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Competition and Crisis in Mortgage Securitization

Michael N Simkovic, Seton Hall University School of Law
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Michael Simkovic *

ABSTRACT

U.S. policymakers often treat market competition as a panacea. However, in the case of mortgage securitization, policymakers’ faith in competition is misplaced. Competitive mortgage securitization has been tried three times in U.S. history—during the 1880s, the 1920s, and the 2000s—and every time it has failed. Most recently, competition between mortgage securitizers led to a race to the bottom on mortgage underwriting standards that ended in the late 2000s financial crisis. This article provides original evidence that when competition was less intense and securitizers had more buyer power, securitizers acted to monitor mortgage originators and to maintain prudent underwriting. However, securitizers’ ability to monitor originators and maintain high standards was undermined as competition shifted power away from securitizers and toward originators. Although standards declined across the market, the largest and most powerful of the mortgage securitizers, the Government Sponsored Enterprises (“GSEs”), remained more successful than other mortgage securitizers at maintaining prudent underwriting. This article proposes reforms based on lessons from the recent financial crisis: merge the GSEs with various government agencies’ mortgage operations to create a single dedicated mortgage securitization agency that would seek to maintain market stability, improve underwriting, and provide a long term investment return for the benefit of taxpayers.

* Associate Professor, Seton Hall University School of Law. Msinkovic@gmail.com, 516-423-9187. Thanks go to Cynthia Furmanek, Timothy Malacrida, Jason Mushnick, and William Pugh for outstanding research support. Thanks also go to Professors Vicki Been, Susan Block-Lieb, Ryan Bubb, Amedeo DeCesari, Kathleen Engel, Linda Fisher, Timothy Glynn, Dwight M. Jaffee, Edward Janger, Kristin Johnson, Edward J. Kane, Robert Lawless, Adam Levitin, Stephen J. Lubben, Robert J. Martin, Saule Omarova, Chrystin Ondersma, Frank Pasquale, Jon Romberg, David Reiss, Michael Risinger, Adam Steinman, Charles Sullivan, Susan Wachter, Arthur Wilmeth, to the Seton Hall Faculty Colloquium and participants in the Canadian Law and Economics Association conference and American Association of Law Schools conference for helpful comments and suggestions and to IMF researchers Narayan Suryakumar and Rebecca McCaughrin for sharing data and related assistance.
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I. INTRODUCTION

U.S. policymakers often assume that market competition is a panacea. This faith in competition motivates proposals by the U.S. Treasury department to radically transform the U.S. residential mortgage market. However, in the case of mortgage securitization, policymakers’ faith in competition is misplaced. Competitive mortgage securitization has been tried three times in U.S. history—during the 1880s, the 1920s, and the 2000s—and every time it has failed.

Securitization is a method of financing whereby loan receivables or other cash flows are bundled into securities and sold to investors.1 Mortgage securitization divides lending into four functions generally handled by four different types of specialized financial institutions: origination, or the initial step of making loans to individual borrowers; servicing, managing the ongoing relationship with individual borrowers and collecting payments; securitization, or buying large numbers of loans from originators and packaging those loans into investments that can be sold to investors; and funding, buying mortgage backed securities (“MBS”) from securitizers and holding them in portfolio as an investment.

Securitization can provide a long-term source of funding and thereby reduce financial institutions’ exposure to fluctuations in prevailing interest rates. Traditional depository institutions fund long-term fixed rate mortgages with short-term deposits. Because of the duration mismatch, if interest rates increase, depository institutions face rising funding costs and declining loan portfolio values. Securitization can transfer interest rate risk from financial institutions to professional fixed income investors. Indeed, securitization reemerged in the U.S. shortly after the devastating rising interest rate environment of the late 1970s and early 1980s.

Securitization can also be used to transfer the loan-specific risk that borrowers will default, or fail to repay their loans. After securitization, institutions that originate or service mortgages will generally have the best information about mortgage default risk, because originators may have

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collected private information about borrowers during their initial intake, and because servicers are the first to know about delinquent payments. However, investors with less information about default risk and less expertise in the mortgage market will bear much of that default risk. That is, unless an extremely well capitalized financial institution or the government fully guarantees the underlying mortgages.

In the mid 2000s, competition between mortgage securitizers for loans led to deteriorating mortgage underwriting standards and a race to the bottom that ended in the late 2000s financial crisis. Underwriting means preventing losses at the front end by basing loan approval decisions and lending terms on data-driven predictions of the likelihood of default, or failure to repay, and the severity of losses to lenders in the event of default. Loose underwriting means making loans that are likely to default.

This article provides original evidence that when competition was less intense and securitizers had more buyer power, securitizers acted to monitor mortgage originators and to maintain prudent underwriting. However, securitizers’ ability to monitor originators and maintain high standards was undermined as competition shifted buyer power away from securitizers and increased originators’ supplier power. Although standards declined across the market, the largest and most powerful of the mortgage securitizers, the Government Sponsored Enterprises (“GSEs”), remained more successful than other mortgage securitizers at maintaining prudent underwriting.

Competitive pressures exacerbated private financial institutions’ strong incentives to take risks. Whereas private investors and managers capture most of the upside of mortgage lending, taxpayers bear much of the downside risk because of the cyclicality of default risk, limited liability, and public safety nets. Because financial institution bailouts are routine, private financial institutions rationally prefer to take more risk than is optimal for taxpayers, while government agencies rationally prefer to limit risk.

These findings have profound implications for post-crisis reform of U.S. residential mortgage finance. 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
be before Treasury proceeds with radical reform of U.S. housing finance.

This article proposes reforms based on lessons from the recent financial crisis and the U.S.’s successful post-WWII mortgage market. Because securitizer buyer power is an important determinant of stability and prudent underwriting, buyer power should be increased by merging the GSEs with various government agencies’ mortgage operations to create a single dedicated mortgage securitization agency that would seek to maintain market stability, improve underwriting, and provide a long term investment return for the benefit of taxpayers.

II. A HISTORY OF MARKET FAILURES AND GOVERNMENT RESCUES

Mortgage securitization by competing private financial institutions has been tried three times in U.S. history, and each time the market collapsed. Primitive private mortgage securitization was tried in the late 1800s and failed in the 1890s. Another variation on private mortgage securitization failed in the late 1920s. Private investors have not been very successful at evaluating the complex risks associated with pools of mortgages.

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; the Department of Veterans Affairs (“VA”) loan guarantee program, established in 1944; and the Farmers Home Administration (“FmHA”), established in 1946. The

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6 Susan A. Schneider, Financing the Agricultural Operation: Recent Developments and Current Trends, 4 DRAKE J. AGRIC. L. 215, 230 (1999), available at
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. A government agency originated a very large number of mortgage loans during the Great Depression, but the government rarely originates loans today.

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. 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. 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”). The government allocates capital through laws, regulations and policies that limit eligibility for government mortgage programs and set credit standards and pricing.


8 Snowden, supra note 3 at 21-22 (“[The Home Owners’ Loan Corporation 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 mortgagors 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.

13 Peter P. Swire, The Persistent Problem of Lending Discrimination: A Law and
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. The recent mortgage crisis is at least the third failure of private mortgage securitization in U.S. history. Figures 1, 2, and 3 below document the almost complete collapse of private mortgage securitization.

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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, 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

*Originations, Real 2010 USD trillions*  
*Securitization rate, percent*

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

*Note: Agency MBS issuance includes GNMA, FHLMC, and FNMA.*

Figure 3: The Federal Reserve and U.S. Treasury have dramatically increased MBS purchases while most private investors stopped buying MBS

Change in Mortgage Related Securities Holdings, Dec. 2007 - Dec. 2010
USD billions

III. COMPETITION, SUPPLIER POWER, AND THE RACE TO THE BOTTOM

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

15 See Michael C. Keeley, *Deposit Insurance, Risk and Market Power in Banking*, 80 AM. ECON. REV. 1183, 1183-85 (1990) (finding that the surge of bank failures in the U.S. during the 1980s was caused by deregulation and market pressures that reduced banks’ monopoly rents and incentivized greater risk-taking); Thomas Hellman, Kevin Murdock & Joseph Stiglitz, *Liberalization, Moral Hazard in Banking and Prudential Regulation: Are
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


17 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 and competition are both associated with greater financial system stability); Allen N. Berger, Leora F. Klapper & Rima Turk Ariss, supra note 15, at 16 (arguing that
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 underpricing of mortgage risk may be inevitable.18 Because of the importance of definitional and contextual issues,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.

Prudent mortgage 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; securitizers 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.

Underwriting shifted toward riskier loans in the years leading up to the financial crisis, especially 2004 to 2007.20 As will be shown below, these were the years in which the securitization market became far less concentrated and buyer power of GSEs declined relative to supplier power.
of originators.\textsuperscript{21}

Scholars, government commissions, and others have identified many possible causes of the financial crisis of the late 2000s.\textsuperscript{22} 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.

\textit{A. Mortgage underwriting deteriorated from 2004 to 2007}

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.

\textsuperscript{21} 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").

\textsuperscript{22} 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.
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

*Market share, percent*


U.S. residential mortgage origination, by product, 1990-2010

*Real 2010 USD trillions*

Conventional conforming mortgages experienced the most sudden and
dramatic declines, losing almost half of their market share in two years. 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.

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. The market share of loans with these features increased dramatically from 2004 to 2007.

Deteriorating underwriting standards were also manifest in the proliferation of non-traditional mortgage loan features, such as Adjustable Rate Mortgages (“ARMs”), interest only mortgages, pay option mortgages, and mortgages with large final payments known as balloon payments. The choice between ARMs and FRMs is essentially a question of who should forecast and hedge interest rate risk—individual retail borrowers or sophisticated financial professionals working at large institutions.

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.

23 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.

24 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.

25 Belsky, 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 12. 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, 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, supra note 20 at 39, 160 Figure 2-6. The choice between ARMs and FRMs is essentially a question of who should forecast and hedge interest rate risk—individual retail borrowers or sophisticated financial professionals working at large institutions.

26 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.

27 INSIDE MORTGAGE FINANCE, 2011 MORTGAGE MARKET STATISTICAL ANNUAL Vol. 1, 23 [hereinafter INSIDE MORTGAGE FINANCE]; Belsky, supra note 20 at 159, Figure 2-5.
called ‘piggy-back’ loans) proliferated, and combined-loan-to-value (CLTV) ratios climbed.\textsuperscript{28} 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{29}

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}

\textbf{Changes in underwriting standards for residential real estate loans, 1996-2011}

\textit{Net percentage of national banks tightening underwriting standards*}

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{underwriting_standards.png}
\caption{Changes in underwriting standards as reported by national bank examiners. Net percentage calculated by subtracting the percent of banks tightening from the percent of banks easing; negative values indicate easing. Source: Office of the Comptroller of the Currency Survey of Credit Underwriting Practices 2011, Tables 45, 47, 51; OCC Survey of Credit Underwriting Practices 2002 pg. 33-36.}
\end{figure}

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

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.

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31 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.
Figure 6: Loan performance by vintage improved from 2000 to 2003 and then deteriorated from 2004 to 2007

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

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. 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.

The impact of housing price changes is somewhat more challenging to

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33 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. Civilian Unemployment Rate, Fed. RESERVE BANK OF ST. LOUIS, http://research.stlouisfed.org/fred2/data/UNRATE.txt (last visited June 22, 2011).
interpret. The pattern of changes in housing prices could make later loans perform worse, even with consistent underwriting standards. However, declines in housing prices may have been foreseeable. In the early to mid-2000s, a number of scholars and regulators argued that housing was overpriced. They noted deviations from historic relationships between housing prices and rental prices, as well as between housing prices and economic fundamentals such as wages, employment and population levels. Nevertheless, mortgage lenders continued to make loans that depended on optimistic projections of housing appreciation. The assumption of continued increases in housing prices in the face of a likely housing bubble was itself a relaxation of underwriting standards.


37 Bhardwaj & Sengupta, supra note 34 at 1, 15-16 (acknowledging that the growth of the subprime market itself constitutes deterioration of underwriting standards in the overall
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. GSEs historically monitored and disciplined 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. 38 Centralization not only enhanced GSE control, it also increased efficiency and contributed to MBS market growth and liquidity. 39 Notable efficiency gains include the use of automated underwriting based on objective, statistically validated criteria for predicting default risk. 40

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38 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.\(^{41}\) Compared to private securitizers, the GSEs have been more aggressive in their use of such repurchase agreements,\(^{42}\) and more successful in enforcing their rights against originators.\(^{43}\) By bringing claims based on these repurchase agreements, the GSEs have already recovered from originators between 10 and 15 percent of their credit losses.\(^{44}\)

The GSEs’ large market share and therefore large buyer power may
have helped them maintain tighter control over originators compared to other securitizers.\textsuperscript{45} Enforcing repurchase agreements requires sampling loans to identify those that are defective. In the mid-2000s, private securitizers in need of loans from originators reduced their loan sampling rates\textsuperscript{46} and waived in many non-compliant loans.\textsuperscript{47} Originators also often “gamed” securitizers’ quality control systems, resubmitting previously rejected loans in new pools.\textsuperscript{48} 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 originator’s loans.\textsuperscript{49} 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.\textsuperscript{50} Since the financial crisis caused private securitizers to exit the market and thereby enhanced GSE buyer power, the GSEs have become

\textsuperscript{45} See, e.g., Ryan Bubb & 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 Fannie and Freddie to enforce their underwriting guidelines through software, contractual provisions, and monitoring. . . . [L]arge securitizers like Fannie and Freddie, were to some extent able to regulate lenders’ screening behavior.”).

\textsuperscript{46} FCIC Report at 165.

\textsuperscript{47} Id. at 166.

\textsuperscript{48} Id. at 168.


more aggressive with originators.\textsuperscript{51}

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.\textsuperscript{52}

C. Originators consolidated and diversified away from prime mortgages

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 buyer 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.

\textsuperscript{51} 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 10-Q) 45 (May 4, 2011).

\textsuperscript{52} 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).
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.

D. Securitizers competed for market share by relaxing standards

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 disproportionately large share of private label MBS issuance, as shown in Figure 9.

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53 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 27, Vol. 1, p. 144, 157.

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

55 INSIDE MORTGAGE FINANCE, supra note 27, 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.
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

MBS issuance as a percent of originations


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

Non-Agency MBS issuance by type, 1995-2010

Real 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.

E. Power shifted from GSEs to originators

Figure 10 below shows an index of the relative buyer power of the GSEs and supplier power of 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 originates primarily conventional mortgages is more dependent on the GSEs to securitize and guarantee those mortgages than is an originator who has diversified and also originates subprime and Alt-A mortgages. Similarly, the index assumes that the GSEs are more dependent on conventional originators with larger market share, because those originators are important suppliers of raw material.56

These assumptions are 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.57

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.58

58 For each originator, the index is the originator’s dependence on the GSEs—measured by the originator’s annual conventional mortgage origins as a share of the originator’s annual overall mortgage origins—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.
Figure 10: The GSEs’ buyer power relative to large originators’ supplier power reached very low levels in 2004 to 2008

Index of GSE market power relative to top conventional originators, 2000-2010

*Originators’ conventional originations as share of product mix divided by conventional origination market share*

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. Competitive, fragmented securitizers faced increasingly consolidated originators, and power shifted from securitizers to originators. Without a clear securitization market leader capable of enforcing standards and penalizing non-compliant originators, discipline broke down.

One of the most impressive studies linking local competition between

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60 See Figure 7 showing increasing consolidation among mortgage originators.
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.\(^6\) Using data from 2000 to 2006 including over 50 million individual mortgage applications across 387 Metropolitan Statistical Areas\(^6\) and controlling for local and national economic variables,\(^4\) the authors found that incumbents’ lending standards\(^5\) declined after new competitors entered local markets.\(^6\) The authors argue that local lenders felt compelled to cut their underwriting standards to compete effectively with the new entrants.\(^6\)

The authors’ 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.\(^6\) Specifically, the authors found that subprime underwriting standards declined more in areas with a larger number of lenders and more new entrants.\(^6\)

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.\(^7\) Whereas subprime lenders became less


\(^{6}\) Id. at 9.

\(^{6}\) 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. at 9-10. They also controlled for securitization rates. Id. at 5.

\(^{6}\) The authors used two measures of lending standards: denials as a percent of loan applications and loan to income ratios. Id. at 1, 9.

\(^{6}\) Id. at 2, 21.

\(^{6}\) Id. at 2.

\(^{6}\) Id. at 9-10 ("The number of competing lenders is a proxy for the competitive conditions in the MSA."); Id. at 12.

\(^{6}\) 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.").

\(^{7}\) 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
cautious as the number of applications increased, prime lenders became more cautious.\footnote{71}

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 played a minor role in the subprime market\footnote{72}—helped maintain higher underwriting standards by exercising greater control over the originators who supplied them with loans.

\textbf{F. GSE underwriting remained more conservative than average}

High market share and a high degree of centralized control over underwriting appear to be associated with more conservative underwriting. 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\footnote{73} suggest that the GSEs were in fact more successful than almost any other secondary market actor in maintaining high standards 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.

\textsuperscript{27} (“[T]he 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.”).

\textsuperscript{71} \textit{Id.} at 1, 15.

\textsuperscript{72} 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} Peter J. Wallison, FIN. CRISIS INQUIRY COMM’N, THE FINANCIAL CRISIS INQUIRY REPORT: DISSENTING STATEMENT (Jan. 2011) 451 fn 5 (2011) [hereinafter “WALLISON DISSENT”].

\textsuperscript{73} 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. It is also consistent with data compiled by the GSEs’ regulator. \textit{Fed. Housing Fin. Agency, Foreclosure Prevention & Refinance Report Third Quarter 2011, 4 (2011); Fed. Housing Fin. Agency, Data on the Risk Characteristics and Performance of Single Family Mortgages Originated from 2001 through 2008 and Financed in the Secondary Market 27 (Sept. 2010).}
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 11.

Figure 11: GSEs loan performance was better than private securitizers and even traditional depository institutions

<table>
<thead>
<tr>
<th>Seriously Nonperforming Loans, Dec. 31, 2010</th>
<th>0%</th>
<th>10%</th>
<th>20%</th>
<th>30%</th>
<th>40%</th>
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<tbody>
<tr>
<td>Freddie Mac</td>
<td>3.8%</td>
<td></td>
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<tr>
<td>Fannie Mae</td>
<td>4.5%</td>
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<td></td>
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<tr>
<td>FHA &amp; VA</td>
<td>8.1%</td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Total Mortgage Market</td>
<td>8.6%</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Non-Agency Prime Jumbo</td>
<td>8.9%</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Banks &amp; Thrifts</td>
<td>9.9%</td>
<td></td>
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<td></td>
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<tr>
<td>Non-Agency Alt-A MBS</td>
<td></td>
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<td></td>
<td></td>
<td></td>
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<tr>
<td>All Non-Agency MBS</td>
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<td></td>
<td></td>
<td></td>
<td>23.3%</td>
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<tr>
<td>Non-Agency Subprime MBS</td>
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<td></td>
<td></td>
<td>25.6%</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>32.6%</td>
</tr>
</tbody>
</table>

Source: Freddie Mac Office of the Chief Economist

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. In May of 2009, Congress appointed the Financial Crisis Inquiry Commission (“FCIC”) to investigate the causes of the financial crisis of 2008.74

The Financial Crisis Inquiry Commission (“FCIC”) analyzed over 25 million mortgages, some of which were purchased or guaranteed by the

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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.\textsuperscript{75}

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\%.\textsuperscript{76}

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.\textsuperscript{77}

The GSEs’ superior performance relative to private label mortgages persists even when controlling for risk factors such as low borrower FICO scores\textsuperscript{78} or high loan-to-value ratios.\textsuperscript{79} The FCIC attributed the GSE’s performance advantage to “differences in underwriting” and to less “risk layering” by the GSEs.\textsuperscript{80} 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.\textsuperscript{81}

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

\textsuperscript{75} Id. at 216.
\textsuperscript{76} Id. at 218-19.
\textsuperscript{77} Id. at 218, Figure 11.3.
\textsuperscript{78} 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.”)
\textsuperscript{79} 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\% versus a rate of 15.5\% for loans in private Alt-A securities.”).
\textsuperscript{80} Id. at 219 (summarizing Pintos claims and rejecting his analysis as “misleading”); 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 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).
\textsuperscript{81} FCIC REPORT at 218-19.
relax their underwriting standards.

G. Experts believe that competition contributed to loose underwriting

Expert opinions that certain kinds of competition can undermine underwriting standards lend additional support to the quantitative empirical evidence presented above.

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 GSEs\(^{82}\) and the private banks\(^{83}\) that purchased and securitized mortgages and similar competition between mortgage originators\(^{84}\) as

\(^{82}\) 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 GSEs’ regulator blamed the GSEs for underpricing risk in order to gain market share and compete with Wall Street banks.).

\(^{83}\) Id. 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: Assessing the Options 4 (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 . . .”).

\(^{84}\) FCIC REPORT 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,
causes of risky lending that led to the crisis. The report also describes competition between financial regulators, which reduced those regulators’ authority. 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 dissenting report by Peter J. Wallison 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.’”)

85 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.’”)

86 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 do 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 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 “penalize[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.”).
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.\textsuperscript{87}

IV. CONCENTRATED MARKET STRUCTURES WORK WELL IN OTHER COUNTRIES

Additional evidence that concentrated mortgage securitization markets tend to be more stable than fragmented, competitive ones can be found in foreign mortgage markets. Advocates of U.S. mortgage market reform have noted mortgage market stability and high home ownership rates in select Western European countries that use covered bonds.\textsuperscript{88} 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.\textsuperscript{89} However, unlike the U.S. GSEs, European institutions did not face competition from more lightly regulated private label securitizers.\textsuperscript{90} The covered bond model might not be workable in a competitive, lightly regulated market. Variations have been tried before in the United States, and failed.\textsuperscript{91}

European covered bonds are similar to all securitization in that investors have first priority claims on a particular set of loans. European covered bonds are similar to GSE 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

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{87} See \textsc{Wallison Dissent} 444, 453-455, 464, 481, 487, 490, 506, 509, 511, 519.
\item \textsuperscript{88} Dwight M. Jaffee, Reforming the U.S. Mortgage Market Through Private Market Incentives, Jan. 31, 2011, 11-24, http://escholarship.org/uc/item/4x0357n0
\item \textsuperscript{90} Lea, \textit{supra} note 89 at 21 (“By legislation, covered bond issuers must be regulated banks.”).
\item \textsuperscript{91} Snowden, \textit{supra} note 2 at 9-12, 30-32.
\end{itemize}
\end{footnotesize}
issuing financial institution.\footnote{Jaffee, supra note 88 at 18.}

The best performing foreign markets were characterized by high market concentration and strict, uniform regulation. Within the best performing foreign countries, a few large, vertically integrated financial institutions dominated mortgage underwriting\footnote{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.”); 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.”).} and therefore had implicit government guarantees,\footnote{Lea, supra note 89 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 . . .”)} or the largest mortgage lenders were state-owned.\footnote{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 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.”).} In many of the best performing foreign markets, a single powerful regulator supervised all financial institutions that originated, underwrote, and guaranteed mortgages.\footnote{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.”).} Within the best performing countries, individual financial institutions had less flexibility than in the U.S. to “innovate” by

\footnote{Lea, supra note 89 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.”).}
relaxing their underwriting standards.\textsuperscript{97}

However, it remains unclear how much insight can be gained by comparing foreign mortgage markets to those in the United States, because of broad economic, legal, and political differences.

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,\textsuperscript{98} stronger labor protections which may reduce the risk of sudden unemployment,\textsuperscript{99} much higher household savings rates\textsuperscript{100} and lower household debt levels,\textsuperscript{101} more robust transit networks which reduce

\begin{flushright}
\textsuperscript{97}Id. at 18 (“The underwriting of Danish mortgages is more strict than 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 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.”).

\textsuperscript{98}The U.S. does less than any developed country, except South Korea, to reduce income inequality through its taxation and transfer spending system, and spends relatively little 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.”)

\textsuperscript{99}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.”)


\textsuperscript{101}EUROPEAN CENTRAL BANK, HOUSING FINANCE IN THE EURO AREA 73 (Mar. 2009) (“[H]ouseholds in the euro area display a lower average level of indebtedness. Crucially, the percentage of households with mortgage debt in the lowest quintiles of the income distribution is relatively small.”)
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.

V. Mortgage market privatization increases risks to taxpayers

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

102 Anne Korin & Deron Lovaas, Taking the Wheel: Achieving a Competitive Transportation Sector through Mobility Choice, Nov. 23, 2010, available at http://www.rockefellerfoundation.org/news/publications/taking-wheel-achieving-competitive (discussing the U.S.’s limited transit options and therefore high dependence on oil); James D. Hamilton, Oil Prices and the Economic Downturn, testimony before the Joint Economic Committee of the United States Congress, May 20, 2009 (arguing that an oil price spike in 2007 was an important cause of the recession).


private financial institutions to compete with one another.\textsuperscript{106}

Treasury’s motivation appears to be at least partly ideological. Treasury has 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.\textsuperscript{107}

Treasury has emphasized the importance of the government reducing its market share so that private financial institutions can expand and make greater profits.\textsuperscript{108} 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.”\textsuperscript{109}

These statements reflect a normative preference that the government play a limited role in mortgage finance.\textsuperscript{110} 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.\textsuperscript{111}
Treasury has suggested that winding down the GSEs and reducing the government’s role in the mortgage market would protect taxpayers. Contrary to Treasury’s claims, the analysis presented here suggests that residential mortgage market privatization along the lines envisioned by Treasury would put taxpayers at greater risk.

A. Private competition leads to more failures and “bailouts”

As discussed above, a fragmented, competitive, privatized mortgage market leads financial institutions to take greater risks and makes financial crises more likely. The government cannot credibly commit in advance to refrain from bailing out financial institutions during the next crisis.

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.

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

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obtain post-petition financing. 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, bailouts may be driven by political considerations rather than economic necessity. Whether bailouts are driven by politics or true economic necessity, they generally function as a mechanism for transferring losses from private investors and other creditors to taxpayers.

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

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114 See Kenneth Ayotte & David A. Skeel, Jr., Bankruptcy or Bailouts? 35 J. CORP. L. 469, 476-83, 498 (2010), available at http://ssrn.com/abstract=1362639 (arguing that bankruptcy can be an effective resolution mechanism for financial institutions and is at times preferable to bailouts); Stephen Lubben, Systemic Risk and Chapter 11, 82 TEMP. L. REV. 433, 442-48 (2009), available at http://www.temple.edu/law/tlawrev/content/issues/82.2/82.2_Lubben.pdf (arguing that Chapter 11 Bankruptcy could function as an effective resolution mechanism for financial institutions if exceptions for derivatives were scaled back); Levitin, supra note 113 at 440 (arguing that bailouts are orchestrated to reduce the impact of a firm’s failure on its creditors).


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 even more likely, and perhaps inevitable.121

B. Lender-of-last resort programs transfer cyclical losses to taxpayers

Mortgage default risk is highly cyclical.122 During times of general distress, all loans, not just “risky” loans, become much more likely to default. During boom periods, all loans, including risky loans, are much less likely to default. The cyclicity of default risk is illustrated well by Figure 12 below.

Figure 12 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 cyclicity 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.

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121 Treasury Report 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.”)

In light of the cyclicity of default risk, proposals that the government withdraw except as a limited lender of last resort 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.

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

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123 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 FINANCE AGENCY, CONSERVATOR’S REPORT ON THE ENTERPRISES’ FINANCIAL PERFORMANCE 3 (Aug. 16, 2010), available at http://www.fhfa.gov/webfiles/16591/ConservatorsRpt82610.pdf; Thomas & Van Order, supra note 156; Dwight M. Jaffe, Reforming the U.S. Mortgage Market Through Private...
profitable during the sixteen years from 1990 to 2006 and paid private investors tens of billions of dollars in dividends, as shown in Figure 13. And because the GSEs were highly leveraged, private shareholders captured substantial upside while putting minimal capital at risk, as shown in Figure 14.

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.


124 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.”).

125 Frame, supra note 124, 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.’”
Figure 13: GSEs were profitable in the decade and a half before the financial crisis and paid substantial dividends.

Net Income of GSEs and dividends paid, 1990-2007

Real 2010 USD billions

Note: Dividends include dividends paid to both common and preferred equity holders.
Source: Bloomberg Professional Service, Most Recent Company Financial Statements; Bureau of Labor Statistics

Figure 14: GSEs’ shareholders captured outsized returns while risking minimal capital.

GSE equity capitalization and return on equity, 1990-2007

Common Equity / Total Assets, Percent
Return on Common Equity, Percent

Note: Return on Common Equity is calculated as trailing 12 month Net Income (Losses) minus trailing 12 month Cash Preferred Dividends, divided by the average of the start and end balance of Total Common Equity (share capital and additional paid in capital plus retained earnings.)
Source: Bloomberg Professional Service, Most Recent Company Financial Statements
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{126}

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{127} 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{128}

Implicit or explicit government guarantees to private financial institutions perpetuate a system in which 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 during normal times, it might recapture the subsidies that now flow to private investors.

\textit{C. Reinsurance adds agency cost and complexity}

Treasury’s privatization proposals include a hybrid model with the government reinsuring private mortgage insurance companies. Like the GSEs, government backed private mortgage insurers (“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.

\textsuperscript{126} Omarova, \textit{supra} note 113 at 118-19.
\textsuperscript{127} \textit{Id.} at 142-45. Professor Omarova documents guarantee leakage both before and during the financial crisis.
\textsuperscript{128} \textit{Id.} at 185-88.
Positioning the government at the re-insurance level 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.

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, collateralized debt obligations, and credit default swaps on collateralized debt obligations. Similarly, the GSEs suffered far higher loss rates from the private MBS they purchased and retained on their balance sheet than from individual mortgage loans they packaged and guaranteed. There is little reason to believe that the government would fare well today.

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131 Simkovic, Secret Liens, supra note 1 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); 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 failed to react to credit downgrades of CDOs to which the monoline insurers were exposed).

132 Belsky, supra note 20; FCIC REPORT at 123, 316; Ellen, supra note 83 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.”).
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.\(^{133}\) 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.

VI. GOVERNMENT POLICIES PROBABLY DID NOT DRIVE LOOSE UNDERWRITING

A number of commentators have argued that lax underwriting was not caused by profit-seeking in a competitive market, but was instead caused by government policies and pressure to promote home ownership among low-income individuals. These commentators generally point to two government policies: the Community Reinvestment Act\(^{134}\) (“CRA”) and affordable housing goals for the GSEs that were established by the Department of Housing and Urban Development (“HUD”).\(^{135}\)

\[ A. \text{ Industry has sought to defend itself by blaming government} \]

Arguments that government policy primarily caused the financial crisis have generally been made in the context of advocacy paid for by the financial industry 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. Wallison\(^{136}\)—are not academics

\(^{133}\) Figure 11 above suggests that the GSEs, and to a lesser extent, the FHA/VA, were better than average underwriters compared to most other financial institutions.

\(^{134}\) WAllison Disent 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.

\(^{135}\) WAllison Disent at 452-454, 487-519.

\(^{136}\) Peter J. Wallison has been affiliated with AEI since the mid 1990s. AEI SHADOW FINANCIAL REGULATORY COMMITTEE 1999 ANNUAL REPORT, http://www.aei.org/aei-website/managed-content/site-pages/shadow-financial-regulatory-committee/1999-annual-
but are instead affiliated with “think tanks” such as the American Enterprise Institute (“AEI”) which fundraise 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. AEI is “is governed by a Board of Trustees, composed of leading business and financial executives.” During the five-year period from 2005 to 2009, the vast majority of its revenues came from annual donations.

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. The report also highlighted AEI’s ability to influence “Financial Regulation’s Future” because of Wallison’s role on the Financial Crisis Inquiry Commission. The report suggested that Wallison would likely use the opportunity to blame the GSEs for the financial crisis and to combat more comprehensive financial regulation.

AEI’s 2010 annual report points out that in his role as a dissenting member of the FCIC, Wallison did in fact blame government policy for the financial crisis. The report reiterates Wallison’s opposition to regulation...
and his ability to influence legislation.  

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 single-minded approach.  

B. There is no evidence against the Community Reinvestment Act  

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. 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 . . . .” Furthermore, according to Wallison, even “[w]here these loans are today must remain a matter of speculation.”

The handful of academic articles

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144 Id. at 2, 3.  
145 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.’”).  
146 WALLISON DISSERT at 527, Table 13. Wallison also lists specific commitments by four large banks. Id. at 529.  
147 Id. 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.  
148 WALLISON DISSERT 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 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
suggesting that the CRA might have caused the financial crisis also do not present empirical evidence to support this claim.\textsuperscript{149}

There is, however, substantial empirical evidence that the Community Reinvestment Act was not a significant cause of the financial crisis.\textsuperscript{150} Empirical studies by two different teams of Federal Reserve economists both suggest that CRA lending accounted for a minority of subprime lending,\textsuperscript{151} and that CRA loans performed better than subprime loans that were driven purely by market considerations.\textsuperscript{152}

C. “Synthetic” CDOs suggest that risk-taking was market-driven

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. Rather than purchase MBS and thereby fund mortgages, synthetic CDOs used Credit Default Swaps to enable investors to make side bets on the performance of existing MBS or CDOs. Even if the government were trying to promote affordable housing, it had no reason to play any role in


\textsuperscript{150} See generally FCIC REPORT at 72, 219-21.

\textsuperscript{151} 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{152} Bhutta, supra note 151 (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 151 (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 over-all declines in underwriting standards.”).
the synthetic CDO market.

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.\textsuperscript{153} It is far more time-consuming and labor-intensive to originate and aggregate billions of dollars in mortgages than to simply match investors willing to place opposite bets on the performance of existing mortgage backed securities.

The existence of the synthetic CDO market suggests that investors’ appetite for risk exceeded any floor supposedly set by government affordable housing policies.

\textit{D. Mortgage lenders lobbied against safe-lending regulations}

Additional evidence that market forces pushed toward greater risk-taking comes from lobbying activity of 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.\textsuperscript{154} This suggests that government regulation was for the most part a restraining force that pushed toward more conservative underwriting.

\textit{E. HUD affordable housing goals played at most a limited role}

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.\textsuperscript{155}

\textsuperscript{153} Anna Katherine Barnett-Hart, \textit{supra} note 130; FCIC REPORT at xxiv, 142-46.

\textsuperscript{154} Deniz Igan, Prachi Mishra, & Thierry Tressel, A Fist Full of Dollars: Lobbying and the Financial Crisis, (Dec. 2009) (IMF working paper) (finding that lenders who lobbied on issues related to substantive regulation of mortgage underwriting engaged in riskier lending than lenders who did not lobby).

\textsuperscript{155} See \textit{supra} note 123; Fannie Mae and Freddie Mac 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, \textit{supra} note 20 at 5.
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.\textsuperscript{156}

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.\textsuperscript{157}

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.\textsuperscript{158} 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.

\textsuperscript{156} 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), available at 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.”); \textit{id.} at 123-125; Ellen, supra note 83 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, \textit{The Role of the GSEs and Housing Policy in the Financial Crisis}, 16 (Feb. 25, 2010), available at http://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0227-Jaffee-ppt.pdf

\textsuperscript{157} 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.

\textsuperscript{158} 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.
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.\footnote{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.} Notwithstanding their portfolio losses, overall GSE loan delinquency rates are still substantially below those of most other market participants.\footnote{See supra Figure 1.}

VII. DODD-FRANK REGULATION MAY NOT BE ENOUGH TO PREVENT ANOTHER CRISIS

Theoretically, the government could protect taxpayers from another race to the bottom in a fragmented, competitive mortgage securitization market by implementing strong, uniform underwriting and compensation regulations and funding a powerful enforcement agency. In practice, recent regulatory changes constitute modest reforms backed by limited resources.

A. High-risk loans can still be originated

The Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) includes reforms that move the U.S. mortgage market toward more standardized minimum underwriting and documentation standards. Under Dodd-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.\footnote{12 U.S.C. § 1385 (2010).} 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.\footnote{12 U.S.C. § 1385 (2010).} Income must be verified through W-2s, tax returns, payroll receipts, or financial institution records.\footnote{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
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.

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 mortgages” can still include risky features such as adjustable interest rates, and under certain circumstances, interest-only or negative amortization loans.¹⁶⁴

B. Compensation can still create perverse incentives

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.¹⁶⁵ These scholars’ recommended reforms—compensation tied to

¹⁶⁵ See Frederick Tung, 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);
long-term performance, less equity and more debt-like compensation—are not mandated by Dodd-Frank.\textsuperscript{166} 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.

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{167}

C. Regulators remain vulnerable and underfunded

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 \textit{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 \textit{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); 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).

\textsuperscript{166} 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’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. 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. 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.

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169 The CFPB is currently more insulated from political influence than most regulators. Under Section 1017 of the Dodd-Frank Act, codified at 12 U.S.C. § 5947, the Consumer Financial Protection Bureau’s annual budget is not determined through congressional appropriation but is capped as a percent of the Federal Reserve’s operating expenses. The cap is 10 percent in 2011, 11 percent in 2012, and 12 percent in 2013. The funding mechanism also provides for adjustments for inflation. 12 U.S.C. § 5947(a)(1),(2).

170 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.

171 Lender lobbying is associated with riskier underwriting practices. See supra note 154 and accompanying text. Consumer protection regulation may help maintain financial system stability. See Erik F. Gerding, The Subprime Crisis and the Link between Consumer Financial Protection and Systemic Risk, Fl. INT. U. L. REV. (2009) (arguing that consumer protection would promote stability by reducing the number of defaults, making defaults more predictable, and making defaults less correlated with one another); Patricia
The rationale claimed by members of Congress who wish to defund the CFPB—budgetary necessity\(^{172}\)—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—pales in comparison to the resources the GSEs can devote to the residential mortgage finance market. For example, in 2010, the GSEs’ administrative expenditures were over four billion, focused entirely on managing the residential mortgage finance market.\(^{173}\)

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\(^{172}\) 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 . . .’”). 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.

CONCLUSION

Recent experience in the U.S. mortgage securitization market illustrates how competition between financial institutions seeking market share can destabilize 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.¹⁷⁴

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 and profit margins can instead compete by taking on more risk, ultimately keeping most 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.¹⁷⁵ Perhaps competition on underwriting could be made safer under a different, idealized regulatory regime¹⁷⁶ or a different, idealized

¹⁷⁵ See FCIC 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 engaged in fraudulent practices, efficiency is possible without fraud. Id. at 12-14; 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.”).
¹⁷⁶ See OECD, 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.”); see also Andrea Beltratti & Rene M. Stulz, Why Did Some Banks Perform Better during the Credit Crisis? A Cross-Country Study of the Impact of Governance and Regulation (July
system of compensation for financial professionals.\textsuperscript{177} 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.

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

\textsuperscript{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); see also supra note 171 (discussing a possible link between consumer protection and financial system stability).

\textsuperscript{177} See supra note 165.
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. These improvements could be reinforced by granting the new dedicated mortgage agency the exclusive right to securitize mortgages.

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 tying a substantial portion of each individual employee’s compensation to the long-term performance of mortgage loans that employee approves.

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. It may 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.

Perhaps risks could also 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.

Rather than rely solely on regulators with limited budgets, political vulnerability, and limited control over the financial institutions they 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.

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 an exclusive mortgage securitization license and the GSEs’ infrastructure 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.