Is competition the solution or the problem? An analysis of U.S. mortgage securitization

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Michael Simkovic¹  
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This article’s original contribution to the literature about the causes of the U.S. mortgage crisis of the late 2000s is to analyze two important causes that have thus far only been discussed in passing. First, this article provides evidence that fragmentation of the securitization market in the mid-2000s and competition between mortgage securitizers undermined securitizers’ ability to control originators, and that such competition led to a race to the bottom on underwriting standards. Second, this article provides evidence of a shift in market power away from securitizers and toward originators during the mid-2000s, and argues that this shift in power eroded securitizers’ ability to enforce discipline and maintain prudent underwriting standards.

This article provides evidence that Government Sponsored Enterprises (“GSEs”) were more successful than other mortgage securitizers at maintaining prudent underwriting. Underwriting means preventing losses at the front end rather than shifting losses after the fact by basing loan approval decisions and lending terms on data-driven predictions of the likelihood of default and severity of losses in the event of default. The GSEs success is probably in part because of the large size and therefore large market power of the GSEs.

This article explains another reason why a higher degree of government control may be associated with more conservative mortgage underwriting: incentives. Whereas private investors and managers capture most of the upside of mortgage lending, taxpayers bear most of the downside risk because of limited liability, public safety nets, and the cyclicality of default risk. This article discusses the effects of longstanding public subsidies of private financial institutions through safety nets and tax policy, as well as “bailouts” during times of crisis. This article also reviews evidence from loan performance and lobbying activity consistent with the view that government often prefers more conservative underwriting, while private financial institutions seek to take greater risks.

These findings have profound implications for post-crisis reform of U.S. residential mortgage finance. U.S. policy makers often assume that consumers, investors, and government finances are best protected not by centralized power,

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but rather by market competition. This faith in competition motivates proposals by the U.S. Treasury department for radical reform. Specifically, Treasury has put forth three options, all of which seek to reduce centralization and stoke competition between financial intermediaries such as mortgage securitizers and guarantors. However, Treasury’s proposals overlook the role that competition played in the subprime mortgage crisis and also overlook the relatively more prudent underwriting by government-affiliated secondary market players.

This article concludes that notwithstanding recent financial regulation reforms, fragmentation of the mortgage securitization market may still lead to greater risk-taking by mortgage originators, future public bailouts of private financial institutions may be inevitable, and that a reprivatized, fragmented securitization market could ultimately prove more dangerous to taxpayers than the post-crisis status quo of de facto government monopoly. Though not definitive, the evidence presented in this article raises serious concerns that should be addressed before Treasury proceeds with radical reform of U.S. housing finance.

This article proposes an alternative based on the U.S.’s successful post-WWII mortgage market and lessons from the recent financial crisis: merge the GSEs with various government agencies’ mortgage operations to create a single state owned enterprise that would seek to maintain market stability, improve underwriting, and provide a long term investment return for the benefit of taxpayers.

I. Introduction: Our government-run mortgage market

Mortgage securitization by competing private financial institutions has been tried three times in U.S. history, and each time the market collapsed. Securitization is a method of financing whereby loan receivables or other cash flows are bundled into securities and sold to investors. Primitive private mortgage securitization was tried in the late 1800s and failed in the 1890s.\(^2\) Another variation on private mortgage securitization failed in the late 1920s.\(^3\)

After the second failure of private mortgage securitization and the Great Depression, the U.S. government started to play a more active role in housing finance—bearing credit risk, allocating capital, and—under very limited circumstances—originating loans. The Federal government bore credit risk by insuring mortgages through the Federal Housing Administration (“FHA”),


established in 1934,⁴ the Department of Veterans Affairs ("VA") loan guarantee program, established in 1944,⁵ and the Farmers Home Administration ("FmHA"), established in 1946.⁶ The government also bore credit risk by buying mortgages through Federal National Mortgage Association ("Fannie Mae"), originally established as a division of the government in 1938.⁷ The government originated a very large number of mortgage loans during the Great Depression through the Home Owners' Loan Corporation,⁸ but the government rarely originates loans today.⁹

Fannie Mae was privatized in 1968 to shrink the Federal Government’s balance sheet, although it was generally assumed by investors that the Federal Government would probably rescue Fannie Mae if it ever became insolvent.¹⁰ Because of its origins as a government agency, Fannie Mae is referred to as a Government Sponsored Enterprise ("GSE") and its securities are sometimes referred to as “Agency” securities. In 1970, a similar GSE, Federal Home Loan Mortgage Corporation ("Freddie Mac"), was created to serve a slightly different set of mortgage originators and to compete with Fannie Mae.¹¹ After the privatization of Fannie Mae in 1968, the government continued to directly bear credit risk by guaranteeing mortgage-backed securities through a government agency, Government National Mortgage Association ("Ginnie Mae").¹² The government allocates capital through laws, regulations and policies that limit

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⁸ Snowden, supra note 3 at 21-22 ("HOLC [opened] 400 offices throughout the country and employ[ed] a staff of 20,000 to process loans and appraise properties. In only three years the agency received applications from 40 percent of all residential mortgagees and wrote new loans on ten percent of the owner-occupied homes in the U.S.").
¹¹ Freddie Mac was created by the government as a private company. FREDDIE MAC, Company Profile, http://www.freddiemac.com/corporate/company_profile/ (last visited June 22, 2011).
¹² Ginnie Mae is backed by the full faith and credit of the U.S. government. GINNIE MAE, About Ginnie Mae, http://www.ginniemae.gov/about/about.asp?Section=About (last visited June 22, 2011). Technically, Ginnie Mae does not actually securitize mortgages; it guarantees mortgage backed securities ("MBS") comprised of loans insured by the Federal Housing Administration ("FHA") or guaranteed by the department of Veterans Affairs ("VA"). Id.
eligibility for government mortgage programs and set credit standards and pricing.\textsuperscript{13}

Large-scale private mortgage securitization by non-GSEs reemerged in the early 1980s. In the mid-2000s, competition between private mortgage securitizers—large investment banks, commercial banks, and the GSEs—intensified, with non-GSE securitization overtaking GSE securitization in 2005. After extremely high default rates for securitized subprime mortgages, private non-GSE securitization collapsed in late 2007 and early 2008. The U.S. government provided low cost capital, guarantees, and other public support to both GSEs and large non-GSE securitizers. The GSEs were effectively renationalized in September of 2008, while other financial institutions remained privately owned.\textsuperscript{14} The recent mortgage crisis is at least the third failure of private mortgage securitization in U.S. history.

In the wake of the crisis, U.S. residential mortgage finance has become heavily dependent on government support. Mortgages originated since 2008 have overwhelmingly been financed through securitization, mortgages have been securitized almost exclusively by renationalized GSEs or guaranteed by government agencies, and the largest net purchasers of mortgage backed securities are now the Federal Reserve and U.S. Treasury. Figure 1 below shows that annual mortgage origination volume has plunged since 2006, while the share of mortgages that are funded through securitization has shot up. Figure 2 shows that after the financial crisis, most new mortgage backed securities have been issued by government-backed entities. These entities include the GSEs—Fannie Mae and Freddie Mac—as well as a government agency, Ginnie Mae. Even though these securities carry government guarantees, figure 3 shows that most private investors have nevertheless reduced their exposure to mortgage backed securities ("MBS"), while the Federal Reserve and Treasury have purchased MBS and thereby provided much of the funding for new mortgage loans.


\textsuperscript{14} In September 2008, the Federal Housing Finance Agency ("FHFA") became the conservator of the GSEs. In connection with the conservatorship, Treasury committed to fund any shortfalls in their net worth. Fannie Mae, \textit{supra} note 10.
Figure 1: While home mortgage origination volume has fallen to below 2001 levels, securitization rates have climbed to record highs since 2008

U.S. home mortgage origination volume and securitization rates, 1989-2010

<table>
<thead>
<tr>
<th>Originations, USD trillions</th>
<th>Securitization rate, percent</th>
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Note: Total MBS figures used to calculate securitization rates excludes re-securitizations, scratch-and-dent MBS and deals backed by seasoned loans.

Figure 2: After the financial crisis, GSE/Agency market share of mortgage securitization shot up to 95 percent, the highest government share in 20 years

U.S. mortgage-backed securities issuance, 1985-2010

<table>
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<tr>
<th>Market share, percent</th>
<th>MBS Issuance, USD trillions</th>
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Note: Agency MBS issuance includes GNMA, FHLMC, and FNMA.
II. Competition may lead to a race-to-the-bottom on underwriting and risk management

As discussed in greater detail below, the U.S. Treasury department and a number of experts have expressed concern about the extent of government involvement in mortgage finance and would like to restore a competitive, private market. However, the role of competition as a contributing cause of the mortgage crisis suggests that privatization could lead to instability and future losses for taxpayers.

Traditional economic theory generally suggests that greater competition between financial institutions leads to more risk-taking and more frequent financial crises. This traditional view is supported by empirical studies of the United...
States and a handful of other countries. The traditional view, though still dominant, has been challenged by some studies of select non-U.S. markets, and by studies that measure competition using alternate measures such as barriers to entry, pricing, and profit margins. These varied results suggest that it may be risky to generalize about the impact of competition, and that specific financial markets should be studied individually, in depth. At least one theoretical paper has suggested that in a fragmented, competitive mortgage market, the

at http://webprofesores.iese.edu/xvives/Docs/p_English/99.pdf (noting that regulations have often been used to try to control excessive risk taking caused by competition); Thorsten Beck, Asli Demirguc-Kunt & Ross Levine, Bank Concentration and Fragility: Impact and Mechanics, in THE RISKS OF FINANCIAL INSTITUTIONS (Rene M. Stultz & Mark Carey eds.), available at http://www.econ.brown.edu/fac/Ross_Levine/Publication/Forthcoming/Forth_3RL_Book_Stultz.pdf (arguing that the traditional 'competition-fragility' view, more bank competition erodes market power...[t]his encourages banking organizations to take on more risk to increase returns.).


John H. Boyd & Gianni De Niccolo, The Theory of Bank Risk-Taking and Competition Revisited, 60 J. FIN. 1329, 1329-1343 (2005); Klaus Schaeck, Martin Cihak & Simon Wolfe, Are Competitive Banking Systems More Stable?, 41 J. MONEY, CREDIT & BANKING 711, 711-734 (Jun 2009), available at 2009 WLNR 10798376 (finding that concentration is associated with greater financial system stability, but so is competition measured by alternate measures); Allen N. Berger, Leora F. Klapper & Rima Turk Ariss, supra note 15, at 16 (arguing that the traditional view is largely supported by the information collected in 23 industrial nations, but that some support for alternative models is also shown); Thorsten Beck, Asli Demirguc-Kunt & Ross Levine, Bank Concentration and Fragility: Impact and Mechanics, in THE RISKS OF FINANCIAL INSTITUTIONS (Rene M. Stultz & Mark Carey eds.), available at http://www.econ.brown.edu/fac/Ross_Levine/Publication/Forthcoming/Forth_3RL_Book_Stultz.pdf (arguing that alternative models show competition does not increase fragility); Ramon Caminal & Carmen Matutes, Market Power and Banking Failures, 20 INT’L J. INDUS. ORG. 1341, 1341-61 (2002), available at http://www.iae.csic.es/investigatorsMaterial/a9167113500archivoPdf20526.pdf.
underpricing of mortgage risk may be inevitable.\textsuperscript{18} Because of the importance of definitional and contextual issues,\textsuperscript{19} this article will limit its analysis to the impact of competition, defined with respect to market concentration, in the specific institutional context of the U.S. residential mortgage securitization market.

The process of mortgage funding consists of several different functions—origination;\textsuperscript{20} servicing;\textsuperscript{21} financial intermediation and risk structuring;\textsuperscript{22} and holding risk, most significantly for our purposes, default risk.\textsuperscript{23}

\begin{itemize}
  \item \textsuperscript{18} Andrey Pavlov and Susan M. Wachter, The Inevitability of Market-Wide Underpricing of Mortgage Default Risk (forthcoming, REAL ESTATE ECON.).
  \item \textsuperscript{19} See e.g. Thorsten Bek, \textit{supra} note 17 (finding that higher banking industry concentration relates to lower risk of financial crisis, but arguing that this relation may be mediated by some factor other than competition); Klaus Schaeck, \textit{supra} note 17); Luc Laeven & Stijn Claessens, \textit{What Drives Bank Competition? Some International Evidence}, 36 J. MONEY, CREDIT & BANKING 563, 563-83 (2004), \textit{available} at http://papers.ssrn.com/sol3/papers.cfm?Abstract_id=509605.
  \item \textsuperscript{20} Origination is the initial interaction with a potential borrower. It is a combination of sales, underwriting, and compliance. After a borrower chooses whether to apply for a loan, an originator or several originators gather information about the borrower and the collateral and choose whether to accept or reject the loan application and what terms to offer. The potential borrower then decides whether or not to accept the offered terms. Originators can be depository institutions such as national or state chartered banks, thrifts, or credit unions, or can be non-depository mortgage lending companies. Origination can also be handled either by salaried employees over whom the institution has a great deal of control or by independent mortgage brokers who work on commission, can source individual mortgages to multiple lenders, and over whom institutions have less control. See Eric S. Belsky & Nela Richardson, \textit{Understanding the Boom and Bust in Nonprime Mortgage Lending} 5-8 (Sept. 2010), http://www.jchs.harvard.edu/publications/finance/UBB10-1.pdf; PHIL ANGELIDES ET AL., FIN. CRISIS INQUIRY COMM’N, THE FIN. CRISIS INQUIRY REPORT at 157 (2011) [hereinafter “FCIC REPORT”].
  \item \textsuperscript{21} Mortgage servicers continue to interact with borrowers after origination. Servicers send bills and collect and process payments. Servicers have some of the most granular, detailed data about individual loan performance—delinquencies, foreclosures, prepayments, etc. One of the two major commercial providers of such information is Lender Processing Services (“LPS”). The other is CoreLogic’s LoanPerformance database (“LP”). LENDER PROCESSING SERVICES, http://www.lpsvcs.com/Pages/default.aspx (last visited June 28, 2011); CORELOGIC, http://www.corelogic.com/ (last visited June 28, 2011).
  \item \textsuperscript{23} Every time money is lent, there is some chance that the borrower will default or fail to repay. Estimates of this default risk are one of the most important determinants of the interest rate that the borrower pays and the lender receives. See Michael Simkovic & Benjamin Kaminetzky, \textit{Leveraged Buyout Bankruptcies, the Problem of Hindsight Bias, and the Credit Default Swap

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Prudent underwriting can be promoted or undermined by any entity that has the knowledge and power to influence originators' loan approval decisions. This could include originators themselves, financial intermediaries such as GSEs and private banks that purchased individual loans from originators and packaged them for sale to investors, credit rating agencies, investors, or regulators.

There is powerful evidence of deterioration in underwriting and a shift toward riskier lending in the years leading up to the financial crisis, especially 2004 to 2007.24 As will be shown below, these were the years in which the securitization market became far less concentrated and market power of GSEs declined relative to originators.25

Scholars, government commissions, and others have identified many possible causes of the financial crisis of the late 2000s.26 This article focuses primarily on competitive dynamics and also discusses a limited subset of other possible contributing causes. The focused analysis in this article is not meant to deny other contributing causes, but rather to highlight factors that have not been adequately discussed in the literature and whose implications have been overlooked by leading proposals for market reform.

A. Mortgage underwriting and risk management deteriorated from 2004 to 2007


25 EUROPEAN CENTRAL BANK, HOUSING FINANCE IN THE EURO AREA 74 (Mar. 2009) (“Interestingly, the lending boom in the United States has coincided with the imposition of limits on the activity of GSEs, which triggered increased competition from new entrants”).

26 These include, but are not limited to, conflicts of interest at credit rating agencies and overly optimistic credit ratings for mortgage backed securities (“MBS”); ample liquidity, low interest rates, and investors reaching for higher yields; moral hazard and information inefficiencies related to securitization; conflicts of interest and information inefficiencies related to financial innovations such as collateralized debt obligations; limited liability, high leverage, and financial executives incentivized to take big risks; fragmented and light-touch regulation; and possibly affordable housing policies.
Both ex-ante information about changes in loan characteristics over time and ex-post loan performance suggest that loan quality was relatively stable or improving from 2000 to 2003, and then deteriorated sharply from 2004 to 2007.

Evidence of deteriorating underwriting standards in 2004 to 2007 includes a dramatic shift away from relatively safe loan categories to relatively risky loan categories. The origination market product mix shifted from relatively safe mortgages—including conventional conforming mortgages typically sold to the GSEs, FHA and VA loans, and private Jumbo loans which were generally high quality but were above the GSEs maximum loan limits—toward riskier mortgages, including subprime loans, Alt-A (or low documentation) loans, and second lien home equity loans.

Figure 4 below shows this dramatic shift. The bottom three shades are relatively safe loans while the top three shades are relatively riskier loans.

**Figure 4: In 2004 to 2007, origination shifted dramatically away from safe prime mortgages toward risky, subprime and Alt-A mortgages and home equity loans**

![U.S. residential mortgage origination, by product, 1990-2010](image)

Conventional conforming mortgages experienced the most sudden and dramatic declines, losing almost half of their market share in two years.\textsuperscript{27} Subprime mortgages increased dramatically, from approximately 7 to 8 percent of the market in 2000 to 2003, to approximately 18 to 20 percent in 2004 to 2006.\textsuperscript{28}

Deteriorating underwriting standards were also manifest in the proliferation of non-traditional mortgage loan features, such as Adjustable Rate Mortgages ("ARMs"),\textsuperscript{29} interest only mortgages, pay option mortgages, and mortgages with...

\textsuperscript{27} Conventional conforming mortgages increased their market share from 2000 to 2003, increasing from 47 percent to 62 percent, then plummeted from 2004 to 2006, reaching a low of 33 percent in 2006, and began to recover thereafter. FHA/VA loans experienced steady declines, falling from 11 percent in 2000 to three percent in 2006. Private Jumbo loans experienced a gradual decline, peaking at 25 percent in 1999 and declining thereafter.

\textsuperscript{28} Alt A loans also increased from 1 to 3 percent in 1990 to 2003 to 7 to 11 percent in 2004, with a peak of 13 percent in 2006. Home equity loans’ market share doubled, from about 5 to 6 percent in 2003 and before to 11 to 14 percent in 2004 to 2007.

\textsuperscript{29} Belsky \textit{supra} note 20 (using CoreLogic LoanPerformance data to show that subprime loans shifted from primarily FRMS to ARMs). Adjustable Rate Mortgages ("ARMs") are far more likely to default than fixed rate mortgages ("FRMs"), as shown in Figure 14. This relationship was known long before the financial crisis. Fannie Mae had found that adjustable rate mortgages were particularly default-prone in the early 1980s, and therefore substantially reduced its purchases of these loans in 1985. Edward J. Pinto, \textit{Fannie Mae and Freddie Mac's Key Role in Subprime Lending}, Statement before the Committee on Oversight and Government Reform, U.S. House of Representatives, Dec. 9, 2008, at 22 n.7, available at http://www.aei.org/docLib/20090116_kd4.pdf. Adjustable rate mortgages are default-prone because the required monthly payments can dramatically increase as short-term interest rates increase, whereas borrowers’ capacity to pay (i.e., monthly income) typically does not increase as short-term interest rates increase. ARMs also often feature low initial teaser rates which reset to higher floating rates after a few years. Belsky, \textit{supra} note 20, at 39, 160 Figure 2-6 (Sept. 2010) (using Freddie Mac’s ARM annual survey to show that the difference between the low initial
large final payments know as balloon payments.\textsuperscript{30} The market share of loans with these features increased dramatically from 2004 to 2007.\textsuperscript{31} Simultaneous second mortgages (also called ‘piggy-back’ loans) proliferated, and combined-loan-to-value (CLTV) ratios climbed.\textsuperscript{32} The percent of loans with full documentation fell from the first quarter of 2005, bottoming out in the subprime market in late 2006 and in the prime and Alt-A markets in early 2007.\textsuperscript{33}

Further evidence of deteriorating underwriting in 2004 to 2007 comes from assessments by national bank examiners that underwriting standards tightened from 2000 to 2003, then loosened in 2004 to 2007. Figure 5 below shows the net percent of national bank examiners who reported tightening residential mortgage underwriting standards in the O.C.C.’s annual survey of bank examiners.

\textbf{Figure 5: Underwriting standards tightened from 2000 to 2003, eased from 2004 to 2007, then tightened sharply after the mortgage crisis}

\textsuperscript{30} Interest only, pay option, and balloon payment mortgages are risky because they amortize more slowly than traditional mortgages and therefore loan-to-value ratios remain higher for a longer period of time. Underwriting often relies on optimistic projections of rising borrower income, rising home prices, and ample opportunities to refinance. These mortgages may have low short term default rates because required payments are initially low, but they will typically have either higher long term default rates or higher loss rates in the event of default.

\textsuperscript{31} \textit{INSIDE MORTGAGE FINANCE, 2011 MORTGAGE MARKET STATISTICAL ANNUAL Vol. 1, 23} [hereinafter \textit{INSIDE MORTGAGE FINANCE}]; Belsky \textit{supra} note 20 at 159, Figure 2-5.


\textsuperscript{33} Belsky \textit{supra} note 20 at 39, 161.
These changes in underlying loan quality are largely consistent with the subsequent pattern of loan performance. Figure 9 below shows the percent of loans that were more than 60 days delinquent, by months since origination. Each line represents a different vintage year; the time scale on the x-axis is relative to the date of origination. A more steeply upward sloping line for a given vintage year suggests a higher percentage of delinquent loans within a shorter period of time since origination, and therefore poorer performance.

Three charts are presented, one for subprime loans, one for Alt-A (low documentation) loans, and one for prime loans.

Figure 6: Loan performance by vintage improved from 2000 to 2003 and then deteriorated from 2004 to 2007

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A similar analysis appeared in an October 2008 publication by the International Monetary Fund, GLOBAL FINANCIAL STABILITY REPORT, MACRO FINANCIAL IMPLICATIONS AND POLICY as Figure 1.8. The IMF’s analysis showed essentially the same pattern of improving performance from 2000 to 2003, followed by deteriorating performance from 2004 to 2007, but delinquencies were scaled by original loan balance instead of by current balance. Two researchers at the IMF who prepared the original analysis, Narayan Suryakumar and Rebecca McCaughrin, graciously shared updated data and provided guidance. The advantage of scaling the data by the current balance is that the resulting performance figures are less likely to be skewed by differences across vintages in refinancing and loan modification rates. Reported delinquency rates are generally higher than they would be if scaled by original loan balance.

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U.S. Subprime mortgage delinquencies by vintage year
Percentage of current balance 60+ days delinquent, by months since origination

Note: Delinquencies include foreclosures and bank owned real estate.
Current loan balance is current as of April 2011.
Source: International Monetary Fund, Corelogic Loan Performance

U.S. Alt-A mortgage delinquencies by vintage year
Percentage of current balance 60+ days delinquent, by months since origination

Note: Delinquencies include foreclosures and bank owned real estate.
Current loan balance is current as of April 2011.
Source: International Monetary Fund, Corelogic Loan Performance database
Loan quality at origination may not fully explain the pattern of subsequent loan performance; economic shocks after origination such as changes in housing values, unemployment, and liquidity also play a role.\textsuperscript{35} The overall pattern of changes in unemployment should make 2000 to 2003 vintage loans perform worse relative to 2004 to 2006 vintage loans, and therefore bolsters support for the claim that underwriting loosened in 2004 to 2006.\textsuperscript{36} The impact of housing price changes is somewhat more challenging to interpret. The pattern of changes in housing prices could make later loans perform worse, even with consistent underwriting standards.\textsuperscript{37} In the early to mid-2000s, a number of

\begin{center}
\textbf{U.S. Prime mortgage delinquencies by vintage year}
\end{center}

\textit{Percentage of current balance 60+ days delinquent, by months since origination}

![Graph showing U.S. Prime mortgage delinquencies by vintage year](image)

\begin{flushleft}
Note: Delinquencies include foreclosures and bank owned real estate.  
Current loan balance is current as of April 2011.  
Source: International Monetary Fund, Corelogic Loan Performance database
\end{flushleft}


\textsuperscript{36} National unemployment rates generally increased from around 4 percent in mid-2000 to around 6.3 percent in mid-2003 then generally decreased through mid-2007, when unemployment reached 4.6 percent. Unemployment rates increased through year-end 2009, then started to decrease. Unemployment reached 5 percent by the end of 2007, 7.4 percent by the end of 2008, 10 percent by the end of 2009, and then declined to 9.4 percent by the end of 2010. Timing varies somewhat by locality. \textit{Civilian Unemployment Rate}, FED. RESERVE BANK OF ST. LOUIS, http://research.stlouisfed.org/fred2/data/UNRATE.txt (last visited June 22, 2011).

scholars and regulators argued that housing was overpriced relative to long term relationships between housing prices and rental prices, as well as between housing prices and economic fundamentals such as wages, employment and population levels. \(^{38}\) Therefore, an assumption by originators or investors of continued increases in housing prices in the face of a possible housing bubble was arguably itself a relaxation of underwriting standards. \(^{39}\)

All three data sources—ex-ante loan characteristics, contemporaneous surveys of knowledgeable experts, and ex-post loan performance—are consistent with a dramatic deterioration in loan quality at origination for 2004 to 2007 vintages.  


This data raises an intriguing question. Why did loan quality deteriorate so dramatically during these years? Many of the possible contributing causes that have been identified in the literature existed long before 2004 to 2007. Was some sort of tipping point suddenly reached?

A casual glance at Figure 2 suggests that dramatic changes took place in the market during these years, as private securitizers gained market share while GSEs and government agencies lost ground. Could this swing in securitizer market share have led to changes in underwriting by originators?

B. Experts believe that competition led to deterioration in underwriting standards

Why the various responsible entities did not maintain prudent underwriting prior to the mortgage crisis remains highly contentious, and there are probably many factors that played a role. However, there is substantial evidence that competition—though at times beneficial for driving down costs and promoting efficiency—tends to lead to greater risk taking.

The OCC’s annual survey reported that for both commercial and retail lending, banks that eased underwriting standards did so primarily because of competition.40

In May of 2009, Congress appointed the Financial Crisis Inquiry Commission (“FCIC”) to investigate the causes of the financial crisis of 2008.41 One of the major themes of the FCIC’s report is that competitive pressures led to greater risk-taking and poor mortgage underwriting. The report identifies competition for market share, revenue and profits between the GSEs42 and the private banks43

41 FCIC REPORT, supra note 209 at xi.
42 Id. at xix, 18; Id. at 122 (“In 2004, Fannie and Freddie . . . were losing market share to Wall Street . . . . Struggling to remain dominant, they loosened their underwriting standards, purchasing and guaranteeing riskier loans, and increasing their securities purchases.”); see also id. at 178-182 (discussing the debate among managers of the GSEs in 2004 about whether to loosen underwriting standards to preserve market share and profitability, and the ultimate decision to do so); id. at 318 (noting that the Federal Housing Finance Agency (“FHFA”), the regulator of the GSEs and Federal Home Loan Banks created in 2008 by merging three pre-financial crisis supervisory authorities, blamed the GSEs for underpricing risk in order to gain market share and compete with Wall Street banks.).
43 FCIC REPORT at 88 (noting that investment banks began to compete for supplies of subprime loans to feed their securitization machinery); id. at 166; (“Keith Johnson, the president of [a large third-party loan due diligence firm that worked for private securitizers] told the Commission . . . that his clients often waived in loans [that didn’t meet their own underwriting criteria] to preserve their business relationship with the loan originator—a high number of rejections might lead the originator to sell the loans to a competitor. Simply put, it was a sellers’ market. ‘Probably the seller had more power than the Wall Street issuer,’ Johnson told the FCIC.”). See also Ingrid Gould Ellen, John Napier Tye & Mark A. Willis, NYU FURMAN CENTER FOR REAL ESTATE AND URBAN POLICY, Improving U.S. Housing Finance through Reform of Fannie Mae and Freddie Mac:
who purchased and securitized mortgages and similar competition between mortgage originators as causes of the risky lending that led to crisis. The report also describes competition between financial regulators, which reduced those regulators’ authority over the firms they were supposed to be regulating. The report also describes how competition between credit rating agencies for market share and profits reduced the rating agencies’ ability to honestly and diligently evaluate the collateral underlying MBS. Like the majority report, the FCIC

Assessing the Options (May 2010), http://furmancenter.org/files/publications/Improving_US_Housing_Finance_Fannie_Mae_Freddie_Mac_9_8_10.pdf (“As a result of this new and aggressive competition from the PLS market, the GSEs saw their market share erode. In response, the GSEs loosened their underwriting guidelines . . .”).

44 Id. at 20 (“‘Poison’ was the word famously used by Countrywide’s [CEO Angelo] Mozilo to describe one of the loan products his firm was originating. . . . Others at the bank argued in response that they were offering products ‘pervasively offered in the marketplace by virtually every relevant competitor of ours.’”); id. at 79 (Noting that according to FDIC Chairman Sheila Bair “really poorly underwritten loans” originated outside the traditional banking sector, pulled market share from traditional banks, and “created negative competitive pressure for the banks and thrifts to start following suit.”); id. at 105 (“In 2004, Mozilo announced a very aggressive goal of gaining ‘market dominance’ . . . But Countrywide was not unique: Ameriquest, New Century, Washington Mutual, and others all pursued loans as aggressively. They competed by originating types of mortgages created years before as niche products, but now transformed into riskier, mass-market versions.”); id. at 108 (“Mentioning . . . competitors, John Stumpf, the CEO, chairman, and president of Wells Fargo, recalled Wells’s decision not to write option ARMs . . . These were ‘hard decisions to make at the time,’ he said, noting ‘we did lose revenue, and we did lose volume.’”)

45 Id. at xviii (“The government permitted financial firms their preferred regulators in what became a race to the weakest supervisor.”); id. at 94-95 (“Greenspan and other [Federal Reserve] officials were concerned that routinely examining the nonbank subsidiaries could create an uneven playing field because the subsidiaries had to compete with the independent mortgage companies, over which the Fed had no supervisory authority. . . .”); id. at 154 (“[According to] Mark Olson, a Fed governor from 2001 to 2006, ‘There was a lot of competitiveness among the regulators.’ In January 2008, Fed staff had prepared an internal study to find out why none of the investment banks had chosen the Fed as its consolidated supervisor. . . . the biggest reason firms opted not to be supervised by the Fed was the ‘comprehensiveness’ of the Fed’s supervisory approach, particularly when compared to alternatives such as Office of Thrift Supervision (OTS) or Securities & Exchange Commission (SEC) holding company supervision.”); id. at 306 (“In an August 2008 interview, William Isaac, who was chairman of the FDIC from 1981 until 1985, noted that the OTS and FDIC had competing interests. . . . FDIC Chairman Sheila Bair underscored this tension, telling the FCIC that ‘our examiners, much earlier, were very concerned about the underwriting quality of WaMu’s mortgage portfolio, and we were actively opposed by the OTS in terms of going in and letting our [FDIC] examiners do loan-level analysis.’”).

46 Id. at xxv (“[T]he forces at work behind the breakdown at Moody’s [Investor Service, one of the three major rating agencies, included] pressure from financial firms that paid for the ratings, the relentless drive for market share, the lack of resources to the job despite record profits . . .”); id. at 206-212; Id. at 210 (“[T]he pressure for market share, combined with complacency, may have deterred Moody’s from creating new models or updating its assumptions . . . .”); id. at 210 (“Richard Michalek, a former Moody’s vice president and senior credit officer, testified to the FCIC, ‘The threat of losing business to a competitor, even if not realized, absolutely tilted the balance away from an independent arbiter of risk towards a captive facilitator of risk transfer.’ [Gary] Witt [a former Managing Director at Moody’s] agreed. When asked if the investment banks frequently threatened to withdraw their business if they didn’t get their desired rating, Witt replied, ‘Oh God, are you kidding? All the time. I mean, that’s routine. I mean, they would threaten you

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dissenting report by Peter J. Wallison identifies competition for loans as a cause of poor underwriting, although the dissent claims that the competition for loans was driven by government affordable housing policies rather than the pursuit of revenue, market share, and profit. 47 Much of the evidence cited in the FCIC report is qualitative, including opinions of financial executives, regulators, and other experts.

The credibility of these expert opinions is bolstered by quantitative empirical evidence, presented below, consistent with the hypothesis that certain kinds of competition can undermine underwriting standards. Rather than try to survey the field, this article will focus more narrowly on competitive dynamics in the primary mortgage market—origination—and in the secondary mortgage market—securitization and guarantees.

C. The GSEs historically established underwriting standards, monitored loan quality, and disciplined non-compliant originators

The GSEs historically controlled originators by establishing national standards for “conforming” loans as well as standardized documents, underwriting practices, loan products, and servicing arrangements. 48 Centralization not only enhanced GSE control, it also increased efficiency and contributed to MBS market growth and liquidity. 49 Notable efficiency gains include the use of automated underwriting based on objective, statistically validated criteria for predicting default risk. 50

all of the time. . . . It’s like, ‘Well, next time, we’re just going to go with Fitch and S&P.’” [Moody’s President Brian] Clarkson affirmed that “it wouldn’t surprise me to hear people say that” about issuer pressure on Moody’s employees.”); id. at 211 (quoting an internal memorandum from October 2007, in which Moody’s Chief Credit Officer Andrew Kimball warned that investment banks that issued MBS were “penaliz[ing] quality by awarding rating mandates based on the lowest credit enhancement needed for the highest rating. Unchecked, competition on this basis can place the entire financial system at risk.”).

48 Belsky, supra note 20 at 14, 17-19.
The GSEs also exercised control through contractually negotiated rights to sell back to originators loans that did not comply with GSE standards, breached representations and warranties, and subsequently became non-performing.\textsuperscript{51} Compared to private securitizers, the GSEs have been more aggressive in their use of such repurchase agreements,\textsuperscript{52} and more successful in enforcing their rights against originators.\textsuperscript{53} By bringing claims based on these repurchase agreements, the GSEs have already recovered from originators between 10 and 15 percent of their credit losses.\textsuperscript{54}

The GSEs' large market share and therefore large market power may have helped them maintain tighter control over originators compared to other securitizers.\textsuperscript{55} Enforcing repurchase agreements requires sampling loans to

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\textsuperscript{51} When mortgage insurers rescind coverage, or a loan defaults, GSEs require that the potential losses be indemnified or the loan be repurchased. \textsc{Fed. Nat'l Mortg. Ass'n}, \textsc{Annual Report (Form 10-K)} 167 (Feb. 26, 2010); \textit{See also JPMorgan Chase & Co., Annual Report (Form 10-K)} 98 (Feb. 28, 2011); \textit{see also FCIC Report at} 224.

\textsuperscript{52} One of the largest originators, \textsc{JPMorgan Chase}, reports that its “repurchase agreements liability is 'predominantly' with the GSEs” and that repurchase demands from “private-label securitizations have been limited.” \textsc{JPMorgan Chase & Co., Annual Report (Form 10-K)} 98 (Feb. 28, 2011). Similarly, \textsc{Bank of America} (which has acquired \textsc{Countrywide}, one of the largest originators), reports that non-GSE repurchase agreements have “less rigorous representations and warranties” and therefore present less risk to originators. \textsc{Bank of America Corp.}, 2010 \textsc{Annual Report} 59 (2011). \textsc{Bank of America} notes that GSEs can force repurchases of individual loans when those loans default and an investigation reveals that the loans did not meet GSE standards, whereas private securitization investors can generally only trigger a repurchase if misrepresentations are so severe that it “materially and adversely affects the interest of all investors.” \textsc{Bank of America Corp.}, 2010 \textsc{Annual Report} 59, 187 (2011).

\textsuperscript{53} \textsc{Bank of America's} 2010 annual report reveal that the GSEs have brought more claims, both in absolute terms and as a percentage of loans purchased, than private securitization investors, and the GSEs have been more successful in resolving those claims. \textsc{Bank of America Corp.}, 2010 \textsc{Annual Report} 57-59 (2011). On \$1.1 trillion in loan sales to the GSEs from 2004 to 2008, the GSEs brought \$21.6 billion in claims, or approximately 2 percent. Of these claims, \$18.2 billion, or over 80 percent, have been resolved, with \textsc{Bank of America} claiming net losses of 27 percent. On \$963 billion in loan sales to private securitizations, investors and private mortgage insurers brought \$13.7 billion in claims, or less than 1.5 percent. Of these claims, \$6 billion, or less than half, have been resolved. Recent news reports suggest that \textsc{Bank of America} may be settling more claims with private investors. Dan Fitzpatrick, \textit{Bank of America Agrees to \$8.5 billion mortgage settlement}, \textsc{WSJ.com}, June 29, 2011.

\textsuperscript{54} \textsc{FCIC Report at} 224 (Jan. 2011) (“\textsc{D}uring the three years and eight months ending August 31, 2010, \textsc{Freddie} and \textsc{Fannie} required sellers to repurchase 167,000 loans totaling \$34.8 billion. So far, \textsc{Freddie} has received \$9.1 billion from sellers, and \textsc{Fannie} has received \$11.8 billion—a total of \$20.9 billion. The amount put back is notable in that it represents 21% of \$163 billion in credit-related expenses recorded by the GSEs since the beginning of 2008 through September 2010.”) The GSE's actual recovery of \$20.9 billion is 13 percent of \$163 billion.

\textsuperscript{55} \textit{See, e.g.,} Ryan Bubb and Alex Kaufman, \textit{Securitization and Moral Hazard: Evidence from Credit-Score Cutoff Rules} 3-4 (“The ubiquity of . . . credit score cutoff rules in the mortgage markets is a testament to the ability of \textsc{Fannie} and \textsc{Freddie} to enforce their underwriting guidelines through software, contractual provisions, and monitoring, . . . [L]arge securitizers like \textsc{Fannie} and \textsc{Freddie}, were to some extent able to regulate lenders' screening behavior.”).
identify those that are defective. In the mid-2000s, private securitizers in need of loans from originators reduced their loan sampling rates and waived in many non-compliant loans. Originators also often “gamed” securitizers’ quality control systems, resubmitting previously rejected loans in new pools. Resubmissions would presumably be less likely to succeed if the securitization market was highly concentrated and a single securitizer was reviewing the same loan a second time.

The GSEs most powerful tool for exercising control over originators may have been their centralized purchasing power. The GSEs can discipline originators by ending their relationship if the originator fails to comply with GSE underwriting standards or if there is an unusual increase in defaults of the originators’ loans. A decision by the GSEs to cut off funding for an originator by refusing to purchase that originator’s loans could have a devastating and almost immediate impact on the originator’s revenues and potential profits. The GSEs have in fact cut off a number of originators over the years, usually putting those originators out of business. Since the financial crisis caused private securitizers to exit the market and thereby enhanced GSE power, the GSEs have become more aggressive with originators.

Standard setting by the GSEs is most influential if there are no alternatives. To the extent that non-GSE securitizers created alternative, competing channels for originators to sell their loans, they undermined the GSEs ability to control originators.

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56 FCIC Report at 165.
57 Id. at 166.
58 Id. at 168.
61 Freddie Mac has begun to require larger seller and servicers to agree to repurchase plans as well as financial penalties in the event of non-compliance with those plans. FED. HOME LOAN MORTG. CORP., QUARTERLY REPORT (FORM 10Q) 45 (May 4, 2011).
62 Originators were able to survive GSE termination when they could find an alternate source of funding. Although Fannie Mae terminated its relationship with First Beneficial Mortgage Corporation in the late 1990s after discovering fraud, because Fannie Mae did not share its discovery with other secondary market players, First Beneficial was able to continue obtaining funding from Ginnie Mae for several years. Kenneth M. Donohue, Fraud, Mortgage-Backed Securities, and Ginnie Mae, 68 MORTGAGE BANKING 80 (2008).
D. Originators consolidated and diversified, the GSEs lost their leadership position in securitization, and market power shifted to originators

Two developments in the origination market may have shifted the balance of power away from GSEs and toward originators. First, increasing concentration in the origination market may have enabled originators to counter GSE market power. Second, the growth of non-prime securitization gave originators an alternate option for funding and reduced their dependence on the GSEs.

Although specific local markets experienced an increase in the number of originators in the 2000s, much of the local growth came from the entry of large national chains into local markets. At the national level, a few large originators accounted for an increasing share of originations. Figure 7 below shows that mortgage origination has steadily become more concentrated at the national level. By 2004, the top 10 players accounted for over 50 percent of originations, and climbing.

Figure 7: Mortgage origination became highly concentrated

Market share of top mortgage originators, 1998-2010
Percent of 1-4 family U.S. residential mortgages originated, by dollar volume

Originators also diversified away from conventional/prime origination and toward nonprime origination. Nonprime lending did not simply grow because of growth at specialty nonprime originators; it grew in part because large, established prime originators entered the business of nonprime lending. As the top conventional/conforming mortgage originators diversified into non-prime mortgage originations, they became less dependent on the GSEs.

Private bank securitizers’ willingness to relax their underwriting standards and securitize nonprime loans enabled them to dramatically increase market share and race ahead of the GSEs. Nonprime mortgages were funded primarily through the private (non-GSE) securitization market. Because non-prime mortgages were securitized at a very high rate, as shown in Figure 8, and were primarily securitized by private banks, non-prime mortgages constituted a significant share of total mortgage originations.

63 Whereas nonprime mortgage origination had once been a niche specialty, large, mainstream mortgage originators increasingly shifted toward nonprime origination. In 1998, the top six subprime lenders were Household Financial Services, Associates First Capital, ContiMortgage Company, The Money Store, and Green Tree Financial. By 2007, the top six subprime mortgage originators included divisions of Citi, HSBC, Countrywide, Wells Fargo and Chase. INSIDE MORTGAGE FINANCE, supra note 31, Vol. 1, p. 144, 157.

64 See Figure 2 showing a dramatic decline in GSE and FHA market share in 2004 to 2007.

65 INSIDE MORTGAGE FINANCE, supra note 31, Vol. 2, p. 3-6, 36. As discussed below, the GSEs purchased a significant quantity of the highest rated tranches of subprime and Alt-A private label MBS as portfolio investments. As purchasers of select tranches of pre-packaged MBS, the GSEs would likely have had far less control over individual loan selection than as purchasers and securitizers of individual whole loans. GSE MBS purchases, though substantial, were a minority of private label issuances.
disproportionately large share of private label MBS issuance, as shown in Figure 9.

**Figure 8:** By 2004 to 2007, nonprime mortgages were securitized at the same rate as conventional conforming mortgages

![Securitization rates by loan type, 2000-2010](image)

*Securitization rates by loan type, 2000-2010
MBS issuance as a percent of originations*

![Chart showing securitization rates](chart)


**Figure 9:** Subprime and Alt-A loans accounted for the majority of private label (non-GSE) MBS issuance and volume growth from 2004 to 2007

![Non-Agency MBS issuance by type, 1995-2010](chart)

*Non-Agency MBS issuance by type, 1995-2010
USD billions*

Note: Scratch-and-dent (S&D) includes reperforming FHA/VA loans, resecuritized loans from existing MBS and conduit fallout loans. S&D and second lien transactions backed by suprime loans are not included in the subprime category.

Figure 10 below shows an index of the relative market power of the GSEs and the top conventional/conforming mortgage originators. Top conforming/conventional mortgage originators are defined as institutions that originated more than $400 billion in conventional/conforming mortgages from 2000 to 2010.

The fundamental assumption behind the index is that an originator who primarily originates conventional mortgages is more dependent on the GSEs to securitize and guarantee those originations than an originator with a diversified mix of subprime and Alt-A originations. Similarly, the GSEs are more dependent on conventional originators with larger market share, because those originators are important suppliers of raw material.\textsuperscript{66}

This assumption is consistent with widely used business strategy frameworks such as Porter’s Five Forces (“Porter”), which are based on the Structure-Conduct-Performance paradigm in Industrial Organization economics. Porter posits that greater concentration and an absence of substitutes at one position in a production value chain confer greater market power on firms in that position, while greater concentration and market power of suppliers reduces firms’ bargaining power.\textsuperscript{67}

\textsuperscript{66} Patricia A. McCoy, Andrey D. Pavlov & Susan M. Wachter, \textit{Systemic Risk Through Securitization: The Result of Deregulation and Regulatory Failure}, 41 CONN. L. REV. 493, 533-37 (2009) (Discussing a race to the bottom on underwriting standards and loss of market share at the GSEs and FHA relative to private subprime securitizers who were more willing to relax their underwriting standards).

\textsuperscript{67} Michael E. Porter, \textit{The Five Competitive Forces that Shape Strategy}, 86 HARV. BUS. REV. 78, 78-93 (January 2008) (discussing how external pressures such as those created by suppliers and potential substitutes drive business strategy and affect a firm). For information regarding the
For each originator, the index is the originator’s dependence on the GSEs—measured by the originator’s annual conventional mortgage originations as a share of the originator’s annual overall mortgage originations—divided by the GSEs’ dependence on the mortgage originator—measured by the originator’s annual conventional mortgage originations as a share of all annual conventional mortgage originations by all originators.

As can be seen from Figure 10, the GSEs power over the top conventional originators declined to relatively low levels in 2004 to 2007, the years in which the worst quality mortgages were originated.

**Figure 10: The GSEs market power relative to large originators reached very low levels in 2004 to 2008**

A new private market leader did not emerge to replace the GSEs and discipline originators. Although the private banks collectively captured more market share than the GSEs, no individual institution matched the GSEs' previous level of market dominance. In other words, as the GSEs lost market share, the secondary market became fragmented.

Figure 11 below shows that the secondary mortgage market became more fragmented in 2004 to 2007, the years in which the worst performing loans were originated. Competitive, fragmented securitizers faced increasingly consolidated originators, and market power shifted from securitizers to originators. Without a clear securitization market leader capable of enforcing standards and penalizing non-compliant originators, discipline broke down.

**Figure 11: The secondary mortgage market became fragmented in 2004-2007**

![Chart showing market share of top mortgage backed securities issuers, 1998-2010](chart)

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<th>Top 10</th>
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Note: Includes both Agency (Fannie Mae, Freddie Mac, Ginnie Mae) and Non-Agency MBS issuance.


Further evidence of a shift in market power away from securitizers and toward originators in 2004 to 2007 comes from the high revenue multiples paid by securitizers for mortgage originators. Insert Discussion of rising Acquisition Multiples for Mortgage Originators; chart / table

One of the most impressive studies linking local competition between originators to deteriorating mortgage underwriting standards in the years leading up to the mortgage crisis was conducted by three economists at the International Monetary Fund (“IMF”), Giovanni Dell’Ariccia, Deniz Igan, and Luc Laeven. Using data from 2000 to 2006 including over 50 million individual mortgage applications across 387 Metropolitan Statistical Areas and controlling for local and national

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68 See Figure 7 showing increasing consolidation among mortgage originators.
70 *Id.* at 9.
economic variables, the authors found that incumbents' lending standards declined after new competitors entered local markets. The authors argue that local lenders felt compelled to cut their underwriting standards to compete effectively with the new entrants.

The author’s findings are consistent with the hypothesis that underwriting standards tend to be lower in fragmented markets—in which competition is generally more intense—than in concentrated markets, in which competition tends to be more restrained. Specifically, the authors found that subprime underwriting standards declined more in areas with a larger number of lenders, but found that overall lending standards actually increased when large lenders with substantial market share and market power entered local markets.

The authors also found substantial differences between the drivers of lending standards in prime and subprime mortgage markets: the effect of competition in driving down underwriting standards was largely limited to subprime mortgage markets. Whereas subprime lenders became less cautious as the number of applications increased, prime lenders became more cautious.

One possible explanation for differences in the prime and subprime markets is that the GSEs—who remained major loan purchasers in the prime market but

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71 Id. at 1. The authors controlled for variables that might affect mortgage application denials, including average income, income growth, the unemployment rate, and the self-employment rate, and house price appreciation to take into account the role of collateral. Id. 9-10. They also controlled for securitization rates. Id. at 5.
72 The authors used two measures of lending standards: denials as a percent of loan applications and loan to income ratios. Id. at 1, 9.
73 Id. at 2, 21.
74 Id. at 2.
75 Id. at 9-10 (“The number of competing lenders is a proxy for the competitive conditions in the MSA.”); Id. at 12.
76 Id. at 2, (“Denial rates declined more in areas with a larger number of competitors.”); 18 (“A one standard deviation increase in the number of competitors reduces MSA-level subprime denial rates by 3 percentage points.”); id. at 21; id. at 25 (“The effect of competition is also confirmed with higher LTI [Loan-to-Income] ratios in MSAs with larger number of competing lenders.”).
77 [check with the authors] Id. at 21. (“[W]e find that an increase in the number of entrants (i.e., competing institutions) increases the denial rates of incumbent institutions in the overall mortgage market. . . . In this regression, we use the market share of entrants, computed as the sum of each entrant’s share in total loan applications, rather than the simple number of entrants, to control for the size of each entrant and capture overall market power of entrants.”).
78 Id. at 16 (“In the subprime mortgage market, denial rates were lower in more competitive markets as measured by the number of competitors in the MSA. This coefficient was, instead, not statistically significant for the prime market.”); id. at 21; id. at 27 (“The effects we identify for the subprime market are either much weaker or absent in the prime mortgage market, lending additional support that the deterioration in lending standards was more pronounced in the subprime mortgage market. Our evidence suggests that while in the prime market lending standards were largely determined by underlying fundamentals, for subprime loans lending market conditions and strategic interactions played an important role in lending decisions.”).
79 Id. at 1, 15.
played a minor role in the subprime market\textsuperscript{80}— helped maintain higher underwriting standards by exercising greater control over the originators who supplied them with loans.

E. GSE underwriting remained more conservative than most secondary mortgage market participants

High market share and a high degree of centralized control over underwriting appear to be associated with more conservative underwriting and better quality control. Both underlying loan performance data and financial market prices for packaged securities suggest that the GSEs maintained higher underwriting standards than most other secondary market actors.

Loan performance data compiled by Freddie Mac’s Office of the Chief Economist\textsuperscript{81} suggest that the GSEs were in fact more successful than almost any other secondary market actor in maintaining quality control in the individual loans that they purchased. The data also suggests that the FHA and VA were more successful than the average private label securitizers and also more successful than banks and thrifts that retained loans in their portfolios.

The data are current as of Dec. 31, 2010 and were compiled by Freddie Mac from sources including the Mortgage Bankers Association National Delinquency Survey, Federal Reserve Board Flow of Funds Data, FHA and VA monthly reports, Freddie Mac’s most recent annual 10-K report, Fannie Mae’s Fourth Quarter 2010 Credit Supplement, Core Logic LoanPerformance data, the FDIC and the NCUA. Data is presented in Figure 12.

\textbf{Figure 12: GSEs loan performance was better than private securitizers and even traditional depository institutions}

\textsuperscript{80} Dell’Ariccia et. al define the subprime market as consisting of loans originated by lenders listed as subprime lenders by the U.S. Department of Housing and Urban Development (“HUD”). \textit{Id.} at 6. This is the same definition of the subprime market used by the GSEs themselves in classifying the overwhelming majority of their loans as prime. \textit{See} WALLISON DISSENT at 451 fn. 5.

\textsuperscript{81} Although Freddie Mac is an interested party, the credibility of its data is bolstered by its consistency with financial market assessments of relative losses and analyses conducted by the Financial Crisis Inquiry Commission.
The implication of Freddie Mac’s data—that the GSEs were better at quality control than other entities—is broadly consistent with a detailed analysis of loan performance conducted by the Financial Crisis Inquiry Commission. The Financial Crisis Inquiry Commission (“FCIC”) analyzed over 25 million mortgages, some of which were purchased or guaranteed by the GSEs, some of which were insured by the FHA or VA, and the remainder of which were Alt-A or Subprime mortgages securitized in the private market.82

The FCIC found that:

The data illustrate that in 2008 and 2009, GSE loans performed significantly better than privately securitized, or non-GSE subprime and Alt-A loans. . . . In 2008, the respective average delinquency rates for non-GSE and GSE loans were 28.3% and 6.2%.83

Like Freddie Mac, the FCIC found that FHA/VA loans performed much better than private label Alt-A and subprime loans, but not as well as GSE loans.84

The GSEs’ superior performance relative to private label mortgages persists even when controlling for risk factors such as such as low borrower FICO scores85 or high loan-to-value ratios.86 The FCIC attributed the GSE’s

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82 FCIC Report at 216.
83 Id. at 218-19.
84 Id. at 218, Figure 11.3.
85 Id. at 218 (“[A]mong loans to borrowers with FICO scores below 660, a privately securitized mortgage was more than four times as likely to be seriously delinquent as a GSE.”)
performance advantage to “differences in underwriting” and to less “risk layering” by the GSEs. In other words, the GSEs were less likely to combine low FICO scores with high loan-to-value ratios in the same loan. The FCIC’s findings undercut claims by Edward Pinto, a mortgage market consultant who has frequently testified before Congress, that the GSEs funded the riskiest mortgages.

Financial market prices arguably also suggest that market participants believed that loans selected and packaged by the GSEs were less likely to default than loans selected and packaged by private banks. The markets probably believed that the U.S. Treasury was more likely to backstop GSE guarantees and protect investors from loss regardless of underlying GSE loan performance than to protected private label investors. However, as of July 2008, Treasury had not yet pledged to make good on the GSE’s guarantees, and unless Treasury stepped in, GSEs’ thin capitalization would therefore limit the value of those guarantees in the event of large-scale defaults.

Figure 13 below shows financial market prices for MBS through the end of June 2008. The data shows that Agency MBS retained their value while private label MBS dropped below par, especially subprime MBS (represented by the ABX indices), and Alt A-MBS.

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86 Id. at 219 (“[I]n 2008 among loans with an LTV above 90%, the GSE pools have an average serious delinquency rate of 5.7 percent versus a rate of 15.5% for loans in private Alt-A securities.”).
87 Id. at 219 (summarizing Pintos claims and rejecting his analysis as “misleading”); Edward J. Pinto, Fannie Mae and Freddie Mac’s Key Role in Subprime Lending, Statement before the Committee on Oversight and Government Reform, U.S. House of Representatives, Dec. 9, 2008, at 3-4, available at http://www.aei.org/docLib/20090116_kd4.pdf (suggesting that many “subprime” loans by loan-to-value ratio or by FICO score were mislabeled as “prime” in many databases).
88 FCIC REPORT at 218-19.
90 The Jumbo MBS represents MBS backed by loans that were larger than GSE loan limits, but were generally of good quality.
The GSEs superior performance may be due in part to their size and market power, and perhaps also to regulations which limited their ability to relax their underwriting standards.

F. International comparisons offer limited insight, but generally suggest advantages to consolidated regulatory and market structures

Advocates of privatizing the U.S. mortgage market have cited mortgage market stability and high home ownership rates in select Western European countries with alternate mortgage funding structures, in particular, covered bonds. One important difference between U.S. agency securitization and European covered bonds is off-balance-sheet accounting treatment for securitizations versus on-balance-sheet accounting treatment for covered bonds. On-balance-sheet accounting treatment might improve regulators’ and investors’ ability to understand and limit financial institution leverage levels.

Covered bonds are similar to securitization in that investors have first priority claims on a particular set of loans. Covered bonds are similar to U.S. Agency

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93 Simkovic, Secret Liens, supra note 22.
securitizations—and different from most U.S. private label securitizations—in that investors have recourse not only to the loans backing the covered bonds or MBS, but also to a guarantee from the issuing financial institution.\textsuperscript{94}

Upon close examination, the European model shares many features of the U.S. GSE model—both models involve large financial institutions, which select and back mortgages, which have implied guarantees from their respective governments, and whose ability to relax underwriting standards is limited by regulation. Within the best performing foreign countries, a few large, vertically integrated financial institutions dominated mortgage underwriting\textsuperscript{95} and therefore had implicit government guarantees,\textsuperscript{96} or the largest mortgage lenders were state-owned.\textsuperscript{97} In many of the best performing foreign markets, a single powerful regulator supervised all financial institutions that originated, underwrote, and guaranteed mortgages.\textsuperscript{98} Within the best performing countries, individual financial institutions had less flexibility than in the U.S. to “innovate” by relaxing their underwriting standards.\textsuperscript{99} In other words, the best performing foreign

\textsuperscript{94}Jaffee, supra note 91 at 18.
\textsuperscript{95}Lea, supra note 92 at 7 (“Mortgage lending tends to be dominated by banks and highly concentrated in most countries. The top five lenders have more than a 50 percent market share in Australia, Canada, Denmark, Netherlands and the UK. . . .”) id. at 18 (“The MCI in Denmark specialize in residential, commercial and agricultural mortgage lending. The market is highly concentrated with MCI providing over 80 percent of the market.”); id. at 26 (“[M]ortgage lending in most markets is dominated by large commercial banks. There is some evidence . . . that large lenders avoided the excesses of non-conforming lending due to concerns about reputation risk.”).
\textsuperscript{96}Id. at 21 (“Irish, German, and Belgian governments had to step in and rescue covered bond issuers . . . The European covered bond markets were stressed during the crisis. Issuance of jumbo covered bonds . . . was only restarted in the first quarter of 2009 after the European Central Bank (ECB) announced a purchase program of up to 65 billion Euros. [There were also] widespread government guarantees of bank debt . . . in most countries during the crisis.”); \textsc{International Monetary Fund, Denmark—2010 Article IV Consultation, Concluding Statement of the Mission}, Nov. 1, 2010 (“The [Danish] banking system was fortified by a wide range of measures, including a blanket government guarantee for depositors and creditors; liquidity support; capital injections; and a temporary bank resolution scheme.”).
\textsuperscript{97}Lea, supra note 92 at 7 (“Banks are the largest lender class in Germany and Spain but the individual institution market shares is much smaller. . . . Savings banks (owned by the state governments) are the largest lenders in these countries . . .”)
\textsuperscript{98}Id. at 13 (“The US is unique in its fragmented regulatory structure with numerous specialized regulatory agencies. . . . An advantage to having a single financial sector regulator is the lower likelihood of regulatory capture or regulatory arbitrage . . .”); id. at 25 (“The Canadian financial regulatory structure is widely credited with enhancing the stability of the system. The IMF commended the Canadians on their highly effective and nearly unified regulatory and supervisory framework.”); id. at 26 (“[T]he decline in underwriting standards inherent in sub-prime lending was responsible for . . . the financial crisis. No other country experienced a similar decline in standards. . . . [N]o one created a market with as poor quality loans as the US. . . . [N]o other country had as significant a shadow banking system as the US. In all other countries there was greater regulatory oversight of mortgage lending which may have slowed the move to lower standards. Having one financial regulator with responsibility for non-bank as well as bank lenders is an important attribute of regulation.”).
\textsuperscript{99}Id. at 18 (“The underwriting of Danish mortgages is more strict that of the US. The maximum LTV is 80 percent and borrower income is fully documented. . . . The Danish system has performed well throughout the crisis. Despite having a larger house price bubble the Danish
markets were characterized by a higher degree of centralized control over mortgage underwriting and stricter regulation than the U.S.

The difference between the U.S. and European mortgage markets may not be that foreign markets lacked GSEs, but rather that the most important mortgage lenders in European markets all resembled GSE, and European institutions therefore did not face competition from more lightly regulated private label securitizers. The covered bond model, in the absence of stringent uniform government regulation and implied government guarantees, might not be workable; variations have been tried before in the United States, and failed.

Covered bonds may also have little to do with performance differences between Western European and U.S. mortgage markets. There are large differences between Western Europe and the United States that may explain lower default rates in Western Europe, including more extensive social welfare systems which stabilize household income, stronger labor protections which may reduce the risk of sudden unemployment, much higher household savings rates and

system has had far fewer defaults and foreclosures.); id. at 24 ("Canada is unique in requiring mortgage insurance on all bank originated mortgages with LTV >80 percent. . . . The maximum LTV is 95 percent."); id. at 26 ("requiring lenders to explicitly consider borrower affordability as is the case in many other countries would have reduced the prevalence of stated income loans and teaser ARMs.").

100 Id. at 21 ("By legislation, covered bond issuers must be regulated banks.").
101 Snowden, supra note 2 at 9-12, 30-32.
102 Jaffee, supra note 91 at 18 ("Tests for statistical correlations indicate no significant relationships between [Western European countries'] covered bond use . . . and the mortgage market performance . . . .").
103 The U.S. does less than any developed country, except South Korea, to reduce income inequality through its taxation and transfer spending system, and has low spending on unemployment and family benefits. OECD, GROWING UNEQUAL?: INCOME DISTRIBUTION AND POVERTY IN OECD COUNTRIES, COUNTRY NOTE: UNITED STATES (2008), available at www.oecd.org/els/social/inequality. See also International Monetary Fund, Denmark—2010 Article IV Consultation, Concluding Statement of the Mission, Nov. 1, 2010 ("Domestic demand was buttressed by large automatic stabilizers.")
104 Unionization rates in the U.S. (around 12 percent) are much lower than unionization rates in Canada and most of Western Europe. Jelle Visser, Union membership statistics in 24 countries, MONTHLY LAB. REV. 38-49 (Jan. 2006), available at http://www.bls.gov/opub/mlr/2006/01/art3full.pdf. Although the U.S. has historically had relatively low unemployment, unemployment more than doubled between 2007 and 2009, while Western European and Canadian unemployment remained relatively stable. U.S. BUREAU OF LABOR STATISTICS, INTERNATIONAL UNEMPLOYMENT RATES AND EMPLOYMENT INDEXES, SEASONALLY ADJUSTED, 2007-2011, 3, Table 1, available at http://www.bls.gov/fls/intl_unemployment_rates_monthly.pdf. See also International Monetary Fund, Denmark—2010 Article IV Consultation, Concluding Statement of the Mission, Nov. 1, 2010 ("Extended active labor market policies helped contain employment losses, while relatively generous unemployment benefits lessened the social impact.")
lower household debt levels, more robust transit networks which reduce economic vulnerability to oil price shocks, a more punitive approach to financial institution bailouts, and more creditor-friendly insolvency and debt collection laws which shift the risk of loose underwriting away from creditors and toward debtors.

Because of these broad economic, legal, and political differences, it is unclear how much insight can be gained by comparing foreign mortgage funding mechanisms to those in the United States.

**G. There is little evidence that loose underwriting was driven by government affordable housing policies rather than market forces**

A number of experts have argued that government policies designed to promote home ownership among low-income individuals caused the mortgage crisis by pressuring private financial institutions to relax their underwriting standards to meet these goals. If such arguments are correct, and it can be shown that greater government involvement generally leads to looser underwriting standards, then there is reason to be concerned about direct government control of the GSEs, notwithstanding the advantages of centralized quality control.

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106 **EUROPEAN CENTRAL BANK, HOUSING FINANCE IN THE EURO AREA** 73 (Mar. 2009) (“households in the euro area display a lower average level of indebtedness. Crucially, the percentage of households with mortgage debt in the lowest quantiles of the income distribution is relatively small.”)


These arguments have generally been made in the context of financial industry advocacy rather than through empirically substantiated academic scholarship. Many of the most forceful proponents of these arguments—such as mortgage consultant Edward Pinto and Financial Crisis Inquiry Commission dissenting member Peter J. Wallison110—are not academics but are instead affiliated with “think tanks” such as the American Enterprise Institute (“AEI”) which raise funds based on their efforts to deflect blame for the financial crisis from private financial institutions and which are committed to advocating free market ideology and limited government.111

AEI encourages donors to “Invest in AEI” because:

“AEI sees in today’s economic and political circumstances not only great challenge but also great opportunity. The Institute is promoting market-driven approaches as the solution to our current woes and not their cause.”112

AEI’s 2009 report trumpeted Wallison and other AEI-funded writers efforts to deflect blame for the financial crisis from private financial firms and to place the blame for the financial crisis on government policies:

“Many pundits and politicians blamed the financial crisis on a supposedly unfettered free market, a viewpoint Peter J. Wallison [and other AEI-funded writers] rebutted in substantial essays exploring the policies that were the true cause of the crisis. . . . In 2009, a banner year for government interventions in the private economy, AEI scholars mounted a spirited defense of free enterprise.”113

The report also highlighted AEI’s ability to influence “Financial Regulation’s Future” because “Mr. Wallison and Bill Thomas were named to the Financial Crisis Inquiry Commission, a distinguished panel charged with identifying the causes of the meltdown and proposing reforms.”114 AEI’s 2009 annual report


111 AEI describes “strengthening free enterprise” as one of its “unchanging ideals.” WHY SHOULD I INVEST IN AEI, supra note 112. AEI encourages corporations and wealthy individuals to “support AEI” by assuring them that “A donation to AEI is fully tax-deductible and is a sound investment in limited government [and] private enterprise . . . .” AEI’S ORGANIZATION AND PURPOSE, SUPPORT AEI, http://www.aei.org/about (last visited May 31, 2011).


113 AEI 2009 ANNUAL REPORT at 2.

114 AEI 2009 ANNUAL REPORT at 3.
suggested that Wallison would likely use the opportunity to blame the GSEs for the financial crisis and to combat more comprehensive financial regulation:

“Mr. Wallison had become well known for his prophetic warnings about the financial risks posed by the government-sponsored enterprises . . . He . . . has argued firmly against employing the Federal Reserve as a ‘systemic risk’ regulator . . . [and] discussed the serious shortcomings of the administration’s proposed Consumer Financial Protection Agency.”

AEI’s 2010 annual report points out that in his role as a dissenting member of the FCIC, Wallison did in fact “identify[] federal affordable housing policies and the buildup of weak and high risk mortgages as the primary culprits of the financial crisis.” AEI also notes that in his other writings, Wallison has “warned that new regulation could cripple the . . . financial system”, and that Wallison’s and other AEI-supported writers’ “work on the problems at Fannie Mae and Freddie Mac . . . and their contribution to the financial crisis will be influential when Congress takes up an overhaul of the nation’s housing policy next session.”

To its credit, AEI is transparent about the fact that AEI “is governed by a Board of Trustees, composed of leading business and financial executives.” According to AEI’s annual reports, during the five-year period from 2005 to 2009, the vast majority of its revenues came from annual donations. AEI claims that it protects the integrity and independence of its research, but AEI researchers do not have protections such as tenure, and at least one prominent former employee has suggested that he was terminated because of donor pressure.

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115 AEI 2009 ANNUAL REPORT at 3, 4.
117 AEI 2010 ANNUAL REPORT at 2, 3.
121 AEI’s publicly disclosed “policies and procedures for assuring the integrity and reputation of its work” do not include tenure or similar protections for its research staff. AEI’S ORGANIZATION AND PURPOSE, http://www.aei.org/about (last visited May 31, 2011). AEI recently terminated the employment of a prominent member of its research staff—who had been with AEI for seven years—almost immediately after the researcher publicly criticized Republican policies. Howard Kurtz, Conservative David Frum loses think-tank job after criticizing GOP, WASHINGTON POST, Mar. 26, 2010, http://www.washingtonpost.com/wp-dyn/content/article/2010/03/25/AR2010032502336.html?hpid=topnews.
Wallison’s unwavering efforts to blame GSEs and government policies for the financial crisis were noted by other members of the commission, including fellow Republicans, who were often critical of his ideologically charged approach.\textsuperscript{122}

Those who argue that government policies pressured financial institutions to relax their underwriting standards generally point to two government policies: the Community Reinvestment Act\textsuperscript{123} ("CRA") and affordable housing goals for the GSEs that were established by the Department of Housing and Urban Development ("HUD").\textsuperscript{124}

The claim that the Community Reinvestment Act caused the financial crisis is not supported by empirical evidence. In his FCIC dissenting opinion, the only data Wallison provides to support this hypothesis is a table showing annual and cumulative dollar volumes of low-income lending to which financial institutions committed from 1977 to 2007.\textsuperscript{125} This table not only fails to establish causation; it fails to even establish a connection between commitments under the CRA and actual lending activity. Wallison acknowledged that lenders appear to have frequently failed to fulfill their commitments and that the available data makes it “impossible to determine how many loans were actually made under . . . CRA commitments . . . .”\textsuperscript{126} Furthermore, according to Wallison, even “[w]here these loans are today must remain a matter of speculation.”\textsuperscript{127} The handful of

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\textsuperscript{122} Louise Radnofsky and Alan Zibel, Democrats Pounce as Oversight Panel Calls Off Hearing, WSJ.COM, July 13, 2011, http://blogs.wsj.com/washwire/2011/07/13/democrats-pounce-as-oversight-panel-calls-off-hearing/ ("[E]mails show[] Republican commission member Peter Wallison trying to persuade his colleagues to use their positions to help House Republicans overturn the Dodd-Frank financial regulation legislation. . . . Emails exchanged by the other three Republican commissioners and their staffs shows they thought Mr. Wallison 'overplays' the argument that government housing policy caused the 2008 financial meltdown and they expressed concerns that Mr. Wallison was 'intractable.'").

\textsuperscript{123} WALLISON DISSENT at 443-44 ("The Community Reinvestment Act of 1977 . . . [was one of the] government social policy mandates responsible for the mortgage meltdown and the financial crisis."); id. at 524-532. Wallison relies heavily on research by Edward Pinto. \textit{Id.} at 451, fn. 4.

The CRA was enacted in 1977 to prevent banks from denying credit to individuals and businesses in certain neighborhoods without regard to their creditworthiness. The CRA requires certain depository institutions to lend, invest, and provide services to the communities from which they take deposits, consistent with bank safety and soundness. FCIC REPORT at xxvii. The CRA does not apply to mortgage brokers. FCIC REPORT at 220.

\textsuperscript{124} WALLISON DISSENT at 452-454, 487-519.

\textsuperscript{125} WALLISON DISSENT at 527, Table 13. Wallison also lists specific commitments by four large banks. \textit{Id.} at 529.

\textsuperscript{126} WALLISON DISSENT at 530. Even if one were to assume that the annual commitments contained in Wallison’s Table 13 were proportional to Community Reinvestment Act lending, there is no correlation with deterioration in underwriting quality. Whereas underwriting standards generally improved from 2000 to 2003, annual commitments increased during this time period. Whereas underwriting standards generally worsened from 2004 to 2007, Community Reinvestment Act commitments decreased. See, e.g., Figure 7, Figure 8, and Figure 9 and accompanying text.

\textsuperscript{127} WALLISON DISSENT at 530. Wallison blames the lack of data on what he claims was “the dilatory nature of the Commission’s investigation” although he admits that the banks the FCIC contacted “supplied only limited information. They contended that they did not have the
academic articles suggesting that the CRA might have caused the financial crisis also do not present empirical evidence to support this claim.\textsuperscript{128}

There is, however, substantial empirical evidence that the Community Reinvestment Act was not a significant cause of the financial crisis.\textsuperscript{129} Empirical studies by two different teams of Federal Reserve economists both suggest that CRA lending accounted for a minority of subprime lending,\textsuperscript{130} and that CRA loans performed better than subprime loans that were driven purely by market considerations.\textsuperscript{131}

Further evidence that subprime lending was driven by market forces rather than government affordable housing policies comes from the existence of a multi-billion dollar “synthetic” CDO market. Traditional CDOs are investment vehicles that purchased securitized bonds, and were major investors in subprime MBS. Synthetic CDOs provided investors with similar risk exposures, but did not actually fund any new mortgages.\textsuperscript{132} These synthetic instruments existed to a large extent because, at the height of the mortgage boom, investor demand for U.S. mortgage exposure exceeded originators’ and securitizers’ capacity to produce cash investments.\textsuperscript{133} It is far more time-consuming and labor-intensive to originate and aggregate billions of dollars in mortgages than to simply match information, that it was too difficult to get, and the information they supplied was sketchy at best.” Id. The banks also missed deadlines. Id. Wallison does not explain why private financial institutions—which would presumably be eager to demonstrate that government policies rather than their own failures led to the financial crisis—would fail to timely provide supporting data.


\textsuperscript{129} See generally FCIC REPORT at 72, 219-21.

\textsuperscript{130} See Neil Bhutta & Glenn Canner, Did the CRA Cause the Mortgage Market Meltdown? Federal Reserve Board of Governors, March 2009 (finding that less than 6% of subprime loans, defined as high cost loans under HMDA, had any connection to the CRA); Elizabeth Laderman & Carolina Reid, Lending in low and moderate income neighborhoods in California: The Performance of CRA Lending During the Subprime Meltdown, November 26, 2008, working paper to be presented at the Federal Reserve System Conference on Housing and Mortgage Markets, Washington, DC, December 4, 2008 (finding that in California, non-CRA-regulated mortgage brokers devoted a higher proportion of their lending to high priced loans than CRA-regulated institutions); FCIC REPORT xxvii, 220.

\textsuperscript{132} Bhutta, supra note 130 (finding that loans made by lenders regulated under the CRA in the neighborhoods in which they were required to lend were half as likely to default as similar loans made in the same neighborhoods by independent mortgage originators not subject to the law); Laderman, supra note 130 (finding that loans by CRA-regulated lenders in CRA assessment areas were half as likely to default as similar loans made by independent mortgage companies not subject to CRA, and concluding that “this suggests that the CRA, and particularly its emphasis on loans made within a lender’s assessment area, helped to ensure responsible lending, even during a period of overall declines in underwriting standards.”).

\textsuperscript{133} Rather than purchase MBS and thereby fund mortgage securitizers and originators, synthetic CDOs used Credit Default Swaps to enable investors to make side bets on the performance of existing MBS or CDOs.

investors willing to place opposite bets on the performance of existing mortgage backed securities. Synthetic CDOs efficiently enabled bets to be placed on the performance of mortgages without new mortgages being originated.

Still more evidence of the market-driven nature of the deterioration in underwriting standards comes from empirical studies of lobbying activity by mortgage lenders. If government pressure were forcing lenders to lend imprudently against their wishes, one would expect the lenders who lobbied most aggressively on issues related to underwriting regulation to receive dispensation that would enable them to have more conservative underwriting practices. However, the opposite appears to be true—the lenders who lobbied most aggressively had the riskiest underwriting practices, and generally lobbied against substantive limits on their ability to take risk. This suggests that government regulation was for the most part a restraining force that pushed toward more conservative underwriting.

The argument that HUD affordable housing goals led to greater risk-taking may have some merit. The GSEs failure was due at least in part to losses they suffered on highly rated tranches of non-prime MBS that the GSEs purchased from private securitizers and which the GSEs held in portfolio on their balance sheets. Why the GSEs purchased private label MBS remains open to debate, with some contending that the GSEs were attempting to meet affordable housing goals imposed on them by HUD, and others contending that the GSEs purchased these securities because they offered high yields, were highly rated by the rating agencies, and seemed to be a profitable investment that would benefit GSE shareholders.

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135 See infra note 191; Fannie Mae and Freddie Mac, GSEs with very large securitization market share, reportedly securitized a very low percentage of Alt-A securitizations (11 percent in 2005 and 12 percent in 2006) and zero percent of subprime loans. However, they purchased the highest rated tranches securitized by the private banks Belsky, supra note 20 at 5.

136 See Jason Thomas & Robert Van Order, Fannie Mae and Freddie Mac: What We Know, What We Think We Know and What We Don’t Know 1 (Mar. 2011)(draft paper), http://business.gwu.edu/creua/research-papers/files/fannie-freddie.pdf (finding that the GSEs “did build a large portfolio of AAA-rated PLS, probably in response to affordable housing goals”); FCIC REPORT at xxvi-xxvii (“Based on the evidence and interviews with dozens of individuals involved in this subject area, we determined these [HUD affordable housing] goals only contributed marginally to Fannie’s and Freddie’s participation in those mortgages.”); id. at 123-125; Ellen supra note 43 at 5 (“While it appears that the primary impetus for [the GSEs’] movement into risky, non-prime investments was the higher interest rates that these investments paid, there is considerable debate about whether the GSEs were also motivated by their need to meet the affordability goals mandated by Congress”); Dwight M. Jaffee, The Role of the GSEs and Housing Policy in the Financial Crisis, Feb. 25, 2010, 16.
It may not be possible to ever conclusively determine the GSEs’ motivation. But this much is clear: the GSEs made the same mistake that many other buy-side financial institutions made—trusting underwriting at non-GSE securitizers and private label MBS ratings—and those other investors could not have been driven by HUD’s affordable housing goals for the GSEs.137

From 2001 to 2008, the GSEs purchased approximately 30 percent of subprime private label MBS and approximately 10 percent of Alt-A private label MBS. GSE purchases grew from 2001 to 2004, and then declined from 2004 to 2008.138 As previously noted, the worst performing loans were originated in 2004 to 2007. In 2004 to 2007, subprime and Alt-A private label MBS volume increased, meaning that many other investors stepped up their purchase activity at the worst possible time, providing funding as the GSEs withdrew. Although the GSEs reduced their purchase activity as the quality of the underlying collateral deteriorated, their policy shift may have had less to do with investment acumen than with regulatory pressure following an accounting scandal.139 Notwithstanding their portfolio losses, overall GSE loan delinquency rates are still substantially below those of most other market participants.140

In light of the GSEs poor performance as portfolio investors in MBS, it may be prudent to limit their activity—and the activity of any other secondary mortgage market player with ties to the government—to purchasing whole loans rather than packaged MBS.

It may also be prudent for the government to commit, through legislation, to prioritize sound underwriting and profitability for the benefit of taxpayers over widespread access to mortgage credit or targeted subsidies for favored political groups.

III. Centralized underwriting through regulation may not be an adequate substitute for GSE market power

The Dodd-Frank Wall Street Reform and Consumer Protection Act does in fact include reforms that move the U.S. mortgage market toward more centralized, standardized minimum underwriting and documentation standards. Under Dodd-

137 Private institutions including Citi, insurers AIG, Ambac, MBIA, and several European banks all were sufficiently exposed to subprime MBS that they either became insolvent or would likely have become insolvent but for government intervention.
138 FCIC REPORT at 124, Figure 7.3. GSE subprime MBS purchases peaked at slightly below 40 percent in 2003 to 2004, and dropped to closer to 25 percent by 2006 to 2007. GSE Alt-A MBS purchases peaked around 25 percent in 2004 and declined to around 5 percent by 2006 to 2007.
139 According to the FCIC, the GSEs’ pullback from private label MBS purchases was related to agreements they reached with their regulator to settle accounting scandals. According to their regulator, the GSEs manipulated their financial reporting in the late 1990s and early 2000s to increase payments to senior executives under incentive compensation plans. FCIC REPORT at 122-23, 180, 310-11.
140 See supra Figure 12.
Frank, mortgage lenders must evaluate whether a prospective borrower is likely to be able to repay the mortgage, and only originate the mortgage if the borrower is likely to repay. The basis for this determination must be objective factors such as credit history, current income, expected income, current obligations, debt-to-income ratio, employment status and other measures of financial resources. Income must be verified through W-2s, tax returns, payroll receipts, or financial institution records.

These reforms are a step in the right direction, but they may not go far enough: the statute itself includes exceptions which can be exploited; detailed rule making is delegated to the Consumer Financial Protection Bureau (“CFPB”), a regulatory agency with huge responsibilities and limited resources; and enforcement built around consumer protection may not adequately protect the interests of taxpayers.

A major limitation of Dodd-Frank is that it does not standardize underwriting criteria per se, but instead provides a list of factors that originators should consider and documentation that they should collect. Detailed rule making is delegated to the CFPB.

Dodd Frank establishes a two-tiered origination market in which more restrictive, detailed rules are reserved for "qualified residential mortgages" ("QRMs"). The primary advantage to originators of QRMs is that they are exempt from risk retention requirements of at least 5 percent. In other words, originators and securitizers need only be concerned about more restrictive QRM rules if they are unwilling to retain a small fraction of the mortgages they originate. By contrast, the GSEs’ market power and industry expertise may enable them to require originators to both retain significant default risk and to comply with stringent underwriting standards, for example, through repurchase agreements.

A full discussion of QRM rules is beyond the scope of this article, but minimal risk retention requirements may not fundamentally alter the economic rationale for issuing and then securitizing risky mortgages. Though more restrictive, “qualified

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141 12 U.S.C. § 1385 (2010) (providing that “no creditor may make a residential mortgage loan unless the creditor makes a good faith determination based on verified and documented information that, at the time loan was consummated, the consumer had reasonable ability to repay loan, according to its terms, and all applicable taxes, insurance and assessments.”)


143 There is an exception to the income verification requirement for loans made, guaranteed or insured by federal departments or agencies. 12 U.S.C. § 1385 (2010). It is unclear why loans explicitly backed by taxpayers are not subject to the same stringent income verification requirements as other loans.

144 Technically, repurchase agreements do not require originators to retain a portion of the loan. Instead, they give GSEs the right to put-back loans that breach representations and warranties. Because the GSEs sample defaulting loans at a much higher rate than they sample performing loans, the economic effect is very similar to partial default risk retention by the originator.
mortgage” can still include risky features such as adjustable interest rates, and under certain circumstances, interest-only or negative amortization loans.\footnote{145}

Many scholars have argued that compensation schemes for financial professionals contributed to the financial crisis because they established asymmetric equity-like payoffs (high upside for success, limited downside for failure), prioritized short term financial results over more reliable, long term measures of value-creation, and thereby incentivized excessive risk-taking.\footnote{146} These scholars’ recommended reforms—compensation tied to long-term performance, less equity and more debt-like compensation—are not mandated by Dodd Frank.\footnote{147} Because financial institutions can still offer their equity holders and managers limited liability, high leverage, and huge upside potential, a high-risk strategy can still benefit shareholders and managers by transferring most of the downside risk to investors and much of the rest to taxpayers.


\footnote{146}{See Frederick Tung, \textit{Pay for Banker Performance: Structuring Executive Compensation for Risk Regulation}, 105 NW. U. L. REV. __ (2010) (reviewing the role of equity compensation in encouraging risk-taking and arguing that financial managers should be compensated with subordinated debt instead of equity to make them more cautious); Frederick Tung & Xue Wang, \textit{Bank CEOs, Inside Debt Compensation, and the Global Financial Crisis} (Mar. 24, 2011) (providing empirical evidence that inside debt compensation of CEOs is associated with better performance and less risk taking during the financial crisis); Lucian A. Bebchuk, Alma Cohen, & Holger Spamann, \textit{The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008}, 27 YALE J. REG. 257 (2010) (reporting that the top five executives at two failed U.S. financial firms, Bear Stearns and Lehman Brothers, were able to cash out large amounts of bonus compensation that was not clawed back when the firms failed, and to sell large amounts of equity prior to their firms’ collapse, and became substantially wealthier during the 2000 to 2008 period); Lucian A. Bebchuck & Holger Spamann, \textit{Regulating Bankers’ Pay}, 98 GEO. L. J. 247 (2010); Patrick Bolton, Hamid Mehran, & Joel D. Shapiro, \textit{Executive Compensation and Risk Taking} (June 1, 2010) (arguing that executive compensation based in part on debt prices will reduce risk for financial institutions); Rüdiger Fahlenbrach & Rene M. Stulz, \textit{Bank CEO Incentives and the Credit Crisis}, J. FIN. ECON. (forthcoming) (finding some evidence that banks with CEOs whose incentives were better aligned with the interests of shareholders performed worse during the financial crisis and no evidence that they performed better); Sanjai Bhagat & Roberta Romano, \textit{Reforming Executive Compensation: Simplicity, Transparency, and Committing to the Long Term} (October 21, 2009) (arguing for restricted stock compensation); Jeffrey N. Gordon, \textit{Executive Compensation and Corporate Governance in Financial Firms: The Case for Convertible Equity-Based Pay} (July 9, 2010) (arguing that finance CEOs should be paid in equity that converts to subordinated debt upon credit downgrades); Divya Anantharaman, Vivian W. Fang, & Guojin Gong, \textit{Inside Debt and the Design of Corporate Debt Contracts} (Jan. 19, 2011) (providing empirical evidence that creditors believe that it is safer to lend to firms in which managers hold a higher ratio of debt to equity than the firm as a whole); Rangarajan K. Sundaram & David Yermack, \textit{Pay Me Later: Inside Debt and Its Role in Managerial Compensation}, J. FIN. (forthcoming) (reporting that CEOs with high debt incentives manage firms conservatively); Lucian A. Bebchuk & Jesse M. Fried, \textit{Paying for Long Term Performance}, 158 U. PENN. L. REV. 1915 (2010) (discussing implementation challenges for incentive-based pay in light of hedging opportunities available to executives).}

\footnote{147}{Dodd Frank’s compensation provisions generally rely on greater disclosure to shareholders and greater shareholder influence. 15 U.S.C. § 78n-1 (2010). Because shareholders should rationally prefer high-risk strategies, Dodd Frank’s approach is unlikely to result in compensation schemes that reduce managers’ incentives to take risks.}
Dodd Frank also does not prevent originators from again using their compensation schemes to emphasize quantity of mortgages over quality of mortgages. Dodd Frank does not prohibit originators from compensating loan officers based on the volume of loans they produce, or how readily those loans can be sold.\textsuperscript{148}

Dodd Frank’s effectiveness may also be limited by its fragmented enforcement mechanisms. The principal rule-making agency, the CFPB, cannot enforce its rules against depository institutions with less than $10 billion in assets, and must instead rely on those institutions’ prudential regulators.\textsuperscript{149} Because there are many different prudential regulators, the door remains open for uneven enforcement and regulatory arbitrage. By contrast, to the extent that originators depend on the GSEs for financing, originators will face largely standard, uniform risk management practices and relatively swift penalties for non-compliance.

The effectiveness of the CFPB will also likely be hampered by continued efforts to de-fund it and reduce its ability to operate independent of politics.\textsuperscript{150} Given the

political influence of the financial services industry, it seems unlikely that the CFPB could effectively regulate underwriting if it were subject to annual appropriations by Congress.

The rationale claimed by members of Congress who wish to defund the CFPB—budgetary necessity—would be more difficult to apply to the risk management function of a government owned enterprise that was profitable and entirely self-funding. The CFPB’s budget—likely a few hundred million dollars spread across many consumer product markets and initiatives—pales in comparison to the resources the GSEs can devote to the residential mortgage finance market. For

151 According to the Center for Responsive Politics, the Finance, Insurance and Real Estate industries have spent over $4.5 billion in lobbying since 1998, more than any other sector. See Lobbying: Ranked Sectors, http://www.opensecrets.org/lobby/top.php?indexType=c.


Critics of consumer protection regulation have focused on the possibility that such regulation might increase compliance costs for private financial institutions and that consumer credit might become more expensive or less available. See David S. Evans and Joshua Wright, The Effect of the Consumer Financial Protection Agency Act of 2009 on Consumer Credit, 22 LOYOLA CONSUMER L. REV. 277 (2010); but see Adam J. Levitin, A Critique of Evans and Wright’s Study of the Consumer Financial Protection Agency Act, (Dec. 11, 2009), available at http://ssrn.com/abstract=1492471.

153 Jessica Holzer, House Panel Targets Consumer Bureau, SEC Budgets, WALL STREET J., June 23, 2011, (“Rep. Jo Ann Emerson (R., Mo.) acknowledged that some Republicans want to hobble the agency created by the Dodd-Frank financial law by depriving it of funds. But she argued that . . . ‘With the debt that we’ve got right now, $200 million is more than ample, more than fair for an agency that isn’t required to report to us . . . .’”) Congress’s attention to detail when it comes to the CFPB is impressive: if fully funded at $500 million, the CFPB’s budget would equal less than 0.02 percent of the Federal Government’s $3.8 trillion budget for 2011. OFFICE OF MANAGEMENT AND BUDGET, BUDGET OF THE UNITED STATES FOR THE FISCAL YEAR 2011, 151, http://www.gpoaccess.gov/usbudget/fy11/pdf/budget.pdf.
example, in 2010, the GSEs’ administrative expenditures were over four billion, focused entirely on managing the residential mortgage finance market.  

IV. Treasury’s plans to privatize the mortgage market overlook the dangers of competition and private ownership of systemically important financial institutions

Treasury appears to be concerned about the extent to which the Federal government’s balance sheet is being used to directly fund the mortgage market. Treasury recently published a report to Congress, Reforming America’s Housing Finance Market (“Treasury Report”), which outlines a plan to “reduce the role of [Fannie Mae and Freddie Mac] in the mortgage market, and ultimately, wind down both institutions.”  

The plan calls for restoring market competition by making “private markets . . . the primary source of mortgage credit” and by acting to “eliminate unfair capital, oversight and accounting advantages and promote a level playing field” for private financial institutions to compete with one another.  

Treasury’s motivation appears to be at least partly ideological. Although there are choices to be made about how fast and how much to reduce the role of government in the mortgage market, Treasury has apparently already decided that its ultimate goal is to reduce the role of government:

There will of course be significant debate . . . But we must be careful not to let that debate keep us from the immediate task at hand: we need to scale back the role of government in the mortgage market, and promote the return of private capital . . . . The housing finance system must be reformed.  

Treasury has emphasized the importance of the government reducing its market share so that private financial institutions can expand and make greater profits. 

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156 Id. at 1.
157 Id. at 31 (emphasis in original).
158 Id. at 12-13 (“We support ending the unfair capital advantages that Fannie Mae and Freddie Mac previously enjoyed and recommend FHFA require that they price their guarantees as if they were . . . private banks or financial institutions. This will . . . help the private market compete on a level playing field, reducing Fannie Mae and Freddie Mac’s market share over time.”); Id. at 13. (“In order to further scale back the [GSEs'] share of the mortgage market, the Administration recommends that Congress allow the temporary increase in limits [on the size of mortgages the GSEs are allowed to purchase and securitize] to expire . . . As a result of these reforms, larger loans for more expensive homes will once again be funded only through the private market.”); Id. at 14. (“As Fannie Mae and Freddie Mac’s presence in the market shrinks . . . we will coordinate
According to Treasury, “[u]nder normal market conditions, the essential components of housing finance . . . lending money, determining how best to invest capital, and bearing credit risk – are fundamentally private sector activities.”

These statements reflect a normative preference that the government play a limited role in mortgage finance. However, the claim that mortgage finance consists of “fundamentally private sector activities” is hardly an accurate description of how mortgage finance has functioned in the United States for the last seventy years.

The government is capable of performing many of the same economic functions as for-profit financial institutions. However, it is not necessarily advisable that the government should. In establishing a role for the federal government in the secondary residential mortgage market, Treasury set forth four policy goals that it will try to balance: (1) protecting the financial interests of taxpayers; (2) avoiding economic distortions that lead to overinvestment in housing; (3) maintaining a stable financial system and economy; and (4) reducing the cost of mortgages for borrowers.

Treasury has suggested that many of these goals—particularly protecting taxpayers—would best be served by winding down the GSEs and reducing the government’s role in the mortgage market. Contrary to Treasury’s claims, the analysis presented here suggests that residential mortgage market privatization along the lines envisioned by Treasury could put taxpayers at greater risk.

Treasury’s three proposals are: (1) a near complete withdrawal of the government as guarantor or funder of mortgages, except to veterans, low income households, and other specially designated groups; (2) targeted subsidies as in option one, plus a government lender-of-last resort program that would provide credit or guarantee loans during times of crisis when private credit becomes unavailable or very expensive; and (3) Government guarantees of private mortgage insurers, who would essentially function as smaller, competing versions of the pre-crisis GSEs—for profit, private financial institutions capable of offering guarantees ultimately backstopped by taxpayer money.

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159 Id. at 12.
160 Treasury’s view is not that the government should play no role whatsoever. Treasury has suggested that the government should remain active as a regulator protecting borrowers and investors, possibly to provide “targeted” subsidies to low-income borrowers, and possibly as a lender of last resort in times of crisis. Id. at 1, 27-30. However, in Treasury’s view, government generally should not provide funding in the ordinary course, as the GSEs do now.
161 See supra part I.
162 Id. at 1, 27-30, 25-26, 31.
163 Id. at 27-28.
164 Id. at 28-29.
165 Id. at 29-30.
A. Treasury’s option 1 fails to protect taxpayers if the government is likely to bail out systemically important private financial institutions in the future

Treasury has argued that a complete withdrawal of the government from the mortgage market could insulate taxpayers from losses in the event of financial institution failure, but only if the government can commit to not bail out the remaining private financial institutions in the event of a crisis.  

As discussed above, a fragmented, competitive, privatized mortgage market leads financial institutions to take greater risks and makes financial crises more likely. In the event of a crisis, the absence of a government-controlled alternative to private financial institutions would make government bailouts of systemically important financial institutions likely, and perhaps inevitable.

In 2008 the Federal government "bailed out" GSEs (which had been private for almost 40 years) and many other large private financial institutions—or to be more precise, those institutions’ creditors and shareholders. A number of bankruptcy scholars have argued that bailouts often relate less to the future operation of an institution—liquidation vs. reorganization—than to who will incur losses that have already been realized.  To the extent that this is true,

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166 Id. at 12-13, 27-28.
167 Id. at 28 ("A related risk would exist if investors believe that the government would inevitably step in to save whatever private financial institutions or banks have become necessary to maintain the flow of mortgage credit.")
bailouts may be driven by political considerations rather than economic necessity, and are largely a mechanism for transferring losses from private investors and other creditors to taxpayers.

The government structured the bailout of AIG—for which it received liens on AIG’s assets and warrants on nearly 80 percent of AIG’s stock—in a way that was relatively favorable to taxpayers and relatively less favorable to AIG’s shareholders.\(^{170}\) This may be because AIG was in effect a mortgage investor rather than a mortgage financial intermediary. AIG did not securitize mortgages directly, but indirectly funded mortgage securitization by accepting risks that mortgage securitizers wished to hedge. In cases involving large institutions that directly securitized or originated mortgages, the government was far more generous, often purchasing equity in institutions that were likely already insolvent, thereby reducing losses of existing shareholders and shielding creditors from any loss.\(^{171}\)

Under non-bailout insolvency resolution mechanisms such as bankruptcy, shareholders are wiped out and many creditors incur losses, but the institution itself may be reorganized and continue to function if it can obtain post-petition financing. In some cases, the only institution with sufficient liquidity to provide post-petition financing may be the government.\(^{172}\)

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The 2008 mortgage crisis was not the first time the U.S. government (or the Federal Reserve) has “bailed out” private financial institutions. Other notable bailouts have included: elite financial institutions in the late 1920s and early 1930s after the Great Crash; Franklin National Bank in 1974; Continental Illinois National Bank and Trust Company in 1984; and most of the Savings and Loan Industry and their exhausted insurance fund in 1989. Furthermore, the U.S. is not unique in its proclivity for bailouts: since WWII many other governments have bailed out their financial sectors.

Financial markets expect that the U.S. government will continue to bail out large, private financial institutions on favorable terms. Because these institutions enjoy an implied government guarantee, investors are willing to lend them money at lower rates than their smaller competitors.


178 Omarova, supra note 168 at 108 (arguing that current regulations are unsuited to the task of protecting the system, leaving the door open for future financial crises); Levitin, supra note 168 at 477 (arguing that “ex ante responses to systemic risk” only serve to mitigate, and not eliminate, that risk); Jeffrey N. Gordon & Christopher Muller, Confronting Financial Crisis: Dodd-Frank’s Dangers and the Case for a Systemic Emergency Insurance Fund 4 (Columbia Law and
Professor Adam Levitin argues that rather than making unrealistic proclamations that bailouts are behind us, the government should prepare itself to conduct bailouts in a transparent, democratic, and legitimate way.

B. Treasury’s option 2 fails to protect taxpayers if a lightly staffed agency cannot distinguish between market panic and rational withdrawal of private capital

Treasury’s second proposal calls for the government to retain a limited lender-of-last resort program that would provide credit or guarantee loans during times of crisis when private credit becomes unavailable or very expensive. It is more realistic than option one, in that it acknowledges that future financial crises may be inevitable, and that government intervention can help maintain stability. It tries to restrict government intervention to managing times of crisis rather than use government control during normal times to maintain prudent underwriting and prevent a crisis.

According to Treasury:

This backstop would maintain a minimal presence in the market during normal times, but would be ready to scale up to a larger share of the market as private capital withdraws in times of financial stress. One approach would be to price the guarantee fee at a sufficiently high level that it would only be competitive in the absence of private capital. . . . Another approach would be to restrict the amount of public issuance sold to the private market in normal times, but allow the amount of issuance offered to ramp up to stabilize the market in times of stress.

To appreciate this proposal, it is important to realize that default risk is highly cyclical. During times of general distress, all loans, not just “risky” loans, 

Economics Working Paper No. 374, 2010), available at http://ssrn.com/abstract=1636456 (arguing that systemic crises are inevitable without “good faith” regulatory reform); Skeel, supra note 177 at 3 (arguing that there will inevitably be another financial crisis in the future).

Levitin, supra note 168 at 487.

Id. at 514.

TREASURY REPORT at 28-29.

Id. at 28.


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become much more likely to default. During boom periods, all loans, including risky loans, are much less likely to default. The cyclicality of default risk is illustrated well by Figure 14 below.

Figure 14 shows that although prime loans perform better than subprime loans, and although fixed rate mortgages (“FRMs”) generally perform better than adjustable rate mortgages (“ARMs”), all loans performed much better during the boom period from late-2003 until mid-2006 than they did before or after.

In fact, the cyclicality is so pronounced that risky subprime mortgages performed better during the 2004 to 2006 boom period than “safe” adjustable rate prime mortgages performed during the crisis from late 2008 on.

**Figure 14: Default risk is cyclical across loan classes**

*Seriously delinquent loans by class, 2002-2011*  
Percent of loans seriously delinquent, not seasonally adjusted

In light of the cyclicality of default risk, Treasury’s proposal could be rephrased as follows: during prosperous times when unemployment is low, defaults are rare, and mortgage lending is highly profitable, the government will price itself out of the market and allow the profitable business of mortgage funding to be dominated by private financial institutions. During shocks to the economy, when unemployment and default risk are high, the government will rush in to guarantee loans at rates that are below what any private investor would demand.

Although the government could theoretically try to protect itself by tightening underwriting standards, so too could private lenders—which is why liquidity

becomes scarce in a crisis. The government can only act counter-cyclically if it is prepared to accept risks when others are not.

This approach might not result in losses to taxpayers if the crisis is caused by market panic and an irrational withdrawal of private liquidity. On the other hand, if private investors refuse to lend because of economic fundamentals and elevated default risk rather than liquidity constraints, then this proposal simply calls for “stabilizing the market” by transferring cyclical losses away from private mortgage lenders and toward taxpayers.\(^{184}\)

In an ideal world, government officials would be able to quickly distinguish between an irrational panic that could be solved with a temporary injection of liquidity and underlying weakness in collateral that will inevitably result in losses.\(^{185}\) But that kind of judgment would require an experienced bureaucracy, with detailed knowledge of the latest developments in the mortgage market, and with access to ample resources.

Treasury’s proposal calls for a lightly staffed agency that will have had “a minimal presence in the market” in years leading up to the crisis. Without extensive experience, this agency may not be equipped to underwrite prudently under normal conditions, let alone in times of crisis. Although the government could temporarily recruit experienced individuals from the private sector to help manage a crisis, such an approach entails challenging conflict of interest issues. The interests of private industry and taxpayers may not perfectly coincide, and officials who earn most of their lifetime income in the private sector may find it difficult to place taxpayers’ interests ahead of the interests of their previous and prospective future employers.\(^{186}\)

Although Treasury acknowledges “a significant operational challenge” and “uncertainty around how well it would be able to scale up in times of crisis,”

\(^{184}\) This could be accomplished either by insuring previously uninsured mortgage backed securities or by refinancing uninsured mortgages at risk of default and replacing them with mortgages insured by the government.

\(^{185}\) See Walter Bagehot, LOMBARD STREET: A DESCRIPTION OF THE MONEY MARKET (1873) (arguing that central banks can prevent financial panics by lending to illiquid but solvent banks against good collateral and at a punitive rate); id. at 197 (“The end is to stay the panic . . . . And for this purpose there are two rules: First, that these loans should only be made at a very high rate of interest. This will operate as a heavy fine . . . . Secondly, that at this rate these advances should be made on all good banking securities . . . . No advances indeed need be made by which the Bank will ultimately lose . . . . The great majority, the majority to be protected, are the ‘sound’ people, the people who have good security to offer.”).

\(^{186}\) See Edward J. Kane, Redefining and Containing Systemic Risk 10-11 (May 25, 2009) (“To be complete, reform strategies must address features of top officials’ employment situation . . . . Limited terms and relatively low salaries encourage top regulators to use their government service to nurture post-government career opportunities in the very industries they regulate . . . . The result is that de facto accountability to informed and politically powerful sectors routinely trumps the abstract duties that top regulators owe to society as a whole”); id. at 18-21 (arguing that top regulatory posts should be held by professional, dedicated, and highly trained career civil servants with financial incentives that align their interests with taxpayers).
Treasury’s suggestions for automating government guarantees suggests that Treasury expects this agency to not exercise judgment. Treasury’s two automation proposals both suffer from serious moral hazard problems. Treasury’s first proposal—offering guarantees at all times at a price that would only be attractive during times of crisis—is analogous to offering life insurance to both 30 year olds and 90 year olds at a price that would be attractive to 60 year olds. Treasury’s second proposal, offering more insurance during times of crisis, is analogous to selling homeowners’ fire insurance primarily to people whose kitchens have been declared fire hazards.

Even though ex-ante underwritings standards tightened dramatically in 2008 compared to previous years, mortgages originated that year have performed poorly. Lending in the midst of a crisis can be perilous, even for experienced professionals exercising independent judgment. Presumably, worse results could be expected from a lightly staffed agency operating on autopilot.

C. Treasury’s option 2 fails to protect taxpayers if systemically important financial institutions can convert guarantees and safety nets into ordinary course subsidies

According to Treasury, a government guarantee or funding available only during market contractions would “avoid the distortions [of excessive risk-taking and overinvestment] in the housing market associated with a broad-based guarantee and thus reduce both moral hazard and taxpayer risk.” It seems far more likely that this proposal will simply prevent the government from charging insurance premiums and building up reserves during boom times so that those reserves can be used to fund bailouts during busts.

Private financial institutions have historically proven adept at converting emergency safety nets into ordinary course subsidies. Although the GSEs experienced steep losses in 2007 to 2010, they were highly profitable during

187 See supra figures 4, 5.
188 See supra figure 6.
189 TREASURY REPORT at 29.
190 Congress similarly rejected financial reform proposals for a systemic risk insurance fund, to be pre-funded by large, “systemically important” financial institutions. Wilmarth, Dodd-Frank, supra note 177 (criticizing financial reform measures because “Dodd-Frank does not require [systemically important financial institutions] to pay risk-based assessments to pre-fund… the costs of resolving failed SIFIs. Instead, the [orderly liquidation fund] will be forced to borrow the necessary funds in the first instance from the Treasury (i.e., the taxpayers).”); See also Gordon & Muller, supra note 178 (arguing for a Systematic Emergency Insurance Fund funded by large financial institutions); Wilmarth, Too-Big-To Fail Wilmarth, Too-Big-To Fail, supra note 171 (arguing for a prefunded systematic risk insurance fund, separate from FDIC deposit insurance).
191 According to the companies’ financial statements, their aggregate net loss in those years exceeded $200 billion, largely due to provisions for loan losses (write downs of non-performing assets). A number of scholars have suggested that most of these losses were due to write-downs of private label MBS purchased from non-GSE securitizers and held on their balance sheets, but reports from the GSE’s conservator appear to suggest that most of the losses were due to guarantees of poor quality mortgages originated in 2006 and 2007. FEDERAL HOUSING
the sixteen years from 1990 to 2006 and paid private investors tens of billions of dollars in dividends, as shown in Figure 15. And because the GSEs were highly leveraged, private shareholders captured substantial upside while putting minimal capital at risk, as shown in Figure 16.

A number of studies have suggested that a significant portion of the GSEs’ profitability was due to their implied government guarantee. An implied guarantee enabled the GSEs to borrow cheaply even though they were highly leveraged, because creditors expected taxpayers instead of private capital to absorb any loss. Had these profits gone to benefit taxpayers—the largest holders of residual risk—instead of private investors—who absorbed limited losses—taxpayers would be in a better position today.

Figure 15: GSEs were profitable in the decade and a half before the financial crisis and paid substantial dividends

FINANCE AGENCY, CONSERVATOR’S REPORT ON THE ENTERPRISES’ FINANCIAL PERFORMANCE 3 (Aug. 16, 2010), http://www.fhfa.gov/webfiles/16591/ConservatorsRpt82610.pdf; Thomas & Van Order, supra note 136; Dwight M. Jaffe, Reforming the U.S. Mortgage Market Through Private Market Incentives 9 (Nov. 15, 2010)(Conference Draft), http://research.stlouisfed.org/conferences/gse/Jaffee.pdf; Belsky, supra note 20, at 5-8 (detailing the holdings of the GSEs and the effects of those holdings on their respective balance sheets); Ellen supra note 43 at 10 (showing the subprime acquisitions by the GSEs in the years immediately preceding the financial crisis).

192 See, e.g., W. Scott Frame & Lawrence J. White, Fussing and Fuming over Fannie and Freddie: How Much Smoke, How Much Fire?, J. ECON. PERSP., Spring 2005, at 159, 164 (“Evidence suggests that financial markets believe that the federal government would come to the rescue of Fannie Mae and Freddie Mac (and hence their creditors) in the event of financial difficulties. As a result of this perceived implicit guarantee, Fannie Mae and Freddie Mac can typically borrow at interest rates” that are more favorable than their stand-alone rating.); Wayne Passmore, The GSE Implicit Subsidy and the Value of Government Ambiguity, 33 REAL EST. ECON. 465, 466 (2005) (“Fannie Mae’s and Freddie Mac’s ambiguous relationship to the government imparts an implicit subsidy to GSE shareholders and homeowners...”); U.S. CONG. BUDGET OFFICE, FEDERAL HOUSING SUBSIDIES AND THE HOUSING GSEs (2001) (The special legal status of Fannie Mae and Freddie Mac as GSEs “enhances the perceived quality of the debt and mortgage-based securities...that they issue or guarantee and translates into a federal subsidy.”).
193 Frame, supra note 192, at 174 (“Because of the implied guarantee, creditors do not monitor the firms’ activities as closely as they otherwise would. As a consequence of this reduced monitoring, the management of Fannie Mae and Freddie Mac can engage in activities that involve greater risk (with greater consequences for the government), since the companies’ owners will benefit from the ‘upside’ outcomes while being buffered (because of the limited liability of corporate owners) from the full consequences of large ‘downside outcomes.’")
GSEs are not the only financial institutions who extracted transfers from taxpayers. Many other financial institutions have also converted safety nets into subsidies.
Professor Saule Omarova has demonstrated that since the passage of the Gramm-Leach-Bliley Act and for a decade before the financial crisis of 2008, the Federal Reserve Board repeatedly authorized large private financial institutions to subsidize their lightly regulated, high-risk subsidiaries through their government backed, regulated deposit-taking subsidiaries by suspending the restrictions of Section 23A of the Federal Reserve Act.\textsuperscript{194}

Government guarantees and subsidies ear-marked to stabilize a limited set of systemically important financial activities "leaked" through "firewalls" and were used—with the Federal Reserve’s authorization—to enhance private financial institutions' profitability.\textsuperscript{195} Rather than being used to stabilize firms through a short-term injection of liquidity, these subsidies were used by private financial institutions to take greater risks at taxpayers’ expense.\textsuperscript{196}

Treasury’s claim that limiting guarantees will avoid distortions also overlooks the fact that the Federal Government already provides huge, distortionary subsidies to mortgage lending through the mortgage interest deduction and related tax subsidies to home ownership.\textsuperscript{197} Estimates of tax expenditures from provisions of the federal income tax code that encourage residential mortgage lending—such as the mortgage interest deduction, the exclusion of gain on the sale of principal residence, and the deductibility of state and local property taxes on owner occupied homes—suggest that the government has provided over $1 trillion in subsidies from 2000 to 2009.\textsuperscript{198}

\textsuperscript{194} Omarova, \textit{supra} note 168 at 118-19.
\textsuperscript{195} Id. at 142-45. Professor Omarova documents guarantee leakage both before and during the financial crisis.
\textsuperscript{196} Id. at 185-88.
\textsuperscript{197} Although interest on business loans is generally deductible, the Tax Reform Act of 1986, made interest on consumer and personal loans generally not deductible. IRC § 163(a),(h) (LexisNexis 2011). The most important exception to this rule is interest on mortgage loans, including acquisition indebtedness with a principal balance up to $1 million and home equity indebtedness with a principal balance up to $100 thousand. IRC § 163(h)(3) (LexisNexis 2011). The Joint Committee on Taxation therefore counts the mortgage interest deduction as a tax expenditure, or a covert subsidy through the tax code. \textit{JOINT COMM. ON TAXATION, Background Information on Tax Expenditure Analysis and Historical Survey of Tax Expenditures, JCX-15-11} (February 28, 2011).
Part of this tax subsidy probably makes homeownership more affordable by reducing the after-tax cost of mortgages. However, mortgage lenders probably capture some of this subsidy by charging higher fees and interest rates and lending more than they otherwise could.\textsuperscript{199}

Option 2 would likely perpetuate a system in which tax and safety net subsidies flow to private financial institutions, while taxpayers continue to take on large downside risk with little upside potential.

On the other hand, if the government could participate more actively in the mortgage funding market, it might recapture some of the tax and safety net subsidies that now flow to private investors.

\textbf{D. Treasury’s option 3 enables the government to charge for its safety net, but overlooks the possibility that reduced market concentration may increase risk}

In some respects, the third option proposed by Treasury is the most attractive, because the government will be able to charge a fee for the guarantees it provides and thereby build up reserves against future losses. This approach essentially places private mortgage guarantee companies in a very similar position to the pre-financial crisis GSEs—private, for profit entities with access to government guarantees—with a few differences.

Before the financial crisis, the GSEs and virtually every systemically important private financial institution enjoyed an implied guarantee from the government, essentially free of charge.\textsuperscript{200} This implied guarantee turned into an actual guarantee during the financial crisis, transferring losses from financial institutions’ unsecured creditors to taxpayers.\textsuperscript{201}

The new government backed private mortgage insurers ("GB-PMIs") would differ from the GSEs in that they would have an explicit guarantee from the government for which they would pay a fee.\textsuperscript{202} Charging something for a

\begin{flushleft}
\textsuperscript{199} See Dennis J. Ventry, Jr., \textit{The Accidental Deduction: A History and Critique of the Tax Subsidy for Mortgage Interest} 102 (UC Davis Legal Studies Research Paper No. 196, 2009), available at http://ssrn.com/abstract=1498784 (suggesting that the mortgage interest deduction artificially raises housing prices and leads to an overinvestment in the asset class relative to other investments).

\textsuperscript{200} See supra note 176 and accompanying text.

\textsuperscript{201} See supra note 168 and accompanying text. The exception was Lehman Brothers, which was denied government assistance and entered bankruptcy.

\textsuperscript{202} TREASURY REPORT at 29-30.
\end{flushleft}
government guarantee is better for taxpayers than charging nothing, but the Treasury has acknowledged substantial risk that lax oversight or underpricing of the guarantee fee could lead to excessive risk taking and more losses for taxpayers.\textsuperscript{203}

Like the GSEs, the GB-PMIs would have incentives to maximize short-term profits for the benefit of executives and private shareholders. The GB-PMIs could, for example, underprice insurance to chase market share and increase revenue, while paying out accounting “profits” as dividends and compensation. In other words, GB-PMIs could easily maximize “profits” by increasing long-term risks to government guarantors.

It seems likely that the GB-PMIs would underprice insurance and the government would underprice reinsurance, given the historic underpricing of other government guarantee programs, such as deposit insurance.\textsuperscript{204}

Private investors will be most likely to participate if they believe that they can make an attractive profit, either because the government will charge too little for reinsurance or because the GB-PMIs can charge high fees for private mortgage insurance.

It is unlikely that GB-PMIs could charge high fees for insurance. High pricing would require that GB-PMIs have substantial market power. However, the GB-PMIs would have less market power than the GSEs.

There would probably be six GB-PMIs instead of only two GSEs, because there are currently six PMIs who collectively account for almost the entire private mortgage insurance market.\textsuperscript{205} These smaller, more numerous GB-PMIs would have less market power than the old GSEs and—unless they illicitly collude—would likely compete with one another more aggressively. Competition between GB-PMIs would likely lead to pricing concessions to large mortgage lenders and willingness to take more risk for less return. Private mortgage insurers already

\textsuperscript{203} Id. at 30.
\textsuperscript{204} During the two decades between 1989 and 2009, deposit insurance funds have twice become insolvent and been forced to either merge with other funds or borrow from the Treasury (i.e., taxpayers). In late 2009, the Federal Deposit Insurance Corporation’s (“FDIC”) deposit insurance fund had a negative balance of $8.2 billion and increased its borrowing from the Treasury. See Eric Dash, \textit{As Bank Failures Rise, F.D.I.C. Fund Falls Into Red}, \textit{N.Y. TIMES}, B4, Nov. 25, 2009. In the late 1980s, a similar institution, the Federal Savings and Loan Insurance Corporation, became insolvent after the Savings and Loan Crisis and was merged into the FDIC in 1989. See \textit{Financial Industry Reform, Recovery, and Enforcement Act of 1989}, Pub. L. No. 101-73, 103 Stat. 183; Timothy Curry & Lynn Shibut, \textit{The Cost of the Savings and Loan Crisis: Truth and Consequences}, FDIC Banking Review at 28 (2000). One deposit insurance fund insolvency per decade strongly suggests that guaranty fees were underpriced.
\textsuperscript{205} There are currently six major private mortgage insurers. There were seven from prior to 2008, when Triad Guarantee Insurance ceased writing new business. INSIDE MORTGAGE FINANCE, \textit{supra} note 31, Vol. 1, p. 368-385; WELCOME TO TRIAD GUARANTEE INSURANCE, http://www.tgcic.com (last visited June 10, 2010).
offer substantial concessions to large mortgage lenders in the form of reinsurance premiums.\textsuperscript{206} Private mortgage insurers may lose business if they refuse to offer such concessions to lenders.\textsuperscript{207}

As discussed above, there is strong reason to believe that greater competition between mortgage funders or mortgage guarantors will lead to greater risk taking and deterioration in underwriting standards. Because the government would bear the ultimate downside risk for all GB-PMIs, permitting the GB-PMIs to compete with one another on insurance pricing or loan quality would in effect be the government bidding against itself—a poor strategy for protecting taxpayers’ interests. Establishing weak GB-PMIs as a replacement for powerful GSEs might therefore make future mortgage crises and taxpayer losses far more likely than they were before the financial crisis.

E. Treasury’s option 3 could increase risk by increasing complexity, exacerbating information asymmetries, and stripping the government of important capabilities

Positioning the government at the re-insurance level also exacerbates information asymmetries and thereby puts the government at a disadvantage. Rather than analyzing and evaluating simple individual mortgage loans prior to guaranteeing them and tracking the performance of particular mortgage originators—as the GSEs do now—the government would be limited to evaluating the aggregated credit-worthiness of six huge insurers, each exposed to the risk of millions of mortgages in complex ways governed by the provisions of insurance and reinsurance contracts.

\textsuperscript{206} In 1996, the Office of the Comptroller of the Currency (“OCC”) permitted lenders to indirectly insure the mortgage loans they originated via the creation of captive reinsurance subsidiaries. Prior to this, lenders were prohibited by the Real Estate Settlement Procedures Act (“RESPA”) (12 U.S.C. §2607(a)-(b)) from either directly underwriting insurance on the mortgages that they themselves originated or from receiving payments from mortgage insurers. See Office of the Comptroller of the Currency, Interpretive Letter #743 (October 17, 1996). These reinsurance arrangements enabled large lenders to share in the profitable business of mortgage insurance while technically complying with regulatory requirements to separate mortgage lending and mortgage insurance. Timothy J. Cremin, USING A BANK CAPTIVE SUBSIDIARY TO REINSURE MORTGAGE INSURANCE, http://www.captive.com/service/milliman/article3_mortgage.shtml (last visited June 10, 2011). Today, there are at least 20 to 25 captive reinsurers owned by large mortgage lenders. INSIDE MORTGAGE FINANCE, supra note 31, Vol. 1, p. 393-398. Reinsurance premiums ceded to top lender captives totaled roughly $750 million to $1 billion dollars per year from 2005 to 2009, and were slightly above $550 million in 2010. Id. Because the reinsurance contracts are often structured so that the lender’s captive reinsurer bears only nominal risk, the arrangement can arguably resemble an illegal insurance kickback scheme. See Alston v. Countrywide Fin. Corp., 585 F.3d 753, 756-57 (3d Cir. 2009) (plaintiffs alleged that defendant lender collected $892 million in reinsurance premiums over a six year period while paying nothing in claims and that premiums were not commensurate with risk).

\textsuperscript{207} See Alston, 585 F.3d at 756 n. 3 (defendant required eligible homeowners to obtain PMI from one of several insurers who had been approved by the defendant).
Prior to the financial crisis, many professional investors poorly evaluated mortgage credit risk when it was placed in similarly complicated, aggregated packages such as private mortgage backed securities,\textsuperscript{208} collateralized debt obligations,\textsuperscript{209} and credit default swaps on collateralized debt obligations.\textsuperscript{210} Similarly, the GSEs suffered far greater losses from the private MBS they purchased and retained on their balance sheet than from individual mortgage loans that they packaged and guaranteed.\textsuperscript{211} There is little reason to believe that the government would fare well today when faced with the complexity and opacity inherent in reinsurance.

Placing the government at the primary insurance level, where the government could analyze individual loan data—the position currently occupied by the FHA, VA, Ginnie Mae, and the GSEs—would substantially simplify credit analysis and risk management.\textsuperscript{212} The institutional ability to analyze loans in granular detail would also reduce the government’s dependence on private financial institutions, and thereby reduce those institutions’ ability to extract bailouts.

V. Conclusion: Toward a more efficient government-run mortgage market

Recent experience in the U.S. mortgage securitization market illustrates how competition between financial institutions seeking market share can destabilize


\textsuperscript{209} Anna Katherine Barnett-Hart, supra note 23; FCIC REPORT at 18, 190-212.

\textsuperscript{210} Simkovic, Secret Liens, supra note 22 at 273-74 (discussing analytic challenges of analyzing CDS on CDOs, even with full disclosure); Id. at 283-287 (showing that even highly sophisticated investment banks failed to accurately judge AIG’s mortgage risk exposures through CDS on CDOs, forcing a massive bailout of AIG); Michael Simkovic, Presentation at the World Bank: Bankruptcy Immunities, Transparency, and Capital Structure (Jan. 2011). http://ssrn.com/abstract=1738539 (same); Robert P. Bartlett III, Inefficiencies in the Information Thicket: A Case Study of Derivative Disclosures During the Financial Crisis (UC Berkley Public Law Research Paper No. 1585953), available at http://ssrn.com/abstract=1585953 (finding that investors in monoline insurers and derivatives markets failed to react to credit downgrades of CDOs to which the monoline insurers were exposed, even though the monoline insurers exposures were a matter of public record).

\textsuperscript{211} Belsky supra note 20; FCIC REPORT at 123, 316; Ellen supra note 43 at 5 (“It may simply be true that the GSE risk managers were not able to obtain as much information on the quality of the underlying mortgages backing the securities purchased for the portfolio, thereby increasing uncertainty and exacerbating risks.”).

\textsuperscript{212} Figure 12 above suggests that the GSEs, and to a lesser extent, the FHA/VA, were better than average underwriters compared to most other financial institutions.
financial systems and ultimately result in losses to taxpayers. Mortgage underwriting and loan performance generally improved from 2000 to 2003, during a period of GSE dominance, and dramatically deteriorated from 2004 to 2007 as originators consolidated and intense competition from smaller, private securitizers reduced GSE influence. Although the GSEs appear to have relaxed their underwriting standards somewhat during this latter period, on the whole GSE loans remained far less default-prone than those of smaller financial institutions, and the recent period of restored GSE dominance has been one of relatively pristine underwriting.\textsuperscript{213}

Competition makes it harder to say “no,” because other institutions can always say “yes.” Profit driven institutions that don’t wish to compete by reducing their revenues (fees and interest) can instead compete by taking on more risk, ultimately keeping any upside while transferring most downside risk to taxpayers. Competition is most dangerous when financial institutions serve underwriting functions—as mortgage originators and securitizers do—but may be less of a concern for institutions whose activities are purely administrative or transactional in nature.

Perhaps competition could be channeled toward purely administrative functions that do not critically affect risk management or underwriting decisions.\textsuperscript{214} Perhaps competition on underwriting could be made safer under a different, idealized regulatory regime\textsuperscript{215} or a different, idealized system of compensation for financial professionals that emphasized long term subordinated debt over short term cash or equity.\textsuperscript{216} However, it is an act of great faith to assume that incremental and largely untested financial reforms have established that idealized system and removed the threat of another race to the bottom if full-fledged competition is restored.


\textsuperscript{214} See FCIC \textit{REPORT} at 89 (describing how one large mortgage originator used specialization to cut costs and sell mortgages for 0.55% less than competing firms). Although this particular firm was also engaged in fraudulent practices, there doesn’t seem to be a reason to believe that operational efficiency necessarily leads to fraud. \textit{Id.} at 12-14; \textit{Id.} at 89 (“For decades, a version of the originate-to-distribute model produced safe mortgages. Fannie and Freddie had been buying prime, conforming mortgages since the 1970s, protected by strict underwriting standards.”).

\textsuperscript{216} See OECD, \textit{Competition Concentration and Stability in the Banking Sector} 27 (2010) (arguing that although recent financial crises in the U.S., Scandinavia, and Asia “suggest that liberalization and competition contribute to financial crises . . . the relationship between competition and stability depends on the regulatory framework.”); \textit{see also} Andrea Beltratti & Rene M. Stulz, \textit{Why Did Some Banks Perform Better during the Credit Crisis? A Cross-Country Study of the Impact of Governance and Regulation} (July 13, 2009) (providing empirical evidence that banks in countries with more independent regulators and higher capital requirements performed better than other banks during the financial crisis); \textit{see also supra} note 152 (discussing a possible link between consumer protection and financial system stability).

\textsuperscript{216} \textit{See supra} note 146.
While a system of suppressed competition may have its own flaws—perhaps mortgages would become more expensive, perhaps access to credit for marginal borrowers would be reduced—taxpayers would be safer. And to the extent that higher mortgage pricing results in higher profits and higher dividends to the Treasury—that is, if the government can capture the full upside of mortgage funding during profitable years, rather than taking only a minority of the upside through taxation and guarantee fees—profits could be used to repay the debt incurred during the most recent financial sector bailouts and to build reserves for future crises.

Treasury’s proposed approach—a gradual shrinking of the GSEs and FHA—could lead to a more fragmented, competitive and dangerous securitization market in which for-profit institutions backed by implied government guarantees once again compete for market share and revenue.

The results of this analysis are by no means definitive, but they raise questions about Treasury’s assumptions and doubts about its proposals for reforming housing finance. At a minimum, more study should be undertaken before Treasury moves forward with a program of radical reform. More traditional alternatives—such as a return to the concentrated, government-led market structure and conservative underwriting standards that prevailed from the mid-1940s to the late 1960s—should be considered in light of empirical evidence linking such structures to greater financial stability in the U.S. residential mortgage market.

Instead of entertaining radical proposals for privatization, the Federal Government could focus on improving the operational efficiency of the many mortgage funding agencies that it now controls, reducing risks, and boosting profits for taxpayers. There are now at least five government-controlled agencies that play a role in guaranteeing and funding mortgages—the FHA, the VA, Ginnie Mae, Fannie Mae, and Freddie Mac. Greater efficiency could be realized by merging these entities’ mortgage operations into a single state owned enterprise, streamlining redundant functions and reducing costs, integrating information systems and boosting loan sampling rates to better monitor loan originators, and analyzing the vast collective repository of ex-post loan performance data to improve ex-ante underwriting capabilities.

Greater size and consolidated funding would enhance the ability to monitor originators, discipline those who originate risky loans, and maintain high, uniform underwritings standards.

The government could also use the size and market power of a single state owned mortgage enterprise to institute changes to mortgage industry compensation that could better align the interests of its employees with those of taxpayers. These changes could include lower cash salaries, higher pensions...
that vest after extended service, and tying individual employee’s pensions to the long-term performance of mortgage loans which that employee approves. Smaller private employers might not feel that they can individually institute such reforms because of concerns that competitors could poach their best performers. The government might also be better positioned to insist on strict non-compete clauses and rules that reduce conflicts of interest from potentially more lucrative employment in the private sector, and to thereby build a professional, experienced, and dedicated civil service.

There is a long-term risk, to be sure, of a state owned enterprise succumbing to political pressure—just as there are risks of regulatory capture. Perhaps this risk could be mitigated through legislation granting political independence as long as certain benchmarks of operational efficiency are met. There are many examples of successful independent agencies and profitable state owned enterprises, such as the Government Accountability Office, the Port Authority of New York and New Jersey, and the Triborough Bridge and Tunnel Authority, most of which were founded during the heyday of the progressive era and have lasted nearly a century.

If a state owned enterprise proved to be loss-making over the long term and an unacceptable drain on taxpayer resources—and it would have to be very inefficient to rival the damage to public finance from private financial institutions’ risk-taking activities during the recent crisis—privatization would always remain an option. Freely ceding market share to for-profit competitors—as a number of advocates of privatization propose—is unlikely to yield much in the way of returns for taxpayers. However, selling the GSEs’ franchise intact to the highest bidder (and regulating the private monopoly thereby established) could be considered as an option that might better protect taxpayer interests while maintaining a stable, concentrated market structure.

Rather than rely solely on regulators with limited budgets, political vulnerability, and therefore limited control over the financial institutions they are meant to regulate, the government could “regulate” the mortgage market directly by establishing corporate underwriting policy at a fully government owned and controlled mortgage funding agency. Such “regulations”—backed by trillions of dollars in purchasing power—are at least as likely to be effective as threats of sanctions from regulatory agencies, and could reinforce such agencies’ efforts to maintain prudent underwriting and protect taxpayers. Given the GSEs relatively strong record on whole loan purchases, dominant secondary market position, and current de-facto ownership by the government, they could be reformed into a powerful, permanent vehicle for long term stabilization of the mortgage market and taxpayer protection.