Tim Friend, *Power Grid Vulnerable to Attack, Report Warns,* USA TODAY, June 25, 2002, at 21A (discussing the importance of strengthening the nation's power grid because its failure "could result in a devastating domino effect" harming health care, food and water supplies).

15. *See* Reiss, *supra* note 8, at 1024 (discussing the magn tude of the international financial crisis which could result if the federal government did not bail out Fannie Mae or Freddie Mac).

16. *See* Cassandra Jones Havard, *"Goin' Round in Circles" . . . and Letting the Bad Loans Win: When Subprime Lending Fails Borrowers: The Need for Uniform Broker Regulation*, 86 NEB. L. REV 737, 751 (2008) (finding an increase in adverse selection because brokers "have consistently identified a prototype subprime borrower, oftentimes seeking them out and allegedly steering them to higher risk loan products"); Ruth Simon & James R. Hagerty, *Debt Bomb: Inside the 'Subprime' Mortgage Debacle—The Middlemen: Mortgage Mess Shines Light on Brokers' Role—Job-Hopping Mr. Shaikh Left Trail of Lawsuits, Failed License Exam*, WALL ST. J., July 5, 2007, at A1 ("[Brokers] provided the low-cost sales force that made it possible for lenders to quickly ramp up production . . . .").

17. *See* Havard, *supra* note 16, at 742 (stating that brokers made 70% of delinquent subprime loans); *see also* Simon & Hagerty, *supra* note 16 (finding that brokers originate about 75% of subprime loans and 70% of Alt-A mortgages and noting that defaults have "skyrocketed" in part because "some brokers put borrowers into loans they didn't understand, couldn't afford or were otherwise ill-suited for").

18. *See, e.g.*, Patricia A. McCoy et al., *Systemic Risk Through Securitization: The Result of Deregulation and Regulatory Failure*, 41 CONN. L. REV. 1327, 1351–53 (2009) (claiming that the origination of no-documentation loans and option ARMs along with the regulatory failures of the Office of Thrift Supervision contributed to the

shaping the manufacturing and distribution process for mortgages must address this incentive problem.

Other incentive problems in the mortgage industry that require attention include the competing private-public mission of Fannie Mae and Freddie Mac, a lack of transparency in the bundling of mortgages and associated securities, a classic principal-agent problem among mortgage servicers, and even issues with borrowers regarding fraud, fairness and protections against predatory lending.[19] The distortions from the dual mission of the agencies are well known and few at this point challenge the need to move away from such a structure.

An area that has only recently come to light that is fraught with incentive problems is mortgage servicing, as recently evidenced by the latest foreclosure crisis.[20] Mortgage servicers enjoy a special role in the industry, receiving a servicing fee in return for the distribution of cash flows to relevant parties from mortgage payments received by the servicer.[21] These operations are predicated on exploiting economics of scale, hence the ongoing consolidation in the industry over time.[22] The cyclical nature of the mortgage industry coupled with the focus on efficiency gains yields a servicing business that at times is unable to sufficiently process mortgages.[23] Fur-

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downfall of the three largest thrifts); *see also* JOINT REPORT, *supra* note 1, at 5–6 ("Millions of borrowers who purchased these [nonstandard] products proved unable to make required payments, resulting in widespread defaults . . . .").

19. *See, e.g.*, Lloyd L. Drury, III, *Predatory Lending and its Impact on Consumer Credit*, 10 LOY. J. PUB. INT. L. 137, 142–43 (2009) (noting an increase of predatory lending strategies, which include improperly soliciting borrowers, charging unnecessary fees, and taking advantage of borrower ignorance); Wallison & Calomiris, *supra* note 8, at 1 (explaining the conflict between the GSEs' public mission, which sought to lower interest rates and provide affordable housing, and their private mission, which sought to increase shareholder wealth and "fight increases in their capital requirements and regulation"); Gretchen Morgenson, *Pools that Need Some Sun*, N.Y. TIMES, Mar. 21, 2010, at BU1 (arguing that the securitization market "will remain frozen and unworkable" unless "sunlight shines on these loan pools" and makes the bundling process more transparent); *infra* notes 25–26 and accompanying text (discussing principal-agent conflict in mortgage servicing industry).

20. Adam J. Levitin & Tara Twomey, *Mortgage Servicing*, 28 YALE J. ON REG. 1, 3 (2011) ("Mortgage servicing has begun to receive increased scholarly, popular, and political attention as a result of the difficulties faced by financially distressed homeowners when attempting to restructure their mortgages amid the home foreclosure crisis.").

21. *See, e.g.*, U.S. FED. TRADE COMM'N, MORTGAGE SERVICING: MAKING SURE YOUR PAYMENTS COUNT 1 (2010), *available at* http://www.ftc.gov/bcp/edu/pubs/consumer/homes/rea10.pdf (discussing the responsibilities of a mortgage servicer to manage mortgage loan accounts by collecting and crediting loan payments and handing escrow accounts).

22. *See* Levitin & Twomey, *supra* note 20, at 4 (explaining that in a stable financial climate, "servicers compete by improving their economies of scale and automation"). Clifford V. Rossi, *Mortgage Banking Cost Structure: Resolving an Enigma*, 50 J. ECON. & BUS., 219–34 (1998).

23. *See id.* at 5 ("Although housing markets are cyclical, servicers find t more profitable to automate everything across the cycle than to invest in countercyclical hands-on loss mitigation when the market is up in preparation for when the market falls."); Gretchen Morgenson, *In This Play, One Role Is Enough,* N.Y. TIMES, Aug. 15,

thermore, servicers do not always act in the best interest of their investor, creating a principal-agent problem.[24] Finally, competitive forces reduce the ability for agile and consistent application of policy such as for loan modifications as well as cooperation in tackling such important issues as linkages between first and second lien mortgages.[25]

With these policy objectives in mind, the fundamental question is what type of structure is best able to address the weaknesses of the current system. The housing crisis has taught us at least two lessons: first, housing finance is of critical importance to the global economy, borrowers and the financial system;[26] and second, lapses in strong oversight throughout the mortgage cycle exacerbated the crisis.[27] Adhering to these points, the future design of a sustainable housing finance system requires a strong regulatory presence. The Office of Federal Housing Enterprise Oversight (OFHEO) was for many viewed as one of the weakest regulatory links in the system leading up to the crisis.[28] Moreover, the fragmentation of mortgage regulation across multiple agencies limits regulatory effectiveness.[29] Borrowing from the electric power industry, a strong public utility-style of regulation has the

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2010, at BU1 (explaining that as defaulting rates rise, loan servicing becomes more complex because "[s]ervicers must chase delinquent borrowers for payments").

24. Levitin & Twomey, *supra* note 20, at 69 (explaining that the principal-agent conflict arises because servicers are disinterested in the performance of the loan since their "compensation is not keyed to the return to investors" and because the servicing industry encourages "underinvest[ment] in default management capab lities, leaving them with limited ability to mitigate losses").

25. Morgenson, *supra* note 23 ("Often, the same bank that services a primary mortgage owned by another institution also owns a second mortgage . . . on the same property. When that borrower has trouble meeting both payments, the servicer has an interest in making sure that amounts owed on the second lien, which t owns, continue to be paid even if the first loan, which it has no interest in, slides into delinquency.").

26. *See, e.g.*, Appelbaum, *supra* note 7 (describing how Fannie and Freddie helped increase home ownership and explaining that their disappearance will increase borrower interest rates); Reiss, *supra* note 8, at 1024–25 (comparing the collapse of Fannie and Freddie to other international financial crises and explaining that the federal government would need to bail out the GSEs "in order to avoid a financial contagion that could quickly spread throughout the global financial markets").

27. Press Release, U.S. Department of the Treasury, Assistant Secretary for Financial Institutions Michael S. Barr Remarks to the Mortgage Bankers Association (Apr. 13, 2010), *available at* http://www.treasury.gov/press-center/press-releases/Pages/tg638.aspx ("There were inadequate rules, inadequate monitoring, and inadequate enforcement on all levels of the mortgage market.").

28. *See* Wallison & Calomiris, *supra* note 8, at 6 (noting that OFHEO failed to monitor subprime purchases because it was understaffed and did not have adequate authority to do so); *see also* Christopher L. Peterson, *Fannie Mae, Freddie Mac, and the Home Mortgage Foreclosure Crisis*, 10 LOY. J. PUB. INT. L. 149, 163 (2009) ("OFHEO, a relatively underfunded and weak regulator even in a climate amenable to oversight, was essentially silent as the GSEs shifted investment into the controversial subprime and risky Alt-A private securities.").

29. *See* Reiss, *supra* note 8, at 1033–34 (explaining that because GSE regulation is divided between the Treasury Department, HUD, and OFHEO, "it is generally agreed that Fannie and Freddie are insufficiently monitored as compared to other federally regulated financial institutions").

best chance of guarding against future housing bubbles.[30] Today, the absence of widespread power blackouts across the U.S. is testament to the strong oversight in managing the power grid, which on its own is of enormous complexity.[31] The costs faced from the housing crisis are of no less consequence for this country and yet it remains astonishing the degree of loose oversight of the mortgage industry.[32]

The mortgage industry also parallels the electric power industry in another important way, namely product commoditization.[33] Reviving the secondary mortgage market is not unlike reestablishing down transmission lines connecting a public utility to consumers.[34] Lenders, as will be discussed below, do not have the capacity on balance sheets to support a fully functioning housing market.[35] As a result, restarting the secondary market in a way that does not equate to a government-only market is critical to turning the housing market around.[36] Further, some form of credit guarantee is required to induce investors into the market and to do that effec-

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30. *See, e.g.*, *Reliability Considerations from the Integration of Smart Grid*, NORTH AMERICAN ELECTRIC RELIABILITY CORPORATION 6–11 (DEC. 2010), *available at* http://www.nerc.com/files/SGTF_Report_Final_posted_v1.1.pdf (summarizing the regulatory initiatives driving the development of smart grid technology); *see also infra* notes 27–69 and accompanying text (discussing a public utility model for structural reform).

31. *See* Paul Davidson, *U.S. Power Grid in Better Shape 5 Years After Blackout*, USA TODAY, Aug. 13, 2008, at 6A (noting that compared to 2003, after the worst blackout in U.S. history, the United States' electrical system is far better equipped to prevent a major outage, largely because of new standards for upkeep of the power grid and new systems to monitor the network).

32. *E.g.,* McCoy et al., *supra* note 19, at 1332 (declaring that lax regulations in the securitization market lead to one-sixth of borrowers being "underwater" and prompted a housing crisis that "paralyzed credit markets worldwide and triggered the deepest recession in the United States since the Great Depression").

33. *See* Daniel Immergluck, *Private Risk, Public Risk: Public Policy, Market Development, and the Mortgage Crisis*, 36 FORDHAM URB. L.J. 447, 461 (2009) ("[T]he scale and inherent subsidies of the secondary markets meant that they offered lenders lower cost capital for making mortgages. Loans became more standardized and 'one-size-fits-all.' Mortgages increasingly resembled commodities rather than individualized products.").

34. *See generally* Ben S. Bernanke, Chairman, Fed. Reserve, Address before the Federal Reserve Bank of Chicago's 43rd Annual Conference on Bank Structure and Competition, Chicago, Illinois: The Subprime Mortgage Market (May 17, 2007), *available at* http://www.federal reserve.gov/newsevents/speech/bernanke20070517a.htm (discussing the benefits of the secondary mortgage market, including the increased access to capital markets for mortgage lenders, the lowered transaction costs, the more widely distributed risk and the increased output of mortgage credit).

35. *See* Charles Duhigg, *Pressured to Take More Risk, Fannie Reached Tipping Point*, N.Y. TIMES, Oct. 5, 2008, at A1 (explaining that Fannie Mae's purchase of mortgages enabled lenders to make more loans, which increased the number of homeowners).

36. *See generally* JOINT REPORT, *supra* note 1, at 26–27 (rejecting a nationalization approach to housing finance because it "runs too high a risk of crowding out private capital, distorting investment decisions, and putting too much taxpayer money at risk" and finding that the best approach strikes a balance between privatization and nationalization).

tively and to minimize taxpayer exposure requires tight standardization through federal regulation.[37]

The crisis has clearly demonstrated that poor governance practices, coupled with weak product and process oversight, provide incentives for lenders to rationally maximize short-term profit at the expense of long-term performance. Therefore, a fully private solution to the GSE issue is not desirable. Likewise, a fully public solution is not optimal as this misplaces financial responsibility for housing finance on the US government and taxpayer. The need for some federal credit guarantee to resuscitate secondary markets must in return require a strong public utility style of regulation. Such a regulator determines the products under which taxpayers would be willing to accept risk, rather than leave it up to lenders and the GSEs.[38] For so many years we have treated housing as a social prime directive without realizing that in doing so we have elevated its criticality to our economic well being far beyond other asset classes and investments.[39] Imposing a strong regulatory apparatus at the center of the mortgage industry charged with comprehensive oversight of housing finance and associated participants provides the best chance for long-term performance while reducing the subsidies to housing that have created economic distortions.

Countering this proposal, some would argue that a public utility model has the potential to stifle innovation and efficiency.[40] To some degree, an excess of innovation contributed to the crisis as witnessed by the financial engineering of mortgage cash flows through the development of credit default swaps, credit default obliga-

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37. *See Housing Finance—What Should the New System Be Able to Do?: Part I—Government and Stakeholder Perspectives: Hearing Before the Committee on Fin. Services*, 111th Cong. 49 (2010) (statement of Michael D. Berman, Chairman-Elect, The Mortgage Bankers Association) [hereinafter Berman statement] ("[T]o promote uninterrupted market liquidity for the core mortgage market, the government should provide an explicit credit guarantee on a class of mortgage-backed securities backed by core, single family and multifam ly mortgage products . . . [T]axpayers and the system should be protected through limits on the mortgage products covered, limits on activities, limits on portfolio size and purpose, strong risk-based capital requirements, and risk-based payments into a Federal insurance fund.").

38. *See, e.g.*, AMY ABEL, CONG. RESEARCH SERV., RL 33875, ELECTRIC TRANSMISSION: APPROACHES FOR ENERGIZING A SAGGING INDUSTRY 20 (2008) [hereinafter ELECTRIC TRANSMISSION] (describing FERC's requirement under the Federal Power Act to set rates for transactions and FERC's traditional way of calculating such rates through a method accounting for recovery of capital costs, operative expenses, depreciation and a rate of return).

39. *See* Roger Lowenstein, *Tax Break: Who Needs the Mortgage-Interest Deduction?*, N.Y. TIMES, Mar. 5, 2006, at 6, 3. (quoting President Reagan and Kevin Hassett of the American Enterprise Institute on the American idealization of the home-mortgage-interest deduction).

40. ELECTRIC TRANSMISSION at 38 (noting that the current pricing mechanism for transmission is criticized because it "discourages investment" and "creates a disincentive for transmission owners to increase capacity").

tions and other derivative instruments.[41] Moreover, the relative plain vanilla product set in Canada's mortgage industry has apparently done little to hurt homeownership while appearing to largely sidestep a housing crisis in that country.[42] From that perspective, a public utility model's focus on standardization may actually be a beneficial long-term outcome. It may be true that such a model has the potential to dampen efficiency, thereby driving up the costs of production; however, any incremental increase in costs are likely to be overwhelmed by the real and human costs from future housing.

The new structure for housing finance would feature a Federal Housing Regulatory Commission (FHRC) charged with establishing rules and guidance over mortgage product and security standards (including loan limits), servicing standards, borrower protections, guarantee pricing, mortgage security rating review, reinsurance product standards, capital requirements on guarantor agencies and mortgage origination and servicing data standards. Clearly such powers elevate the importance of the FHRC beyond any agency responsible for housing to date.

First, among its primary responsibilities, is oversight of the new guarantor agencies. To guard against systemic risk, 10 new privately capitalized guarantor companies (Mortgage Guarantee Agencies, or "MGAs") would be created. These institutions would have no implicit or explicit guarantee provided by the federal government.[43] Distributing the risk across multiple agencies of largely equal size considerably reduces the systemic risk exposure to any individual firm. Distributing the potential exposures of the guarantors across even 5 firms would pose unacceptable risk based on the exposures of the two GSEs today. Under this model, the current Federal Home Loan Bank System (FHLBs) would be wound down. The FHLBs pose a smaller but still important component of the housing finance system; however, they enjoy a similar status as Fannie Mae and Freddie Mac collectively as GSEs and so pose future taxpayers risk that should be addressed in comprehensive overhaul of the system. The FHRC would tightly regulate the activities of the MGAs as described above.

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41. *See* Wilmarth, Jr., *supra* note 7 ("The combined volume of MBS, cash flow CDOs, CDS, and synthetic CDOs created an 'inverted pyramid of risk,' which enabled investors to place 'multiple layers of financial bets' on the performance of high-risk loans in securitized pools. Consequently, when the underlying loans began to default, the leverage inherent in this 'pyramid of risk' produced losses that were far larger than the face amounts of the defaulted loans.").

42. Alex Pollock, *Comparing International Housing Finance Systems*, NAT'L MORTGAGE NEWS, Oct. 11, 2010, at 4 (demonstrating that despite Canada's relative credit conservatism the country's homeownership rate is eighty-six percent while the United States' rate is sixty-seven percent).

43. *Cf.* Mark J. Flannery & W. Scott Frame, *The Federal Home Loan Bank System: The "Other" Housing GSE*, 91 FED. RESERVE BANK OF ATLANTA ECON. REV., 33, 36 (2006) (discussing the contradictory belief held by the markets that "the GSEs's obligations carry an implicit federal guaranty").

An important oversight function will be setting product standards. A component of this will be loan limits and the policy issues surrounding which borrowers should benefit from a federal guarantee. Envisioned in this framework are three secondary market segments: the first is the FHA market which would largely remain intact under this proposal performing the role as provider of credit to a variety of lower income and affordable home buyers.[44] The second segment would be represented by the standard mortgage market supported by the MGAs with an explicit federal credit guarantee for the security instrument.[45] The third segment would be represented by a market for private-label securities in which no federal guarantee is provided by the government but requires close product supervision to ensure no spillover effects into the other two segments.[46] The combination of new loan limits and product standards would demarcate the standard product segment from the other two.

Product standards will, to some degree, define the size of the standard market. To ensure minimal exposure to the taxpayer from the federal guarantee, certain risk combinations must not be permitted under this market segment. Specifically, broker-originated loans would not be allowed to be securitized with a federal guarantee. Additional requirements should include full documentation of income and employment (although self-employed borrowers would be included), no second lien mortgages, or investor and second home properties. The federal guarantee should be allowed only to enhance liquidity to mortgages where individuals reside and not to provide advantages for vacation or investment home purchases. These loans would be more appropriate to be securitized in the private-label market. Further, limitations on loan-to-value ratios (e.g., set at 90%), credit scores, and payment to income ratios should be required to ensure adequate willingness and ability to repay the obligation. Again, Canada's mortgage product set presents a useful model to emulate for the standard mortgage segment.[47] Among the benefits from

44. *See* JOINT REPORT, *supra* note 1, at 14 (discussing the manner in which the Obama administration plans to "[r]eturn[] [the] FHA to its traditional role as targeted lender of affordable mortgages").

45. *See* Berman statement, *supra* note 37, at 49 (advocating for a credit guarantee from the government in order to provide market liquidity for the core mortgage market).

46. *See* JOINT REPORT, supra note 1, at 16 (discussing consumer protection provisions in the Dodd-Frank Act including prohibitions on high-cost loans with abusive features, improvements in the overall transparency of mortgage origination and simplification of required disclosures to consumers, and stronger underwriting standards).

46. *See* Poonam Puri, Legal Origins, Investor Protection, and Canada, 2009 BYU L. REV. 1671, 1682 (2009) (reporting that the Canadian banking system remained profitable, solvent, and stable during the recent global economic crisis and that the IMF regarded Canada's banking system as a "paragon of international best practices" while the World Economic Forum ranked it "soundest in the world").

47. *See* Poonam Puri, *Legal Origins, Investor Protection, and Canada*, 2009 BYU L. REV. 1671, 1682 (2009) (reporting that the Canadian banking system remained profitable, solvent, and stable during the recent global

such tight product standards are the ability to more accurately price risk and eliminate the race to the bottom effect that drove many firms into insolvency.[48] Banks selling loans into a secondary market with a federal backstop would no longer be allowed to compete on price and product which leads to risky underwriting practices and product sets.

Another important responsibility for FHRC is setting prices for the federal guarantee. Under the proposed structure, originating firms would be required to hold a first-loss position in the mortgage. The FHRC would establish the expected loss threshold of mortgages to be securitized much as the GSEs do today in setting guarantee fees. Lenders would thus have sufficient 'skin in the game' from a risk retention perspective and they would then be required to hold a loan loss reserve as if they actually retained the loan on balance sheet.[49] The mortgage security instrument would receive a reduced risk weight for risk-based capital than if the loan were held in portfolio. The MGAs would accept credit losses above that expected loss attachment point. Only in the event of an MGA's inability to pay losses would the federal guarantee step in. For that reason, the need for tight product standards is imperative. Under this structure, private mortgage insurance companies would be permitted to provide borrower- and lender-paid insurance programs to facilitate additional risk transfer. However, captive reinsurance programs that many large lenders developed during the boom period would no longer be permitted. These entities have come under close review by a number of states concerned with the risk-sharing arrangements between state-regulated insurance companies and lenders that ceded insurance premiums to lenders in return for taking additional risk.[50]

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economic crisis and that the IMF regarded Canada's banking system as a "paragon of international best practices" while the World Economic Forum ranked it "soundest in the world").

48. *See* Howard Schneider, *No Bubble, Please, We're Canadian: Conservative Approach to Mortgage Finance Could Provide Model for U.S.*, WASH. POST, June 24, 2010, at A16 (pointing to Canada as better able to weather market fluctuation risks where the majority of Canadian mortgages allow interest rates to reset after five years and carry prepayment penalties); *see also* Eliot Blair Smith, *'Race to the Bottom' at Moody's, S&P Secured Subprime's Boom, Bust*, BLOOMBERG, Sept. 25, 2008, *available at* http://www.bloomberg.com/apps/news?pid=Newsarchive&sid=ax

3vfya_Vtdo (discussing the unsuccessful credit rating models in the U.S. that inflated ratings on unregulated investment pools and induced Wall Street to invest in unsound mortgage-backed securities).

49. Nick Timiraos, *Bank Law Hung Up on Down Payments*, WALL ST. J., Jan. 13, 2011, at C1 (quoting a Wells Fargo official as saying that a risk-retention requirement that banks retain five percent of securitized loans would force a bank to "put[] [its] money where [its] mouth is").

50. *See* Kenneth R. Harney, *Big Rebukes on Title Referrals*, WASH. POST, Dec. 1, 2007, at F01 (discussing the federal government and state regulators' concentration on "under-the-table kickbacks" which had costly results for consumers); *see* Mary Williams Walsh, *California Examines Title Insurers in Fee Splitting*, N.Y. TIMES, Feb. 23, 2005, at C2 (questioning the practice of reinsurance premiums paid from insurers back to captive reinsurers).

Given the criticality of the credit rating process to housing finance,[51] the FHRC would be required to conduct ongoing reviews of the credit ratings assigned to securities under its auspices. This was a significant deficiency by regulators leading up to the crisis and one that is essential to perform in order to maintain integrity and confidence in the secondary market for investors.[52] FHRC would also establish a set of standards for mortgage data origination and servicing across the industry. Such efforts ensure the conformity of data, better accuracy in reporting and aggregation to understand the totality of risk exposures in the market.[53]

While a federal security guarantee would not apply to the private-label market, the FHRC would have an important role in establishing standards for that market. The rationale for this responsibility is to avoid potential contagion effects that could impact the standard market. The subprime mortgage crisis swept through the private-label market and in its path impacted the prime and FHA markets.[54] For that reason, the FHRC would be empowered to set broad programmatic standards with input from lenders and investors.

Defining the structure of the MGAs represents one of the most important aspects of this housing reform proposal. Beyond establishing a minimum number that would mitigate the occurrence of a Too-Big-To-Fail outcome, other considerations for relative size, activities and interactions should be clearly established.[55] MGAs would be managed to comparable size in terms of exposure at risk and would maintain comparable geographic concentrations. This would differ markedly from the FHLB model where 12 regional FHLBs support specific geographies.[56]

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51. *See generally* Wilmarth, Jr., *supra* note 7 (finding that agencies inflated credit ratings and misrepresented the risks of mortgage-related securities during the real estate boom, and thus brought about the collapse of the securitization markets when they cut those ratings in mid-2009).

52. *Cf.* STAFF OF THE OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS, DIVISION OF TRADING AND MARKETS AND OFFICE OF ECONOMIC ANALYSIS, U.S. SECURITIES & EXCHANGE COMMISSION, SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMMISSION STAFF'S EXAMINATIONS OF SELECT CREDIT RATING AGENCIES (2008) (reviewing investigative methodologies used by credit rating agencies, but noting that the SEC is expressly prohibited from regulating "the substance of the credit ratings or the procedures and methodologies" by law).

53. *See* JOINT REPORT, *supra* note 1, at 19 (calling for national standards for mortgage servicing that "better align incentives and provide clarity and consistency to borrowers and investors regarding their treatment by servicers, especially in the event of delinquency").

54. *See Hot Topic: The Subprime Market's Rough Road*, WALL ST. J., Feb. 17, 2007, at A7 (discussing the effect of the subprime mortgage crisis on institutions such as Merill Lynch and J.P Morgan Chase); *see* Kathleen M. Howley, *FHA, Prime Mortgages Defaults at Records on Job Losses*, BLOOMBERG, Nov. 19, 2009, *available at* http://www.bloomberg.com/apps/news? pid=newsarchive&sid=apOfNyUT0FGE (noting that foreclosures on prime mortgages and home loans have resulted in the biggest job losses since the Great Depression).

55. *See Reiss*, supra note 8, at 1050–51 (explaining that Fannie Mae and Freddie Mac are considered by the market to be "Too Big to Fail" because "many financial institutions hold particularly large portions of their portfolios in the two companies' obligations because of federal regulations that encourage such holdings").

56. Flannery & Frame, *supra* note 43, at 38.

Imbalances over time in terms of member institutions have resulted in significant differences in size and risk over time, posing some issues over the viability of the FHLB structure over the long-term.[57] To facilitate comparability, lenders would through a form of deal syndication work with a designated lead MGA through which all MGAs would participate in an equal sharing of risk with issuing lenders. The designated lead MGA would rotate on a periodic basis. In this way, the MGAs would provide comparable risk sharing in the securitization and the syndication process would minimize operational burdens for lenders. MGAs would be prohibited from developing a retained portfolio and are solely in the business of insuring losses in excess of first-loss. Each MGA would be privately capitalized.

FHRC would be complemented by two other entities. First, a Federal Mortgage Guarantee Corporation (FMGC) would provide the FHRC with explicit pricing of the guarantee, maintain and manage the guarantee reserve, and payout as needed on any claims. This agency could remain a standalone entity outside the FHRC. Second, a National Mortgage Servicing Unit (NMSU) would be established to provide direct servicing of mortgages covered by the federal guarantee. The NMSU would be cooperatively owned and funded by the MGAs. Servicing costs would be a component of the fees charged by the MGAs. The NMSU would also fall under regulatory review of the FHRC.

Creating this single mortgage servicing company is a departure from current practice where large lenders maintain mortgage servicing units. Several flaws in that process have emerged, rendering that model unsuitable for taxpayers and borrowers. First, mortgage servicing and the advent of the market for mortgage servicing rights (MSRs) is a volatile business that over time has caused considerable trouble for mortgage firms trying to manage this business via sophisticated hedging strategies.[58] Several large banks have experienced major swings in earnings as a result of poor hedging of MSRs in recent years.[59] Allowing for a cooperative-

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57. *See generally id.* at 38–52 (illustrating difference in asset size and number of members of each regional FHLB in Table 4 and concluding that risk-taking incentives at the individual banks is increased by joint-and-several liability across the FHLB system).

58. *See* Levitin & Twomey, *supra* note 21, at 21 ("[I]nvestors in [private-label securitizations (PLS)] assume both credit and interest-rate risk on the mortgages. PLS do not come with a guarantee of timely payment of principal and interest. Because of this, PLS typically involve some sort of interest-rate hedge, as well as various internal and external credit enhancements to reduce credit risk."). *See generally* Gretchen Morgenson, *Opening the Bag of Mortgage Tricks*, N.Y. TIMES, Dec. 19, 2010, at BU1 (discussing lawsuit brought by mortgage investors against servicer where jury affirmed claims of conspiracy and breach of contract, of fiduciary duty, and of good faith and fair dealing).

59. *See, e.g.*, Peter Eavis, *Unlocking the MSR Mystery*, WALL ST. J., Oct. 23, 2009, at C10 (describing how shares in Wells Fargo decreased upon disclosure that hedging, designed to offset sharp fluctuations in MSR, produced a 150% increase in servicing income compared to the prior quarter despite an actual decrease in the value of its MSRs during that time).

ownership model of servicing operations among the MGAs would mitigate some of the volatility issues affecting banks by transferring this critical service to an entity solely focused on its mission.[60]

That mission includes timely distribution of payments to stakeholders and investors, ensuring data integrity and quality as the nation's repository for standard mortgage servicing data, and ensure adherence to federal and state default and foreclosure programs and laws. Consolidation of the mortgage servicing business over time has brought significant efficiencies; however, the cyclicity of the mortgage business and a general unevenness across the industry in terms of process effectiveness, platform consistency, data standardization and warehousing capability have posed serious challenges to coordinated default and foreclosure management as well as generating considerable confusion over title claims among various parties.[61] Establishing a single servicing platform with state-of-the-art systems and practices would greatly enhance the housing finance system. Fannie Mae and Freddie Mac servicing systems have been patched together over the last couple of decades with great difficulty, expense and with limited effect.[62] The Mortgage Electronic Registry System (MERS) was established to improve the process surrounding mortgage registration, but the recent foreclosure crisis has shown that even this process has had its challenges.[63] Another benefit from the NMSU is that it eliminates the principal-agent problems of current servicing arrangements.[64] Today, Fannie Mae and Freddie Mac provide limited review of mortgage servicing operations.[65] This presents challenges to ensuring that each servicer is performing its duties consistent with the

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60. *See id.*(discussing the changing value of mortgage-servicing rights); Levitin & Twomey, *supra* note 21 (explaining how the principal-agent conflict arises because servicers are disinterested in the performance of the loan and how the servicing industry encourages underinvestment); Morgenson, *supra* note 48 (discussing conflicts of interest that arise with servicers in denying loan modifications because the servicer owns a second mortgage on the property and when default fees go to the servicer instead of the investor).

61. *See* Levitin & Twomey, *supra* note 21, at 4–5, 25 n.73 (discussing the increasingly consolidated nature of the servicing industry and problems associated w th automated default administration, including the robo-signing scandal which involved major servicers carelessly signing off foreclosure cases without personal knowledge).

62. *See generally* Zachary A. Goldfarb, *Officials Looking at Ways to Protect Housing Market*, WASH. POST, Jan. 19, 2011, at A10 (describing how a new compensation structure for servicers would allow them to receive fees for restructuring mortgages in order to prevent foreclosures).

63. *See* Michael Powell & Gretchen Morgenson, *MERS? It May Have Swallowed Your Loan*, N.Y. TIMES, Mar. 5, 2011, at BU1 (describing the impetus for the creation of MERS as streamlining and centralizing record-keeping, but reporting that the recent foreclosure crisis revealed the system to be unreliable and that MERS "often confused or misrepresented who owned mortgage notes").

64. *See* Levitin & Twomey, *supra* note 21 (explaining that the principal-agent conflict arises because servicers are disinterested in the performance of the loan because their compensation is not dependent on the return to investors).

65. *Id.* at 66.

servicing agreements in place with each GSE. With the NMSU, clear tracking of each mortgage with its associated security would be conducted and with it improvements in reporting aggregate exposures in the system. Beyond these benefits lies more responsive and accurate treatment of delinquent borrowers that have thus plagued servicer loan modification and foreclosure efforts.[66]

Thus far little has been established regarding the type of financing structures that could accommodate this new regulatory and guarantee framework.[67] Under this proposal, a standard MBS structure would be allowed within the risk-sharing arrangement described earlier. With the first loss risk retention component for originators, the MBS is a preferred instrument for promoting market liquidity. By removing all but the first loss exposure from a bank's balance sheet, it frees up capital for additional lending. A covered bond structure on its own is unlikely to provide sufficient market liquidity on the scale needed in the US due largely to the requirement that the underlying mortgages remain on the bank's balance sheet and presumably with regulatory capital charges more onerous than securitization. That does not mean that covered bonds do not have a major role in housing finance going forward.

One of the major ways banks fund mortgages today is via FHLB advances.[68] Advances bear some similarities to covered bonds in that they serve as collateralized loans allowing banks to fund their mortgage activities.[69] While intended to provide low-cost financing of mortgages due to the GSE implied subsidy to the FHLBs, recent evidence has found that advances are likely to have financed nonmortgage activities.[70] Under the proposed reform structure, with the elimination of the FHLBs, advances would be replaced with covered bonds. Banks could offer covered bond programs directly, if sufficiently large to enter capital markets, or could work with an MGA to pool covered bond assets across multiple lenders for sale into a secondary market. A constraint that would need to be addressed is FDIC's limit on a

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66. *See e.g.*, Jenifer McKim, *Promised Relief, Many Instead Deeper in Debt*, BOSTON GLOBE, Mar. 7, 2011 (describing CitiMortgage's rejection of an individual's loan modification application when he owed twelve months of deferred principal, interest and fees).

67. *See infra* p. 369.

68. *See* W. Scott Frame et al., *Federal Home Loan Bank Advances and Commercial Bank Portfolio Composition* 5 (Federal Reserve Bank of Atlanta, Working Paper 2007-17, July 2007) ("Advances are historically the dominant activity conducted by the FHLB System[.]"); Arthur Wilmarth, Jr., *Subprime Crisis Confirms Wisdom of Separating Banking and Commerce*, BANKING & FIN. SERVICES POL'Y REP., May 2008, at 1, 6 ("During the second half of 2007, the [FHLBs] provided more than $200 billion in secured credit to Citigroup, Countrywide, Merrill Lynch, Wachovia, and Washington Mutual[.]").

69. *See* Flannery & Frame, *supra* note 43, at 33.

70. *See generally* Frame et al., *supra* note 68, at 3 (finding that FHLB advances are as likely to fund other types of bank credit as they are to fund mortgages and that banks are increasingly relying on the advances as a wholesale funding source).

bank's percentage of covered bonds to total liabilities. Covered bondholders have seniority in claims on the institution should it fail, and that has presented challenges to FDIC in ensuring depositors maintain a senior position in claims on assets of failed banks. FHLB advances likewise enjoy seniority in claim status over assets and the FDIC could easily raise the covered bond limit as advances are replaced with covered bonds in the system.

Establishing this new structure provides a way forward for transformative change in the way housing is financed. But comprehensive reform must address the transition of Fannie Mae, Freddie Mac, the FHLBs and their regulatory agency. Until the new structure is fully functioning, the GSEs would continue to operate under conservatorship as today.[71] During this transition period, a new temporary agency would be formed from units of Fannie Mae, Freddie Mac, and the FHLBs to serve as a wind-down facility on the existing assets of all entities. This "bad bank" solution would continue to manage and oversee the rundown of the portfolios and outstanding MBS over time. Units from the current Federal Housing Finance Agency could be incorporated into the new regulatory agency and it is possible that units from Fannie Mae and Freddie Mac guarantor and capital markets functions could be brought into the new Federal Mortgage Guarantee Corporation.

This proposal to reform the housing finance sector addresses the objectives set out at the onset of this discussion. A central theme to the proposal is that housing will remain in a class by itself from other assets due to its longstanding specialness in terms of social policy and its unique importance in promoting economic stability and performance. That significance warrants tighter oversight of the mortgage lifecycle than ever before, particularly with the inclusion of a federal guarantee for the mortgage security instrument. Consequently, the best model fitting that situation is a form of public utility regulation that closely monitors and regulates product standards and establishes a set of fair prices for its regulated entities. Creation of ten new privately funded mortgage guarantee corporations mitigates the Too-Big-To-Fail exposure to the taxpayer.[72] However, the systemic risk in the event of another major mortgage crisis affecting the entire industry, while remote is not eliminated, from the process but no system can completely remove that risk. A tightly regulated industry augmented with a single servicing entity for securitized mortgages under federal guarantee represents the best chance for long-term viability of housing by addressing critical deficiencies in the current system.

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71. *See* JOINT REPORT, *supra* note 1, at 7.

72. *See* note 58 and accompanying text.