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## ESSAY

# A TROUBLED HOUSE OF CARDS: EXAMINING HOW THE HOUSING AND ECONOMIC RECOVERY ACT OF 2008 FAILS TO RESOLVE THE FORECLOSURE CRISIS

CHAD D. EMERSON\*

### *I. Introduction*

Since the American housing crisis erupted in the summer of 2007, Congress has succumbed to a law-making binge aimed at mitigating the growing problems in the real estate industry. Unfortunately, most of these legislative maneuvers utterly fail to address the core causes behind the housing predicament. The worst example of this problem is the Housing and Economic Recovery Act of 2008—a recently-signed bill that mistakes spending vast sums of money, while establishing new layers of federal bureaucracy, with actually resolving the underlying issues that have provoked this deepening crisis.<sup>1</sup>

This essay examines the origins of the Housing and Economic Recovery Act of 2008 (the HERA Act) and identifies the Act's two most significant failures. In doing so, the essay provides regulatory alternatives to the failures of the Act—solutions geared toward fixing the underlying problems that have exacerbated what some commentators consider to be the worst American housing crisis since the Great Depression.<sup>2</sup>

### *II. Origins of the Housing and Economic Recovery Act of 2008*

Congress passed the HERA Act on July 26, 2008, which President George W. Bush then signed four days later on July 30, 2008.<sup>3</sup> The result of these actions was that, within the course of one week, one of the most misdirected

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1. Pub. L. No. 110-289, 122 Stat. 2654 (2008).

2. The Worst Economic and Financial Crisis in Decades: Posting to Nouriel Roubini's Global EconoMonitor, [http://www.rgemonitor.com/blog/roubini/253378/the\\_worst\\_economic\\_and\\_financial\\_crisis\\_in\\_decades](http://www.rgemonitor.com/blog/roubini/253378/the_worst_economic_and_financial_crisis_in_decades) (Aug. 20, 2008) (login required).

3. 122 Stat. 2654.

attempts at addressing the ongoing housing crisis was enacted into law. To understand the failures of the Act, one must consider how the American housing market arrived at such an ominous point in the first place.

*A. The Birth of Mortgage Debt as a Trading Tool*

Under current practice, after a new mortgage is closed, that loan is often packaged with other home loans into a device known as a mortgage-backed security.<sup>4</sup> The security is then sold on a secondary market to an investor who typically receives a portion of the interest or, in some cases, the principal of the aggregated loans.<sup>5</sup>

At face value, this concept seems to make sense: a large group of mortgages combined together present less risk than the purchase of a single mortgage investment because, even if a percentage of the pooled loans fail, the remaining ones continue to provide some value to the security. On the other hand, if you invest in a single loan and that loan defaults, then the entire investment is lost. As one commentator noted:

Institutional investors who would have stayed away from investing in whole mortgages due to the risk of default . . . were much more likely to purchase credit-enhanced multi-class mortgage-backed securities that resembled corporate bonds.<sup>6</sup>

Ultimately, the key for the mortgage-backed security investor is to make sure that the overall pool of loans is reliable enough to offset failures in individual parts of the pool. Significantly though, the buying, selling, and trading of mortgages is a relatively new phenomenon. Historically, the bank providing the loan would keep the loan as an asset.<sup>7</sup> However, from the 1970s to the 1990s, the secondary market for mortgage securities exploded in growth.<sup>8</sup> For instance, in 1984, Americans possessed \$1.3 trillion worth of

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4. U.S. Sec. & Exch. Comm'n, Mortgage-Backed Securities, <http://www.sec.gov/answers/mortgagesecurities.htm> (last visited Jan. 6, 2009) (describing the mortgage-backed security process).

5. *Id.*

6. Michael H. Schill, *The Impact of the Capital Markets on Real Estate Law and Practice*, 32 J. MARSHALL L. REV. 269, 280 (1999).

7. Peter M. Carrozzo, *Marketing the American Mortgage: The Emergency Home Finance Act of 1970, Standardization, and the Secondary Market Revolution*, 39 REAL PROP. PROB. & TR. J. 765, 766 (2004-2005).

8. *Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit Before the H. Subcomm. on Housing and Community Opportunity*, 108th Cong. (2003) (statement of Cameron L. Cowan of Orrick, Herrington, and Sutcliffe, L.L.P. on behalf of the American Securitization Forum), available at <http://financialservices.house.gov/media/pdf/110503cc.pdf>.

mortgage debt with 23%, or \$303.6 billion of that total held as mortgage-backed securities.<sup>9</sup> By 1998, the overall mortgage total had grown to \$4.1 trillion while the percentage held as securities had expanded to \$2.1 trillion, or 52% of all mortgages.<sup>10</sup>

Driving this expansion of the secondary mortgage market were two unique corporate entities. In 1938, Congress established the Federal National Mortgage Association to provide loan liquidity during the Depression Era.<sup>11</sup> Known more commonly as Fannie Mae, the association was originally structured as a government entity that bought and sold federally insured mortgages.<sup>12</sup> This allowed a secondary market to grow as potential investors expressed greater confidence in a federally-backed scheme.<sup>13</sup> Then, in 1968, Congress established the Government National Mortgage Association (Ginnie Mae) to operate low income home loan programs previously controlled by Fannie Mae.<sup>14</sup> In turn, Fannie Mae was converted into a private corporation that bought and sold both government insured and non-government insured mortgages.<sup>15</sup> The unique twist was that, even though Fannie Mae was a private company with shareholders and its own management team, the federal government implicitly guaranteed the loans that Fannie Mae transacted.

Apparently pleased with its creation, Congress established a similar corporation in 1970—the Federal Home Loan Mortgage Corporation, commonly known as Freddie Mac.<sup>16</sup> The end result was an unprecedented situation: these two privately-held corporations operated in the private mortgage market with implicit federal financial backing—partly justified because both corporations continued to maintain some affordable housing quotas within their federally-established charters.<sup>17</sup> In an attempt to define

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9. Fed. Reserve, *Financial & Business Statistics*, 73 FED. RES. BULL. A39 (June 1987).

10. Fed. Reserve, *Financial & Business Statistics*, 85 FED. RES. BULL. A35 (Aug. 1998).

11. Federal National Mortgage Association Charter Act, 12 U.S.C. §§ 1716-1723 (2006), available at <http://www.ofheo.gov/media/pdf/FNM charter406.pdf>.

12. Kate Pickert, *A Brief History of Fannie Mae and Freddie Mac*, TIME, July 14, 2008, available at <http://www.time.com/time/business/article/0,8599,1822766,00.html> (last visited Mar. 10, 2009).

13. FundingUniverse.com, Fannie Mae, <http://www.fundinguniverse.com/company-histories/Fannie-Mae-Company-History.html> (last visited Mar. 10, 2009).

14. Housing and Urban Development Act of 1968, Pub. L. No. 90-448, 82 Stat. 476.

15. 12 U.S.C. §§ 1716-1723 (2006).

16. Federal Home Loan Mortgage Corporation Act, Pub. L. No. 91-351, 84 Stat. 450 (1970).

17. See Fannie Mae, About Fannie Mae, <http://www.fanniemae.com/aboutfm/charter.jhtml> (last visited Jan. 6, 2009) (describing a general history of the congressional acts creating and transforming Fannie Mae); Freddie Mac, About Freddie Mac, [http://www.freddiemac.com/corporate/about\\_freddie.html](http://www.freddiemac.com/corporate/about_freddie.html) (last visited Jan. 6, 2009) (describing Freddie Mac).

their unique nature, Congress elected to describe Fannie Mae and Freddie Mac as Government Sponsored Enterprises (GSEs).<sup>18</sup>

Up until this time, the secondary mortgage market was relatively nascent. The slow emergence of the secondary mortgage market was no surprise because an effective secondary market requires pooling a large number of overall loans so that risk can be disbursed within the aggregate. It was not until Fannie Mae and Freddie Mac began buying large chunks of conventional loans in the 1970s that such a critical mass existed.<sup>19</sup>

Rather than simply buying the loans from the issuing lender and holding them as an investment, Fannie Mae and Freddie Mac realized that they could capitalize on their economies of scale and package these loans into a larger security, which they could then resell to investors and realize an even larger profit than they did from the interest on individual loans. The importance of this increased profit potential was especially strong since the companies (and their management) were “owned” by private shareholders.

The growth of Fannie Mae and Freddie Mac provided a powerful impetus for an expanding secondary mortgage market.<sup>20</sup> There were willing and almost guaranteed buyers for many mortgage loans, a reality that incentivized banks and other lenders prolifically to write loans that could then be sold to Fannie Mae and Freddie Mac.<sup>21</sup> Indeed, as one commentator noted, “[f]inancial institutions became increasingly willing to originate home loans when they knew that a secondary mortgage market agency such as Fannie Mae or Freddie Mac stood ready to purchase them.”<sup>22</sup> Unfortunately, the number of Americans that maintain strong enough finances to qualify for a conventional mortgage, one that requires a 10% to 20% down payment and a fixed rate interest term, is finite. Therefore, just as mortgage lenders were writing more loans, they were also depleting the available pool of homebuyers who could reasonably afford these loans.

Two solutions existed for this problem: reduce the number of loans or expand the pool of potential homebuyers. For a private mortgage industry seeking to generate profits, the best choice was obvious—increase the pool of available borrowers. To do this, the market would deviate from the conventional format of fixed-rate loans that included a homebuyer down payment to a system of new loan types that temporarily reduced the interest rates, dramatically cut or eliminated the down payment amount or, in some

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18. Rob Alford, *What Are the Origins of Freddie Mac and Fannie Mae?*, HISTORY NEWS NETWORK, Dec. 8, 2003, available at <http://hnn.us/articles/1849.html>.

19. Carrozzo, *supra* note 7, at 800.

20. *Id.*

21. Schill, *supra* note 6, at 280.

22. *Id.*

cases, did both. This system became known as the subprime mortgage market.<sup>23</sup> By offering low, teaser rate loans, the lenders were able to reduce the mortgage's monthly payment to a level that more homebuyers could afford, at least during the initial phase of the teaser rate.<sup>24</sup> As Federal Reserve Chairman Ben Bernanke would note in May 2007, just as the subprime mortgage market was realizing an increased number of defaults, "[t]he expansion of subprime mortgage lending has made homeownership possible for households that in the past might not have qualified for a mortgage and has thereby contributed to the rise in the homeownership rate since the mid-1990s."<sup>25</sup>

Unfortunately, these low interest rates were not fixed, meaning that after an initial time period, they would "adjust" to a permanent rate, one that almost invariably would be significantly higher than the original teaser rate.<sup>26</sup> As a result, as the interest rate rose, so, too, did the monthly payment—a dangerous new expense for homeowners who needed these gimmick loans in the first place because their finances did not qualify them for conventional loans. This dubious method for increasing the potential pool of mortgages would be aided by an unexpected event whose aftermath would infuse the economy with the large amount of cheap capital needed to feed the rapidly expanding mortgage machine.

#### *B. The Black Swan of 9/11*

In his 2007 bestselling book, epistemologist Nassim Nicholas Taleb discusses what he calls the "Black Swan" phenomenon.<sup>27</sup> The "Black Swan" metaphor is based on the once held belief that all swans were white rather than black swans, a belief that would prove inaccurate when a black swan was discovered in seventeenth century Australia.<sup>28</sup> Taleb's theory is that major societal changes are sometimes instigated by unanticipated events—the

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23. Ben S. Bernanke, Chairman, Fed. Reserve Bd., Speech at the Federal Reserve Bank of Chicago's 43rd Annual Conference on Bank Structure and Competition: The Subprime Mortgage Market (May 17, 2007), *available at* <http://www.federalreserve.gov/newsevents/speech/bernanke20070517a.htm> (general description related to the development of the subprime mortgage market).

24. *Id.*

25. *Id.*

26. Robert Kuttner, *The Bubble Economy*, AM. PROSPECT, Oct. 2007, at 20, *available at* [http://www.prospect.org/cs/articles?article=the\\_bubble\\_economy](http://www.prospect.org/cs/articles?article=the_bubble_economy).

27. NASSIM N. TALEB, *THE BLACK SWAN: THE IMPACT OF THE HIGHLY IMPROBABLE* (2007).

28. Stephanie Baker-Said, *Taleb Outsell Greenspan as Black Swan Gives Worst Turbulence*, BLOOMBERG MARKETS, May 2008, at 38, *available at* [http://www.bloomberg.com/apps/news?pid=20601109&refer=home&sid=aHfkhe8.C.\\_8](http://www.bloomberg.com/apps/news?pid=20601109&refer=home&sid=aHfkhe8.C._8).

discovery of a black swan—that, until then, were not considered to be within the realm of possibility.<sup>29</sup>

Under Taleb's thesis, society often does not recognize the triggering event for significant changes until after the event has occurred.<sup>30</sup> This is often because the event itself would not have seemed predictive of the major change.<sup>31</sup> In the context of the subprime mortgage market, the tragic events of September 11, 2001, represented a leading "Black Swan" trigger for the current housing crisis.

The 9/11 terrorist attacks fulfilled this role because, in their immediate aftermath, a battered U.S. financial system prompted the United States Federal Reserve (the Fed) to dramatically lower its main lending rate, eventually reducing it to 1%, among the lowest rates ever offered by the Fed.<sup>32</sup> The Federal Reserve took this step to stimulate economic activity by making the cost of borrowing money extremely low.<sup>33</sup> The idea was that, even with its confidence shaken by brazen terrorist attacks, the U.S. economy would be unable to resist such historically cheap money.<sup>34</sup> Such a response would, in turn, lead to increased lending and spending, activities that had driven domestic financial growth through the previous two decades.<sup>35</sup>

As one commentator Daniel Gross summarized the situation:

After the recession came in 2001, followed by the attacks of 9/11, Congress and the White House jacked up spending and cut taxes massively, and Alan Greenspan sought to blow air into a slack economy by slashing interest rates furiously and keeping them low—which has proved a huge boost to the vast housing-related complex. Cheap and easy money begat higher home prices, which further boosted the demand for cheap and easy money, which begat higher home prices yet again. Meanwhile, falling interest rates allowed people to turn their homes into ATMs through mortgage refinancings.<sup>36</sup>

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29. TALEB, *supra* note 27, at Introduction.

30. *Id.*

31. *Id.*

32. Martin Crutsinger, *Greenspan, Other Fed Officials Sought to Restore Confidence Following 2001 Terrorist Attacks*, ASSOCIATED PRESS, May 15, 2007, available at [http://www.blnz.com/news/2007/05/15/Federal\\_Reserve\\_details\\_post-9/11\\_effort\\_9-11.html](http://www.blnz.com/news/2007/05/15/Federal_Reserve_details_post-9/11_effort_9-11.html).

33. See Daniel Gross, *Bubble over Troubled Waters*, SLATE, June 28, 2005, <http://www.slate.com/id/2121684>.

34. *Id.*

35. *Id.*

36. *Id.*

Though Daniel Gross would correctly recognize that the Federal Reserve's interest rate cuts would spur higher home prices, his conclusion that this strategy would benefit the U.S. economy wildly missed the mark.<sup>37</sup> Indeed, the Federal Reserve's plan to keep America churning through the availability of cheap money actually worked too well. The low interest rates not only navigated the economy through the post-9/11 challenges but also provoked such prolific lending that it would transform itself from the solution to the problem.

By 2003, the financial markets had become so flush with money that the traditional market for mortgages would prove insufficient compared to all of the available money.<sup>38</sup> This further whetted the lenders' appetite for riskier subprime mortgages and increased their already large pool of potential applicants. All seemed well for several years post-9/11 as home values increased, and the large doses of cheap money stoked credit spending by consumers and businesses.

By October 2005, though, problems began to emerge. Wall Street analyst Meredith Whitney made news by predicting that the subprime housing situation was a crisis-in-waiting.<sup>39</sup> Her prediction was generally regarded as one of the first major warnings that the mortgage house of cards was about to crumble.<sup>40</sup> As it turned out, the accuracy of this prediction would soon prove true.

### *C. The Failure to Learn From the LTCM Debacle*

In the mid 1990s, the federal government's response to a similar financial crisis unwittingly encouraged the financial markets (including the housing concerns) to continue these risky lending strategies while hedging those risks on the possibility that, if things got too bad, the federal government would provide a safety valve.<sup>41</sup> The previous crisis was the failure of the Long-Term Capital Management (LTCM) hedge fund.<sup>42</sup> Following the 1997 Asian Financial Crisis and the 1998 Russian Government Debt Default, the highly

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37. *Id.*

38. Fred W. Frailey, *15 Things You Need to Know About the Panic of 2008*, KIPLINGER, Sept. 19, 2008, [http://www.kiplinger.com/features/archives/2008/09/how\\_the\\_financial\\_crisis\\_started.html](http://www.kiplinger.com/features/archives/2008/09/how_the_financial_crisis_started.html).

39. Jon Birger, *Whitney: Credit Crunch Far from Over*, FORTUNE, Aug. 5, 2008, [http://money.cnn.com/2008/08/04/news/newsmakers/whitney\\_oppenheimer.fortune/](http://money.cnn.com/2008/08/04/news/newsmakers/whitney_oppenheimer.fortune/).

40. *Id.*

41. See Roger Lowenstein, *Long-Term Capital: It's a Short-Term Memory*, N.Y. TIMES, Sept. 7, 2008, at BU1, available at [http://www.nytimes.com/2008/09/07/business/07lctm.html?\\_r=1](http://www.nytimes.com/2008/09/07/business/07lctm.html?_r=1).

42. *Id.*



leveraged LTCM found itself unable to meet all of its financial obligations.<sup>43</sup> However, rather than allow the hedge fund to fail—primarily because it feared the intertwined consequences that might result from such a large failure—the Federal Reserve organized a \$3.6 billion bailout package that allowed the fund to meet its obligations.<sup>44</sup> While this staved off the fund's immediate death, LTCM would eventually close down in 2000.<sup>45</sup>

The LTCM bailout raised the concern that the Federal Reserve's intervention would implicitly promote the risky type of highly leveraged strategies embraced by LTCM because other large funds and companies could also expect the federal government to bail them out.<sup>46</sup> In other words, though no express guarantees would be made, companies with extensive and intertwined investment portfolios would reasonably believe that, in the event of catastrophic losses, the government would save them to avert a perceived larger risk to the system.

Indeed, even while denying that the LTCM intervention constituted a bailout, Alan Greenspan, then-Chairman of the Federal Reserve Board, acknowledged this very risk in testimony before Congress:

Of course, any time that there is public involvement that softens the blow of private-sector losses—even as obliquely as in this episode—the issue of moral hazard arises. Any action by the government that prevents some of the negative consequences to the private sector of the mistakes it makes raises the threshold of risks market participants will presumably subsequently choose to take. Over time, economic efficiency will be impaired as some uneconomic investments are undertaken under the implicit assumption that possible losses may be borne by the government.<sup>47</sup>

The government's intervention in LTCM's failure would seem to have done exactly what was feared—provide a financial backstop for the riskiest forms of financial behavior.<sup>48</sup> Indeed, by 2008, this reality was lent further credence as the federal government stepped in to orchestrate massive bailout programs

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43. BRUCE I. JACOBS & KENNETH N. LEVY, *MARKET NEUTRAL STRATEGIES* 159 (2005).

44. Lowenstein, *supra* note 41.

45. JACOBS & LEVY, *supra* note 43, at 162.

46. Tyler Cowen, *Was an Old Bailout a Bad Precedent?*, N.Y. TIMES, Dec. 28, 2008, at BU5, available at [http://www.nytimes.com/2008/12/28/business/economy/28view.html?\\_r=2&ref=todayspaper](http://www.nytimes.com/2008/12/28/business/economy/28view.html?_r=2&ref=todayspaper).

47. Alan Greenspan, Chairman, Fed. Reserve Bd., Private-Sector Refinancing of the Large Hedge Fund, Long-term Capital Management: Testimony Before the Committee on Banking and Financial Services, U.S. House of Representatives (Oct. 1, 1998), available at <http://www.federalreserve.gov/BOARDDOCS/TESTIMONY/1998/19981001.htm>.

48. Lowenstein, *supra* note 41.

for the investment bank Bear Stearns and multi-national insurance giant AIG.<sup>49</sup> Even before 2008, however, the U.S. housing industry was engaged in equally risky investment strategies that would ultimately and brilliantly fail beginning in the summer of 2007.

#### *D. The Breaking Point of 2007*

Every house of cards eventually has a breaking point at which the entire structure collapses even though only a single new card is added. For the housing industry (and many would argue the financial industry as a whole), this pivotal time occurred in mid-2007.

One of the first indices of the housing meltdown occurred in April 2007 when the country's largest subprime lender, New Century Financial, capitulated to collateral calls that resulted from increasing mortgage defaults and filed bankruptcy.<sup>50</sup> By August 2007, the mortgage problems extended beyond the subprime market as American Home Mortgage, a company that generally operated above the subprime market, filed bankruptcy.<sup>51</sup> Later that month, the growing defaults in mortgages, both prime and subprime, would force Countrywide Mortgage, the nation's largest mortgage issuer when measured by dollar amounts, to seek \$11.5 billion worth of emergency financing.<sup>52</sup> It would also drive large subprime lender AmeriQuest into bankruptcy.<sup>53</sup>

Once again, as it had done following 9/11, the Federal Reserve (and numerous other central banks) attempted to stave off fiscal disaster by injecting "cheap money" back into the financial markets.<sup>54</sup> This time, however, the gambit failed to work; there was by then simply too much bad

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49. Edmund L. Andrews, *Fed's \$85 Billion Loan Rescues Insurer*, N.Y. TIMES, Sept. 17, 2008, at A1, available at <http://www.nytimes.com/2008/09/17/business/17insure.html?scp=1&sq=FED%20IN%20AN%20%2485%20BILLION%20RESCUE%20OF%20AN%20INSURER%20NEAR%20FAILURE&st=cse>.

50. Adam B. Ashcraft, *Measuring the Impact of Securitization on Imputed Bank Output at 6* (Feb. 4, 2008) (unpublished manuscript), available at [http://www.vanderbilt.edu/AEA/AEAStat/papers/Ashcraft\\_and\\_Steindel\\_1-2008.pdf](http://www.vanderbilt.edu/AEA/AEAStat/papers/Ashcraft_and_Steindel_1-2008.pdf).

51. *American Home Mortgage Files for Bankruptcy*, USA TODAY, Aug. 7, 2007, available at [http://www.usatoday.com/money/economy/housing/2007-08-06-american-home-mortgage-bankruptcy\\_N.htm](http://www.usatoday.com/money/economy/housing/2007-08-06-american-home-mortgage-bankruptcy_N.htm).

52. Neil Irwin & Tomoeh M. Tse, *Wall St. Buckles, Bounces Back*, WASH. POST, Aug. 17, 2007, at A1, available at [http://www.washingtonpost.com/wp-dyn/content/article/2007/08/16/AR2007081600773\\_pf.html](http://www.washingtonpost.com/wp-dyn/content/article/2007/08/16/AR2007081600773_pf.html).

53. Posting of Matt Padilla to <http://mortgage.freedomblogging.com/2007/08/31/ameriquest-to-shut-down> (Aug. 31, 2007, 18:54 PST).

54. Nils Pratley, *Markets in Trouble? Throw Money at the Problem. Lots of It*, THE GUARDIAN (London), Aug. 11, 2007, at 1, available at <http://www.guardian.co.uk/business/2007/aug/11/usnews.useconomy2>.

debt from failing mortgage-backed securities. Though the Federal Reserve and Treasury Department would devise a host of responses well into 2008, by that summer the crisis continued to grow as the government resorted to guaranteeing the bad debt of a failing Bear Stearns.<sup>55</sup> With options running low, Congress decided to step in and open the federal coffers in an attempt to stop the mortgage failures that seemed intent on breaking the financial markets that invested in them. As credit tightened, Congress acted. Unfortunately, it elected for a fundamentally flawed response.

#### *E. Congress' Fundamentally Flawed Response*

Once upon a time, Americans often celebrated a mortgage payoff with a ritual burning of the mortgage papers, an act so symbolic that iconic television families such as the Waltons and the Bunkers centered whole episodes on this type of celebration.<sup>56</sup> Yet, today, rather than burning them, many Americans are getting burned by their mortgages. For instance, in the 1980s, the equity in the homes of Americans reached approximately 70% of the home's value.<sup>57</sup> However, with the increasing popularity of second mortgages (marketed more palatably as "home equity loans") and low or no down payment loans, the percentage had dropped to less than 50%, the first time that level has been reached since World War II.<sup>58</sup>

By May 2008, the foreclosure crisis had also expanded to prime mortgages with the two key measures of mortgage delinquencies almost doubling over the prior year.<sup>59</sup> The failure of these traditionally reliable loans further entrenched a cycle where increased foreclosures led to banks tightening lending standards which, in turn, reduced the available pool of loans and

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55. Jim Zarroli, *Morning Edition: Bernanke Defends Fed's Rescue of Bear Stearns* (Nat'l Pub. Radio broadcast Apr. 4, 2008), available at <http://www.npr.org/templates/story/story.php?storyId=89369942>.

56. See TV.com, All in the Family: "Mike Makes His Move," <http://www.tv.com/all-in-the-family/mike-makes-his-move/episode/38216/summary.html> (last visited Oct. 12, 2008) (Bunker Family mortgage-burning party); TV.com, The Waltons: "The Celebration," [http://www.tv.com/the-waltons/the-celebration/episode/59429/summary.html?tag=ep\\_list;ep\\_title;14](http://www.tv.com/the-waltons/the-celebration/episode/59429/summary.html?tag=ep_list;ep_title;14) (last visited Oct. 12, 2008) (Walton party).

57. Louise Story, *Home Equity Frenzy Was a Bank Ad Come True*, N.Y. TIMES, Aug. 14, 2008, at A1, available at [http://www.nytimes.com/2008/08/15/business/15sell.html?pagewanted=2&\\_r=2&adxnnl=1&ref=business&adxnnlx=1219154453-HaN14pYFYOGkd13YdJTkew](http://www.nytimes.com/2008/08/15/business/15sell.html?pagewanted=2&_r=2&adxnnl=1&ref=business&adxnnlx=1219154453-HaN14pYFYOGkd13YdJTkew).

58. *Id.*

59. Les Christie, *The Next Wave of Mortgage Defaults*, CNNMONEY.COM, Aug. 16, 2008, [http://money.cnn.com/2008/08/12/real\\_estate/prime\\_defaults\\_price\\_drops/index.htm?ref=patrick.net](http://money.cnn.com/2008/08/12/real_estate/prime_defaults_price_drops/index.htm?ref=patrick.net).

stunted sales. The consequence of these stunted sales was an even greater decline in home values.<sup>60</sup>

In July 2008, Congress responded to this reversal of fortunes by passing the Housing and Economic Recovery Act of 2008.<sup>61</sup> While many economists trace the actual housing crisis to 2007, the true origins of the problem—and, for that matter, the HERA Act itself—go back much further. Indeed, the housing crisis can be traced to the popularization of the idea that the “American Dream” was centered on home ownership—a premise that sounded noble but ultimately proved disastrous in actual practice.

Promoting home ownership is a flawed strategy if accomplishing that goal requires providing unconventional loans to individuals who could not otherwise qualify for conventional ones. Doing so ignores the reality that loans are only as useful and valuable as the borrower’s ability to repay them. Instead of devising unconventional means for writing loans, the logical route would have been to encourage borrowers to delay their home purchase until they had the means for entering into a conventional loan—that is, a loan with a fixed rate and down payment that they could reasonably expect to avoid defaulting on.

This is not to say that emergencies in life sometimes do not create unexpectedly difficult financial challenges. In the present crisis, however, the massive number of loans in default is not the result of medical emergencies or other personal crises. Rather, these loans are overwhelmingly the result of unconventional loans whose terms, once adjusted from their initial rates, overwhelmed the borrower’s budget.<sup>62</sup>

The fact that default rates are significantly tied to the effects of the new rates on adjusting mortgages leads to a significant point: American society unreasonably maintains a strong bias against renting one’s dwelling while saving toward a conventional home purchase. If this bias did not exist, then policymakers might devise a strategy that would promote quality and affordable rental housing that at the very least would allow potential homebuyers to establish the down payment and credit needed to obtain a stable mortgage based on personally-affordable terms. Unfortunately, Congress simply reinforced this bias against rental housing through the provisions of the HERA Act.

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60. *Id.*

61. Pub. L. No. 110-289, 122 Stat. 2654.

62. Patrick Bajari, Sean Chu & Minjung Park, *Quantifying the Triggers of Subprime Mortgage Defaults*, VOXEU.ORG, Feb. 2, 2009, <http://www.voxeu.org/index.php?q=node/2937>.

*F. The Major Provisions of the HERA Act*

The HERA Act itself is divided into three general subparts.<sup>63</sup> The first governs “housing finance reform” and the second and third address “foreclosure prevention” and housing tax-related issues.<sup>64</sup>

The first subpart on housing reform focuses primarily on improving the supervision over the GSEs, both in their financial standing and their progress toward accomplishing their unique missions.<sup>65</sup> This subpart also creates a new regulatory body, the Federal Housing Finance Agency, and outlines the authority that the nascent agency will have over Federal Home Loan Banks like the GSEs.<sup>66</sup> In addition, this first subpart includes the HOPE for Homeowners Program, a somewhat curious location for this provision since it would logically seem to fall within the “foreclosure prevention” umbrella of the second subpart.<sup>67</sup>

The second major part of the HERA Act related to foreclosure prevention includes as its centerpiece the FHA Modernization Act of 2008.<sup>68</sup> Operating under the goal of “Building American Homeownership,”<sup>69</sup> this program revamps FHA lending practices related to: a) down payments; b) conforming loan types; and c) mortgage counseling matters.<sup>70</sup> This part also includes new programs and reforms related to veterans’ housing,<sup>71</sup> service member housing,<sup>72</sup> mortgage disclosure matters,<sup>73</sup> and block grants covering “emergency assistance for the redevelopment of abandoned and foreclosed homes.”<sup>74</sup>

The third and final section of the HERA Act regulates multi-family, single family, and real estate investment trust tax matters, and it includes increased tax deductions and a form of tax credit “loan” for certain homebuyers.<sup>75</sup>

While the HERA Act itself is filled with a wide variety of matters, several provisions represent the most significant aspects of the legislation. These

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63. 122 Stat. 2654-2913.

64. *Id.*

65. *See id.* at 2661-62.

66. *See id.* at 2661-64.

67. *Id.* at 2800.

68. *Id.* at 2830.

69. *Id.*

70. *Id.* at 2836.

71. *Id.* at 2858.

72. *Id.* at 2848.

73. *Id.* at 2855.

74. *Id.* at 2850.

75. *Id.* at 2877.

include: the HOPE for Homeowners Act of 2008, the Foreclosure Prevention Act of 2008, and the restructuring of GSEs and their lending practices.

*1. HOPE for Homeowners Act of 2008*

The HOPE for Homeowners Act is a voluntary program whereby Congress provides \$300 billion to the Federal Housing Authority (the FHA) to put toward modifying defaulted loans into fixed-rate, thirty-year mortgages.<sup>76</sup> Under this “sub-act,”<sup>77</sup> lenders must first agree to reduce the unpaid principal balance to 90% of the home’s current value—essentially a write-off equating to ten cents on the dollar for the defaulted loan.<sup>78</sup> If the lender agrees to this modification, then the FHA will insure the new loan against default.<sup>79</sup> Other key provisions include limiting the program to only first-time homeowner-occupants,<sup>80</sup> requiring that the homeowners’ mortgage debt exceeds 31% of the homeowners’ income,<sup>81</sup> requiring that homeowners certify under penalty of perjury that they have not intentionally defaulted on their mortgage,<sup>82</sup> and mandating that lenders document and verify the borrower’s actual income via IRS records.<sup>83</sup> The program is scheduled to sunset on September 30, 2011.<sup>84</sup> Housing and Urban Development (HUD) anticipates that 400,000 homeowners (and their lenders) will utilize the program.<sup>85</sup> Funding for the program will primarily come from a new Affordable Housing Trust Fund that will be funded by regular contributions from the GSEs.<sup>86</sup>

*2. Foreclosure Prevention Act of 2008*

The HERA Act also establishes a multifaceted program whose potluck of mini-programs is intended to stave off foreclosure and neighborhood blight.<sup>87</sup> It seeks to accomplish this by “modernizing” the FHA. Examples of this modernization include raising the FHA loan limit from 95% of the area median

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76. *Id.* at 2802.

77. Within the HERA Act, Congress dubbed several provisions as “Acts” themselves. I refer to these provisions as “sub-acts” to clarify this confusing nomenclature that Congress created.

78. 122 Stat. 2801.

79. *Id.* at 2800.

80. *Id.* at 2803.

81. *Id.* at 2801.

82. *Id.*

83. *Id.* at 2803.

84. Housing and Economic Recovery Act of 2008 Frequently Asked Questions, <http://www.hud.gov/news/recoveryactfaq.cfm> (last visited Mar. 13, 2009) [hereinafter HERA FAQs].

85. 122 Stat. 2803.

86. *Id.* at 2712.

87. *Id.*

home price to 110%—with this number capped at 150% of the GSE loan limit.<sup>88</sup> In addition, the Act requires FHA loan recipients to provide down payments of at least 3.5%<sup>89</sup> and undergo even more extensive pre-loan counseling than the FHA currently requires.<sup>90</sup>

Another component of this sub-act provides local communities with nearly \$4 billion worth of additional Community Development Block Grants.<sup>91</sup> These grants are earmarked for redeveloping, rehabilitating, and even purchasing foreclosed homes in an attempt to prevent the crime and blight sometimes associated with neighborhoods with foreclosed homes.<sup>92</sup> This portion of the HERA Act also establishes a revamped loan assistance program for military veterans.<sup>93</sup>

### *3. Restructuring of GSE Regulations and Lending Practices*

The HERA Act also mandates that the GSEs expand the number of loans in low income areas and increase the loan limits in areas that have high costs of living.<sup>94</sup> These efforts, aimed at promoting affordable housing, are supplemented by the Affordable Housing Trust Fund whose proceeds are designated for the development of affordable rental housing.<sup>95</sup>

While the HERA Act contains many more provisions loosely tied to housing and foreclosures, the above provisions represent the most significant (and publicized) portions of the Act. Indeed, they are the components that Congress apparently believes will rescue the residential housing market from the foreclosure malaise. As set forth in the following sections, a closer examination of the Act reveals that this belief is founded neither in fact nor sound practice. Indeed, once exposed to close scrutiny, the HERA Act is likely to wilt through ineffectiveness.

### *III. Positive Effects of the HERA Act*

While the HERA Act is fundamentally flawed in several important ways, it includes several provisions that may have a limited positive effect on the residential mortgage market. Ironically, this positive result is likely unintentional.

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88. *Id.* at 2830-31.

89. *Id.* at 2831.

90. *Id.* at 2836.

91. *Id.* at 2850.

92. *Id.* at 2851.

93. *Id.* at 2858.

94. *Id.* at 2853.

95. *Id.* at 2712.

In particular, the HERA Act overhauls much of the home loan program administered by the FHA. This was done with the goal of saving homeowners from foreclosure by providing a mechanism for restructuring troubled variable interest loans into fixed-rate mortgages.<sup>96</sup> The Act authorizes the FHA to back \$300 billion worth of these revamped loans.<sup>97</sup> In doing so, it also provides several new underwriting requirements:

- The new loan cannot exceed 90% of the appraised value for the property.<sup>98</sup>
- The new loan shall maintain a fixed-rate of interest and shall not be for a term less than thirty years.<sup>99</sup>
- Second liens are prohibited on the new loan for five years.<sup>100</sup>
- Mortgagee income must be documented and verified through IRS income tax filings.<sup>101</sup>
- Down payment assistance is essentially eliminated.<sup>102</sup>

The combined effect of these provisions is that they severely limit the ability of lenders to offer riskier loans such as subprime, Alternative-A, payment option ARM, and other loans where the buyer has little to no equity investment in the purchase. This is a positive step since these are the very types of loans that are driving the foreclosure crisis because they were the loans of last resort for individuals who could not qualify for or afford conventional mortgages.

By culling these unconventional loans from the FHA program, fewer people will qualify for home loans, and those who do will likely qualify for smaller loans. In other words, the HERA Act establishes a more logical nexus between the borrower's financial situation and the cost of the loan.

The reality is that lender participation in the program is voluntary; theoretically, the program could go unused if lenders decide the financial sacrifices are too onerous—for instance, participation will require a lender to waive many delinquency-related fees and penalties.<sup>103</sup>

In addition, the problematic idea of having the federal government actually participate in the private mortgage loan market remains unaddressed as

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96. HERA FAQs, *supra* note 84.

97. 122 Stat. 2712.

98. *Id.* at 2801.

99. *Id.* at 2802.

100. *Id.*

101. *Id.* at 2803.

102. *Id.* at 2831.

103. *Id.*



apparently too dramatic an option for a politically-motivated body like Congress to carefully consider. Nevertheless, the HERA Act does lay the groundwork for limiting federally-backed unconventional mortgage products. Unfortunately, many of the Act's other provisions offset these benefits to the point of turning the Act into an incredibly ineffective response to the housing foreclosure crisis. The following sections examine the especially misguided provisions of the Act.

*IV. The First Major Failure: Poorly-Defined Loan Modification and Foreclosure Provisions*

Though the HERA Act was signed by President Bush in late July 2008,<sup>104</sup> the FHA loan modification portion of the legislation was not scheduled to begin until October 1, 2008.<sup>105</sup> This delay was designed to give the FHA time to coordinate the vast new administrative responsibilities related to coordinating hundreds of thousands of loan modifications with lenders and homeowners. Even before the President's signing, however, HUD officials had warned that the program's vast and complex nature would likely delay its implementation until as late as mid-2009.<sup>106</sup> While this position was said to have "ticked off" Representative Barney Frank, one of the bill's leading congressional proponents,<sup>107</sup> such a timeframe should hardly have been surprising. Indeed, the idea that a federal agency could establish a new federally-backed loan modification system unlike any program that the government had previously developed, and that it could do so in roughly two months, strained credulity. This is especially true since that program is replete with many instances of unstructured requirements and vague instructions. The following section examines the significant instances where the HERA Act's loan modification provisions prove ill-conceived.

*A. The Intentional Default Provision*

The HOPE for Homeowners portion of the HERA Act empowers the FHA to facilitate the modification of existing variable rate loans into fixed rate

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104. David M. Herszenhorn, *Bush Signs Sweeping Housing Bill*, N.Y. TIMES, July 31, 2008, at A1, available at <http://www.nytimes.com/2008/07/31/business/31housing.html?partner=rssnyt>.

105. 122 Stat. at 2807.

106. Stacy Kaper, *HUD: Foreclosure Program Will Not Be Ready by October*, AM. BANKER, July 28, 2008, available at <http://americanbanker.com/article.html?id=200807250C5X6HK6> (login required).

107. Paul Jackson, *As Housing Act Passes Congress, Questions Emerge*, HOUSINGWIRE.COM, July 26, 2008, <http://www.housingwire.com/2008/07/26/as-housing-act-passes-questions-emerge/>.

versions.<sup>108</sup> While the program is voluntary for lenders, if they do participate, the FHA will back the modified loans.<sup>109</sup> Several practical problems exist with this plan though. For instance, lenders must agree to waive fees related to delinquency.<sup>110</sup> They must also write down the loan value to 90% of the overall amount.<sup>111</sup> In addition, the first mortgage holder must negotiate with secondary mortgage holders (including home equity loan owners) to extinguish those secondary loans.<sup>112</sup> However, the bill does not provide any incentive for those secondary lien holders to agree to waive their rights; meaning that without the secondary mortgage holders unlikely participation, the loan modification cannot occur.

These types of provisions clearly undermine the likelihood of lender participation. However, even if the lender opts to join the program, several other provisions must be met before a borrower is eligible.

One of those provisions—requiring that the borrower cannot have intentionally defaulted on a loan—seems logical on the surface. After all, borrowers who agreed to disadvantageous loan terms, but who can still afford those terms, should not be able to purposefully default in order to obtain better terms. As reasonable as this sounds, the provision is still fraught with trouble.

In particular, how will the government determine whether a default was intentional or simply the result of bad financial decisions by the borrower? While obvious schemes to purposefully default on a loan could be discovered through empirical research, such as a decision not to pay one's mortgage even though an individual continues to possess the financial means to do so, poor stewardship and wasteful spending by the consumer is much harder to quantify. Would a borrower who just purchased a new car that now forces them into mortgage default fall within the intentional provision, or would they simply be chalked up as a lousy money manager?

The resources and time required to determine whether a default is intentional or merely the result of negligent spending would likely make the program unworkable beyond a limited scale as it would necessitate scouring a borrower's financial habits and decision-making. Considering that the purpose of the program is to resolve the large number of defaulted mortgages, this creates an inherent conflict: the program only works on a small scale, but it is intended to work on a much larger one.

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108. 122 Stat. at 2802.

109. HERA FAQs, *supra* note 84.

110. 122 Stat. at 2801.

111. *Id.*

112. *Id.*

Ultimately, the HERA Act nobly endeavors to keep fraudulent defaults out of the loan modification program. Unfortunately, the mechanism for doing so is too vague and subjective.

*B. The Minimum Down Payment Provision*

The Foreclosure Prevention section of the HERA Act usefully eliminates seller down payment assistance programs. Under these programs, a home builder could contribute money to a non-profit association which would then turn around and provide the home buyer with down payment assistance funds.<sup>113</sup> This essentially allows buyers to purchase a home without putting any of their own money down—a problematic approach since it enables those without even the slightest liquidity for a down payment to qualify for a home loan.

Though such an approach does open the door to home purchasing for more individuals, it does so for a population segment that—because of its lack of liquidity—is not well-suited for financial challenges such as a job losses, medical emergencies, and upward adjustments on a variable mortgage rate. This creates the untenable situation of providing a mortgage to buyers who apparently lack sufficient reserve savings to provide for such contingencies.

Both the FHA and the IRS previously opposed down payment assistance programs as prone to loan defaults or even fraud.<sup>114</sup> This is hardly surprising according to respected economist William R. Emmons:

One indicator of increasing risk is greater borrower leverage. About 45 percent of subprime borrowers in 2001 had less than 20 percent equity in their houses at the time they took out the mortgage. Five years later, 58 percent were in this category, an increase of 13 percentage points.<sup>115</sup>

The HERA Act's elimination of this practice serves as one of its highlights. Unfortunately, rather than mandating that home buyers invest in a significant down payment in order to qualify for an FHA loan, the Act only requires a minimum 3.5% down payment as opposed to more historically-common 10%

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113. Paul Jackson, *Housing Bill Adds Second Lien Amendment; DAPs to Be Eliminated*, HOUSINGWIRE.COM, July 23, 2008, <http://www.housingwire.com/2008/07/23/housing-bill-adds-second-lien-amendment-daps-to-be-eliminated/>.

114. Posting of Devona Wells to the News Tribune, [http://blogs.thenewstribune.com/real-estate/2008/08/01/down\\_payment\\_assistance\\_killed\\_by\\_mortga](http://blogs.thenewstribune.com/real-estate/2008/08/01/down_payment_assistance_killed_by_mortga) (Aug. 1, 2008, 12:49 PST).

115. William R. Emmons, *The Mortgage Crisis: Let Markets Work, but Compensate the Truly Needy*, REGIONAL ECONOMIST, July 2008, at 10, 12, available at <http://www.stls.frb.org/publications/re/2008/c/pages/mortgage.html>.

to 20% down payment amounts.<sup>116</sup> This opens the door to individuals who are likely not well-positioned to be purchasing a home until they have amassed additional savings.<sup>117</sup>

*C. Conforming Loan Limits that Remain Too High*

One effect of the housing crisis has been a dramatic reduction in home prices; in some cases, home prices have fallen over 20% off their peak.<sup>118</sup> This reduction represents the private market correcting itself. One effect of this correction is that lowered home prices means homes become more affordable. Despite this reduction in price, the HERA Act empowers the FHA to increase its loan amount to 150% of the present cap for the GSEs.<sup>119</sup> Currently, that number stands at \$625,000,<sup>120</sup> which presents an obvious question: *why is the federal government backing loans this large?*

After all, if the justification for federal participation in the private housing market is centered on the goal of subsidizing affordable housing, \$600,000 loans would hardly seem to fit within that scope. Even in high cost housing markets, that amount represents an expensive number, especially when one considers that those very markets (such as California) are realizing some of the highest price decreases.<sup>121</sup>

Worse still, insuring such high loans ultimately exposes the U.S. taxpayer to large losses in an overheated housing market where, as evidenced by the current crisis, the value of the home drops well below the loan value—a prime indicator of default potential.<sup>122</sup> Rather than reign in maximum loan amounts

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116. Kenneth R. Harney, *20% Down Seems like Ancient History*, L.A. TIMES, Feb. 11, 2007, at K3, available at <http://articles.latimes.com/2007/feb/11/realestate/re-harney11>.

117. Emmons, *supra* note 115, at 12 (“When house prices stop rising or actually fall, the sale-or-refinancing escape hatch begins to close. Any financial setback can translate quickly into mortgage delinquency and, sometimes, into default.”).

118. Martin Feldstein, *The Problem Is Still Falling House Prices*, WALL ST. J., Oct. 4, 2008, at A15, available at [http://online.wsj.com/article/SB122307486906203821.html?mod=google\\_news\\_wsj](http://online.wsj.com/article/SB122307486906203821.html?mod=google_news_wsj).

119. U.S. DEP’T OF HOUS. & URBAN DEV., MORTGAGEE LETTER 2008-36, 2009 FHA MAXIMUM MORTGAGE LIMITS (2008), available at <http://www.fand.com/PDF/HUD%20ML%202008-36.pdf>.

120. U.S. Senate Comm. on Banking, Hous. & Urban Affairs, Summary of the “Housing and Economic Recovery Act of 2008,” [http://banking.senate.gov/public/\\_files/HousingandEconomicRecoveryActSummary.pdf](http://banking.senate.gov/public/_files/HousingandEconomicRecoveryActSummary.pdf) (last visited Jan. 9, 2009) [hereinafter Senate Summary of HERA].

121. Sharon L. Lynch, *Metro U.S. Home Prices Fall on Higher Foreclosures (Update 2)*, BLOOMBERG, Oct. 2, 2008, <http://www.bloomberg.com/apps/news?pid=20601213&sid=aAaW9UAEs8Dk&refer=home>.

122. See, e.g., John Gittelsohn, *WaMu Loaned Millions to California Home Flippers Convicted in Fraud Scheme*, Sept. 22, 2008, at E1, available at <http://seattletimes.nwsourc>.

for the GSEs and the FHA, the HERA Act expanded the limits and, quixotically, suggested that doing so promoted affordable housing.<sup>123</sup> This illogical justification bears witness to the problem with federal involvement in the home loan market, namely that it cannot reasonably delineate between small amounts of mortgage assistance to lower income buyers and large loans for middle and upper income buyers who otherwise would be unlikely to qualify for higher priced homes. While aiding lower income borrowers to obtain basic housing may warrant some government intervention, a federal role in backing individuals above a low income classification does not advance any reasonable affordable housing policy.

In order to avert future mortgage crises, the HERA Act should have, at most, limited home loan assistance to basic and safe housing for lower income borrowers who possess a reliable means for paying the loan. The decision to increase loan amounts without placing a hard cap on the amount of those loans exposes the federal government, and therefore the taxpayer, to more open-ended liabilities.

*V. The Second Major Failure: HERA Maintains the GSE's Flawed Corporate Structures*

As early as 1999, the *New York Times* somewhat prophetically predicted the folly of permitting the GSEs involvement in the subprime mortgage market:

In moving, even tentatively, into this new area of lending, Fannie Mae is taking on significantly more risk, which may not pose any difficulties during flush economic times. But the government-subsidized corporation 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.<sup>124</sup>

These words of caution followed the GSEs insistence that they should expand mortgage availability to “borrowers whose credit is just a notch below what our underwriting has required.”<sup>125</sup> Such a ridiculous notion of watering down objective loan requirements to expand the loan pool clearly indicated that both the GSE's leadership and their government regulators had cast aside sound

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com/html/businesstechnology/2008194436\_wamu220.html.

123. Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, § 2201, 122 Stat. 2654, 2848.

124. Steven A. Holmes, *Fannie Mae Eases Credit to Aid Mortgage Lending*, N.Y. TIMES, Sept. 30, 1999, at C2, available at <http://query.nytimes.com/gst/fullpage.html?res=9C0DE7DB153EF933A0575AC0A96F958260&sec=&spon=&pagewanted=print>.

125. *Id.* (quoting Franklin D. Raines, Fannie Mae's Chairman and Chief Executive Officer at time of article).

business principles in their rush to extend home ownership to unqualified borrowers, while simultaneously attempting to maximize the mortgage-backed security profits for their private shareholders.

The fact that commentators noted this nearly a decade in advance indicates that the existing GSE regulations were failing. Yet, rather than revisit the efficacy of these regulations, the HERA Act opts for creating a new regulator apparently to govern such illogical behavior. In particular, the Act purports to establish a new “world class” regulator for the GSEs.<sup>126</sup>

This situation lends itself to two important questions. First, it implies that the existing regulatory combination of HUD and the Office of Federal Housing Enterprise Oversight (OFHEO) is something less than “world class,” which, in turn, begs the obvious question: why? What about the current regulatory scheme falls short of reaching “world class” regulator status? Indeed, one could reasonably argue that it is the existing regulations—rather than the regulators themselves—that represent the core of this problem. More importantly, why has Congress neglected to restructure the entire regulatory framework for the GSEs as opposed to simply establishing yet another federal agency?

Unfortunately, the HERA Act provides little useful guidance in answering these questions. Instead it seems to merely adopt the approach that, if a crisis strikes, the best response is to shift the problem to a new agency to address the problem. By doing so, it neglects the underlying problem that the GSEs operate under inherently flawed corporate structures. In the end, it does not matter how “world class” a regulator may be if the regulations to be administered are decidedly third world. The HERA Act’s failure to remedy this represents a major failure and missed opportunity.

*A. Restructure the GSEs as Either a Private Entity or a Government Concern*

In 2002, the *Wall Street Journal* made what turned out to be an astute prediction:

The point all of this makes, and the point we’ve been trying to make all along, is that Fan and Fred don’t function like other companies. The two biggest mortgage holders in the country are allowed to pile up debt, implicitly guaranteed by taxpayers, without being held to even the minimum of corporate governance standards that every other publicly traded company has to observe. Sooner or later this is asking for trouble.<sup>127</sup>

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126. Senate Summary of HERA, *supra* note 120.

127. Editorial, *Inside Fannie*, WALL ST. J., Mar. 19, 2002, at A22, available at <http://online>.

Six years later, the companies were no longer just asking for trouble but, instead, had become so compromised that the United States Treasury was forced to place them under conservatorship in order to preserve their existence.<sup>128</sup> It was within the HERA Act itself that Congress provided the Treasury with authority for such an unprecedented action.<sup>129</sup> Treasury Secretary Henry Paulson's suggestion that merely providing his department with the authority would likely be sufficient to ward off the companies' collapse<sup>130</sup> proved wrong. Instead, the credit crisis forced the Treasury essentially to take over Freddie Mac and Fannie Mae and, in so doing, expressly established the federal government as guarantor for their failing loan portfolios.

A major failure in the HERA Act is that this authority granted to the Treasury did not require the government to precisely define the GSEs as either private corporations or public agencies. Rather, it allowed them to remain in the hybrid form while their profits were realized by the private market, yet their risks were backed by the public coffers. The net effect is that the GSEs are even more directly tied to the public monies trough but are then allowed to run up large lobbying bills at taxpayer expense.<sup>131</sup> Richard Syron, Freddie Mac's CEO during much of the subprime loan boom, acknowledged that the company's current corporate structure creates an inherent problem: "This company has to answer to shareholders, to our regulator and to Congress, and those groups often demand completely contradictory things."<sup>132</sup> An August 2008 *New York Times* article demonstrated the challenge:

[T]he companies were constantly under pressure to buy riskier mortgages. Once, a high-ranking Democrat telephoned executives and screamed at them to purchase more loans from low-income borrowers, according to a Congressional source. Shareholders

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[wsj.com/article/SB1016494105312486320.html?mod=Extra](http://www.wsj.com/article/SB1016494105312486320.html?mod=Extra).

128. See MARK JICKLING, GOV'T & FIN. DIV., CONG. RESEARCH SERV., CRS REPORT FOR CONGRESS, FANNIE MAE AND FREDDIE MAC IN CONSERVATORSHIP (2008), available at <http://fpc.state.gov/documents/organization/110097.pdf>.

129. *Id.*

130. Andrew Ross Sorkin, *Paulson's Itchy Finger, on the Trigger of a Bazooka*, N.Y. TIMES, Sept. 8, 2008, at C1, available at <http://www.nytimes.com/2008/09/09/business/09sorkin.html?ref=business>.

131. Lindsay Renick Meyer, *Update: Fannie Mae and Freddie Mac Invest in Lawmakers*, OPENSECRETS.ORG, Sept. 11, 2008, <http://www.opensecrets.org/news/2008/09/update-fannie-mae-and-freddie.html>.

132. Charles Duhigg, *At Freddie Mac, Chief Discarded Warning Signs*, N.Y. TIMES, Aug. 5, 2008, at A1, available at [http://www.nytimes.com/2008/08/05/business/05freddie.html?\\_r=1&oref=slogin&pagewanted=print](http://www.nytimes.com/2008/08/05/business/05freddie.html?_r=1&oref=slogin&pagewanted=print).

attacked the executives for missing profitable opportunities by being too cautious.<sup>133</sup>

If Congress was interested in resolving the underlying problem, it too should have recognized the competing forces that vie for the GSEs fiscal attention. In doing so, Congress could have federalized the GSEs and operated them as a national housing entity. Or it could have fundamentally revamped the charters for Freddie Mac and Fannie Mae by explicitly privatizing their operations. While both approaches present challenges, either one would have eliminated the inherent conflicts faced by having to financially perform for private shareholders while being forced to comply with business goals established by the public government.

Significantly, a full privatization of the GSEs would not require Congress to reject a federal role in affordable housing. Instead, it would simply restrict the government's ability to back risky loans to unqualified borrowers under the guise of a private market participant. Instead of the ambiguous GSE model, Congress could utilize a variety of legislative tools, such as tax incentives and regulatory reform, to promote safe and affordable housing.

Unfortunately, Congress appeared obsessively predisposed against the very reasonable proposition that rental housing can constitute safe and affordable housing. Thus, leaving the GSEs essentially in their suspended state of public/private limbo will leave them as a competitor in the private mortgage market, empowered to transact riskier loans than the rest of the private market because of the GSE's federal backing.

*B. In the Alternative, Prohibit the GSEs From Transacting Unconventional Loans*

The HERA Act also empowers the FHA to purchase billions of dollars' worth of mortgages and convert them into new loans with fixed rates and lower monthly payments.<sup>134</sup> While this might seem like a compassionate thing to do—after all, no reasonable person would celebrate another's default—the provisions' lack of precision fails to delineate between fraudulently established loans and those that simply resulted from an overstretched borrower meeting an overeager lender.

The problem of this "reform" is really quite simple: the GSE's will still be permitted to generate private profits while shifting the risks to the federal government and, by extension, the American taxpayers. Under the HERA Act, this fundamental flaw remains unresolved because, in the end, the Act does not expressly prohibit the GSEs from purchasing so-called "Liar Loans"—those

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133. *Id.*

134. Senate Summary of HERA, *supra* note 120.



loans where the purchaser is not required to provide proof of their income, debts, or other indices of financial soundness.<sup>135</sup> This represents a terrible omission when one considers that liar loan defaults alone may reach \$100 billion dollars.<sup>136</sup>

If Congress is insistent upon retaining the GSE's hybrid structure, at the very least it should limit the damage enabled through such a scheme by limiting the GSEs' portfolio to only conventional mortgage loans. Unfortunately, the HERA Act fails to accomplish even that.

### VII. Conclusion

*From the perspective of maximizing long-run economic efficiency, it would be better to allow housing and mortgage markets to sort themselves out, as painful as that may be.*<sup>137</sup>

It is easy to act like a Monday morning quarterback while sitting on the sidelines outside the glaring lights of a crisis. Something that seems so obvious from that vantage point might not be so clear from within the tempest of the problem. However, even allowing for that, the Housing and Economic Recovery Act of 2008, though borne out of crisis times, simply fails to address the underlying issues that provoked the continuing housing and credit challenges facing this country. Instead of a comprehensive solution, the HERA Act dangles a disparate collection of piecemeal responses.

Not surprisingly, the ultimate result is the misdirected spending of money and promulgation of laws that, at best, might temporarily provide a narrow swath of relief. This haphazard approach is not the cadence of problem-solvers committed to placing sound economic theory before political machinations. It is for this very reason that the Housing and Economic Recovery Act of 2008 will not solve the vexing predicament it seeks to address. As a result, the crisis continues.

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135. *Liar Loans to Prolong Mortgage Crisis*, ASSOCIATED PRESS, Aug. 18, 2008, available at <http://www.azcentral.com/business/articles/2008/08/18/20080818biz-liarloans18-ON.html>.

136. *Id.*

137. Emmons, *supra* note 115, at 10.