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**Reforming the Residential
Mortgage-Backed Securities Market**

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Reforming the Residential Mortgage-Backed Securities Market

David Reiss¹

I. Introduction

The issues that we are struggling with now are, in many ways, the equivalent of the issues that we struggled with during the Great Depression: what should housing policy look like and what decisions should be made in the next five years or so to bring us from crisis to stability? In all likelihood our answer to this question will define the housing market for generations. To help answer the question, this essay will proceed as follows. First, it will provide some context for American housing policy discussions.² It will then outline three ethics that inform housing policy, often not explicitly, but that are there under the surface.³ The essay will then focus on one of the key issue that we face—what should happen with Fannie and Freddie as they exit conservatorship.⁴ It concludes by highlighting some of the other housing finance issues that must be addressed before we can move forward with a coherent plan of reform.⁵

II. American Housing Policy

The Federal government has a bewildering array of programs that directly fund, with tens of billions of dollars per year, our housing stock. These programs include, in the broadest strokes: the Federal Housing Administration, Ginnie Mae, the Federal Home Loan Banks

¹ Professor of Law, Brooklyn Law School. This essay is based on a talk that I gave at the *Federal Housing Finance Policy, Secondary Mortgage Market Issues: Causes and Cures, Secondary Mortgage Market Reform* symposium at Hamline University School of Law. The essay is drawn in large part from other articles by the author, including David J. Reiss, *First Principles for an Effective Federal Housing Policy*, 35 BROOK. J. INT'L L. 795 (2010); David J. Reiss, *Fannie Mae and Freddie Mac and the Future of Federal Housing Finance Policy: A Study of Regulatory Privilege*, 61 ALA. L. REV. 907 (2010) [hereinafter *Regulatory Privilege*].

² See *infra* Part II.

³ See *infra* Part III.

⁴ See *infra* Part IV.

⁵ See *infra* Part V.

system, and of course Fannie and Freddie. And there are other heavily funded programs: project-based rental assistance, housing vouchers, supportive housing for particular populations like the elderly and the disabled; the list goes on and on. On top of these direct expenditures, the federal government spends hundreds of billions of dollars more in tax expenditures that fund or incentivize homeownership and other real estate ownership as well. The main ones include the deductibility of mortgage interest on owner-occupied homes, the deductibility of state and local property taxes, and the capital gains exclusion on home sales; that list goes on and on as well.

Housing's regulatory web is also immense and intricate, including regulators such as the newly created Federal Housing Finance Agency, the Department of Housing and Urban Development, the Federal Reserve Board, the Federal Trade Commission, the Office of the Comptroller of the Currency, and the National Credit Union Administration. Trying to derive a clear understanding of federal housing policy in the face of such enormous expenditures and extraordinary complexity is no mean task, but that is what I will try to do below.

III. First Principles of Housing Policy

Three broad ethics inform federal housing policy. Let us call the first one "housing as an economic good," the second one "housing as a human right," and the third, "housing as a bulwark of democracy." The first, "housing as an economic good," treats housing as any other commodity and asks how government policies will distort the functioning of the market for housing. The "housing as an economic good" ethic is woven through debates regarding federal housing policy in large part because people historically felt that the housing market was different, that it did not work as other markets do. But since the debates about rent control in the 60s and 70s, people have come to understand that housing too is a market and that when we implement policies we need to implement them so that we do not distort the market in

unintended ways. The “housing as a human right” ethic asks how policy furthers the goal of making affordable, decent housing available to all. “Housing as a bulwark of democracy” reaches back at least as far as the time of Thomas Jefferson, to the idea of the yeoman farmer who owns his homestead, is financially self-sufficient and acts the part of a democratic citizen.

If we think of these as the three core ethics of housing policy, we have to be aware that there are other policies that impact housing as well. These relate to the role of housing in our overall economy. For instance, the finance industry has argued for policies that stabilize the mortgage markets, noting that the mortgage industry is key to the health of the overall economy. We saw this during the early stages of the subprime crisis very clearly where calls were made to stabilize mortgage companies because the companies were big employers.

Given the three core ethics, what is or what could be the aim of a housing policy? In other words, what could a well-designed and well-executed housing policy achieve? Echoing the housing ethics outlined above, some assert that the main aim of housing policy is to help Americans to live in a safe, well-maintained, and affordable housing unit; and such a view would be consistent with a rights-based view of housing as something like a human right. This reaches back at least as far as Jacob Riis’ *How the Other Half Lives* and the movement to regulate housing quality that resulted from that book.⁶

Others might have a more modest expectation for housing policy, such as a specialized form of income redistribution that insures the income transferred is consumed in increased housing. This is how a housing economist might approach the problem. There are certainly powerful reasons for the federal government to help make housing affordable for American

⁶ The advocacy of Riis and others led to the Tenement Housing Law of 1901, which was “the first major advance in the fight against the tenement slum.” Francesco Cordasco, *Introduction* to JACOB RIIS, *HOW THE OTHER HALF LIVES*, at viii (Garrett Press 1970) (1890).

households. First of all, as housing is the largest budget item for most households, government subsidies can free up household resources for the other necessities of life. Second, government policies which smooth out the impact of market forces on such a key component of well-being as housing help households as they face the unexpected challenges that such an economy presents to them. Thus, policies that seek to increase affordability, particularly for lower-income households, are easily defensible policy goals.

Finally, one might argue that homeownership and stable housing is fundamental to the American notion of citizenship. That is how many politicians approach the question. The importance of this last approach in American housing finance policy cannot be overstated. As previously noted, the centrality of homeownership to America's vision of itself as a society of equal citizens reaches at least as far back as Jefferson's concept of the yeoman farmer.⁷ In the 19th century, the yeoman farmer morphed into the homesteader contemplated by Lincoln's Homestead Act of 1862. And then in the 20th century, that homesteader morphed into the homeowner. Presidents as diverse as Herbert Hoover, Lyndon Johnson, Bill Clinton, and George W. Bush made homeownership central to their broad political agendas. Indeed, the extraordinary lengths that the Obama and Bush administrations have taken to reduce the number of foreclosures during the credit crisis bears witness to the importance that both political parties place on homeownership.

Homeownership as a civics lesson is not as defensible as the affordability rationale. The bursting of the mortgage market bubble preceding the Great Recession has made many people question whether homeownership is a good in and of itself for all households, a belief that has

⁷ Jefferson's yeoman farmer was his ideal citizen because he was self-sufficient, earning his own keep and considering himself the equal of anyone else, jealously guarding his liberty and unalienable rights. *See* RICHARD HOFSTADTER, *THE AGE OF REFORM* 23 (1955) ("Writers like Thomas Jefferson . . . admired the yeoman farmer not for his capacity to exploit opportunities and make money but for his honest industry, his independence, his frank spirit of equality, his ability to produce and enjoy a simple abundance.").

been a bedrock principle for many Democratic and Republican administrations. But the jury is still out on whether housing policy can, on its own, create a class of Jeffersonian “yeoman farmers” or George W. Bush’s “ownership society.”

IV. The Future of Fannie and Freddie

Approaches to housing policy can be extremely confused and can veer far from the core ethics that should inform federal housing policy. The initial rationale for Fannie and Freddie was to create a national residential secondary mortgage market. That has been achieved. So their exit plan from conservatorship should thus be guided by our contemporary needs, not just from an unthinking reliance on the historical need for Fannie and Freddie.

Fannie’s slogan is, “Our business is the American dream,” and Freddie’s is, “We make home possible.” Taken together, the companies’ slogans reflect their claim that they are acting in accordance with the ethics of “housing as a bulwark of democracy” (a variant of the American Dream) and “housing as a human right.” The two companies do, in fact, modestly reduce the cost of mortgages by passing on to borrowers a portion of the subsidy that results from the implied, and now explicit, federal guarantee of their obligations. They have also created an infrastructure that allows the market to function really well. But the interests of shareholders and management had overwhelmed the public benefit in the last decade or so as the companies took great financial risks, with shareholders getting the upside and taxpayers getting the downside.

A review of Fannie’s and Freddie’s activities demonstrate that their impact on affordability has been modest in recent years, and their impact on increasing the number of citizen-homeowners has been severely compromised by their participation in the massive bubble in the housing markets, one that drove many people into inappropriate homeownership and then left them to lose their homes soon after purchasing them. If one were to properly identify the

policies undergirding the operations of today's Fannie and Freddie, it would be those auxiliary ones that relate to the operation of the market itself and not to the three core ethics described above.

The question then is how do we move forward with Fannie and Freddie? Lots of people are proposing answers to that question. The Obama administration issued a report with three very different policy options in February, 2011.⁸ Republican House members have been sending out bill after bill with ideas of how to modify them going forward.⁹ There are lots of other proposals by policy players as well: think tanks, like the American Enterprise Institute and the Center for American Progress; a number of industry trade associations, like the Mortgage Bankers Association; and even lots of big players in the market, such as Wells Fargo and Credit Suisse have issued proposals. There are a lot of ideas out there.

There are a few broad ways of categorizing these ideas. The first view is that Fannie and Freddie generally do their job. This view acknowledges that they have had some trouble recently, but takes the position that if we tweak their powers and regulate them more effectively we can keep on our current path. That view used to be very popular, but is obviously much less so now. Second, Fannie and Freddie are generally doing their job but retain too much of the subsidies from their special relationship with the federal government, and we should redirect some of those subsidies to public purposes. The third is that Fannie and Freddie should be nationalized because Fannie and Freddie have effectively gone on the taxpayers' tab anyway, so why not just acknowledge that? And finally, there is the view that Fannie and Freddie pose a real

⁸ U.S. DEP'T OF THE TREASURY & U.S. DEP'T OF HOUS. & URBAN DEV., REFORMING AMERICA'S HOUSING MARKET: A REPORT TO CONGRESS 27-30 (2011), available at <http://portal.hud.gov/hudportal/documents/huddoc?id=housingfinmarketreform.pdf>.

⁹ See, e.g., *Federal National Mortgage Association Fannie Mae*, N.Y. TIMES (last updated Dec. 16, 2011), http://topics.nytimes.com/top/news/business/companies/fannie_mae/index.html (follow "Read More..." hyperlink) ("House Republicans responded by announcing a package of eight bills.").

systemic risk to the financial system. This view also takes the position that they do not continue to achieve important objectives other than this market-stabilization role, and as a result they should be privatized in one form or another. This view was kind of a non-starter for many years, but since the crisis, the idea has really taken on a new life as a potential way out of conservatorship.¹⁰

A. Tweaking Fannie and Freddie

Somebody who takes that first view, that Fannie and Freddie are generally doing the job that they were designed to do, might argue “[t]he penetration of competitive markets by laws and regulations is a highly durable and robust intrusion in the U.S. economy [which] is arguably as tightly regulated as the more socialistic economics of Western Europe.”¹¹ They might add that the American financial system is not so different from the European model where markets are heavily entwined with governments. It is just as true here. We have seen that in the subprime crisis, where the government has come to rescue entire industries. Thus, it is important to realize this reality, regulate from that perspective, and move forward.

Proponents of this view often have lots of little fixes that they propose for tweaking the Fannie and Freddie model, such as limiting the size of their mortgage portfolios, limiting how much debt they could issue, or freezing or slowing down the rate of growth of the conforming loan value to limit the size of the mortgages they could purchase and thus to limit them to a smaller part of the overall mortgage market.

B. Modification of Fannie and Freddie for Affordable Housing

¹⁰ This was so particularly because Fannie and Freddie have many allies in the both the Republican and Democratic parties. *See generally Regulatory Privilege, supra* note 1.

¹¹ Michael A. Crew & Charles K. Rowley, *Dispelling the Disinterest in Deregulation*, in *THE POLITICAL ECONOMY OF RENT-SEEKING* 163, 163 (Charles Kershaw Rowley et al. eds., 1988).

Affordable housing providers and advocates unsurprisingly often take the second position that Fannie and Freddie are pretty much doing a good job. They have created this wonderful market that is very liquid and stable over the long term, but management and shareholders have walked off with too much of the profits that they get from Fannie and Freddie's special relationship with the federal government. They argue that we should redirect some of that money to affordable housing programs. Indeed, the Housing and Economic Recovery Act of 2008 created the framework for a \$500 million affordable housing trust fund that would redirect some of that money into affordable housing goals.¹² But, of course, the events of the credit crisis scuttled those plans and this apparently painless way of increasing affordable housing.

C. Nationalization

The third position, nationalization, only began to be taken seriously in the midst of the crisis. Shockingly, then Secretary of the Treasury Paulson raised the idea, an idea that one would have thought would have been anathema to a conservative like himself. That demonstrates how bad the crisis was. He proposed merging the two companies with the Federal Housing Administration.¹³ The FHA is a pure government agency and not a hybrid like Fannie and Freddie. Paulson did note that this would place a lot of underwriting in the hands of the government. People generally do not think governments do underwriting all that well. Paulson said this, however, at a time when we did not think the private sector was doing underwriting all that well either, so that might not have been such a controversial point at the time.

¹² 12 U.S.C. § 4568(a)(1) (Supp. IV 2010) (establishing the Housing Trust Fund). The total amount of funding was to be a percentage of the unpaid principal basis of new business purchases by Fannie Mae and Freddie Mac. 12 U.S.C. § 4567(a) (Supp. IV 2010). The amount raised by this was projected to be \$500 million. *Regulatory Privilege*, *supra* note 1, at 923.

¹³ James R. Hagerty, *Paulson: Redo Fannie, Freddie*, WALL ST. J., Jan. 8, 2009, at A11 (stating that "Fannie and Freddie could be fully nationalized and perhaps combined with the Federal Housing Administration").

The Obama administration had at one point seriously considered such a plan.¹⁴ The conservatorship, for all practical purposes, has nationalized Fannie and Freddie at least for the short term. The government has ordered Fannie and Freddie to engage in a variety of goals to achieve public policy purposes relating to modifications and foreclosures.¹⁵ It is going to be very tempting to Congress to keep a tool that generates such a cash flow under its control. So I think nationalization is on the table to some extent.

D. Fannie and Freddie Pose a Systemic Risk

The fourth view is that Fannie and Freddie pose a systemic risk to the financial system, unfairly benefit from their regulatory privilege, and do not create meaningful net benefits for the American people. In an earlier article I evaluate Fannie and Freddie in the context of six policy goals that derive from regulatory theory.¹⁶ Do they maintain competition? Do they efficiently allocate society's goods and services? Do they promote innovation? Do they prevent inappropriate wealth transfers? Do they preserve consumer choice? Do they prevent an overly concentrated economy? The article found that Fannie and Freddie came up short on nearly all those goals. Fannie and Freddie are really holdovers from an earlier era of government innovation. If we were to design a system today, I do not think we would start with the idea of these incredibly large hybrid organizations as an obvious way to address homeownership policy.

V. The Road Forward

There are other issues that will need to be resolved in order to establish a housing finance policy for the next few generations. First, what is the future of the 30-year mortgage? Second,

¹⁴ See Charles Duhigg, *U.S. Likely to Keep the Reins on Fannie and Freddie*, N.Y. TIMES (Mar. 2, 2009), <http://www.nytimes.com/2009/03/03/business/03mortgage.html> (explaining Fannie and Freddie will not likely return to private control).

¹⁵ See *id.* (“Regulators have ordered the companies to oversee a vast new mortgage modification program, to buy a greater number of loans, to refinance millions of at-risk homeowners and to loosen internal policies so they can work with more questionable borrowers.”).

¹⁶ *Regulatory Privilege*, *supra* note 1.

what is the fate of the lock-in, whereby a person could get a guaranteed interest rate prior to closing the loan? Third, what is the fate of the low-down-payment mortgage? Fourth, what is the appropriate role of the FHA in the context of the entire housing finance infrastructure, and in relationship to Fannie and Freddie in particular? And finally, how much will we allow the goal of increasing homeownership to impact our housing finance system? This last question has been pushed heavily by Peter Wallison, who was on the Financial Crisis Inquiry Commission and is at the American Enterprise Institute, along with Ed Pinto.¹⁷ They challenge the notion that we can create a system that takes only reasonable risks while increasing homeownership. This view is very controversial and has to be addressed before we can move forward with any reform program.

A. The 30-Year Fixed Mortgage

What is the future of the 30-year fixed mortgage? My best bet is that it will survive one way or the other. But I certainly question the knee-jerk support of that mortgage product. The average American household only lives in its home for seven years.¹⁸ That implies that most Americans, or a very large swath of Americans, could do better with a shorter term fixed interest rate, which would result in lower monthly interest payments. This is not to say that ARMs are the answer to everybody's housing situation, but it calls for innovation in the context of the 30-year mortgage.¹⁹

¹⁷ See, e.g., Peter J. Wallison & Edward J. Pinto, *A Government-Mandated Housing Bubble*, Forbes.com (Feb. 16, 2009) http://www.forbes.com/2009/02/13/housing-bubble-subprime-opinions-contributors_0216_peter_wallison_edward_pinto.html (“it had been a mistake to force homeownership on people who could not afford it”).

¹⁸ See, e.g., NAT'L ASS'N OF REALTORS, PROFILE OF HOME BUYERS AND SELLERS 2009 77 (2009) (“The typical home seller has owned their home for seven years.”).

¹⁹ The interest rate for adjustable rate mortgages (ARMs) “changes periodically, usually in relation to an index, and payments may go up or down accordingly.” *Consumer Handbook on Adjustable Rate Mortgages*, THE FEDERAL RESERVE BOARD (last updated Apr. 6, 2011), http://www.federalreserve.gov/pubs/arms/arms_english.htm.

It would be beneficial to see innovation along a variety of axes, such as: (1) longer (ten or fifteen year) fixed periods for interest rates for ARMs as they might cover most households, given how long they typically stay in their homes; (2) interest rates that are based on rolling averages that slow the rate of change of the interest rate; (3) longer adjustment periods so you do not change the interest rate every year, and instead maybe every three or five years; and (4) lower caps on annual interest rate increases, perhaps limiting them to 1% instead of the more typical 2%. All of these suggestions could reduce “payment shock,” when a household is used to making a monthly mortgage payment of a certain size and suddenly has a much bigger bill. Payment shock is really, I think, what people are afraid of, and there are tools other than the 30-year mortgage to respond to that very legitimate concern. The good thing about all of these suggestions is that they would also allow lenders to move away from the 30-year fixed mortgage. 30-year fixed mortgages expose lenders to severe interest rate risk because their business model is based on borrowing short (from depositors and in the commercial paper market) and lending long (to residential borrowers).

B. Fate of the Lock-In

Fannie Mae and Freddie have created a unique “to be announced” (TBA) market that allows originating lenders to hedge the interest rate risk that could arise from a gap between interest rate at the time a mortgage commitment is issued and the interest rate at the time at which the mortgage is closed. Many worry that a fully private market cannot replicate this system if Fannie and Freddie were to be wound down or privatized and borrowers would no longer be able to lock in an interest rate at the time of the loan commitment. While maintaining the TBA market appears to benefit lenders and borrowers by allowing them to hedge interest rate risk, it does not appear to be too difficult to create a private version of this market—it is just a

kind of forward contract. There is no reason that the private market could not create an alternative market that provides a similar type of hedge. But it is likely that such a market would need some type of enabling legislation from Congress.

C. Fate of the Low-Down-Payment Mortgage

From an underwriting perspective, the hallowed 20% down payment is clearly desirable as defaults for such mortgages are exceedingly low. From an opportunity perspective of increasing homeownership, especially with first time homeowners, it is an overwhelming burden. This is why the federal government has implemented a variety of low (for example 3%) down payment mortgage programs, particularly through the FHA. Many of these programs have had very high default rates which have led to calls to abolish them. The problem with such an approach, of course, is that returning to a high down payment requirement would keep a large swath of potential first time homeowners from taking the plunge. There is evidence, however, that there is a down payment sweet spot of around five percent at which default rates are within an acceptable range.²⁰

D. Role of FHA

That brings us to the issue of the FHA more generally—what is its appropriate role? The FHA has been on a rollercoaster ride of 2% market share at the height of the subprime boom to

²⁰ See COAL. FOR SENSIBLE HOUS. POLICY, PROPOSED QUALIFIED RESIDENTIAL MORTGAGE DEFINITION HARMS CREDITWORTHY BORROWERS WHILE FRUSTRATING HOUSING RECOVERY (2011), *available at* <http://www.responsiblelending.org/mortgage-lending/policy-legislation/regulators/Coalition-QRM-White-Paper-1.pdf>. The Coalition argues that:

[O]nce you apply the strong underwriting standards in the sample QRM definition, moving from a 5 percent to a 10 percent down payment requirement reduces the overall default experience by an average of only two- to three-tenths of one percent for each cohort year. However, the increase in the minimum down payment from 5 percent to 10 percent would eliminate from 4 to 7 percent of borrowers from qualifying for a lower rate QRM loan.

Id. at 6.

an extraordinarily large share of the market in the last few years.²¹ The FHA has been a flexible tool of government since it was created in the 1930s, achieving a variety of social purposes through its mortgage insurance programs. The federal government repositioned it a number of times over the following decades to achieve a variety of other goals: helping veterans returning from World War II; stabilizing urban housing markets during the 1960s; and expanding minority homeownership rates during the 1990s. It achieved success with some of its goals and had a mixed record with others. But FHA had one constant over the years. It generally did not need public subsidies to operate. FHA underwriting was always intended to ensure that the FHA would support itself, with its riskier loans subsidized by its less risky ones.

Today's FHA is facing insolvency and is suffering from many of the same unrealistic underwriting assumptions that have done in so many subprime lenders as well as Fannie and Freddie. They have also been harmed, like other lenders, by a housing market as bad as any seen since the Great Depression. And thus, there have been calls to avoid another bailout, like those of Fannie and Freddie. But the government-instrumentality FHA is a very different tool from the public/private hybrids Fannie and Freddie. The FHA can be limited to just a liquidity function to meet demand when credit is restricted. But it has also succeeded at times in expanding homeownership opportunities at a reasonable social cost. We should consciously choose the role the FHA should play going forward as opposed to allow it to be buffeted by market currents or rapidly changing political winds.

E. Appropriateness of Increasing Homeownership

²¹ Joshua Zumbrun & Maurina Desmond, *The Housing Mess: Lending over Backward*, FORBES.COM (Aug. 26, 2008, 6:00 AM), http://www.forbes.com/2008/08/25/fha-housing-mortgages-biz-beltway-cx_jz_md_0826housing.html ("At the height of the lending frenzy in 2006, the proportion of loans insured by the FHA dwindled to a mere 2% of the market. Now, lenders have nowhere else to turn. According to the Mortgage Bankers Association, 30% of all July loan applications had FHA backing.").

As noted, Wallison, Pinto, and others have been pushing against the appropriateness of increasing home ownership as a policy goal. This goal is, however, central to how we view America as a nation.²² Do we buy into homeownership as a “bulwark of democracy” and reject the Wallison/Pinto critique? Do we go along with Wallison and position housing as merely an economic good? This is a question that we need to struggle with. Until we know the answer to that question, we will not even know how to choose among the options before us.

VI. Conclusion

As the homeownership rate slips further and further from a bubble high of 69%, we must decide what type of federal support is appropriate in the context of our homeownership goals. In the next few years, we will make decisions that set up our housing finance system for a long time to come. It is worth thinking about our deeply held values before proceeding to set up that system.

²² See *supra* text accompanying note 17 (explaining Wallison’s critique of the goal of increasing homeownership in the United States).