Fordham Urban Law Journal

Volume 36 | Number 3 Article 3

2009

BRINGING IT ALL BACK HOME: HOW TO SAVE MAIN STREET, IGNORE K STREET, AND THEREBY SAVE WALL STREET

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INTRODUCTION

After a number of heady false starts, against the backdrop of threatened financial catastrophe, Congress and the White House enacted a stopgap financial "bailout" plan early in October 2008.[1] The so-called "Troubled Asset Relief Plan" ("TARP," "the Plan") is remarkable in a multitude of respects. As a fiscal matter, the Plan's sheer size—$700 billion, with no assurance that this will be all—appears to be unprecedented. It dwarfs even the costs of the savings and loan ("S&L") cleanup nearly two decades ago, remarkable as those were in their own day. As a legal matter, the sheer breadth of barely reviewable discretion that the TARP confers upon the Treasury presses hard against Constitutional limits on Executive Branch authority. Indeed, lawyers largely agreed that the original, three-page version of the Plan might well have delegated authority in excess of what the Constitution permits, while the amended, 400-page version squeaks by at best.[2]

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1. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (2008).

2. *See, e.g.*, Andrew Ross Sorkin, *A Bailout Above the Law*, N.Y. TIMES, Sept. 23, 2008, at C1, *available at* http://www.nytimes.com/2008/09/23/business/23sorkin.html; Posting of Eric Posner to The Volokh Conspiracy, http://volokh.com/archives/archive_2008_09_14-2008_09_20.shtml#1221830018 (Sept. 19, 2008, 10:13 EST); Posting of Eric Posner to The Volokh Conspiracy, http://volokh.com/archives/archive_2008_09_14-2008_09_20.shtml#1221958868 (Sept. 20, 2008, 22:01 EST); Posting of Lawrence R. Velvel to Com-

At least as striking as the TARP's fiscal scale and delegated executive scope, however, has been the remarkably *restless* character of the Treasury's actions taken under the Plan since its enactment. Messrs. Bernanke, Bush, and Paulson originally projected the TARP, late in September 2008, as a proposed "buy-up" of mortgage-backed securities ("MBSs") said to be clogging the credit markets.[3] The Treasury next began speaking instead, about mid-October 2008, of "buying-*in*" to financial institutions.[4] This, it was said, would make lendable funds more immediately available to lenders, hence restoring liquidity to credit markets more expeditiously.[5]

By early November, the Treasury was reporting that the buy-in plan would entirely supplant the earlier buy-up plan.[6] About mid-November, however, the Treasury abruptly announced it would enter the short-term debt markets as well, once again "buying-up," in order to get commercial paper circulating again.[7] Then, near the end of November, the Plan changed again: now, we were told, the Treasury would resume purchasing "toxic" assets, but more kinds than MBSs.[8] Finally, in early December, talk had turned toward employing some of the TARP monies to tide over automakers as well, a course of action that indeed began by the new year.[9]

Throughout all of the on-a-dime pivots and changes of direction, a few voices softer than the Treasury's have been offering proposals aimed at the primary *cause* of our present financial worries—the ongoing mortgage

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mondreams.org, http://www.commondreams.org/view/2008/09/19-0 (Sept. 19, 2008); Posting of David Zaring to The Conglomerate, http://www.theconglomerate.org/2008/09/the-bailout-sta.html (Sept. 20, 2008).

3. *Turmoil in US Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 115th Cong. 2 (2008) [hereinafter *Hearing*] (testimony of Henry J. Paulson Jr., Secretary of the United States Treasury), *available at* http://banking.senate.gov/public/_files/PAULSONTestimony92308.pdf.

4. Edmund L. Andrews & Mark Landler, *White House Overhauling Rescue Plan*, N.Y. TIMES, Oct. 11, 2008, at A1.

5. *Id.*

6. More on Henry Paulson's Bailout Update, http://dealbook.blogs.nytimes.com/2008/11/12/henry-paulsons-bailout-update/?scp=44&sq=troubled%20asset%20relief%20&%20novmber%202008&st=cse (Nov. 12, 2008, 11:15 EST).

7. Edmund L. Andrews, *U.S. Shifts Focus in Credit Bailout to Consumers*, N.Y. TIMES, Nov. 13, 2008, at A1.

8. Alan S. Blinder, *Missing the Target with $700 Billion*, N.Y. TIMES, Dec. 21, 2008, at BU4; Jeff Zeleny, *Obama and Bush Working to Calm Volatile Market*, N.Y. TIMES, Nov. 24, 2008, at A1.

9. *See* Posting of Steven M. Davidoff to Dealbook, http://dealbook.blogs.nytimes.com/2008/12/09/the-new-auto-bailout-bill/?scp=7&sq=automobile%20manufacturers%20bailout&st=cse (Dec. 9, 2008, 9:56 EST).

foreclosure crisis afflicting our post-bubble real estate markets.[10] With time and continued tumult, these proposals have gradually come to be more widely heard. Sheila Bair, Republican Chair of the FDIC, can be added to the list of those arguing that mortgage foreclosures lie at the core of our woes—a list that since autumn has included not only progressive housing advocates, but also financiers and economists as ideologically diverse as the Democrats George Soros and Joseph Stiglitz, and the Republican Glenn Hubbard.[11] Even former Federal Reserve Chair Bernanke and former Treasury Secretary Paulson acknowledged the need to stabilize freefalling mortgage markets.

It is very good news that so many, at last, are now looking to stemming the foreclosure crisis as the best means of addressing the present financial crisis. However necessary the "transfusion" supplied by the first half of the Treasury's new $700 billion was to keep the "patients" that are our national and global financial systems alive on the table, the fact is that these patients—and the public fisc—will continue to hemorrhage until we stanch the flow of foreclosures that is still underway. The only real question is how best to do that.

A brief bit of forgotten institutional history, I believe, supplies our answer: the most effective—as well as the most constitutionally sound—way to solve the mortgage crisis, and thereby a looming national and indeed global financial crisis as well, is to direct the new Treasury under the Obama Administration and Secretary Geithner to administer the TARP through twinned institutions we already have. These originally were, and still are established precisely to deal efficiently with low-end mortgage financing and refinancing.[12] Indeed, they were founded to do so precisely to deal with that real estate crisis which immediately preceded (one shudders to say it) a certain notorious Wall Street contraction—one that commenced in October of 1929. Our present woes, moreover, stem directly from intrusions upon these institutions' original missions by under-regulated private

10. *See, e.g.*, R. Glenn Hubbard & Chris Mayer, *First, Let's Stabilize Home Prices*, WALL ST. J., Oct. 2, 2008, at A19, *available at* http://online.wsj.com/article/SB122291076983796813.html; Posting of Robert Hockett to Dorf on Law, http://michaeldorf.org/2008/09/treasurys-planned-bailout-is-fhas.html (Sept. 25, 2008, 14:33 EST); Democracy Now!, Noble Laureate Joseph Stiglitz: Bailout Wall Street Now, Change Terms Later, http://www.democracynow.org/2008/10/2/nobel_laureate_joseph_stiglitz_bailout_wall (last visited Feb. 22, 2009); Democracy Now!, Bridge Loan to Nowhere, http://www.democracynow.org/2008/9/30/bridge_loan_to_nowhere_house_rejects (last visited Feb. 22, 2009).

11. *See supra* note 10; *see also* Blinder, *supra* note 8.

12. *See generally* Robert C. Hockett, *A Jeffersonian Republic by Hamiltonian Means: Values, Constraints & Finance in an Authentic American Ownership Society*, 79 S. CAL. L. REV. 45 (2006).

firms, first in the lead up to, then during, the near-decade-long housing bubble that grew from the late 1990s to about 2006.

The institutions to which I am referring are the Federal Housing Administration ("FHA"), working in tandem with its originally government-sponsored and recently re-federalized sibling enterprises ("GSEs"), Fannie Mae and Freddie Mac. Any properly focused plan for financial bailout will critically involve what amounts to these institutions' original, and now recently restored, bailiwick. To show why and how this is so, Part I briefly reviews the cause of the problems with which we are presently dealing. Part II then briefly reprises the founding and functioning of our newly restored team of mortgage finance institutions. Part III closes with a sketch of how TARP should now be channeled through these institutions.

I. WHERE WE ARE AND HOW WE GOT HERE

Let us begin by noting that there are two salient components of the present crisis. The first, what I'll call "core" component, is the doubtful value of an uncertain number of "subprime," "Alt-A," and "jumbo ARM" MBSs. These are held in varying quantities by a large number of financial institutions ("FIs") worldwide, many of which do not yet appear to have fully reported the sizes of their holdings.[13] These securities, moreover, underlie financial derivative commitments on the part of yet more FIs worldwide, with notional values that similarly appear to be underreported.[14] The MBSs, for their part, are now widely perceived to be "toxic" because many—though certainly not all and indeed not even a majority—of the mortgages backing them are troubled.[15]

Many of the mentioned mortgages are troubled, in turn, because they were imprudently—or in some cases "predatorily"—extended by participants in the shadow industry of scarcely regulated "mortgage banks" that

13. *See Hearing*, *supra* note 3 (testimony of Henry J. Paulson, Jr., Secretary of the United States Treasury); *see also* CHARLES MORRIS, THE TRILLION DOLLAR MELTDOWN: EASY MONEY, HIGH ROLLERS, AND THE GREAT CREDIT CRASH (2008).

14. MORRIS, *supra* note 13, at 80-85.

15. To be more fine-grained, MBSs associated with a particular pool of mortgages are typically divided into three or more tranches. *See, e.g.*, *id.* at 73. The largest tranch generally comprises the least risky, hence lowest return, stream of payments, often accounting for 70% of a pool's nominal value. *Id.* at 39. The next tranch typically comprises a slightly more risky, hence slightly higher return, stream of payments, and accounts for 20% of the pool's nominal value. *Id.* at 40. The final tranch, typically accounting for 10% of the pool's nominal value, comprises the most risky, but also highest yield, stream of payments. *Id.* This tranch is colorfully said to include the pool's "toxic waste." *Id.* at 84. The "toxic" MBSs are principally associated with this tranch of most pools. But as I shall note further below, as confidence is lost, one tranch's "toxicity" comes to taint the perception of other tranches as well.

developed and then grew in the vacuum left by those S&Ls lost in the 1990s.[16] These institutions, most of which are not, legally speaking, banks at all—they take no deposits and are not regulated as depository institutions—proliferated rapidly with, and indeed helping to fuel, our recent Fed-enabled real estate bubble.[17] Naïve, non-credit-checked, and in some cases clearly uncreditworthy borrowers not only received loans from these institutions, but often were lured with offers of newfangled adjustable rate mortgages ("ARMs") featuring low front-end "teaser" payments that later "ballooned."[18] Understanding how this could have happened will take us straight to the second, penumbral component of our present crisis, as well as to how to best solve it.

Ordinarily, neither borrowers nor lenders would likely have expected anything good to come of loans on such terms. But fees, risk-transferability, and especially speculative asset bubbles have a funny way of changing people's calculations. Borrowers reasonably assume they can regularly refinance inexpensively on the strength of the underlying collateral's apparently inexorable appreciation. Primary and secondary lenders naturally assume likewise. Again, such assumptions seem normal while the bubble is growing. Federal Reserve Chairman Greenspan himself said as much at the time, saying the buyers would be irrational *not* to take up ARMs.[19]

Borrowers, then, need not be profligate to "get in" what later proves "too deep" when it comes to levered asset purchases. Lenders, for their part, need not be venal: they can reasonably endorse borrowers' best hopes, even when lured by origination and loan servicing fees, and by the easy sale of

16. The network of S&Ls, fostered by President Hoover in the early 1930s to revitalize real estate markets and further developed by President Roosevelt thereafter to the same end, was done-in by the LBO-fueling junk bond craze of the later 1980s, which was in turn made possible by the Reagan administration's and Congress's elimination of previously tight regulation of S&L investment practices. *See* Hockett, *supra* note 12, at 65, 106.

17. There seems to be growing consensus that the Federal Reserve kept lending rates too low in the early 2000s. *See, e.g.*, WILLIAM A. FLECKTENSTEIN WITH FREDERICK SHEEHAN, GREENSPAN'S BUBBLES: THE AGE OF INNOCENCE AT THE FEDERAL RESERVE 145 (2008); MORRIS, *supra* note 13, at 65-66. A charitable interpretation is that the Federal Reserve overshot in addressing the slowdowns first threatened by the Asian financial crisis and Russian debt default of the late 1990s, then occasioned by the deflation of the tech bubble in 2000 and the 9/11 attacks of 2001. There are, of course, less charitable interpretations.

18. *See, e.g.*, ROBERT SHILLER, THE SUBPRIME SOLUTION: HOW TODAY'S GLOBAL FINANCIAL CRISIS HAPPENED AND WHAT TO DO ABOUT IT (2008); *see also* MORRIS, *supra* note 13, at 68-69.

19. The allusion here is to Chairman Greenspan's now notorious speech given in February of 2004. *See, e.g.*, Associated Press, *Greenspan Says Personal Debt Is Mitigated by Housing Value*, N.Y. TIMES, Feb. 24, 2004, at C11, *available at* http://www.nytimes.com/2004/02/24/business/24fed.html?ex=1231131600&en=8882db4e0fc674da&ei=5070.

resultant mortgages to secondary holders. The secondary holders only add to the pressure. Often they prod loan originators on, as seems to have happened quite widely this time. Why? Perhaps partly because they assume the originators have done the due diligence. But they are lured in any event, by the returns on investments that are there to be had while a bubble is inflating, even if there be defaults here and there. The highest rewards are *always* associated with some risk, after all.

For a time in these cases—often for years—virtually everyone wins. The process takes on a self-fulfillingly prophetic, spontaneous "chain letter" or Ponzi-like character. More are drawn into the market as prices keep rising. Some hope to clear speculative profits by "flipping" the assets they borrow to buy. Others, more innocently perhaps, reasonably judge they can prudently purchase to hold, but on more highly leveraged terms than they might otherwise have accepted. Still others are mixed cases of holder-cum-speculator.[20] In any event, as the new entrants keep entering, the prices do keep rising, effectively validating the judgments of those who act upon the expectation of continued ascent.

As this process continues, some begin to believe, and others perhaps labor to convince themselves, that we have entered upon some permanent "new era," from which point onward asset values quite generally "can only go up." Others, somewhat more modestly, convince themselves simply that the particular asset in question—land or petroleum, say—is in finite supply. Since populations and long-term demand know no limits, they conclude—not implausibly—that *this* one "can only go up." Others, finally, remain fairly certain that all that goes up can come down. However, they cannot know when the descent will begin; so they keep hanging on anxiously, day by day, in hopes of gleaning just that much more profit before exiting. It is in each participant's rational interest, after all, to ride to that asymptote, which is the very inflection point, so most keep on riding.

Bubbles never grow indefinitely; the inflection point always *is* reached. The Ponzi growth rate slows at some point in the indefinite medium term, whatever the more definite, long-term trend-lines might be.[21] When that

20. Those who borrow with a view to buying homes they will actually occupy often buy more expensive homes, for example, their down-payments often constituting smaller portions of the total to be paid. Others borrow with a view to purchasing homes they intend to "flip" at a profit. Still others are actuated by motives that combine the first two, perhaps planning to continue residing in the home if appreciation rates slow, and to "flip" the home or "trade up" should appreciation continue apace. *See generally* RICHARD BITNER, CONFESSIONS OF A SUBPRIME LENDER: AN INSIDER'S TALE OF GREED, FRAUD, AND IGNORANCE (2008).

21. This seems the right place to trot out the inevitable quotation of Keynes, to the effect that "in the long run, we're all dead." *In the Long Run, the Dollar Is Dead*, SEEKING ALPHA,

happens, the spontaneous Ponzi process abruptly halts and then quickly reverses. The buildup of worry—"how long can this last?"—discharges at last. A "Minsky Moment" is reached.[22] Many erstwhile winners, having been nervously mindful all along that a peak followed by mass exit must at some point be reached, seek to salvage gains or cut losses by being first to jump ship. "Sauve qui peut," "Die Letzen beissen die Hunde," or "Devil take the hindmost," as used to be said on the French, German, and English markets, respectively.[23] But in modern, electronically traded markets, the time-span between first and last is paper-thin. Prices plunge very quickly, and with them the reliability of those repayment obligations associated with the credit-extensions that fueled the rise.

This is the fate that befell our own housing bubble quite recently.[24] Prices leveled off, then began falling in mid-2006.[25] The ensuing slump quickly began to throw ill-structured, bubble-time mortgages into default, as market valuations of underlying assets began falling below nominal debt obligations.[26] Default rates, not surprisingly, have since grown steadily.[27] As they have grown, the market values of mortgages, mortgage-backed securities, and associated derivative obligations have dropped yet further.[28] In effect, the same feedback loop structure that characterized the buildup now characterizes the comedown.

The second, penumbral component of our mortgage-rooted financial crisis accordingly is, no pun intended, derivative. It is mass-psychological, simply the flipside of the just described Ponzi process: a proverbial "market for lemons" of the sort known to macroeconomists since at least the time of

Dec. 16, 2008, http://www.seekingalpha.com/article/110849-in-the-long-run-the-dollar-is-dead. We might also liken things here to a sort of reversal of Al Gore's frequent observation that this year's being cooler than last year constitutes no refutation of long-term global warming. AN INCONVENIENT TRUTH (Paramount Classics 2006). The trend-line's sloping upward over the long haul does not prevent its being jagged over long enough periods to be either misleading (in the case of climate change skeptics) or devastating (in the case of investment naifs).

22. HYMAN P. MINSKY, STABILIZING AN UNSTABLE ECONOMY (1986) (using the phrase "Minksy Moment" to describe the turbulent U.S. economy). This work seems, unsurprisingly, to be enjoying a bit of a rediscovery.

23. CHARLES P. KINDLEBERGER & ROBERT ALIBER, MANIAS, PANICS, AND CRASHES: A HISTORY OF FINANCIAL CRISES 32, 48 (5th ed. 2005).

24. *E.g.*, MORRIS, *supra* note 13, at 71; SHILLER, *supra* note 18.

25. *See*SHILLER, *supra* note 18.

26. *Id.*

27. *Id.*

28. *Id.*

Akerlof's and Stiglitz's canonical articles of the early 1970s[29] (for which both won Nobels), and to financiers since Gresham[30] first postulated the "Law" bearing his name, follows many a burst bubble. The prevailing mood changes, tendencies become increasingly risk-averse, and uncertainties are resolved by assuming the worst.

In the present iteration of this depressingly familiar story, no institutions or persons know precisely what portions of their own MBS-holdings will prove "underperforming" in consequence of the mortgage industry's post-crash troubles.[31] That is partly because no one knows precisely which mortgages will foreclose, and thus, which, or by how much, securities will underperform. It is partly because no one knows how low particular property values, or property values more generally, will fall. Finally, it is partly because property values, hence mortgage and MBS values, are themselves partly determined by whatever action we collectively take or do not take to prevent defaults.[32] There is a significant element of self-fulfilling prophecy in whatever we do here, just as there was a self-fulfilling prophecy in the growth of the Ponzi-like bubble itself. Until action on the part of the collective is taken by some agent authorized to act in the name of all, each private party assumes the worst and seeks exit.

This self-fulfilling prophecy steadily radiates outward: the market grows ever more jittery over the just enumerated uncertainties. The longer these jitters endure, the more prone investors become to undervalue affected financial institutions' MBS-including portfolios, and ultimately those institutions' own issuances. The more these investors shed their stakes in these institutions, in turn, the more quickly the remaining such stakes lose *their* short-run values. In effect, there is a "run on the banks," in this case by shareholders rather than depositors—as used to happened before there was federal deposit insurance.[33] The negative feedback loop found in the mar-

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29. George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970); Joseph E. Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 AM. ECON. ASS'N 393 (1981).

30. Sir Thomas Gresham, an English financier who lived between 1519–1579, is credited with the expression of the principle that "bad money drives out good money." Essentially, where two versions of coin that have very different actual market values are artificially forced (by law or regulation, for example) to have the same value, consumers will generally purchase with the coinage of lesser actual value while retaining the more valuable coins. *See* Wikipedia.org, Gresham's Law, http://en.wikipedia.org/wiki/Gresham's_Law (last visited Feb. 27, 2009).

31. *See, e.g.*, MORRIS, *supra* note 13.

32. This is a claim I am making, not an authority to which I am citing. Improved demand for assets pushes values up, lack of demand keeps or pushes them down.

33. *See, e.g.*, KINDLEBERGER & ALIBER, *supra* note 23, at 28; *see also* JOHN KENNETH GALBRAITH, THE GREAT CRASH 1929, at 184 (1954).

ket for MBSs accordingly spreads beyond those securities. The familiar financial "contagion" ensues.

The process is aided by mark-to-market accounting rules that require institutions to value their assets as the market values them[34]—even when, thanks to the panic psychology at work, the market arguably is grossly undervaluing them. With affected institutions interlinked by collateralized debt obligations, credit-default swaps, and other derivative risk-sharing arrangements, even those *not* holding MBSs end up affected. The "downward spiral" winds steadily downward.

But what goes down can be turned back up, and brought to a much more sustainable stratum. Enter here the FHA and its GSE siblings: we can quickly reverse the widening downward spiral that is this crisis's penumbral component, as the Treasury's original late September 2008 plan itself contemplated, by directly addressing the cause at its core—the bad mortgages and the securities they back. This is precisely what the FHA and its newly renationalized GSEs originally were and are *for*. Let us then look, for a moment, a bit further back than the heady early and dismal later 2000s, to the heady mid-1920s and dismal later 1930s.

II. WHERE WE WERE AND HOW WE GOT THERE

Public memory of the era immediately preceding the New Deal features three gaps that we would do well now to fill. One such forgotten fact is that before there was a "Second World War," the "First World War" was called "The Great War." The second forgotten fact is that the 1929 stock market "crash"—commonly singled out as having initiated that Depression which, thank goodness, we still can call "The Great"—was but a stage in a longer-term decline. It was immediately *preceded*, moreover, by a crash in the *real estate* market—most notably perhaps that in Florida, in which none other than Charles Ponzi himself had loomed large.[35]

Finally, the third fact that we have forgotten is that the system of home mortgage finance that has made America "a nation of home-owners" and introduced the financial innovation known as "securitization" itself, was actually designed, and then instituted over the course of the 1930s and 1940s, precisely *in response* to the just mentioned real estate crisis.[36] Be-

34. *See, e.g.*, Brooke Sopelsa, *Former FDIC Chair Blames SEC for Credit Crunch*, CBNC, Oct. 9, 2008, http://www.cnbc.com/id/27100454.

35. FREDERICK LEWIS ALLEN, ONLY YESTERDAY: AN INFORMAL HISTORY OF THE NINETEEN-TWENTIES (1931) (proving a good example of this story).

36. *See, e.g.*, J. Paul Mitchell, *Historical Overview of Federal Policy: Encouraging Homeownership*, *in* FEDERAL HOUSING POLICY AND PROGRAMS: PAST AND PRESENT 39, 41-42 (J. Paul Mitchell ed., 1986); *see also* D. BARLOW BURKE, JR., LAW OF FEDERAL

fore that time, fewer than 50% of American families owned their own homes; since that time, upwards of 60% have come to enjoy that status.[37] Where homes are concerned, in other words, the "ownership society" is a New Deal invention. That society, however, is now under threat—as are, consequently, the world's financial systems—just as they were in the early 1930s.

It is a thus matter of some urgency, rather than mere antiquarian interest, to recollect this history, as well as to see how our present problems take root in our having forgotten and departed from it. We must act quickly to ensure that the Great Depression remains "Great," rather than becoming just "I."

Early in the twentieth century, as now, most who purchased residential real estate did so at least partly on credit.[38] What was different then was that fewer purchased housing at all, for that very reason. Housing credit markets were more fragmented and mortgages, in consequence, were much less liquid investments than they have since become. Home loans, in consequence, were extended for much briefer terms—generally two to three years—at the end of which they would "balloon" to come due in full.[39]

Loan-to-value ratios before the 1930s, in turn, were very low by modern standards.[40] As little as 50% was considered high, and was rare.[41] Financing on such terms, not surprisingly, fell short of most would-be buyers' capacities. As a result, second mortgages, junior liens, and rollover refinancings were the norm. This was not terribly problematic for those who dared to buy, so long as real estate values continued to rise, as they did—very rapidly—through most of the 1920s. Refinancing then, as more recently, was not difficult when the value of one's collateral—the home itself—continued to rise in the real estate boom of the 1920s.

When real estate prices leveled off and then began falling in 1928, however, short-term mortgages no longer could be refinanced in full—again, things were much as they are today. Resultant forced sales and foreclosures, which reached the rate of over 1000 per day once some 50% of all home mortgages in the country had gone into default, brought prices stead-

MORTGAGE DOCUMENTS 2-25 (1989); KENNETH T. JACKSON, CRABGRASS FRONTIER: THE SUBURBANIZATION OF THE UNITED STATES 203 ff. (1988). *See generally* Hockett, *supra* note 12.

37. *See* Hockett, *supra* note 12, at 116.

38. *Id.* at 105.

39. *Id.*

40. *Id.*

41. *Id.*

ily lower.[42] The real estate market fell into the familiar "downward spiral."[43] The parallel with today could not be more striking.

For then as today, the crisis that afflicted the real estate market spread much more widely, ultimately reaching the stock market itself. The reasons were obvious. First, substantial portions of the American labor force were employed either in the home-building industry itself or in industries that were bound to lose business as home-builders went out of business.[44] Second, disemployed labor, like fearful and foreclosed mortgagees themselves, spent less money, feeding further contraction.[45] The vortex of contraction, recession, and then depression was complete.

The programs instituted to address this widening real-estate-rooted crisis—begun in the last year of the Hoover administration, broadened through the Roosevelt years, and continued in minimally altered form today—cannot fail to impress in their innovativeness and comprehensiveness. The process began with the Federal Home Loan Bank Act ("FHLBA") of 1932,[46] which authorized establishment of a system of Regional Federal Home Loan Banks, roughly parallel to that of the Federal Reserve's system of Regional Federal Reserve Banks.[47] The Regional Banks provided standards and supervision to member institutions—the private mutual savings banks ("MSBs") then responsible for most mortgage lending—and in return supplied added lines of credit on the security of mortgage loans that they held (in effect "monetizing" those mortgages).[48]

The new Congress that took office in 1933 built upon Hoover's well designed initiative. It did so first with the Home Owners' Loan Act ("HOLA") in 1933,[49] which temporarily established a Home Owners Loan Corporation ("HOLC") for refinancing foreclosed loans on favorable terms to enable erstwhile home-owners to recover their homes.[50] It also laid the groundwork for a steady spread of more MSBs, by directly affording national charters even where state authorities might have barred entry.[51]

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42. *Id.*

43. Mitchell, *supra* note 36, at 41; *see also* Hockett, *supra* note 12, at 105.

44. *See* Mitchell, *supra* note 36, at 42 (noting that construction workers "constituted a substantial portion of every local labor force").

45. Hockett, *supra* note 12, at 127.

46. ch. 522, 47 Stat. 725 (1932) (codified as amended at 12 U.S.C. §§ 1421-1449 (2006)).

47. *See* Hockett, *supra* note 12, at 106.

48. *Id.*

49. ch. 64, 48 Stat. 128 (1933) (codified as amended at 12 U.S.C. §§ 1461-1468 (2006)).

50. Hockett, *supra* note 12, at 107.

51. *Id.* at 108.

One year later, the National Housing Act ("NHA") of 1934[52] afforded a system of deposit insurance for the MSBs analogous to that newly instituted for depositors in commercial banks, further boosting the availability of lendable deposits.[53] More critically, the NHA instituted a system of insurance for the *MSBs themselves*, against defaulting *mortgagors*: Section 203 of the NHA established a nationwide "mutual mortgage insurance system" through which a newly created, and now permanent, Federal Housing Administration ("FHA") could insure first mortgage loans made for the construction, purchase, or refinancing of one- to four-bedroom family homes.[54] In effect, FHA took over and discharged indefinitely the functions of the HOLC, which from its inception had been conceived as ad hoc and temporary.

FHA still operates today, guaranteeing and, in many cases, originating or refinancing mortgages that conform to the standards that it imposes (so-called "conforming" mortgages). It also affords financial counseling to borrowers.[55] And it does all of this at no cost to the public fisc—the only federal agency to do so.[56]

The FHA and its insurance scheme fundamentally altered the regime of home-financing in the United States. It effectively replaced traditional collateralization requirements with national default-risk-pooling, rendering home loans more affordable. The uniform requirements upon which the FHA conditioned its insurance, for its part, fostered the development of a standardized home mortgage *instrument* marketable throughout the country: the familiar thirty-year, fixed-rate mortgage so common to low-end mortgage finance until recently.[57] This in turn opened the door to securitization, and hence, yet more complete risk-pooling. The housing *quality* requirements upon which FHA *conditioned* its insurance also ensured the financial rationality of federally facilitated home-finance investments.[58] Further, FHA's requirements of (a) actuarial soundness and (b) risk classifying and separate pooling ensured that the system retained the traditional efficiencies of a private insurance market. That is why it still operates in the black.

52. ch. 847, 48 Stat. 1246 (1934) (codified as amended in scattered sections of 12 U.S.C.).
53. Hockett, *supra* note 12, at 109.
54. *Id.* at 110.
55. *Id.* at 92.
56. *See id.* at 93.
57. *See id.* at 108.
58. *Id.* at 112.

Congress effectively completed its ad hoc discovery of our now familiar method of financially engineered home-ownership-spreading in 1938, by chartering the first modern "government sponsored enterprise" ("GSE"): The Federal National Mortgage Association ("FNMA") or "Fannie Mae."[59] Fannie Mae was charged with making a national market in FHA-insured mortgage instruments themselves, in other words, with "securitizing" those mortgages.[60] In effect, Fannie Mae, along with later progeny (in particular Ginnie Mae and Freddie Mac, to say nothing of the higher education loan securitizers like Sallie Mae, expressly patterned after the Fannie Mae model), closed the proverbial circle, separately completing the markets for housing credit and credit-risk-bearing, thereby optimizing the availability of such credit to home-buyers in the manner described earlier.[61]

Fannie Mae proved sufficiently successful, even on market terms, to privatize in 1968.[62] Freddie Mac for its part, was instituted in 1970 specifically in order to compete with the newly privatized and gargantuan Fannie.[63] Both Fannie and Freddie subsequently came to offer a multitude of home finance services, and operated effectively, as well as profitably, in spreading home-ownership until recently.[64]

What, then, went wrong? In essence, the story is just that told in the previous section, albeit now with an added wrinkle: on the one hand, Fannie and Freddie were caught up in bubble psychology just like so many others. It was very profitable to buy ever more risky, non-FHA-conforming mortgages so long as property values kept growing at the rates that they grew in the late 1990s and early 2000s. Global investors in Fannie and Freddie, including many a large sovereign wealth fund or treasury, insisted these profits be sought.[65]

At the same time, in view of their original missions as engines of the American home-ownership society, members of Congress and other officials during the Clinton and Bush years alike—themselves evidently caught up in the belief that real estate "could only go up"—in some cases actively pressured the old GSEs to take on more risky mortgages.[66] *Why not* pursue the original salutary mission all the more aggressively, after all, if even the Federal Reserve Chairman was convinced that real estate would just keep

59. *Id.* at 113.
60. *Id.*
61. *Id.* at 114.
62. *See id*. Sallie Mae did so in late 2004. *Id.* at 150.
63. *Id.* at 113-14.
64. *See* Fannie Mae Homepage, http://www.fanniemae.com (last visited Feb. 26, 2009).
65. *See* MORRIS, *supra* note 13, at 38.
66. *Id.*

rising in value? Finally, in view of Fannie's governmental lineage, Fannie's and Freddie's "implicit" federal guarantees,[67] and both institutions' associated "too big to fail" status,[68] Fannie and Freddie were all the more able to attract plenty of purchasers of their securities.

Ultimately, of course, all of this landed Fannie and Freddie in very hot water. The real estate slump that commenced in the summer of 2006 hit them especially hard, for they held the great bulk of low end mortgages. We know where it led: Fannie and Freddie were ultimately renationalized in September 2008.[69] Many took this for an ominous sign, on all fours with the totterings of Bear Stearns, Countrywide, Lehman Brothers, Merrill Lynch, AIG, and Washington Mutual, among others. What we ought *really* to see in the renationalization of Fannie and Freddie, however, is *opportunity*—an opportunity for the restoration of home values, home-owning, and finance.

III. BRINGING IT ALL BACK HOME

With FHA still in operation as the sole federal agency that operates at no cost to the public fisc, and with its prodigal siblings now back in the family, we are actually very well situated to address the mortgage crisis at the core of our imminent global financial crisis. Indeed we can easily set the team to work in a manner a lot like the manner in which it operated in solving that real estate crisis which prompted its founding in the first place. Here is how to do it.

First, through the now newly refederalized GSEs, employ TARP moneys to purchase and repurchase perceivedly "troubled" MBSs from key financial institutions now holding them as originally envisaged by Treasury, adding them to the large numbers of such securities already held by the GSEs. Pay more than currently undervalued market, but lower than discounted cashflow value. That way value will be recouped as MBSs rise back to less panic-depressed values. This will also ensure that financial institutions that over-invested in MBSs incur some cost, thereby mitigating the moral hazard concerns occasioned by any bailout: in effect, we will be taking a "deductible," or conferring the attributes of "coinsurance" on the bailout.

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67. *E.g.*, *id.*

68. *Id.; see, e.g.*, Peter S. Goodman, *Too Big to Fail?*, N.Y. TIMES, July 20, 2008, at WK1, *available at* http://www.nytimes.com/2008/07/20/weekinreview/20goodman.html.

69. Press Release, Henry M. Paulson, Jr., U.S. Sec'y of the Treasury, Statement on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers (Sept. 7, 2008), *available at* http://www.treas.gov/press/releases/hp1129.htm.

How much more than currently undervalued market, but lower than discounted cashflow value, should we pay out? Many methods have been proposed, best known among them is probably the "reverse auction" first proposed by the Treasury in September of 2008.[70] Reverse auctioning certainly seems the most efficient means of dividing the surplus that we will be recouping. We shall do best to prescind here from fine-tuned accounting and valuation matters, however, as there is surely a range of reasonable possibilities within which to choose. What matters for the present is that MBSs are certainly presently undervalued by a spooked market, for the same psychological reasons that they were overvalued by our erstwhile euphoric market.[71] This fact itself—if there is more or less symmetry between first the euphoric and then the dejected "animal spirits" that have been at work in the MBS market this decade—suggests somewhere near the mean between peak and trough rates as a good working benchmark against which to check observed auction rates, perhaps marginally adjusted in recognition of any asymmetry thought to be worked by endowment or related effects.

Will the MBSs rise back to higher values? Yes, for reasons rooted in the "market for lemons" and "self-fulfilling prophecy" phenomena noted above. The problem in this case is that, while we know that only a small minority of mortgages will actually default and only a minority of MBSs will actually prove to be "toxic," we don't know which ones. During periods of irrational despair that follow periods of irrational exuberance, individuals irrationally fear that they are holding the underperforming investments disproportionately. Let us call it a "reverse Wobegon" problem. Each individual worries, "I might have only the bad ones."[72] Fearing this individually, such investors then, in effect, collectively make it so by stampeding to sell what they irrationally undervalue. In short, this is a classic collective action problem, one that, in this case, artificially deflates value.

Concentrate ownership of the full affected portfolio, then, and the collective action problem is addressed head-on and entirely solved. Each secu-

70. Posting of Ed Bockman to Supply Excellence, http://www.supplyexcellence.com/blog/2008/09/29/bailout-reverse-auctions (Sept. 29, 2008); Posting of Phil Izzo to Real Time Economics, http://blogs.wsj.com/economics/2008/09/23/how-will-troubled-assets-get-priced (Sept. 23, 2008, 17:21 EST); Posting of Ronald P. O'Hanley & Charles. J. Jacklin to Financial Times Economists' Forum, http://blogs.ft.com/wolfforum/2008/09/can-washington-%E2%80%93-and-a-reverse-auction-%E2%80%93-save-the-markets-and-protect-the-taxpayer (Sept. 26, 2008, 17:09 EST).

71. *See* Akerlof, *supra* note 29, at 490.

72. This allusion is to Garrison Keillor's proverbial town of Lake Wobegon, where "all of the children are above average." A Prairie Home Companion from American Public Media: Podcasts, http://prairiehome.publicradio.org/about/podcast/ (last visited Feb. 22, 2009).

rity can effectively be valued at the mean, without the need to know which particular securities in fact possess more or less than mean value. The problem of investors all fearing that they hold securities that are of less than mean value—the "reverse Wobegon problem"—is immediately solved. We restore full portfolio value, in short, precisely by concentrating ownership of the full portfolio, booking the difference between that portfolio and the current irrationally depressed market value of the previously dispersed securities. Concentrating ownership also will facilitate smooth operation of the second part of the FHA/GSE plan that I propose, the part that restores value to underlying mortgages themselves.

The second and complementary part of the plan is, through the FHA, simultaneously to arrange refinancing and financial counseling for those mortgagees who, owing to poorly structured or misleadingly packaged mortgages, are now going under. Make a priority of first-time single-home-buyers who have purchased the homes to occupy them, and who might realistically pay for them if only their payment structures are smoothed. Show less solicitude for "second" or "*n*th" homes that clearly are speculative properties purchased for "flipping," unless there is a good chance of saving foreclosure costs by refinancing. The FHA should show intermediate solicitude for those who, though not strictly speculators, have nonetheless grossly overreached, helping to refinance some while gradualizing workouts and foreclosures on others. The FHA is quite experienced with all of these options.

Note that all of this can be done at a reasonable, unforced pace once the FHA's sibling GSEs have purchased or repurchased the great bulk of MBSs per the first part of the plan. The newly renationalized GSEs do not face the same short-term financial imperatives as private lenders, for they are once again effectively public agencies. Nor do they face the bargaining problems that confront dispersed classes of creditors in more garden variety insolvency situations, for in purchasing up MBSs they will concentrate ownership of those assets. Debt workouts too are familiarly a collective action problem, as any bankruptcy expert will readily attest.[73] This, then, is yet another benefit of concentrating ownership of these now troubled assets in the hands of our GSEs. It will enhance the value of the assets themselves, precisely by preventing massive foreclosures and their associated costs, and thus preserving the value of those mortgages that underlie the presently "toxic" MBSs.

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73. *See, e.g.*, Posting of Bob Rasmussen to The University of Chicago Faculty Blog: Hedge Funds and Collective Action, http://uchicagolaw.typepad.com/faculty/2006/06/hedge_funds_and.html (June 1, 2006 14:51 CST).

It bears mentioning that the FHA can effect mortgage refinancings much more efficiently than judges or any new cadre of bankruptcy trustees of the sort some are proposing would do. This efficiency will result because refinancing is already an FHA specialty and the GSEs' repurchasing of MBSs will eliminate the usual holdout problems that afflict ordinary debt workouts in the vicinity of court-administered bankruptcy. This renders the paired FHA/GSE plan superior, moreover, to Professor Shiller's proposal for a new HOLC.[74] Professor Shiller's proposal would merely recreate an agency that the FHA was itself instituted to replace and make it permanent. His plan also would not yield the concentrated MBS-ownership advantages that this plan involves.

Offer to buy troubled MBSs, then, and most who hold them now will likely sell. Then the FHA can refinance mortgages with speed—*deliberate* speed—without pressure. As for any investors who do not sell their MBSs within the plan, note first that they would have to constitute one third of the mortgage credit outstanding on any one home if they wished to block its refinancing under the Bankruptcy Code, and might very well find themselves subject to a "cram down" by the Bankruptcy judge in a proceeding in any event.[75] It seems unlikely, against that backdrop, that there would be sufficient "holdout" power to impede refinancing. Further, if there existed such a bloc of investors that sought to obstruct refinancing arrangements by FHA, there may be sufficient ground for the government to exercise its eminent domain power and pay the amount paid to the last—or even the first—voluntary sellers of MBSs to the holdouts. A securities covenant is no more a suicide pact than is the Constitution, and there is no reason to honor exploitative holdout power in times of exigency. If anything, there is reason to shame holdouts publicly, along with the worst of

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74. *See* SHILLER, *supra* note 18 (putting forth this proposal). A similar plan, proposed by Congressman Frank and Senator Dodd, was put forth in 2007, but withdrawn in the face of opposition by industry groups, Republicans in Congress, and the now out-of-office Bush administration. The Dodd/Frank plan would have employed FHA, but, proposed as it was before Fannie and Freddie had been renationalized, did not involve GSE's sweeping troubled MBSs from the market. Now that we have the full team together again, prospects look better.

75. Michelle J. White, *Corporate Bankruptcy*, *in* THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW (Peter K. Newman ed., 1998); Letter from The Am. Bankers Ass'n et al. to the Honorable John Conyers and the Honorable Lamar Smith (Jan. 27, 2009), *available at* http://www.icba.org/files/ICBASites/PDFs/ltr012709.pdf; *Business Debt Restructuring Still Available Through Chapter 11*, BANKR. PROTECTOR, Mar. 2008, http://www.wileyrein.com/publication_newsletters.cfm?ID=17&year=2008&publication_id=13515&keyword; First American, Cramdown Plans, Variations, and Alternatives, http://www.firstam.com/content.cfm?id=6854 (last visited Feb. 27, 2009); What Is a Cram down in Bankruptcy?, http://blog.foreclosure.com/2009/01/what-is-a-cram-down-in-bankruptcy/ (Jan. 14, 2009).

that comparative minority of borrowers and lenders who were grossly negligent in the midst of the bubble.

So how much will all of this cost? That is difficult to determine in view of the feedback-effect-rooted indeterminacies at work in the present crisis. The best that can be expected is to recognize the range of reasonably anticipated possibilities. At one end of this range is the possibility that FHA and its renationalized GSE siblings will actually emerge from this crisis in the black. Certainly that is what happened from the late 1930s onward, when the original package was first implemented. Indeed, it is why Fannie Mae was ultimately privatized, and it is why the FHA has operated at a profit since its inception. It should also be noted that Messrs. Bernanke, Bush, and Paulson argued that the TARP, even *without* the salvaging of mortgage—hence MBS—values that refinancing can accomplish, could result in a net gain to the fisc.

What about the less rosy end of the range of possibilities? That one is just a bit harder to estimate. This owes in part to the aforementioned feedback-effect-rooted indeterminacies. It owes also to the countervailing effects of the aforementioned MBS-appreciation apt to be wrought by concentrated ownership on the one hand, and the MBS-depreciation apt to be wrought by continued home-value-decline and foreclosures on the other hand. The worst-case scenario would be that the full amount spent purchasing troubled MBSs would be lost. At present, under the TARP, that would be about $350 billion—the remaining amount now available—plus what ever increment of the first half of funds the Treasury has already spent upon MBSs. This worst-case scenario seems far from plausible, for all of the reasons mentioned above.

CONCLUSION

To our detriment, we have long since forgotten how effective the FHA and its GSE siblings were, upon their foundings during the Roosevelt era, in ending our last mortgage "meltdown." At literally no ultimate cost to the public fisc—none—they cured that real estate crisis, and in so doing transformed us from a nation in which fewer than 40% of the population owned their homes, to a nation in which 70% do.

Since the FHA is both self-funding and the best mortgage financing organization, and since the GSEs have now been refederalized in keeping with their original, pre-privatization mandates, their complementary original missions can now be restored. The FHA and GSE mandates are clear, constitutional, and can still be accomplished at nearly no cost. They exist to spread and maintain non-speculative home-ownership on Main Street.

Set them to work on that now and we will save Wall Street—and the global financial system—as well, at least until the next bubble.