Commentary: Treasury/HUD Report on Reforming America's Housing Finance Market

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By Alvin C. Harrell

I. Introduction

On February 11, 2011, the United States Department of the Treasury and the Department of Housing and Urban Development issued a joint report, entitled "Reforming America's Housing Finance Market," A Report to Congress (Report). The Report addresses the causes and effects of the "Great Recession" that began in roughly 2006-2007 and to some extent (e.g., in housing and employment) continues to this day. It advocates policies for addressing these problems and presents alternative policy approaches for dealing with these goals. Aside from its somewhat flawed, as noted below, description of the causes of this crisis, the Report is necessarily apologetic (and therefore at places seems almost too sophisticated), e.g., in claiming broadly to provide "a strong bi-partisan solution that results in a stronger housing finance market for all Americans." As suggested in this article, this claim is somewhat overstated. Yet, one must admit that there are aspects of the Report that probably can attract bipartisan support, and indeed there should be broad support for the aspirational goals stated in the Report. Therefore, the Report deserves full consideration, and may be considered on its own terms, perhaps even a foundation, for legislative efforts to address the continuing problems in housing and mortgage finance. Unless these problems are effectively addressed, perhaps in a comprehensive manner, the Great Recession in housing and mortgage finance (and perhaps employment) is likely to continue, with serious long-term adverse consequences for American society.

II. Initial Critique

Before proceeding to a point-by-point analysis of the issues addressed in the Report, some initial broad comments are in order as regards its overall approach. First, the Report was issued by two departments of the executive branch of the United States government. It is not customary to expect advocacy of a reduced role for the federal government from such sources. Yet there it is, in black and white: "We need to scale back the role of the federal government," it says bluntly and unequivocally." Yet one may disagree as to the extent to which the various policy prescriptions described in the Report support that goal (and it should be noted that the Report generally seeks enhanced private capital, not public autonomy, an important distinction), but this statement of principle must be regarded as an important recognition that public finance alone cannot adequately serve the needs of American consumers.

Still, as always, the devil is in the details and in your author's view many of the details in the Report undercut this goal or cast doubt on the likelihood of the implementation of the Report's effectiveness. If the goal of re-suscitating the private mortgage markets is to be more than a newspaper headline and political talking point, it must result in concrete steps based on realistic appraisals of the legal impediments that have all but destroyed our traditional system of private mortgage finance. In this respect, the Report is less successful. While, as noted, the nature of the Report is largely aspirational rather than specific, it seriously takes pains to paint certain cherished myths about the problems confronting mortgage finance today. These myths are a barrier to the needed reforms. Some of this is to be expected, given the sources of the Report; nonetheless, it is a factor that may serve to constrain the effectiveness of any solutions that derive from the Report as a foundational source. This criticism aside, the Report is to be commended for taking a relatively fresh look at policy issues and problems that have been festering for the better part of 100 years, and for recognizing the need for a comprehensive solution that revisits some basic tenets of prior public policies. For too long, these policies have been based on individualism, ad hoc responses to misinformation in the popular media, parochial advocates, and political constituencies, with increasingly adverse results that finally have some disastrous effects for American consumers and society. If there is to be any hope of reversing this trend, our fundamental approach to the regulation of mortgage finance will need to be re-examined. By inviting reasoned debate on these issues, the Report provides a public service.

III. The Report

A. Introduction to the Report

The Introduction to the Report sets the stage for the analysis that follows, and also establishes some precedents that provide subtle clues as to the preferred policy approaches. All of this is stated in terms of lofty goals that set high standards for any solution, stated as admirable general concepts, e.g.,

Our plan champions the belief that Americans should have choices in housing that make sense for them and for their families. This means rental options near good schools and good jobs. It means access to credit for those Americans who want to own their own home. While there is probably broad agreement that these are fine goals, it should also be noted that this statement of aspirations suggests that it is the role of the federal government to provide such housing and the related access to credit (e.g., to someone who wants to own a home). This goes somewhat beyond the previously-mentioned parameters of federal public policy, so it is appropriate to consider how such goals are to be accomplished. The Introduction to the Report notes that the plan outlined in the Report "dramatically transforms the role of government and the housing market." If nothing else, this is accurate and gets one's attention. Notably, the Introduction goes on to suggest that this dramatic change should include steps to reduce the risk to taxpayers from federal housing programs. "In the past, the government's financial and tax policies encouraged housing purchases and real estate investment over other sectors of our economy and ultimately left taxpayers responsible for much of the risk." This, however, raises obvious questions, e.g., how does the Report plan to provide attractive rental options and access to mortgage credit for all who want it, while reducing the cost to government and the risk to taxpayers?"}

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"Well, "Mr. Chairman, I believe that the answer is to subsidize rents. If we provide a subsidy for rents, we can reduce the risk to the government and the risk to taxpayers." The Report is therefore to be commended for taking a relatively fresh look at policy issues and problems that have been festering for the better part of 100 years, and for recognizing the need for a comprehensive solution that revisits some basic tenets of prior public policies. For too long, these policies have been based on individualism, ad hoc responses to misinformation in the popular media, parochial advocates, and political constituencies, with increasingly adverse results that finally have some disastrous effects for American consumers and society. If there is to be any hope of reversing this trend, our fundamental approach to the regulation of mortgage finance will need to be re-examined. By inviting reasoned debate on these issues, the Report provides a public service.

"Our plan champions the belief that Americans should have choices in housing that make sense for them and for their families. This means rental options near good schools and good jobs. It means access to credit for those Americans who want to own their own home."
it is obvious that serious choices must be made. While as a general matter commercial mortgages, like the Federal Reserve, is always possible, such an approach is very difficult when the alternatives are in so many ways mutually exclusive, and poses the risk of diluting the effectiveness of every approach. Thus, foundational issues are presented.

To its credit, the Introduction to the Report addresses this concern, at least broadly:

"Going forward, the government's primary role should be limited to robust oversight and consumer protection, targeted assistance for homeowners, and efforts to increase homeownership and renters and carefully designed support for market stability and crisis response..."

Under our plan, private market institutions, including banks, thrifts, and standards for consumer and investor protection — will be the primary source of mortgage credit and bear the burden for losses.11

This language is potentially significant in outlining the parameters of the federal government's intended role in rental markets and housing finance, and the limits of federal funding and credit risk. Of course, as noted above, the devil is always in the details and, in any event, the broad language quoted above somewhat strains the fence as to how much market access, e.g., treating expanded "consumer protection" and "strong oversight" rules as essentially cost-free benefits that have no adverse consequences or alternatives, when in reality the expanded regulatory requirements may be as much a part of the problem as the solution.

Moreover, the Introduction and elsewhere the Report hedges by emphasizing the "fragile state" of the housing markets and a resulting need to implement any public funding at a "measured" pace and to support economic recovery over the next several years.12 While the latter point is sound as a general principle, it can also become a rationale to provide a lower priority for further delay.13

Despite such inevitable limitations and its equivocations, the Introduction to the Report is still a significant step in recognizing that private markets should be the primary source of mortgage credit, and that securitization ("alongside credit" from the banking system)14 should continue to play a major role in housing finance.15 This can be taken as a recognition that public finance (e.g., as practiced over the past five years) cannot be an adequate substitute for our traditional principles of mortgage finance.16

B. Funding for Mortgage Credit

The Introduction to the Report recognizes the need for additional funding to be drawn into the private mortgage markets, as a substitute for the planned withdrawal of the public funding that has sustained mortgage lending (such as it is) since the crash of 2006-2007.17 As a result, the Administration will work with the Federal Housing Finance Agency (FHFA) to develop a plan to recapitalize Fannie Mae and Freddie Mac, and ultimately wind down both institutions.18

The Report also "recommend[s]" that the FHFA expand the use of mortgagebacked securities (like mortgage-backed bonds) in the government.19 However, the details on this are sparse to none. There is somewhat surprising implication that the Dodd-Frank Act will help bring private capital back into the mortgage market and reduce taxpayer risk.20

With due respect, it is not clear to what extent any interest rates or new mortgage requirements and other measures — to bring private capital back into the mortgage market and reduce taxpayer risk.21 The Report does not appear to address this issue. A few more buzzwords or higher down payment requirements on government-subsidized loans seem unlikely to make much difference with respect to this problem. And if the real costs and effects of the private mortgage credit contraction are not addressed, curtailing government assistance may simply make the problems worse.22

Thus, in the Rosen Report,23 the promise in the Report to "mobilitize all tools available" to fix mortgage servicing problems,24 to recapitalize the GSEs,25 and to provide "significant credit and liquidity support" for mortgage lenders including increased guarantee fee pricing, increased down payment requirements, and other measures — to bring private capital back into the mortgage market and reduce taxpayer risk is, at best, empty rhetoric.

As the Report notes, "in the midst of the Great Depression, the federal government began implementing sweeping reforms to the American financial system.26 These included the well-known policy initiatives noted in the Report, e.g., deposit insurance and federal oversight for banks, but went much further with respect to housing finance. The savings and loan (S&L) industry, on which most of the country depended for housing finance, which prior to the 1930s was almost entirely a matter of local law and private transactions, was federalized in the early 1930s by means of a combination of federal deposit insurance, a required mutual charter that eliminated private shareholder interests, "field preemption" of local laws and regulation under the Home Owners Loan Act (HOLA),27 and a mandatory and comprehensive federal business plan essentially limiting thrift institutions to long-term fixed-rate mortgage loans.28

This essentially eliminated the traditional residential mortgage lending systems that were central to finance home ownership. Other, related federal initiatives having the same effect included establishment of the Federal Housing Administration (FHA), the Federal Home Loan Banks (FHLB's), Fannie Mae, and several decades later "Freddie Mac" and Ginnie Mae, all designed to provide federally-subsidized systems of housing finance, essentially at taxpayer risk and expense.29

Thus, in defense of today's massively expensive subsidies of federal housing finance, it can be said that they are a logical extension of eighty-year old policy initiatives—this is a package of New Deal programs that never went away.

The Report seems to argue that this system worked without a hitch until

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11. At.


13. Report, supra text note 1, at 19 ("The Markets").

14. Id.

15. Id. ("The Markets")

16. Report, supra text note 1, at 11 ("The Markets").

17. Id.

18. Report, supra text note 1, at 15 ("The Markets").

19. Id.

20. Id.

21. Id.

22. Id. ("The Markets").


27. Id.


29. Id.

30. Id.
just a few years ago, when the current financial crisis was created by wild and unadulterated speculation and a temptation of taking a lumpy and predatory Judas in 2002 and 2005... [and] [their] pursuit of financial gain... incited them to fall... This is a convenient view, and firmly held in some circles, as it offers a desirable picture of the predatory structure of the system. Unfortunately, the full story is a bit more complicated.

The reality is that the eight years of intense federal regulation and federally-sponsored housing finance have seen a continued pattern of one crisis after another, each one accompanied by significant (even massive) losses (and in some cases bailouts—of various types) imposed on taxpayers, the deposit insurance system, the banking system, mortgage lenders, federal agencies, and, of course, the public (including homeowners). The housing and mortgage crisis of 2006-2011 (and 2012-2013-2017) is merely the latest installment in this saga of continuing, periodic crises and bailouts (often accompanied by promises that it was all a unique event that will never happen again).

So, on this point (as well as a few others to be noted), your author does disagree with some of the Broadway types in the Report. Your author’s personal experience with these issues goes back only to the late 1990s, but in any event that is a good place to start in understanding the 1970s, 1980s and early 1990s were unusal (one can hope, in terms of depression and war) and unencouraging as examples of success in federal policy.

By the 1990s, the federalized thrift industry was a primary source of consumer mortgage credit; while this period is often viewed nostalgically by Elvis fans and in Hollywood movies (and in fact it was the last full decade before yet another wave of activist and volatile federal monetary and regulatory policies, and therefore represents a period of relative stability, or perhaps the quiet before the storm), in fact it was punctuated by economic and housing recessions (including very serious problems in 1998). The Modern Era—1960s to the Great Recession

The 1960s was an even more tumultuous decade, with multiple national recessions, waves of bank failures, and steep declines in housing prices (downward cycles in roughly 1962-63, 1965-66, and 1970-72). Your author personally recalls brand new, two-story, three-bedroom attached-garage brick homes in attractive suburban areas being offered in multiple cases at around $75,000-$80,000, a bargain-base ment price today even after accounting for inflation. As for the 1970s, perhaps the least said the better—this famously painful era of "stagnation" can hardly be cited as an example of federal policy success. Among other things, during the 1970s the federal business model imposed on thrifts, as the primary source for adjustable rate loans (i.e., requiring fixed-rate long-term mortgage loans, with minimal down payments and over-declining capital standards, because such investments were deemed by federal policy-makers to be socially desirable and essentially risk-free, was revealed to be a catastrophic waiting to happen. By the end of the decade, the existence of the entire industry was in doubt, along with its federal deposit insurer; the mortgage and housing markets (and much of the U.S. economy) were in tatters; and the "misery index" (unemployment and inflation rates combined) was going through the roof. In the 1980s, remedial efforts included some modest product deregulation designated to allow thrifts to diversify their lending and investment portfolios, in an effort to save the thrifts from their federally-mandated housing finance plan. Too late. As the FRB struggled to contain inflation by pushing interest rates to levels more or less in line with the real rate, tax changes affecting real estate were enacted to address ballooning deficits, the housing markets crashed and the federalized thrift industry was rendered hopeless and insolvent.

Amidst a media and political crusade to blame "S&L cooks and kingspins," the traditional thrift industry was essentially shut down and replaced by its very different modern descendant. This left many Americans without access to mortgage credit, and it was at this point that a different version of federal housing finance gained new prominence, with increased federal credit mandates, and Fannie and Freddie increasingly acting as giant federalally-subsidized thrifts to support mortgage originations by large and small mortgage bankers, and securitization. There is little in all of this that is aberrational or defensible reasonable expectations. As noted, the Report suggests that a potential "product market" for primary financial industry, and expanded access to homeownership for responsible borrowers. This was no longer garrisoned by the credit risk to the riskier borrowers and home prices were peaking. Of course, it would be nice if a federal agency or GSE could be created that would command the confidence of the capital markets and adjust policy accordingly, at just the correct time. But can it be observed that in our history this has not happened yet, despite regular promises to the contrary. Does this mean we should stop trying? Perhaps not, but perhaps we should also stop putting so many eggs in this basket. The Report essentially explains the 1993-2006 housing boom and its subsequent collapse as a series of unfortunate events for which "(almost no one) prepared, so that mortgages be- came "tools" for speculation and "easy cash," homeowner" were ["filled into a false sense of an over-riding real estate market, some homebuyers took on more debt than they could afford to purchase homes beyond their means, and existing homeowners sold their homes [to convert] home equity to cash." All true, but no doubt also difficult to avoid in a free economy with an inflationary, low interest rate environment.

This explanation in the Report is quite convenient, and has been expressed by more than one commentator. However, it fails to account for the obvious effects of federal housing finance subsidies and mandates, fifteen years of mostly crony FRB monetary policy that created an expectation of continuing inflation and easy profits in housing prices, and a consistent policy favoring ex- panded access to mortgage credit, fol- lowed by a contradictory policy crusade against "predatory lending" that ultimately cut off the sales and refinanc- ing options for millions of consumers as the market was casing.

So, your author also must disagree with the Report suggesting that the causes of this devastating volatil- ity in mortgage credit availability and housing prices are somehow mysterious and too complex to easily explain, that federal policy has been "conditioned on successfully managing downturns in the housing market, and that, barring a few aberrations, the past eighty years illustrate an unbroken string of successes in federal management of these transactions, issues, and markets.

To be sure, cycles and matters having countercyclical effects (though at what ultimate cost and level of success are another matter), but arguably the real historical lesson and
problem is that the federal policies and regulations contributed to the 1993–2006 housing bubble and its subsequent collapse, all driven by artificial growth and housing finance that flouted the mortgage markets, and that federal funding (with limited success and perhaps at high cost to taxpayers) has not been able to replace it.64 But, the real question is: What caused this private capital to flow, and what can be done to get it to come back? Those issues are largely skirted in the Report does not detract from its productive contributions to the discussion of potential future solutions, but neither does it avoid such obvious shortcomings in the scope and background material of the Report.


The Report accurately yet somewhat understatedly states that "[a] single cause can fully explain the crisis. Misbehavior, misjudgments, and missed opportunities—on Wall Street, on Main Street, and in Washington—all can come together to push the economy to the brink of collapse."65 The Report goes on to outline the "fundamental flaws" in the housing finance system that "contributed to the crisis and must be corrected."66 This is where it starts to get good.

The Report recognizes that "[n]ormal market conditions, the essential components of housing finance—buying houses, lending money, determining how best to invest capital, and bearing credit risk—are fundamentally private sector activities...[P]rivate capital is the primary source of mortgage credit and bears the burden of losses."67 Obvious though it may be, this is a significant departure from the notion of "normal" as the federal government can step in to favor private markets, despite the fact that the Report emphasizes that even in "normal" markets the government still has an important role to play in housing finance [and private markets].68 Again there is no doubt that this is true, but the nature and extent of that government role is the crucial issue. Again the Report largely avoids this question. As noted below, the "options" at the end of the Report offer alternative approaches, including various roles for Fannie Mae and Freddie Mac, and the Report is to be commended for doing so. But the discussion is necessarily broad and in any event does not address the issue or impact of federal regulation on the mortgage markets, which in your author's experience is a primary factor in the collapse of private mortgage finance.69 It seems that the focus of the Report, if it can do this in regard to a promise that [the Obama Administration, in consultation with FHASA and Congress, will work to] "redesign the architecture of mortgage finance in which Fannie Mae, Freddie Mac, and the FHLBs operate, so that overall government support is reduced."70 This is important, and perhaps constructive, but it hardly seems enough to attract private capital and restructure the private mortgage markets.71 And, the Report recognizes, even if implemented, this must be done "carefully," so that "government support is withdrawn at a pace that does not undermine economic recovery."72 One can only assume that this will mean a very slow pace indeed, given the amount of serious effort to attract private risk-capital and the likelihood of ever reaching a consensus that such a recovery is so complete that government support is no longer needed.

2. "Winding Down" Fannie and Freddie

Nonetheless, as noted, the Report is significant for recognizing a need to "wind down" Fannie and Freddie,73 though inevitably at a "deliberate pace" providing ample room for delay. The Report then describes four proposals, or goals, to be considered in establishing a "responsible timeline" for winding down the GSEs:

- increasing guarantee fees to bring in more private capital;
- increasing private risk capital ahead of Fannie Mae and Freddie Mac guarantees;
- reducing conforming loan limits; and
- winding down Fannie Mae and Freddie Mac's investment portfolio.74

Again, these are generally laudable objectives. An increase in guarantee fees could help reduce the GSEs' displacement of private capital and reduce taxpayer risk. A reduction in the GSE loan limits could have the same effect. Reducing the GSEs' securities market activities seems a no-brainer (as this benefited primarily the GSEs, who no longer exist). So these proposals are fine, as far as they go.

It should, however, be noted that these are relatively modest steps, that do not address the larger issues and, one can speculate, may not be sufficient to prevent some form of "government capital". The Report notes that this form of "government capital" is a "historic role of ten-to-fifteen percent." While it may be difficult to accomplish this simultaneously with the shrinking of Fannie and Freddie, the Report promises to do precisely that: "As Fannie Mae and Freddie Mac's presence in the Market shrinks, the Administration will consider the program changes at FHA to ensure that the private market—not FNA—picks up that new market share. Clearly, a simultaneous shrinkage of Fannie, Freddie, and the FHA, without more, would create a giant hole in the funding for mortgage transactions, suggesting the need for a very dramatic reversal of the flight of private capital from these markets that has been evident since 2006. It would, perhaps, be more comforting if the Report focused more on how this revival of private markets is to be accomplished, since any significant evidence of such a revival remains well hidden at the moment. Instead, however, the Report focuses on a tentative withdrawal of FHA guarantees, with a significant decrease in the maximum size of FHA loans and raising the mortgage insurance premiums that FHA charges its borrowers. While such reforms undoubtedly would be helpful, as part of a program to reduce federal subsidies, risks and burdens in the context of resuscitated private markets, essentially they address the easy part of the equation. The more difficult issue is how to reverse the flight of private capital once that is done, it should be easy to cut back unnecessary federal alternatives. But how to get there

64. See supra Part I.C.2.b. for examples thereof.
65. See supra Part I.D.1. All the headlines notwithstanding, it is surely apparent that a couple of things have happened since ROB J. TRAVIS LIT OFFICIALS DEDICATE new 6.25-foot-long monument to the "hurricane busters" in the National Hurricane Center, at 5001 S.W. 18th Street, Miami, on July 25. (See also ROB J. TRAVIS, At 5001 S.W. 18th Street, Miami, on July 25. (See also ROB J. TRAVIS, At 5001 S.W. 18th Street, Miami, on July 25.
66. See supra Part I.C.3. All officials are under oath, and the author is a former U.S. Attorney for the District of Kansas. Therefore, for the purposes of this Article, the author will assume that the officials are telling the truth.
67. See supra Part I.C.4. All officials are under oath, and the author is a former U.S. Attorney for the District of Kansas. Therefore, for the purposes of this Article, the author will assume that the officials are telling the truth.
68. See supra Part I.C.5. All officials are under oath, and the author is a former U.S. Attorney for the District of Kansas. Therefore, for the purposes of this Article, the author will assume that the officials are telling the truth.
69. See supra Part I.C.6. All officials are under oath, and the author is a former U.S. Attorney for the District of Kansas. Therefore, for the purposes of this Article, the author will assume that the officials are telling the truth.
70. See supra Part I.C.7. All officials are under oath, and the author is a former U.S. Attorney for the District of Kansas. Therefore, for the purposes of this Article, the author will assume that the officials are telling the truth.
71. See supra Part I.C.8. All officials are under oath, and the author is a former U.S. Attorney for the District of Kansas. Therefore, for the purposes of this Article, the author will assume that the officials are telling the truth.
72. See supra Part I.C.9. All officials are under oath, and the author is a former U.S. Attorney for the District of Kansas. Therefore, for the purposes of this Article, the author will assume that the officials are telling the truth.
73. See supra Part I.C.10. All officials are under oath, and the author is a former U.S. Attorney for the District of Kansas. Therefore, for the purposes of this Article, the author will assume that the officials are telling the truth.
74. See supra Part I.C.11. All officials are under oath, and the author is a former U.S. Attorney for the District of Kansas. Therefore, for the purposes of this Article, the author will assume that the officials are telling the truth.
is the real question (and, it seems, an unanswered one, at least in the Report).

4. Reforming the FHLB System

As with Fannie and Freddie, the Report notes that the regional Federal Home Loan Banks (FHLBs) have played a significant role in providing funds for housing finance, in this case by providing a source of liquidity for the lending programs of smaller financial institutions.

But, as with other such federal programs, sometimes the cost has been high. The Report notes that the FHLBs have "developed significant weaknesses as the housing finance [has] evolved:[3] that should be addressed as part of housing finance reform." The Report endorses "strict regulatory oversight," and adds that "additional sources of funding including potentially the use of "covered bonds," while also allowing financial institutions to sustain themselves to the limits of the FHLB advances; and (as with Fannie and Freddie[4]) limiting FHLB securities and investment portfolio activities and activities.

5. Improving Agency Coordination

The Report also advocates improved coordination among federal housing agencies and programs, promising that a joint task force will be formed to be under the Department of Housing and Urban Development, the Department of Agriculture, and the Department of Veterans Affairs.

"To explore in particular in which areas of the housing finance programs can be better coordinated."

While a laudable goal (who would argue against better coordination?), I find it odd that obviously redundant policies and programs would be so easily offered to a simple solution but more difficult to achieve in a meaningful manner.

G. Restoring Trust and Integrity in the Housing Market

This is subpart II of the Report segment entitled "Towards a New System of Housing Finance," and is the next major component to the world economy has experienced a dramatic reversal of fortune since 2006, with "home values in the U.S. plummeting" and "the relative economic standing of the U.S.declining." It is apparent that this was triggered by a collapse of mortgage lending that left many mortgagors unable to pay for their houses, or, reformulate a new housing system.

This is a reversal of the fifteen-year housing and credit boom that began in 1993, and was sustained in large measure by accommodative FRB monetary policies and investor confidence in U.S. mortgage losses and market results. In response to the subsequent (and continuing) housing and mortgage crisis, the FRB has massively replicated (and even exceeded) its prior accommodationary monetary stance, to the point of contributing to a world-wide economic conditions that may threaten world financial systems, and investors, lend mortgages to mortgage defaulters, and provoke a repeat of the crisis.

Yet this response has been insufficient to restore trust in the mortgage markets or reverse the flight of private capital from these markets.

Clearly, something structural has changed, requiring monetary policy less effective (and creating new dangers by encouraging its excessive use) and policies for more of the same became increasingly apparent in 2006, and these fears were confirmed in subsequent years and especially with enactment of the Dodd-Frank Act in 2010.

The legal environment changed meaningfully in 2009 in enactment of the Federal Consumer Credit Protection Act (which itself probably led to higher credit costs and consolidation in the mortgage industry), the primary impact was to impose a disclosure regime that left intact the state common law-based structure of substantive law.

This has gradually eroded in the years since, particularly after enactment of HAMP in 2009, which the Truth in Lending Act and associated federal regulations modified, significantly into federal substantive law.

Nonetheless, until the recent explosion of anti-subprime lending initiatives, the problems with HAMP could be easily avoided if mortgage lending increases.

But major changes began apparent beginning in roughly 2006, with changes in the composition of the U.S. Congress accompanied by a noteworthy increase in federal and state regulatory and predatory lending initiatives, culminating in enactment of the Dodd-Frank Act. By 2007 this trend was apparent and amply reflected in the regulations and guidelines being issued by federal agencies.

The Dodd-Frank Act, regarded by some in the industry as a catastrophe piled on top of a disaster, aimed at preventing the "laying the groundwork for many of these reforms."

Turning now to the issue of trust in this context, and that the provision of more risk and interest in the common law system (and especially contract law) was itself something of a historical accident, while it is obviously too much to expect such an accident to recur in a timely manner for our current model of government, there is a strong consensus favoring such a solution, inherent political dynamics favor a worsening legal environment rather than an effective solution. This is reflected experience, and that experience does not bode well for the future.

Aspects of the Report reinforce this concern. The Report cites as a primary solution the need for increased federal regulation of consumer transactions, as the "vigorously implement nationalization of reforms...improve consumer protection...and establish clarity and consolidated regulatory oversight."
This does not mean all Americans should become homeowners.114 Instead, we think that all Americans who have the credit history, financial capacity, and desire to own a home have the opportunity to take advantage of that step. At the same time, we should ensure that there are a range of affordable options for the 100 million Americans who rent, whether they do so by choice or necessity.115

While this may be a "plan [that] works" for homeowners, it does not sound like one that will "scale back the role of government,"116 instead, it is a step toward reducing the role of government in our financial system.117 In any event, the Report cites four "primary areas of reform" that need to be addressed in order to accomplish the goals noted above:

- a reformed and strengthened FHA;
- a commitment to affordable rental housing;
- measures to ensure that capital is available to credit-worthy borrowers who have incomes up to the median level for their area neighborhood with the highest FHA loan limits;
- a flexible and transparent funding source to support targeted access and affordability initiatives.118

The Report goes on to emphasize that "we do all in a way that does not allow the FHA to expand during normal economic times to the extent that it is needed in a time of stress. The current FHA lending limit of $417,000, for example, is set to expire at the end of 2020. In any event, the Report specifically promises to "explore ways to provide greater support for rental housing," with "[o]ne option" being an expansion of FHA programs.119

"(Ensuring that capital is available to creditworthy borrowers in all communities"120 is another laudable goal, and could be taken as a call to address the need for credit for those who are not homeowners. Unfortunately, the Report seemsinclined to use a stick rather than a carrot to achieve this goal, e.g., emphasizing expanded efforts to "ensure that all mortgage markets are complying with laws that prohibit discrimination in providing capital to borrowers and communities."121 These efforts will include "revisiting the practices of financial institutions that have been found to discriminate in their lending practices."122

The Report indicates that this new funding mechanism will "support the development and preservation of more affordable rental housing for the lowest-income families to address serious supply shortages.123 Similar to the Housing Trust Fund that the President has proposed..."124 It will also "support down-payment assistance and counseling to help low- and moderate-income homeowners," and "scale up support for proven nonprofit partnerships for affordable housing production..." This "funding would help overcome market failures..."125 and the "targeted...clearly defined objectives and programs."126

Overall, this section of the Report127 is a call for the government to take a more active role in creating affordable housing, with a focus on providing financial support for those who are unable to purchase a home. This is in line with the Report's goal of "expanding the role of government in our financial system."
mortality, and rental assistance programs. The only apparent exception is the role for private capital in compulsory in nature, i.e., a renewed emphasis on enforcing compliance with federal fair housing mandates.

IV. A Responsible Path Forward for Reform

A. Introduction

This part of the Report addresses scheduling issues relating to implementation of the reforms described in the Report, and outlines three alternative approaches (the "Options"). It is likely that this is the part of the Report that will receive the most attention, with the prior twenty-five pages serving the role of background material and general principles which, though important as groundwork and for purposes of political debate, may yield to the practicalities addressed in the final eight pages of the Report.

The letter discussion begins by restating a central theme of the Report: "The need for a responsible approach to any reduction in the role of Fannie and Freddie, e.g., emphasizing the need for a " prudent transition plan," rather than a "catastrophic transition plan" that avoids "unnecessarily constraining the GSEs in ways that could "limit the availability of mortgage credit," shock the housing market, and expose taxpayers to additional losses." While these are undoubtedly valid concerns, one cannot help recalling again the Red Promising Jam yesterday, and Tomorrow, but never jam today. Clearly this represents a potential trap for advocates of reform: Given the absence of private capital in the mortgage markets, and the lack of any serious plan for getting it back, a winding down of Fannie and Freddie would hit the mortage and housing markets hard, generating pressure for a reversal of the reforms. Here again the Report takes the position that the winddown of Freddie and Fannie are essentially an aberrational event, relating entirely to "bad loans made during the height of the Market," and that the "payment cure" or "temporary lapse in an otherwise stellar record of Federal housing and mortgage programs." This does not sound like an argument for "winding down" the GSEs or the government's role in the housing markets. The Report specifically concludes that today's "setting aside capital" is "likely to pose a significant risk of loss to taxpayers."

But, the emphasis is on a "transition that allows for continued support of the housing market...so that mortgage credit continues to flow..." Given that private capital is essentially not flowing at all in residential mortgage transactions, this raises an interesting issue: How to reduce the only significant source of mortgage credit without reducing the flow of that credit? The Report aims to address this in the material that follows.

B. The Importance of a Responsible Transition

This segment of the Report focuses on the pace of reforms and favors a cautious approach to any reduction in the role of Fannie and Freddie, e.g., emphasizing the need for a " prudent transition plan," rather than a "catastrophic transition plan" that avoids "unnecessarily constraining the GSEs in ways that could "limit the availability of mortgage credit," shock the housing market, and expose taxpayers to additional losses." While these are undoubtedly valid concerns, one cannot help recalling again the Red Promising Jam yesterday, and Tomorrow, but never jam today. Clearly this represents a potential trap for advocates of reform: Given the absence of private capital in the mortgage markets, and the lack of any serious plan for getting it back, a winding down of Fannie and Freddie would hit the mortage and housing markets hard, generating pressure for a reversal of the reforms. Here again the Report takes the position that the winddown of Freddie and Fannie are essentially an aberrational event, relating entirely to "bad loans made during the height of the Market," and that the "payment cure" or "temporary lapse in an otherwise stellar record of Federal housing and mortgage programs." This does not sound like an argument for "winding down" the GSEs or the government's role in the housing markets. The Report specifically concludes that today's "setting aside capital" is "likely to pose a significant risk of loss to taxpayers."

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C. A Path Forward

In this segment the Report again emphasizes the need to exercise "cautious" care in winding down Fannie and Freddie (and reducing the size of the FHA). as access to mortgage credit, []government support for housing finance can provide access to mortgage credit, by attracting additional capital into the housing finance system...[120] This point is brought out in the Report, referring to the "transition to a more privatized market," which should be completed. The Report then provides a number of Options or Options to the basic structure of the market.

D. Options for a Long-Term Structure of Housing Finance—Four Key Factors

Before outlining the three Options offered in the Report, the Report lists four "key factors" that are important considerations in meeting Americans' housing needs, i.e.,

- access to mortgage credit;
- incentives for investment in housing;
- taxpayer protection; and
- financial and economic stability.

As with many of the broad goals and considerations stated in the Report, these are undoubtedly valid and important issues. However, the discussion of each in the Report seems directed to enhance (or at least stress) the positive role of the federal government in meeting the stated goals. While probably this is to be expected in a Report issued by federal entities, it does not appear to support the stated theme of reducing the government's role.

For example, with regard to providing access to mortgage credit, []government support for housing finance can provide access to mortgage credit, ...by attracting additional capital into the housing finance system...[120] This point is brought out in the Report, referring to the "transition to a more privatized market," which should be completed. The Report then provides a number of Options or Options to the basic structure of the market.

Political influences may exacerbate these risks. But this would be difficult to wholly ignore or deny these obvious risks to the economy. It is the concern for at least (if briefly[121]) noting them. As a solution to this, there is one sentence: "[S]triving for private capital to compete with government guarantees or providing a way to ensure taxpayer losses are repaid through future assessments, such as financial fees, may mitigate these risks."

Again, unfortunately, this merely begs the question: How can private risk capital be truly entered, e.g., in the face of an apparent capital structure apparently entrenched at least in part by an overly burdensome and increasingly hostile legal climate? And of course, the promise of "future assessments" as a solution does little to mitigate these problems, quite aside from sidestepping the issue of taxpayer risk by simply passing the cost of any losses further into the future.

Finally, as to the fourth key factor, the need for financial and economic stability, this segment of the Report again stresses the role of government: "Government support can help promote financial stability by ensuring the flow of credit through periods of economic stress...[122] Again as an aspirational statement this is undoubtedly true, though the Report does not offer any indication that in practice there also may be instances where that support is rather more destabilizing.

There can be no doubt that direct (and, in some instances, more subtle） federal support has sustained the housing and mortgage markets (such as they are) since the withdrawal of private capital began in roughly 2008. But it can also be argued...
that the housing bubble that preceded the crash was in significant measure fostered by federal housing, credit and monetary policies, and that the subsequent crash was in part the fault of an increasingly onerous legal and regulatory environment. So, aspirations of federal policies and supports are not appropriately promoting financial stability and home ownership without undue risk to taxpayers are fine, but the reality is that there is considerable doubt as to the likely fulfillment of those aspirations. Thus, some healthy skepticism on this point appears to be warranted.

If we are moving on to describe each of the proposed Options, the Report recognizes the inherent contradictions ("trade-offs") in these four key factors. The Report also recognizes the dramatic polarization of views on these issues, with some advocates seeking a "near complete privatization of the mortgage market"... while others seek "a near complete nationalization." The Report opines that both of these basic approaches are "impossible," but rejects them: "Complete privatization would limit access to...

FRB's ability to respond to crises using its numerous policy tools. Arguably, given viable private market tools are the most effective means of dealing with liquidity crises. But they are currently not functioning as intended. In light of current Federal Reserve's inability to "manage liquidity operations, the 'near complete privatization' scenario represented by Option 1 would hardly seem realistic, and the government's overall role in the housing finance system would be dramatically reduced...

58. The Report cites a strength of Option 2, "the government would also develop a backstop mechanism to ensure access to credit during a housing crisis."

59. "This backstop would maintain a minimal presence in the market during normal times, to ensure that some mortgage borrowers would not have to scale up to a larger share of the market as private capital withdraws in times of financial stress." 515. Suggested approaches for implementing Option 2 include a "confidence" in "normal times," with authority to "ramp up" the "assistance in times of stress.

60. The Report cites in a strength of Option 2 the government's ability to respond in order to "soothe a contraction of credit during a crisis. Thus, government support for the primary mortgage market... only expanded when needed.... During normal times [this would] avoid the distortions in the housing market associated with a broad-based guarantee and thus reduce both moral hazard..." and taxpayer risk. In addition, the government would be in a better position to manage another downturn in the housing market. As private capital pulls back, the government could better step in to mitigate any greater risk than would be more effective than relying only on Congress, FHA, and the Federal Reserve...

61. To its credit, the Report notes the challenges of designing and managing an organization that can remain small...
during normal economic times, yet has the capacity to take on much more business quickly during ... times of need.225 As of September 30, 1986, the Report notes (and with Option 1) that mortgage credit, "particularly the pre-payable, 30-year fixed-rate mortgage, will likely be more expensive under this option" as compared to Option 3.226

C. Option 3: Catastrophic Reinsurance Behind Private Capital227

Option 3 builds on the first two. As in Options 1 and 2, under Option 3 FHA and other federal agency programs are to provide mortgage credit for low- and moderate-income borrowers.228 In this Option, however, the private mortgage markets that serve prime borrowers would be further bolstered by a federal reinsurance program for securities backed by a "targeted range of mortgages."229

One component of this could be to have private mortgage guarantor companies, "that meet stringent capital and oversight requirements," provide guarantees for certain mortgage-backed securities.230 A government reinsurance would then provide a further backstop, in case the private insurers are "wiped out."231 Both the private guarantor companies and the government reinsurance fund would charge premiums designed to cover future claims.232

VI. Report Conclusion

The Report summarizes its conclusions in a final part entitled "The Choice Ahead."233 This conclusion recognizes that decision makers considering these issues are "faced with difficult trade-offs,"234 requiring a "balance between providing broad access to mortgages for American families, managing the risks of taxpayers, and maintaining a stable and healthy mortgage market."235 Trade-offs are particularly acute in view of the parameters and limited range of the policy alternatives considered in the Report (i.e., essentially those dependent on federal oversight and funding mechanisms). Given these constraints, there is inherently an inverse relation between the level of support provided for the mortgage markets and taxpayer protection.

The Report elicits a need to "scale back the role of government," but carefully limits any such effort. The Report apparently contemplates the end of Fannie and Freddie as we know them (though both Options 2 and 3 could well evolve into close relatives, with some of the same problems), and much of the media commentary has logically focused on these issues.236

However, there are other noteworthy aspects to the Report, including:

- an apparent decision that sub-prime borrowers will be served largely by (or at the discretion of) the federal government;237
- an assumption that the best way to attract private capital back to the mortgage markets is more rigorous enforcement of anti-discrimination regulation and enforcement;238
- an apparent belief that the only way to preserve reasonably priced, thirty-year fixed-rate mortgage loans for American home buyers with prime credit is to create some kind of federally-subsidized or federally-insured guaranty system;239
- an apparent belief that private market cycles are not acceptable or self-correcting, and therefore must be managed by federal authorities using "counter-cyclical" assistance;240 and
- consistent with all of the above, there is no perceived need to mention or consider the possibility that some of the federal initiatives cited as benefits and solutions are in fact a part of the problems driving away private risk capital by creating legal and regulatory uncertainties, burdens, costs and risks.

In its concluding paragraph the Report recognizes that "[t]he housing finance system must be reformed" and that "[t]he FHA is central to not only homeownership and anti-discrimination regulation and enforcement."241 Unfortunately, the Report seems to draw lines that preclude reconsideration of federal initiatives that may have contributed to the unprecedented flight of risk capital from American mortgage markets since 2006. Unless these problems are effectively addressed, any additional scaling back of federal housing and mortgage subsidies (including a winding-down of Fannie and Freddie), a reduction in the role of the FHA, and the end of monetary initiatives such as the FRB's "QE2"242 will merely drive new mauls into the eftin of American housing finance, and the economy. It will take much more than such cut-backs, and the other federal solutions advocated in the Report, to re-create a healthy private mortgage finance system that can function adequately without subsidies that constitute a prelude to the next taxpayer bailout.

VII. Legislative Response

In May, 2011 two members of Congress introduced proposed legislation billed as a nonpartisan compromise to reform the housing finance system by replacing Fannie and Freddie with five private companies that would operate with explicit federal guarantees (the proposal).243 The proposal appears to be based, at least in part, on the Report and is designed to attract bipartisan support. A primary selling point seems to be that the proposal is better than nothing-

"The only other approach that's out there in a bill is one that replaces Fan-

niece and Freddie with nothing."244 The proposal is said to have the support of many groups representing the housing and financial-services industries.245 The five private companies would perform essentially the same services as Fannie and Freddie, but also provide a mechanism to meet certain standards and issuing mortgage-backed securities with explicit federal guarantees.246 The companies would operate as federally-sponsored utilities and would not have stock exchange-listed shares. The goal is to use the federal guarantees to attract private capital to the mortgage mar-

tet.247 It is said that the industry opposes more aggressive reform proposals.248 Critics note that the proposal is merely another rebranding of the same old Fannie and Freddie business model, only with taxpayers directly bearing the risk with an explicit federal guarantee. "In reality, this is almost surely going to be the same," said one critic, as these types of federal insurance programs inevitably lead to "a catastrophe."249 As usual with federal legislation, the proposal is short on specifics and "leaves many details to the agencies and the market,"250 with little movement since its introduction.