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Recommended Citation

Combs, Thomas (2010) "A Proposal for Regulation of the Government-Sponsored Enterprises," *St. John's Law Review*: Vol. 84 : No. 2 , Article 6.

Available at: <https://scholarship.law.stjohns.edu/lawreview/vol84/iss2/6>

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A PROPOSAL FOR REGULATION OF THE GOVERNMENT-SPONSORED ENTERPRISES

THOMAS COMBS[†]

I. INTRODUCTION

Excessive subprime residential mortgage lending has plunged the United States into one of the worst recessions in a century. Although the underlying causes were many, securitization played a large role as demand for securities backed by subprime loans enabled subprime lending markets to flourish. This Note argues that regulation of the Government-Sponsored Enterprises¹ (“GSEs”)—Fannie Mae and Freddie Mac—is still insufficient to prevent another crisis. It proposes changes to the Housing and Economic Recovery Act of 2008² (“HERA”) intended to ensure the GSEs’ future safety.

The GSEs were the single largest enablers of the subprime crisis. They purchased and issued vast quantities of residential mortgage-backed securities (“RMBS”) backed by subprime loans, while enabling the deterioration of underwriting standards. They strove to fulfill two contradictory goals: fulfilling the affordable housing goals set by the Department of Housing and Urban Development (“HUD”), while simultaneously producing a healthy return for shareholders. They benefited from a widely held belief that the GSEs’ securities are guaranteed by the federal government. This unique situation—privatization of profits and socialization of risk—created a moral hazard that led GSE executives to take excessive risks.

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¹ The term “government-sponsored enterprise” means a corporate entity created by a law of the United States that has a federal charter, is privately owned, is under the direction of a board of directors, a majority of which is elected by private owners, and is a financial institution with the power to make loans or loan guarantees for limited purposes and to raise funds by borrowing. *See* 2 U.S.C. § 622(8) (2006). It does not exercise powers reserved to the government, may not commit the government financially, and is able to pay its own expenses. *Id.*

² Pub. L. No. 110-289, 122 Stat. 2850 (codified in various sections of 12 U.S.C.)

The legislative and executive branches were unable to stop the GSEs. Using affordable housing as a potent political weapon, the GSEs successfully lobbied to protect their unique congressional charters from effective regulatory oversight. Eventually, however, as the crisis unfolded and loans entered into default, the GSEs sought protection from the federal government and are now under the conservatorship of the Federal Housing Finance Agency ("FHFA").

Recognizing the GSEs' role in the crisis, Congress passed HERA, which altered the GSEs' regulatory regime in significant ways. HERA created the FHFA. FHFA is a strong, independent regulatory agency with broad powers to set the GSEs' capital levels, approve new loan programs, and restrict lobbying activity. HERA also imposed a broad affordable housing mandate on the GSEs, requiring them to support affordable loan programs, and gave FHFA complete discretion over the program's scope.

HERA, however, has several defects. Aside from a general requirement that the GSEs operate safely, the Act does not sufficiently constrict the FHFA's discretion in setting affordable housing goals. Moreover, the Act does nothing to curtail the GSEs' enormous lobbying power.

This Note proposes various amendments to HERA designed to prevent a repeat of the subprime crisis. First, HERA should be amended to prevent the GSEs from lobbying the executive or legislative branches of government. This will likely have the effect of increasing government control over the GSEs. And because the FHFA has already suspended the GSEs' lobbying activity, this is not a new suggestion, but one that has already resulted in substantial positive effects.

Second, the Act should require the GSEs to focus on the core mortgage market, making affordable housing just a small part of their overall business. The GSEs should be prohibited from purchasing private label RMBS, undoubtedly the most toxic assets. The federal government should offer an explicit guarantee on mortgages backed by prime loans. Finally, there should be a definite cap on the number of affordable housing loans the GSEs can purchase. These changes will likely have the effect of stabilizing the secondary mortgage market, and of neutralizing the GSEs' moral hazard by restricting their ability to abuse affordable housing programs for political and financial gain. Any consequential reduction in the availability of

affordable loans can be addressed through other federal programs.

II. PROBLEMS AND NEED FOR CHANGE

This Part discusses how Fannie Mae and Freddie Mac were among the primary causes of the subprime crisis. After a brief background discussion describing the key players in the mortgage markets and data about the subprime crisis, the Section explores the nexus between the RMBS market and subprime loans and argues that investor demand for RMBS provoked much subprime lending. The Part shows how the GSEs stimulated the secondary market by abandoning conservative underwriting standards and investing in subprime securities. In the fallout of their 2003 and 2004 accounting scandals, the GSEs acted with the intent to protect their unique congressional charters. By using their dominant market position to shape the subprime market with their affordable housing programs, they fostered the illusion of prosperity in many congressional districts by increasing the rate of homeownership, but did so in exchange for support from congressmen and women and the President.

A. Background

1. The Key Players

To place this discussion in its proper context, some general background information about how the GSEs impact the residential mortgage market is necessary.

For the better part of a century, the residential mortgage market has been shaped and standardized by federal sponsorship of mortgages.³ Beginning with Depression-era legislation, Congress created entities that gave the federal government enormous influence over the residential mortgage market and greatly increased its complexity: the GSEs, known as Fannie Mae and Freddie Mac.⁴

³ See, e.g., Housing Act of 1949, ch. 338, 63 Stat. 413 (codified as amended at 42 U.S.C. § 1441 (2006)) (providing money for slum-clearance projects and construction of public housing, increasing the role of mortgage insurance, and providing assistance to rural homeowners).

⁴ See Christopher L. Peterson, *Predatory Structured Finance*, 28 CARDOZO L. REV. 2185, 2195–97 (2007).

In 1938, Congress created the Federal National Mortgage Association (“Fannie Mae”).⁵ Fannie Mae’s function was to purchase the Federal Housing Administration’s (“FHA’s”) “nonconventional” insured loans and provide a quick source of capital to mortgage lenders.⁶ This new secondary market gave many mortgage loan companies, insurance companies, and even commercial banks the confidence they needed to get back into the consumer home loan business after the Depression.⁷

In 1968, Congress privatized Fannie Mae and in 1970, created its counterpart, Freddie Mac, and gave them each a new mission: purchasing private non-government insured loans.⁸ Congress’s goal was to “provide liquidity, stability and affordability to the U.S. housing and mortgage markets.”⁹ Relying on the “three Cs” of traditional underwriting—collateral, capacity, and credit reputation—both Fannie and Freddie purchased “conforming” loans meeting fairly stringent underwriting criteria.¹⁰ Although many of these criteria were later abandoned, for many years the GSEs set the gold standard of mortgage underwriting.¹¹

Originally, Fannie and Freddie simply held mortgages themselves,¹² but the nature of their business changed dramatically with the advent of securitization.¹³ In the early 1970s, the GSEs began creating or insuring mortgage-backed securities.¹⁴ These were relatively simple instruments that merely “passed through” interest and principal to investors on a pro-rata basis.¹⁵ The GSEs would purchase residential mortgages, assemble them into homogenous pools, and sell rights in the pool to institutional investors.¹⁶ Under this arrangement,

⁵ See National Housing Act of 1934, Pub. L. No. 73-479, 48 Stat. 1252 (codified as amended at 12 U.S.C. § 1716 (2006)); see also Peterson, *supra* note 4, at 2196.

⁶ Peterson, *supra* note 4, at 2196 (internal quotation marks omitted).

⁷ See *id.*

⁸ See *id.* at 2198.

⁹ Fannie Mae, About Fannie Mae, <http://www.fanniemae.com/kb/index?page=home&c=aboutus> (last visited Aug. 9, 2010); see also 12 U.S.C. § 1716.

¹⁰ See David Schmudde, *Responding to the Subprime Mess: The New Regulatory Landscape*, 14 FORDHAM J. CORP. & FIN. L. 709, 716–17 (2009).

¹¹ See *id.* at 717.

¹² See Peterson, *supra* note 4, at 2196.

¹³ See *id.* at 2198–99.

¹⁴ See *id.*

¹⁵ *Id.* at 2198 (internal quotation marks omitted).

¹⁶ See *id.* at 2198–99.

investors could participate in a large and geographically diversified number of mortgages, lessening the significance of any one default.¹⁷ And, because the pool was homogenous, investors could calculate default and refinancing risks more easily. “Securitization of mortgage loans by the GSEs allowed the larger capital markets to directly invest in American home ownership at a lower cost than the older depository lending model of business.”¹⁸ For the first time, global capital markets were directly linked to residential mortgages.

Fannie and Freddie have since grown to immense proportions. As of December 31, 2009, Freddie’s total mortgage portfolio, including mortgage-related investments and the unpaid principal balance of all other loans and securities that it guaranteed, was \$2.3 trillion.¹⁹ Similarly, as of September 30, 2009, Fannie held or guaranteed \$3.2 trillion in mortgage debt.²⁰ The total U.S. residential mortgage debt outstanding, which includes single-family and multifamily loans, was approximately \$11.8 trillion as of December 31, 2009.²¹ In other words, Fannie and Freddie directly or indirectly bear the risk for forty-seven percent of the total outstanding U.S. residential mortgage debt. Because of losses on more than \$1 trillion of subprime and Alt-A investments²²—almost all of which were added to their single family book of business between 2005 and 2007—Fannie and Freddie have been under conservatorship by the Federal Housing Finance Agency since September 2008.²³

2. The Subprime Market

Although lenders typically form their own precise definitions, a subprime loan is simply one that carries “a premium above the prevailing prime market rate that a borrower

¹⁷ See *id.* at 2199.

¹⁸ *Id.*

¹⁹ See Fed. Home Loan Mortgage Corp., Annual Report (Form 10-K), at 3 (Feb. 24, 2010) [hereinafter Freddie Mac 2009 10-K Report].

²⁰ See *id.* at 2.

²¹ See *id.* at 3.

²² See Schmudde, *supra* note 11, at 718–21. Alternative-A loans (“Alt-A”) are those with a risk profile greater than prime loans but less than subprime loans.

²³ See About Fannie Mae, <http://www.fanniemae.com/kb/index?page=home&c=aboutus> (last visited Aug. 9, 2010); Frequently Asked Questions About Freddie Mac, http://www.freddiemac.com/corporate/company_profile/faqs/#8 (last visited Aug. 9, 2010).

must pay.”²⁴ The loan typically results not only in higher interest rates, but pre-payment penalties, higher closing fees, and other costs.²⁵ “Subprime borrowers typically have weakened credit histories that include payment delinquencies, and possibly more severe problems such as charge-offs, judgments, and bankruptcies.”²⁶

Several key pieces of federal legislation made subprime lending possible. During the 1980s, Congress preempted state laws on interest rate caps,²⁷ permitted the use of loans with variable interest rates and balloon payments,²⁸ and allowed interest deductions for mortgage debt, making it cheaper than consumer debt.²⁹ Congress also enacted legislation benefitting the secondary market. By modifying the Securities Exchange Act of 1934 and preempting state blue sky and legal investment laws, Congress permitted state-chartered and regulated financial

²⁴ Souphala Chomsisengphet & Anthony Pennington-Cross, *The Evolution of the Subprime Mortgage Market*, 88 FED. RES. BANK OF ST. LOUIS REV. 31, 36 (2006), available at <http://research.stlouisfed.org/publications/review/06/01/ChomPennCross.pdf>.

²⁵ See *id.* at 32.

²⁶ OFFICE OF THE COMPTROLLER OF THE CURRENCY ET AL., EXPANDED GUIDANCE FOR SUBPRIME LENDING PROGRAMS 2 (2001), available at <http://www.federalreserve.gov/Boarddocs/SRletters/2001/sr0104a1.pdf>. Much of what complicates empirical research into this area is a lack of precise definitions of “subprime.” Subprime borrowers tend to exhibit one or more of the following characteristics:

- (1) Two or more 30-day delinquencies in the last 12 months, or one or more 60-day delinquencies in the last 24 months;
- (2) Judgment, foreclosure, repossession, or charge-off in the prior 24 months;
- (3) Bankruptcy in the last 5 years;
- (4) Relatively high default probability as evidenced by, for example, a credit bureau risk score (FICO) of 660 or below (depending on the product/collateral), or other bureau or proprietary scores with an equivalent default probability likelihood; and/or
- (5) Debt service-to-income ratio of 50 percent or greater, or otherwise limited ability to cover family living expenses after deducting total monthly debt-service requirements from monthly income.

Id. at 3.

²⁷ See Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132 (codified as amended in various sections of 12 U.S.C.). The Act preempted laws governing the rates of *any* mortgage loan, whether for purchase or refinance. See *id.* Since many subprime loans are refinancing loans, this was a very significant feature of the Act.

²⁸ See Alternative Mortgage Transaction Parity Act of 1982, Pub. L. No. 97-320, 96 Stat. 1545 (codified as amended in various sections of 12 U.S.C. §§ 3801–805 (2006)).

²⁹ See Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (codified at 26 U.S.C. §§ 47, 1042 (2006)).

institutions, pension funds, insurance companies, trustees, and other regulated entities to purchase “mortgage related securities.”³⁰ Congress also amended the Tax Code in 1986 to create Real Estate Mortgage Investment Conduits (“REMICs”) to facilitate securitization of residential mortgages.³¹

Because of the legal changes described above, new loan products came to the market. They offered borrowers greater flexibility, but also posed a danger that uninformed consumers would select a loan product irresponsibly. New products included interest-only loans, adjustable rate mortgages (“ARMs”), option mortgages, and even loans combining various characteristics of each.³² Often, they were available to consumers with less than full documentation of their income and assets.³³ These innovations, combined with a large amount of capital on the secondary market, led to an explosion of mortgage lending: Between 2000 and 2008, the amount of outstanding single-family mortgages of all kinds rose from \$5.1 trillion to over \$11 trillion.³⁴

Although it is generally agreed that the subprime market was an enormous part of the overall market, there appears to be a shortage of “consistent information available about the size of the subprime market.”³⁵ “[T]here are deficiencies in all available single-family mortgage market data series, whether collected by federal agencies, private firms, or trade associations. That is not surprising, as data collection efforts were designed to address specific areas of interest, and data collection is expensive and

³⁰ See Secondary Mortgage Market Enhancement Act of 1984, Pub. L. No. 98-440, 98 Stat. 1689 (codified as amended in various sections of 12 U.S.C. and 15 U.S.C.).

³¹ Though beyond the scope of this paper, much could be said about other securitization structures, which become complex financial instruments that may have obscured the true risks faced by investors by purporting to shield them from a borrower's default. The GSEs were among the leading innovators of residential mortgage-backed securities. See *The Role of Fannie Mae and Freddie Mac in the Financial Crisis: Hearing Before the H. Comm. on Oversight and Government Reform*, 110th Cong. 139–40 (2008) [hereinafter Pinto] (statement of Edward J. Pinto, former Chief Credit Officer, Fannie Mae), available at http://www.aei.org/docLib/20090116_kd4.pdf.

³² See Schmudde, *supra* note 10, at 715–16.

³³ See Pinto, *supra* note 31, at 161.

³⁴ *The Present Condition and Future Status of Fannie Mae and Freddie Mac: Hearing Before the Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises of the H. Financial Servs. Comm.*, 111th Cong. 146 (2009) [hereinafter *Fannie Mae and Freddie Mac Hearing*] (statement of James B. Lockhart III, Director, Federal Housing Finance Agency).

³⁵ Pinto, *supra* note 31, at 139.

seldom done for 'pure' research."³⁶ Also, subprime and Alt-A loans appear in both subprime and prime databases belonging to the GSEs.³⁷ In other words, because many conforming subprime loans purchased by the GSEs were classified as prime, "there are many more subprime and Alt-A mortgages outstanding today than many people suppose."³⁸

For example, according to one estimate, the total amount of subprime originations increased from \$65 billion to \$332 billion between 1995 and 2003.³⁹ According to another estimate, the number of subprime originations increased from 962,000 to 3.2 million between 1998 and 2006.⁴⁰ According to yet another estimate, between 2001 and 2006, subprime originations increased from \$190 billion to \$600 billion.⁴¹ Still another: The "number of subprime originations increased more than five-fold from 2000 through 2005—rising from approximately 457,000 to about 2.3 million—before declining somewhat in 2006 and falling off sharply in 2007."⁴²

Despite considerable variations in the data, it is impossible to deny that nonprime originations increased dramatically in the first half of this decade. High levels of global economic growth made capital available to the secondary markets.⁴³ And a tight

³⁶ FORREST PAFENBERG, OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT, SINGLE-FAMILY MORTGAGES ORIGINATED AND OUTSTANDING: 1990–2004, at 4 (2005), available at <http://www.fhfa.gov/webfiles/1151/mortmarket1990to2004.pdf>.

³⁷ See Pinto, *supra* note 31.

³⁸ *Id.* at 140.

³⁹ See Chomsisengphet, *supra* note 24, at 37 (citing data from the trade magazine Inside B & E Lending).

⁴⁰ See CENTER FOR RESPONSIBLE LENDING, SUBPRIME LENDING: A NET DRAIN ON HOMEOWNERSHIP 4 (2007) (citing data from a proprietary database, *Inside Mortgage Finance*, and SMR Research Corporation), available at <http://www.responsiblelending.org/mortgage-lending/research-analysis/Net-Drain-in-Home-Ownership.pdf>.

⁴¹ *Current Trends in Foreclosures and What More Can Be Done To Prevent Them: Hearing Before the Joint Economic Comm.*, 111th Cong. 1 (2009) (statement of William B. Shear, Director, Financial Markets and Community Investment; Government Accountability Office), available at http://jec.senate.gov/public/?a=Files.Serve&File_id=42eb8117-74c5-4378-a7e8-9505d858d78d.

⁴² U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-848R, CHARACTERISTICS AND PERFORMANCE OF NONPRIME MORTGAGES 6 (2009), available at <http://www.gao.gov/new.items/d09848r.pdf>.

⁴³ See JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., THE STATE OF THE NATION'S HOUSING 2008, at 19 (2008) [hereinafter JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV. 2008], available at <http://www.jchs.harvard.edu/publications/markets/son2008/son2008.pdf>.

housing market drove home prices to new levels.⁴⁴ Both of these factors combined to create a thriving RMBS market, and the GSEs were major drivers of this expansion.

Although detailed data about securitization is also plagued with problems, it appears that the total volume of loans securitized increased with the volume of origination. More specifically, the secondary market's appetite for securities backed by subprime loans increased in the first half of the decade. Between 1995 and 2003, the securitization rate of subprime loans rose from 28.4% to 58.7%.⁴⁵

Given that securitization increased with lending, the inference to be drawn is that one event caused the other.⁴⁶ As Dr. Alan Greenspan observed: "The evidence strongly suggests that without the excess demand from securitizers, subprime mortgage originations (undeniably the original source of crisis) would have been far smaller and defaults accordingly far fewer."⁴⁷

As the housing market imploded in 2007, the demand for subprime loans from both consumers and investors dried up. Between 2006 and 2007, subprime originations decreased from over \$139 billion to less than \$14 billion.⁴⁸ Loan performance deteriorated as the foreclosure rate for subprime loans rose from 4.5% in the fourth quarter of 2006 to 8.7% a year later.⁴⁹

At the height of the crisis, the state of the nation's housing was bleak. Delinquency and foreclosure rates skyrocketed; both

⁴⁴ *Id.*

⁴⁵ Chomsisengphet, *supra* note 24, at 38.

⁴⁶ Dr. Greenspan summarizes how mortgage lenders were simply meeting the demand of investors:

The big demand was not so much on the part of the borrowers as it was on the part of the suppliers who were giving loans which really most people couldn't afford. We created something which was unsustainable. And it eventually broke. If it weren't for securitization, the subprime-loan market would have been very significantly less than it is in size.

Jon Meacham & Daniel Gross, *The Oracle Reveals All*, NEWSWEEK, Sep. 24, 2007, at 32, 34.

⁴⁷ *The Financial Crisis and the Role of the Federal Regulators: Hearing Before the H. Comm. on Oversight and Government Reform*, 110th Cong. 2 (2008) [hereinafter *Financial Crisis Hearing*] (statement of Dr. Alan Greenspan, former Chairman, Board of Governors, Federal Reserve System).

⁴⁸ See JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV. 2008, *supra* note 43, at 19.

⁴⁹ *Id.* at 20.

reached historic highs in 2008–2009.⁵⁰ As introductory rates expired and consumers suffered from a global economic slowdown, foreclosure became a nation-wide problem of epic proportions. For much of this decade, the highest foreclosure rates existed in the economically distressed states of Ohio, Michigan, Indiana, and Illinois.⁵¹ But in 2008, four other states that had over indulged in risky loan products saw large increases in foreclosures.⁵² Foreclosure rates in California, Arizona, Nevada, and Florida rose from less than 0.9% at the start of 2007 to 5.9% by the end of 2008.⁵³ In the last quarter of 2008, the number of foreclosed loans climbed above “660,000 in these four states alone, accounting for . . . 61 percent of the growth in foreclosures nationwide.”⁵⁴

In conclusion, this Section identified the key players in the mortgage market, and explained how an increasingly liberal legal environment led to a sharp increase in subprime lending and subsequent securitization during the first half of the decade. Critical to this expansion was the causal nexus between the secondary market and the consumer market, making the GSEs major enablers of the ensuing crisis. The next Section will illustrate how the GSEs were key players in causing this market explosion.

⁵⁰ U.S. DEP'T OF HOUS. & URBAN DEV., U.S. HOUSING MARKET CONDITIONS: 2ND QUARTER 4 (2009), *available at* http://www.huduser.org/portal/periodicals/ushmc/winter09/USHMC_Q409.pdf.

The delinquency rate on all mortgage loans in the first quarter of 2009 (the data are reported with a lag) was at its highest level since the series began in 1972, according to the Mortgage Bankers Association. The foreclosure start rate on all mortgages also set a record high after remaining steady since the second quarter of 2008. The delinquency rate for all mortgage loans was 9.12 percent in the first quarter of 2009, up from 7.88 percent in the fourth quarter of 2008 and up from 6.35 percent in the first quarter of 2008. The delinquency rate for subprime mortgage loans was 24.95 percent in the first quarter of 2009, up from 21.88 percent in the fourth quarter of 2008 and up from 18.79 percent in the first quarter of 2008.

Id.

⁵¹ JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., THE STATE OF THE NATION'S HOUSING 2009, at 20 (2009) [hereinafter JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV. 2009], *available at* <http://www.jchs.harvard.edu/son/index.htm>.

⁵² *Id.*

⁵³ *Id.*

⁵⁴ *Id.*

B. *The “Ownership Society”: GSEs as Instruments of National Policy and Political Gain*

In understanding the secondary market's role in subprime lending, one must understand how the GSEs were used as instruments both of federal policy and private gain. Because of the enormous volume of securities issued each year, the GSEs are the most significant players in the RMBS field. Due to their implicit governmental guarantees and historically conservative underwriting standards, investors tend to perform minimal due diligence on GSE securities. But unless the GSEs are reformed, marketplace discipline alone will not protect homeowners, taxpayers, or investors from abuses of the GSEs' enormous power to shape the entire marketplace.

The story begins with the GSEs' unique congressional charters. Although the GSEs are publicly traded firms, they share many attributes of public institutions. For example, each has an obligation to support affordable housing, a large line of credit with the treasury, five board members that the President of the United States can appoint, and, most importantly, debt that can be used to collateralize government deposits in private banks.⁵⁵ This last characteristic has contributed to the perception that GSEs are government instrumentalities, and thus would not be allowed to fail. In other words, the common understanding was that their profits were privatized while their financial risks were socialized.⁵⁶

The GSEs are thus inherently conflicted. Because of their implicit governmental backing, they were not discouraged from taking excessive financial risks.⁵⁷ But they were obligated to produce profits for shareholders. And unlike other government-firms that were immune to market discipline, the GSEs were not closely regulated.

⁵⁵ See generally 12 U.S.C.A. § 1452 (West 2009) (establishing the corporate powers of Freddie Mac); Peter J. Wallison & Charles W. Calomiris, *The Last Trillion-Dollar Commitment: The Destruction of Fannie Mae and Freddie Mac*, FIN. SERVICES OUTLOOK, Sept. 2008, at 3, 5, available at <http://www.aei.org/outlook/28704> (explaining that the GSEs appear to have a “tacit understanding” with Congress whereby the government will give them security if they concentrate on providing affordable housing).

⁵⁶ See Wallison & Calomiris, *supra* note 55, at 5.

⁵⁷ For example, their leverage could, by statute, exceed 100 to 1. See *Fannie Mae and Freddie Mac Hearing*, *supra* note 34, at 147 (statement of James B. Lockhart III, Director, Federal Housing Finance Agency).

The first clear threat to their power came after the savings and loan crisis of the 1980s and 1990s (the "S&L Crisis"), which caused Congress to add an affordable housing mandate to their charters and created a full-time regulator called the Office of Federal Housing Enterprise Oversight.⁵⁸

Despite efforts to regulate them, the GSEs successfully protected their charter powers by increasing influence in Congress. Indeed, especially after the S&L Crisis, the GSEs faced a "political risk" that Congress would alter their charters.⁵⁹ But as Franklin Raines, ex-chairman of Fannie Mae once told his investors, "we manage our political risk with the same intensity that we manage our credit and interest rate risks."⁶⁰

Their method was as simple as it was effective: money. Together, Fannie and Freddie contributed \$14.6 million to various congressional campaigns between 2000 and 2008.⁶¹ The GSEs were "double-givers," supporting members of both parties, especially those sitting on committees with jurisdiction over their industry.⁶²

And when they could not buy allegiance, they instead bought influence. Between 2000 and 2008, both GSEs spent a combined \$165 million lobbying Congress.⁶³ The GSEs used this influence to swiftly crush all proposals that might decrease their profitability. During his thirty years in Congress as a former member and chair of the House Financial Services Committee, Jim Leach experienced the GSEs' power first-hand: "When, for instance, I once introduced a battery of constraining amendments, including a doubling of capital requirements, to legislation favorable to Fannie and Freddie, it took each less than

⁵⁸ See Wallison & Calomiris, *supra* note 55, at 2.

⁵⁹ See Niles Steven Campbell, *Fannie Mae Officials Try To Assuage Worried Investors*, REAL EST. FIN. TODAY, May 10, 1999, at 1, 20.

⁶⁰ *Id.* (internal quotation marks omitted).

⁶¹ See COMMON CAUSE, ASK YOURSELF WHY . . . THEY DIDN'T SEE THIS COMING 7-8 (2008), available at <http://www.commoncause.org/site/pp.asp?c=dkLNK1MQIwG&b=4542875>.

⁶² *Id.* at 8.

⁶³ See *id.* at 7-8. GSE contributions are not always above board. "In 2006, the Federal Elections Commission fined Freddie Mac \$3.8 million for violations of the Federal Election Campaign Act (FECA) when it held 70 campaign fundraisers—raising about \$1.7 million—mostly for members of the House Financial Services Committee." *Id.* at 8.

48 hours to orchestrate both parties' leadership to weigh in against trimming their wings of privilege."⁶⁴

Their methods worked. Until their collapse in 2007, the GSEs were both profitable, distributing billions in dividends each year.⁶⁵

Somewhat ironically, the most serious threat to the GSEs' power and credibility was mostly of their own making. Both experienced multi-billion dollar accounting scandals. "In 2003, Freddie Mac understated billions in profits In 2004, the Securities and Exchange Commission ruled that Fannie Mae had overstated profits by an estimated \$9 billion."⁶⁶

As a consequence of the public's response to the accounting scandals, the GSEs faced a political risk that Congress would find the will to alter their charters and lessen their independence. They therefore needed to use their immense financial power to win the necessary political support and protect their charters. They turned to Affordable Housing.

Affordable housing programs translated into real political benefits for congressmen and the President. President George W. Bush promoted the Ownership Society as an ideal model of society, and home ownership was a central tenet.⁶⁷ And when the GSEs focused their affordable housing programs in a Congressman's or woman's district, he or she could return to his or her district claiming credit for the apparent economic prosperity. These reverse kickbacks allowed the GSEs to win allies in Congress.⁶⁸

No other organization had the power to shape the market like the GSEs. From 1997 through 2003, the GSEs' market share of all residential mortgage originations gradually grew to almost fifty-five percent.⁶⁹ They were exempt from state and local

⁶⁴ *Id.* at 7 (internal quotation marks omitted); *see also* 152 CONG. REC. S5217, (daily ed. May 25, 2006) (statement of Sen. McCain) (discussing how the GSEs used their lobbying power to avoid regulatory scrutiny prior to the accounting scandals of 2003 and 2004).

⁶⁵ *See* Wallison & Calomiris, *supra* note 55, at 5.

⁶⁶ COMMON CAUSE, *supra* note 61, at 7.

⁶⁷ *See* Office of the Press Secretary, Fact Sheet: America's Ownership Society: Expanding Opportunities (Aug. 9, 2004), <http://georgewbush-whitehouse.archives.gov/news/releases/2004/08/20040809-9.html>.

⁶⁸ *See* Pinto, *supra* note 31, at 142.

⁶⁹ James B. Lockhart III, Dir., Fed. Hous. Fin. Agency, Speech Before the National Association of Real Estate Editors: The Roles of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks in Stabilizing the Mortgage Market 1 (June 18,

taxes.⁷⁰ And because they could borrow money more cheaply than other investors, they received a federal subsidy of an estimated \$6.5 billion.⁷¹

The President had, to some extent, the power to control the GSEs. Since the early 1990s, Congress had given HUD the power to set affordable housing goals for the GSEs, requiring them to purchase a certain amount of "affordable" loans.⁷² Although an affordable loan is not necessarily a subprime loan, the GSEs had allowed underwriting standards to deteriorate to compete with private label securities. For example, in 1998, Fannie began buying ninety-seven percent loan-to value ("LTV") mortgages, and in 2001, one-hundred percent LTV mortgages.⁷³ After the scandals of 2003 and 2004, Fannie and Freddie were in a perfect position to ramp up their affordable lending programs.

In response to policies of both the Clinton and Bush administration's desires to increase the level of home ownership, HUD imposed aggressive affordable housing goals. Between 2000 and 2007, HUD increased the GSEs' affordable housing goals from forty-two percent to fifty-five percent.⁷⁴ Acting in the name of affordable housing, the GSEs began purchasing subprime loans in earnest in 2005. Fannie and Freddie both reported that "mortgages with subprime characteristics comprised substantial percentages of all 2005–2007 mortgages

2009), available at [http://www.fhfa.gov/webfiles/2919/Lockhart percent20Speech percent20to percent20National percent20Association percent20of percent20Real percent20Estate percent20Editors-06-18-09.pdf](http://www.fhfa.gov/webfiles/2919/Lockhart%20Speech%20to%20National%20Association%20of%20Real%20Estate%20Editors-06-18-09.pdf).

⁷⁰ See 12 U.S.C.A. § 1452(e) (West 2009) (exempting Freddie Mac from federal, state, and local income taxes); Carol D. Leonnig, *How HUD Mortgage Policy Fed the Crisis; Subprime Loans Labeled 'Affordable,'* WASH. POST, June 10, 2008, at A1.

⁷¹ Leonnig, *supra* note 70.

⁷² Federal Housing Enterprises Financial Safety and Soundness Act of 1992, Pub. L. 102-550, § 1333, 106 Stat. 3672, 3958 (1992). The Act allowed HUD to set affordable housing goals for the GSEs, essentially requiring them to purchase certain amounts of "affordable" loans. *Id.* Not all affordable loans are subprime, however.

⁷³ See Wallison & Calomiris, *supra* note 55, at 6. It should be noted here that the GSEs were only prohibited by statute from buying loans above a certain amount. See 12 U.S.C. § 1454(a)(2) (2006); *id.* § 1717(b). They were never required to buy loans conforming to any particular credit quality. See 12 U.S.C. § 1454(a)(1); 12 U.S.C.A. § 1719(a)(1) (West 2010). However, to purchase loans with a LTV ratio greater than eighty percent, due to restrictions in their charters, they had to rely on external credit enhancement. See 12 U.S.C. § 1454(a)(2); *id.* § 1717(b)(5)(C).

⁷⁴ See U.S. DEP'T OF HOUS. & URBAN DEV., OVERVIEW OF THE GSEs' HOUSING GOAL PERFORMANCE, 2000–2007, at 4 tbl.1 (2008) [hereinafter OVERVIEW], available at <http://www.huduser.org/portal/datasets/GSE/gse2007.pdf>.

the compan[ies] acquired.”⁷⁵ They bought no-documentation loans, interest-only loans, negative amortization ARMs, loans with LTVs exceeding ninety percent, loans with FICO scores below 620, and Alt-A loans.⁷⁶ In 2006, for example, nearly thirty percent of certain affordable loans purchased by the GSEs had a LTV ratio of ninety-five percent or greater.⁷⁷ And they bought them in great quantities. In 2005, the GSEs financed 7.4 million units of housing through their affordable housing programs, and 6.6 million in 2006.⁷⁸ As of 2008, Fannie and Freddie held or guaranteed just over \$1 trillion in subprime debt.⁷⁹

Fannie and Freddie also enabled other major players in the financial world to become involved in the subprime market. In 2004, GSE executives made it known to the mortgage industry that they would aggressively pursue subprime lending, thereby encouraging originators to focus on such loans.⁸⁰ Former Fannie Mae Chairman and CEO Franklin Raines declared to “a packed house” at the Mortgage Bankers Association’s 2004 Annual Convention, “We have to push products and opportunities to people who have lesser credit quality.”⁸¹ At the same conference, Richard Syron, former CEO of Freddie Mac, noted that Freddie’s philosophy had changed, and only a small group of leaders would determine the amount of risk the company was willing to take.⁸² Syron also noted that he would encourage lenders to make loans “with lower down payments and credit scores.”⁸³

Raines and Syron delivered on their promises. The GSEs became the largest purchasers of private-label subprime securities (“PLS”), investing more than \$400 billion in subprime-backed securities.⁸⁴ Overall, banks issued PLS in greater

⁷⁵ Wallison & Calomiris, *supra* note 55, at 7.

⁷⁶ *Id.*

⁷⁷ See U.S. DEPT OF HOUS. & URBAN DEV., PROFILES OF GSE MORTGAGE PURCHASES IN 2005–2007, at 30 tbl.7d-2006 (2008), available at http://www.huduser.org/portal/datasets/GSE/profiles_05-07.pdf.

⁷⁸ *Id.* at 14 tbl.4-2005, 15 tbl.4-2006.

⁷⁹ See Wallison & Calomiris, *supra* note 55, at 1. Between 2005 and 2007, “[r]oughly 33 percent of the companies’ business involved buying or guaranteeing these risky mortgages, compared with 14 percent in 2005.” Zachary A. Goldfarb, *Affordable-Housing Goals Scaled Back*, WASH. POST, Sept. 24, 2008, at A11.

⁸⁰ See Pinto, *supra* note 31, at 149.

⁸¹ Neil J. Morse, *Looking for New Customers*, MORTGAGE BANKING, Dec. 1, 2004, at 109.

⁸² See *id.*

⁸³ *Id.*

⁸⁴ See COMMON CAUSE, *supra* note 61, at 8.

quantities than the GSEs.⁸⁵ But because HUD allowed these securities to count towards their subprime lending goals, the GSEs could purchase certain tranches from other financial institutions.⁸⁶ This was favorable to the GSEs, who had experienced a decrease in their market share after the 2003 and 2004 accounting scandals and because of an increase in PLS issuance.⁸⁷ Between 2004 and 2006, Fannie and Freddie purchased \$434 billion in subprime-backed securities, roughly twenty-five percent of all PLS issued by other financial institutions.⁸⁸ Fannie and Freddie encouraged the growth of this market not only by purchasing the securities, but also by lending it an aura of credibility, thereby encouraging other institutional investors to participate.⁸⁹

Ultimately, these investments performed poorly and were disastrous for the GSEs. As Freddie recently reported: "At December 31, 2008 and 2007, our net unrealized losses on mortgage-related securities were \$38.2 billion and \$10.1 billion, respectively."⁹⁰

Fannie and Freddie's abuse of affordable housing programs caused the most damage in the communities most in need of their responsible administration. "Poor neighborhoods and often African-American and Latino neighborhoods have seen the highest incidence of subprime loans and housing foreclosures."⁹¹ Lower-income and minority home buyers were defaulting at a rate at least three times higher than other borrowers.⁹² The industry was rife with sharp practices that made matters worse.

⁸⁵ See *Fannie Mae and Freddie Mac Hearing*, *supra* note 34, at 146 (statement of James B. Lockhart III, Director, Federal Housing Finance Agency) ("Issuance of private-label subprime securities surged beginning in 2004, when 46 percent of all single-family mortgage-backed security issued were PLS. The PLS share peaked at 56 percent in 2006, but fell to 4 percent in 2008.")

⁸⁶ See *id.* at 147 ("To maintain profitability of the retained portfolios and to meet HUD-designated affordable housing goals, each Enterprise increased purchases of PLS backed by alternative mortgages and of high-risk whole loans.")

⁸⁷ See *id.* at 146-47.

⁸⁸ See JAMES LARDNER, BEYOND THE MORTGAGE MELTDOWN: ADDRESSING THE CURRENT CRISIS, AVOIDING A FUTURE CATASTROPHE 10 (2008), *available at* http://www.demos.org/pubs/housingpaper_6_24_08.pdf; Kathleen Day, *Villains in the Mortgage Mess? Start at Wall Street. Keep Going.*, WASH. POST, June 1, 2008, at B1.

⁸⁹ See LARDNER, *supra* note 88, at 10.

⁹⁰ Fed. Home Loan Mortgage Corp., Annual Report (Form 10-K), at 6 (Mar. 11, 2009).

⁹¹ COMMON CAUSE, *supra* note 61, at 3.

⁹² See Leonnig, *supra* note 70, at A1.

For example, by the end of the subprime bubble, more than half of all subprime loans were going to people with credit scores that could have qualified them for traditional mortgages.⁹³

Fannie and Freddie took a leading role in the subprime crisis that crippled the global economy. "What happens to mortgage credit now rests in the hands of the federal government."⁹⁴ As Congress formulates new policy and legislation to deal with the subprime lending crisis, it must look to the future. It cannot overlook the GSEs' role in subprime lending.

III. CURRENT GOVERNING LAW AND CRITIQUE

This Part provides a summary and a critique of the legal status quo governing the GSEs. Section A discusses the most fundamental piece of legislation affecting the GSEs: their unique congressional charters. Then, it describes Congress's latest efforts at regulating the GSEs with the Housing and Economic Recovery Act of 2008.⁹⁵ Section B discusses the authority of the regulator for the GSEs: the FHFA.

Section C critiques the current regime. Current law can be described as Congress's attempt to balance at least two competing and sometimes opposed concerns. One concern is ensuring the financial safety of the GSEs by requiring safe financial practices. The other is an attempt to effectuate the longstanding federal policy of attaining high levels of home ownership by using the GSEs to increase homeownership among low-income borrowers. The Section argues that, although the GSEs should retain much of their unique public/private nature, the current law does too little to address the moral hazards inherent in that structure. This hazard led to a primary cause of the subprime crisis: abuse of the GSEs affordable housing mission.

First, the Part argues that the affordable housing mission is vaguely defined and subject to abuse. Second, it contends that an essential part of controlling the GSEs' behavior is limiting or

⁹³ See Rick Brooks & Ruth Simon, *Subprime Debacle Traps Even Very Credit-Worthy*, WALL ST. J., Dec. 3, 2007, at A1.

⁹⁴ JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV. 2009, *supra* note 51, at 2.

⁹⁵ Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, 122 Stat. 2654.

curtailing their awesome lobbying power, which the current law fails to do.⁹⁶

A. *The GSEs' Core Legislation: The Charters*

Congress created the GSEs and outlined their key powers through unique corporate charters.⁹⁷ The original charters have each been amended several times over the years, but the most comprehensive version of each charter has been codified to title 12 of the United States Code. Although not enacted into law, title 12 of the United States Code does incorporate all of Congress's most recent amendments to the charters, as well as the most current law concerning the regulator: the FHFA.

Fannie and Freddie's charters are, in all essential respects, identical. The charters grant the two GSEs virtually identical organizational structures, corporate powers to buy and sell mortgages, and corporate powers to issue securities.⁹⁸ For convenience, this Section will refer to Freddie Mac's charter, but will note the places where Fannie Mae's charter differs in significant respects.

1. Basic Purpose

The purpose of the corporation is laid out in the beginning of Fannie Mae's charter.⁹⁹ There, Congress declared that the purpose of the Act was "to establish secondary market facilities for residential mortgages, [and] to provide that the operations thereof shall be financed by private capital to the maximum

⁹⁶ Pursuant to its broad powers as conservator, the FHFA stopped all of the GSEs' lobbying after initiating the conservatorship. *See Fannie Mae and Freddie Mac Hearing, supra* note 34, at 142 (statement of James B. Lockhart III, Director, Federal Housing Finance Agency). However, once the conservatorship ends, nothing in current law would prohibit them from resuming their lobbying or campaign contributions.

⁹⁷ Congress created Freddie Mac with the Federal Home Loan Mortgage Corporation Act, Pub. L. No. 91-351, 84 Stat. 451 (1970) (codified as amended at 12 U.S.C.A. § 1452 (West 2009)). Congress created the current version of Fannie Mae with the Federal National Mortgage Association Charter Act, ch. 847, 48 Stat. 1252 (1934) (codified as amended at 12 U.S.C. § 1716 (2006)).

⁹⁸ For convenience, this section will refer to Freddie Mac's charter, but will note the places where Fannie Mae's charter differs in significant respects.

⁹⁹ 12 U.S.C. § 1716. Freddie's charter contains nearly identical language. *See* 12 U.S.C. § 1451 (2006).

extent feasible.”¹⁰⁰ To that end, Congress required the GSEs to meet five goals. They are to

(1) provide stability in the secondary market for residential mortgages; (2) respond appropriately to the private capital market; (3) provide ongoing assistance to the secondary market for residential mortgages . . . by increasing the liquidity of mortgage investments and improving the distribution of investment capital available . . . [;] (4) promote access to mortgage credit throughout the Nation . . . by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing; and (5) manage and liquidate federally owned mortgage portfolios in an orderly manner.¹⁰¹

2. Basic Organization

Freddie is a government-sponsored enterprise, created as “a body corporate under the direction of a Board of Directors.”¹⁰² The board consists of thirteen directors, and has, at all times,

at least 1 person from the homebuilding industry, at least 1 person from the mortgage lending industry, at least 1 person from the real estate industry, and at least 1 person from an organization that has represented consumer or community interests for not less than 2 years or 1 person who has demonstrated a career commitment to the provision of housing for low-income households.¹⁰³

Board members serve for one-year terms and cannot receive compensation for their services if they are employees of the federal government.¹⁰⁴

Freddie has common stock, each share of which is entitled to one vote.¹⁰⁵ Although Freddie cannot restrict the transferability of these shares, it can place “limitations on concentration of ownership” of common shares as it sees fit,¹⁰⁶ presumably to ensure diffused ownership and prevent takeovers. Freddie may

¹⁰⁰ 12 U.S.C. § 1716.

¹⁰¹ *Id.*

¹⁰² 12 U.S.C.A. § 1452(a)(1) (West 2009).

¹⁰³ *Id.* § 1452(a)(2)(A).

¹⁰⁴ *Id.* § 1452(a)(2)(A), (D).

¹⁰⁵ *See* 12 U.S.C. § 1453 (2006).

¹⁰⁶ *Id.* § 1453(a).

also have preferred stock, the terms being set by the board of directors, but preferred shares have no voting rights.¹⁰⁷

The charter gives Freddie many ordinary corporate powers. For example, it enjoys perpetual succession until dissolved by an act of Congress, can make contracts and release claims, sue and be sued, and can determine its necessary expenses, including the salaries of its employees.¹⁰⁸ However, "a significant portion of potential compensation of all executive officers . . . shall be based on the performance of the Corporation."¹⁰⁹

The GSEs are headquartered in Washington, D.C., and are exempt from federal, state, and local taxes.¹¹⁰

3. Secondary Market Activities

The most important aspect of the charters enables the GSEs to operate in the secondary market with considerable flexibility, autonomy, and discretion. The charter accomplishes this by authorizing Freddie to purchase certain mortgages and then to issue securities backed by those mortgages, as well as other kinds of debt instruments.

Freddie is authorized "to purchase, and make commitments to purchase, residential mortgages."¹¹¹ The statute defines the term "residential mortgage" much more broadly than it is conventionally used. For example, the term includes real property containing structures consisting of "one or more condominium units."¹¹² It also includes loans secured by mobile homes, loans used to renovate residential properties, refinance loans, and second lien loans.¹¹³ Freddie is not authorized to originate mortgages.

¹⁰⁷ See *id.* § 1455(f). Dividend payments on all common and preferred stock have been suspended during the conservatorship. FED. HOUS. FIN. AGENCY, STRATEGIC PLAN 2009–2014, at 21 (2009), available at http://www.fhfa.gov/webfiles/14476/FHFA_StrategicPlan_2009-2014n.pdf.

¹⁰⁸ See 12 U.S.C.A. § 1452(c).

¹⁰⁹ *Id.* § 1452(c)(9). Executive compensation is subject to some limitations. The GSEs must submit a report to Congress on "the comparability of the compensation policies of the Corporation with the compensation policies of other similar businesses." *Id.* § 1452(h)(1)(A). Essentially, this provision guarantees that so long as GSE executives earn no more than executives at other extremely large financial firms, then Congress will not take issue with their compensation.

¹¹⁰ *Id.* § 1452(a)(1), (e).

¹¹¹ 12 U.S.C. § 1454(a)(1) (2006).

¹¹² *Id.* § 1451(h).

¹¹³ See *id.*

The statute confines Freddie's activities to residential mortgages, which "are deemed by" Freddie to "meet generally the purchase standards imposed by private institutional mortgage investors."¹¹⁴ The statute authorizes Freddie to classify mortgage sellers based on various financial characteristics to "establish requirements, and impose charges or fees, which may be regarded as elements of pricing."¹¹⁵ In other words, Freddie need not treat all sellers equally, nor must it make all programs available to all sellers, so long as its classifications and discriminations "bear a rational relationship to the purposes or provisions of [the statute]."¹¹⁶ This language is absent from Fannie's charter.

The statute imposes few restrictions on the kinds of mortgages Freddie can buy. Freddie cannot buy a mortgage with a LTV ratio greater than eighty percent, unless one of three conditions is met.¹¹⁷ Two conditions apply to the seller. The seller can retain at least ten percent of the mortgage, or the seller can agree to repurchase the mortgage in the event of default.¹¹⁸ In the alternative, Freddie can obtain a guarantee or insurance on the amount of principal in excess of eighty percent of the value of the collateral from "a qualified insurer *as determined by the Corporation*."¹¹⁹ This provision is of enormous importance because it allows Freddie great flexibility in purchasing external credit enhancements such as credit derivative swaps. This provision enabled the GSEs to purchase subprime loans.

The statute's most concrete limitations are on the size of loans that Freddie may purchase.¹²⁰ The limitations apply to both first and second lien mortgages but allow some flexibility for high-priced markets, as well as for Alaska, Hawaii, and the Virgin Islands.¹²¹ Each year, the limitations are adjusted by

¹¹⁴ *Id.* § 1454(a)(1).

¹¹⁵ *Id.*

¹¹⁶ *Id.*

¹¹⁷ *Id.* § 1454(a)(2).

¹¹⁸ *Id.*

¹¹⁹ *Id.* (emphasis added).

¹²⁰ *See id.* ("Such limitations shall not exceed \$417,000 for a mortgage secured by a single-family residence, \$533,850 for a mortgage secured by a two family residence, \$645,300 for a mortgage secured by a three family residence, and \$801,950 for a mortgage secured by a four family residence.").

¹²¹ *See id.*

FHFA.¹²² Freddie is authorized to lend against the mortgages it holds, provided that “the lending activities shall be conducted on such terms as will reasonably prevent excessive use of the Corporation’s facilities.”¹²³

The statute also authorizes Freddie to sell mortgages with or without recourse. Freddie may sell mortgages according to “terms and conditions relating to resale, repurchase, guaranty, substitution, replacement, or otherwise,” which Freddie prescribes.¹²⁴

Most importantly, Freddie may issue debt instruments and mortgage-backed securities.¹²⁵ These securities are exempt from regulation under the securities laws.¹²⁶ However, Freddie may not guarantee any RMBS unless it has first purchased the underlying mortgage.¹²⁷ The statute requires Freddie to indicate that the securities “are not guaranteed by the United States and do not constitute a debt or obligation of the United States.”¹²⁸ However, the statute does provide that the securities “may be accepted as security for all fiduciary, trust, and public funds, the investment or deposits of which shall be under the authority and control of the United States or any officers thereof.”¹²⁹ The statute gives the Secretary of the Treasury ordinary authority to purchase up to \$2.25 billion worth of debt or securities from Freddie.¹³⁰ The statute also requires the Secretary of the Treasury to approve any new loan programs.¹³¹

4. Oversight and Reporting

The charter itself imposes some obligations on Freddie that increase its transparency and that help Congress ascertain whether Freddie is fulfilling its mission. The statute authorizes the Comptroller General to audit Freddie under “such rules and

¹²² *See id.*

¹²³ *See id.* § 1454(a)(5).

¹²⁴ *Id.* § 1454(a)(3).

¹²⁵ *See id.* § 1455(a).

¹²⁶ *Id.* § 1455(g).

¹²⁷ *Id.* § 1455(h)(1).

¹²⁸ *Id.* § 1455(h)(2). This provision has done little to prevent the common perception that obligations and securities are, in reality, guaranteed by the United States. *See* Richard Scott Carnell, *Handling the Failure of a Government-Sponsored Enterprise*, 80 WASH. L. REV. 565, 583–85 (2005).

¹²⁹ 12 U.S.C.A. § 1452(g) (West 2009).

¹³⁰ *See* 12 U.S.C. § 1455(c) (2006).

¹³¹ *Id.* § 1454(c).

regulations” as he or she may prescribe.¹³² The statute grants the Comptroller full access to Freddie’s books and records.¹³³ It also requires a private audit annually.¹³⁴ Freddie must also submit to the FHFA annual and quarterly reports on its financial condition.¹³⁵

The statute imposes a duty on Freddie to maintain extensive amounts of data relating to its one- to four-family home mortgage portfolios, including such information as “the income, census tract location, race, and gender of mortgagors,” the LTV ratio, and whether the mortgage is new or seasoned.¹³⁶ Freddie must also prepare extensive reports for both the House and Senate on all of its activities.¹³⁷ These reports must be disclosed to the public.¹³⁸

In sum, Fannie and Freddie exhibit many typical corporate characteristics. They have perpetual succession, are governed by a board of thirteen directors, have both common and preferred stock, and possess the same legal capacity to contract and sue as any other corporation. Their corporate powers are specific and are limited to purchasing and securitizing certain residential mortgages. But they also enjoy special privileges, such as an exclusion from state, federal, and local taxes. Interestingly, the GSEs’ commitment to affordable housing is not evident from their charters alone. The charters provide only for an affordable housing advisory council to “advise the Corporation regarding possible methods for promoting affordable housing for low- and moderate-income families.”¹³⁹ The true scope of the affordable housing mission only becomes apparent after a close analysis of the legislation that created and governs the FHFA.

B. *The Regulator*

Congress recently overhauled the GSEs’ regulatory scheme with the passage of the Housing and Economic Recovery Act of 2008.¹⁴⁰ The most significant change affecting the GSEs was the

¹³² 12 U.S.C.A. § 1456(b)(1) (West 2009).

¹³³ *See id.* § 1456(b)(2).

¹³⁴ *See id.* § 1456(d).

¹³⁵ *Id.* § 1456(c).

¹³⁶ *Id.* § 1456(e)(1).

¹³⁷ *See id.* § 1456(f).

¹³⁸ *Id.*

¹³⁹ *Id.* § 1456(g)(1).

¹⁴⁰ Pub. L. 110-289, 122 Stat. 2654 (2008).

creation of the FHFA, an independent agency tasked with oversight of the GSEs and the twelve Federal Home Loan Banks (the "Banks"). If the charters created any ambiguity about the GSEs' duty to participate in affordable housing, the Act clarifies the intent of Congress. The findings show that the GSEs "have an affirmative obligation to facilitate the financing of affordable housing . . . in a manner consistent with their overall public purposes, while maintaining a strong financial condition and a reasonable economic return."¹⁴¹ Congress also seems to recognize, however, that an affordable housing mission is susceptible to abuse, and found that "an entity regulating the [GSEs] should have sufficient autonomy from the enterprises and special interest groups."¹⁴² To that end, Congress created a highly independent agency with considerable authority over the GSEs.

1. The Agency and the Director

FHFA is "an independent agency of the Federal Government,"¹⁴³ with regulatory authority over the GSEs and the Banks. Unlike the previous regulator, FHFA is not situated within any other executive department. Rather, the agency is independent and is fully funded by the GSEs and the Banks, rather than by Congressional appropriations.¹⁴⁴ Although HERA created a Federal Housing Finance Oversight Board, it has no real authority; it instead acts in a purely advisory role to FHFA's director.¹⁴⁵

Virtually all of the agency's power is vested in its director. The director is appointed for five year terms by the President, acting with the advice and consent of the Senate, and must "have a demonstrated understanding of financial management or oversight, and have a demonstrated understanding of capital markets, including the mortgage securities markets and housing finance."¹⁴⁶ In an effort to increase the director's independence,

¹⁴¹ 12 U.S.C. § 4501(7) (2006).

¹⁴² *Id.* § 4501(5).

¹⁴³ 12 U.S.C.A. § 4511(a) (West 2009).

¹⁴⁴ *See id.* § 4516(a). The previous regulator was also funded by the GSEs. *See Omnibus Consolidated Rescissions and Appropriations Act of 1996*, Pub. L. No. 104-134, § 211, 110 Stat. 1321, 1321-288 (providing that the GSEs would fund the regulator).

¹⁴⁵ *See* 12 U.S.C.A. § 4513a(a) (West 2009).

¹⁴⁶ *Id.* § 4512(b)(1), (2).

HERA provides that the director can only be removed by the President “for cause.”¹⁴⁷ Previously, there were no restrictions on the President’s removal powers.¹⁴⁸ The director may not have any financial interest in the GSEs, hold any position of office in a GSE, or have served as an executive officer or director of a GSE for three years prior to his or her appointment as director of the FHFA.¹⁴⁹

2. The Director’s Duties and Powers

The director is given considerable power over the GSEs. In the most general sense, the director must ensure that each GSE “operates in a safe and sound manner, including maintenance of adequate capital and internal controls.”¹⁵⁰ The director must also ensure that the GSEs’ activities “foster liquid, efficient, competitive, and resilient national housing finance markets,”¹⁵¹ and that the GSEs comply with applicable law.¹⁵² The director is authorized to review and “reject any acquisition or transfer of a controlling interest in a” GSE.¹⁵³

On a more specific level, the Act gives the director power over more particular aspects of the GSEs’ operation. For example, the director has broad authority to establish standards relating to the adequacy of internal controls and information systems, management of interest rate and credit risks, management of asset growth, and even the size of investments and acquisitions of assets “to ensure that they are consistent with the purposes of this chapter and the authorizing statutes.”¹⁵⁴

Some of the director’s most important powers concern his or her ability to regulate the GSEs’ capital levels. The director has the authority to establish “risk-based capital requirements for the enterprises to ensure that the enterprises operate in a safe and sound manner, maintaining sufficient capital and reserves to support the risks that arise in the operations and management of

¹⁴⁷ See *id.* § 4512(b)(2).

¹⁴⁸ See Housing and Community Development Act of 1992, Pub. L. No. 102-550, § 1312, 106 Stat. 3672, 3945.

¹⁴⁹ See 12 U.S.C.A. § 4512(g).

¹⁵⁰ *Id.* § 4513(a)(1)(B)(i).

¹⁵¹ *Id.* § 4513(a)(1)(B)(ii).

¹⁵² See *id.* § 4513(a)(1)(B)(iii), (iv).

¹⁵³ *Id.* § 4513(a)(2)(A).

¹⁵⁴ *Id.* § 4513b(a).

the enterprises.”¹⁵⁵ This represents a considerable increase in the director’s authority. Previously, the director only had authority to apply a Risk Based Capital Test that determined the GSEs’ appropriate levels of capitalization.¹⁵⁶

In addition to the director’s discretionary power, the Act also imposes minimum capital levels. The statute requires that the GSEs keep minimum capital levels equal to the sum of 2.5% of on-balance sheet assets, plus 0.45% of the unpaid principal balance of outstanding mortgage-backed securities, plus 0.45% of other off-balance sheet obligations.¹⁵⁷ Thus, for every \$100 worth of outstanding securities the GSEs issue or guarantee, they must keep 45¢ in cash on hand. Of course, the director can impose higher capital levels, and the statute provides an extensive scheme of controls designed to ensure that the GSEs comply with such rules.¹⁵⁸

The director has the obligation to approve all new GSE products and programs.¹⁵⁹ To gain approval, the products or programs must be both “consistent with the safety and soundness of the enterprise or the mortgage finance system” and in the “public interest.”¹⁶⁰ The director must receive public comments on new products and programs according to the Administrative Procedure Act.¹⁶¹

The Act imposes other duties on the director as well. The director must require regular reports from the GSEs on their operations,¹⁶² as well as make regular reports to Congress concerning the GSEs’ housing goals.¹⁶³ The Act imposes sanctions if a GSE misstates information in an annual or special report required to be made to the director. The penalties imposed by the Act are \$2,000 for negligent errors, \$20,000 per day for each day a known negligent mistake is not corrected, and

¹⁵⁵ *Id.* § 4611(a)(1).

¹⁵⁶ *See* Housing and Community Development Act of 1992, Pub. L. No. 102-550, § 1361(a), 106 Stat. 3672, 3941.

¹⁵⁷ 12 U.S.C.A. § 4612(a).

¹⁵⁸ *See, e.g., id.* § 4615 (enumerating actions the director may take with respect to undercapitalized enterprises).

¹⁵⁹ *See id.* § 4541(a).

¹⁶⁰ *Id.* § 4541(b).

¹⁶¹ *See id.* § 4541(c)(2).

¹⁶² *Id.* § 4541(a)(1).

¹⁶³ *Id.* § 4544(a).

\$1,000,000 per day for when the GSE acted “knowingly or with reckless disregard” for the accuracy of the report.¹⁶⁴

3. The Housing Goals

The most important part of HERA gives the director of FHFA complete discretion in setting the GSEs' housing goals. These regulations are promulgated in accordance with the informal rulemaking procedure of the Administrative Procedure Act,¹⁶⁵ a procedure that gives the director considerable discretion. The Act requires the director to set housing goals for several categories of housing, including single- to four-family homes, multi-family housing, and low- and very low-income housing.¹⁶⁶ A GSE may petition the director to reduce these goals, but the director may only reduce the goals if the “market and economic conditions or the financial condition of the enterprise require such action” or if efforts to meet the goal “would result in the constraint of liquidity, over-investment in certain market segments, or other consequences contrary to the intent of this [Act].”¹⁶⁷

The Act imposes a duty to make loans in support of affordable housing. The Act does not define “affordable housing” or “underserved markets.” Rather, it contemplates housing goals in terms of the relative income of borrowers targeted by a particular program. An “affordable loan” is, strictly speaking, simply one made to a borrower who earns at or below the median income for his or her area.¹⁶⁸ The Act is silent about particular credit characteristics of borrowers. Rather, it gives the GSEs considerable flexibility in engineering underwriting standards to meet housing goals. The director is required to set goals for low- and very-low-income families, which are to be expressed as a percentage of total mortgages purchased by the GSEs.¹⁶⁹

¹⁶⁴ *Id.* § 4514(c)(2).

¹⁶⁵ 5 U.S.C. §§ 551–59, 701–06 (2006).

¹⁶⁶ 12 U.S.C.A. § 4562 (West 2009).

¹⁶⁷ *Id.* § 4564(b).

¹⁶⁸ A “moderate income” borrower earns less than the median income. *See id.* § 4502(16). A “low-income” borrower earns less than eighty percent of the median income. *See id.* § 4502(14). A “very low-income” borrower earns less than fifty percent of the median income. *See id.* § 4502(24). And an “extremely low-income” borrower earns less than thirty percent of the median income. *See id.* § 4502(27).

¹⁶⁹ *See id.* § 4562.

In some instances, the Act specifically calls for “flexible” underwriting standards. For example, to benefit markets for manufactured housing and certain projects subsidized under other federal programs, the Act requires the GSEs to “provide leadership to the market in developing loan products and flexible underwriting guidelines to facilitate a secondary market for mortgages for very low-, low-, and moderate-income families.”¹⁷⁰

The Act also requires the GSEs to engage with other organizations to further the federal policy of homeownership. The GSEs must “design programs and products that facilitate the use of assistance provided by the Federal Government and State and local governments.”¹⁷¹ They must also “develop relationships with nonprofit and for-profit organizations that develop and finance housing and with State and local governments, including housing finance agencies.”¹⁷² Also, they must take “affirmative steps to . . . assist primary lenders to make housing credit available in areas with concentrations of low-income and minority families.”¹⁷³

The director also has considerable power to require the GSEs to comply with these goals. For example, once the director has determined that a GSE will not meet its housing goals, he or she may require that the GSE submit a housing plan detailing how the GSE intends to meet the goal.¹⁷⁴ If the GSE does not comply with this order, the director may impose civil sanctions up to \$50,000 for each day that the failure occurs.¹⁷⁵

The Act gives the director discretion in determining which loans count towards these goals, but this discretion is not unlimited. For example, if the director finds that a particular mortgage was made on terms “contrary to good lending practices, inconsistent with safety and soundness, or unauthorized for purchase by the enterprises,” then it may not be counted towards satisfying the housing goals.¹⁷⁶

In sum, HERA created an independent agency with more power over the GSEs than at any other time in their history.

¹⁷⁰ *Id.* § 4565(a)(1).

¹⁷¹ *Id.* § 4565(b)(1).

¹⁷² *Id.* § 4565(b)(2).

¹⁷³ *Id.* § 4565(b)(3).

¹⁷⁴ This determination is made according to procedures laid out in 12 U.S.C. § 4566.

¹⁷⁵ *Id.* § 4585(a)(4), (b)(2).

¹⁷⁶ *Id.* § 4562(i).

FHFA can control their capital levels, can determine which new products and programs make it to the market, and can exercise complete discretion over their affordable housing goals. The director can require the GSEs to engage with certain underserved markets and has considerable discretion in determining if any goal has been met. He or she can encourage the GSEs to develop “flexible underwriting guidelines” to ensure that the nation’s poorest individuals have access to loans.

C. Critique of the Current Regime

1. The Charter Should Remain Largely Unchanged

The GSEs have, for the most part, accomplished the goals Congress gave them. The United States has one of the most liquid and sophisticated markets for residential mortgages in the world. For decades, global capital has had the opportunity to invest in domestic housing markets, and the GSEs have been among the most innovative creators of RMBS products. Because the board has the ability to create preferred shares on their own terms, and because executive compensation is required to be determined with respect to performance, executives and shareholders have the potential to earn great wealth.

Private ownership has, therefore, encouraged efficiency and innovation in the RMBS marketplace. Because Fannie and Freddie compete with one another in identical markets using nearly identical powers and privileges, consumers are generally protected from abuses. Indeed, the subprime crisis was not, in terms of underwriting standards, a race to the top. Rather, it was a race to the bottom as each GSE tried to gain greater and greater shares of the growing subprime market.

The considerable success of the GSEs in accomplishing their core mission illustrates that the recent crisis was a failure of execution, and not of form. Unfortunately, the perceived GSE structure—privatization of profits and socialization of risk—creates a moral hazard that may lead to excessive risk taking by management.

Nowhere does this moral hazard become more apparent than when one considers the dilemma imposed upon management by the need to keep capital reserves. Cash required to be on hand for capital reserves is not available for disbursement as a dividend. As noted previously, the GSEs hold or guarantee over

\$5 trillion in mortgage debt. Given these enormous numbers, tiny adjustments in required capital reserves can have an enormous impact on the amount of money available for dividends. Management has an incentive to keep capital levels as low as possible to maximize distributions to shareholders. And because the market perceives an implied governmental guarantee of all GSE products and debts, it will not necessarily incentivize management to maintain conservative capital levels. Voluntary efforts at safety will not work. This risk is inherent to their structure and can only be countered by a strong regulator with clearly defined powers and duties.

2. HERA's Strengths and Shortcomings: a Powerful Regulator, a Vague Affordable Housing Mandate, and Unchecked Political Influence

Never before have the GSEs been regulated so strongly. The FHFA is considerably more independent than previous regulators because it is not under the control of HUD. This is of critical importance because HUD—whose core mission is to encourage home ownership—was conflicted in its mission of regulating the largest enabler of mortgage markets in the world. It is, therefore, an improvement that FHFA's director is both appointed and removed by the President and is not under the influence of any other executive department.

Among HERA's many strengths are the sweeping powers it gives the director of FHFA to ensure that the GSEs operate safely. FHFA's powers to regulate capital levels, control the size of mortgage portfolios, approve all new products, and have extensive access to all books and records are likely to prevent much risky behavior by GSE management.

Despite these improvements, HERA suffers from considerable defects. The affordable housing mission is vague. For example, aside from a broad command to ensure that the GSEs operate safely, there is no specific command addressing subprime loans.¹⁷⁷ The Act requires the GSEs to purchase loans made to low-income borrowers, but it does not prohibit loans

¹⁷⁷ The closest the Act comes to speaking directly to subprime loans is in 12 U.S.C. § 4601(a) (2006). This provision requires the GSEs to report to Congress on how underwriting standards impact the affordable housing mission. *See id.* Yet this provision has been in place since 1992 and did nothing to discourage excessive managerial risk taking and poor business practices.

made to borrowers with any particular credit characteristic. Nor does the Act say how many subprime loans in the portfolio are “too many.” It does not prohibit the GSEs from purchasing any particular type of private label RMBS. In some instances, the Act requires the GSEs to develop “flexible underwriting guidelines” to further the affordable housing mission.¹⁷⁸

The Act also gives FHFA’s director complete discretion to set housing goals. Indeed, under HERA there is no reason why the director of FHFA could not authorize an affordable housing program exactly like the ones adopted by the GSEs between 2005 and 2007. Not only does HERA not provide for judicial review of affordable housing goals, but, under the Administrative Procedure Act, no federal court would review a decision that HERA commits to agency discretion by law.¹⁷⁹

HERA also does not address the GSEs’ ability to influence policy and legislation in Congress. The GSEs accomplished this in two primary ways. First, GSEs focus programs in particular districts to curry congressional favor. To perform these so-called “reverse kickbacks” the GSEs make “affordable” loans more available in certain congressional districts than others, thereby fostering the perception of prosperity.¹⁸⁰ Second, GSEs still can influence through lobbying and campaign contributions.

The Act addresses neither reverse kickbacks nor lobbying or contributions. Reverse kickbacks and lobbying have, for many years, made the GSEs somewhat independent from congressional or executive control. But, as recent events have illustrated, the GSEs must remain securely under the thumb of their regulator and Congress. The Act encourages reverse earmarking by requiring the GSEs to “develop relationships with nonprofit and for-profit organizations that develop and finance housing and with State and local governments, including housing finance agencies.”¹⁸¹ This provision could be applied selectively to certain districts in an attempt to curry favor with individual congressmen and women.

In sum, HERA provides many badly needed reforms while failing in other critical areas. Its positive changes include increasing the autonomy of FHFA and its director and giving the

¹⁷⁸ See 12 U.S.C.A. § 4565(a)(1) (West 2009).

¹⁷⁹ See 5 U.S.C. § 701(a) (2006).

¹⁸⁰ See Pinto, *supra* note 31, at 142.

¹⁸¹ 12 U.S.C.A. § 4565(b).

director wide discretion over various aspects of GSE policy and practice. These reforms help counter the moral-hazard inherent to the GSEs unique public/private nature. However, while the Act imposes an affordable housing mission, it fails to clearly describe how that mission is to be executed. Although the Act broadly requires the director to ensure sound business practices, it does not specifically prohibit any risky practice. In this sense, the director's total discretion is a potential liability. Nor does the Act constrain the GSEs' proven ability to buy influence in Congress.

IV. PROPOSED CHANGES

This Part will propose two changes designed to avoid abuse of the GSEs' affordable housing program. First, the GSEs' lobbying and campaign activities should be permanently eliminated. Second, the GSEs' affordable housing mission be clarified in three ways. The federal government should offer an explicit guarantee on "core" securities. Congress should amend HERA to prohibit GSEs from purchasing private label RMBS. Finally, HERA should be amended to place a cap on the amount of affordable mortgages that the GSEs can purchase, thereby limiting the director's discretion in setting affordable housing goals.

A. *GSE Lobbying Should Be Curtailed*

The GSEs have a well documented history of abusing their lobbying power in Congress. Some of this criticism comes directly from legislators themselves.¹⁸² Some criticism comes from academics,¹⁸³ while other criticism comes from the press,¹⁸⁴

¹⁸² See, e.g., 152 CONG. REC. S5217 (2006) (statement of Sen. McCain) (discussing how the GSEs used their lobbying power to avoid regulatory scrutiny prior to the accounting scandals of 2003 and 2004); JAMES A. LEACH, *FIXING FANNIE AND FREDDIE* (2008), available at http://www.iop.harvard.edu/var/ezp_site/storage/fckeditor/file/Fannie%20and%20Freddie.pdf (noting that GSE lobbying resulted in "an eight-fold growth in mortgages owned by these two GSEs in less than two decades").

¹⁸³ See, e.g., Chad D. Emerson, *A Troubled House of Cards: Examining How the Housing and Economic Recovery Act of 2008 Fails To Resolve the Foreclosure Crisis*, 61 OKLA. L. REV. 561, 582 (2008) (criticizing HERA for allowing the GSEs to continue their lobbying activities).

¹⁸⁴ See, e.g., David D. Kirkpatrick & Charles Duhigg, *Loan Titans Paid McCain Adviser Nearly \$2 Million*, N.Y. TIMES, Sept. 22, 2008, at A16; Gretchen Morgenson, *The Fannie and Freddie Fallout*, N.Y. TIMES, July 13, 2008, at BU1.

think tanks,¹⁸⁵ and former executives.¹⁸⁶ Indeed, even former FHFA director James Lockhart has recognized the lobbying temptations faced by GSE management, given the moral hazard in which they operate.¹⁸⁷ Although HERA makes considerable changes to the overall regulatory structure, nothing in the Act controls the GSEs' lobbying power. Accordingly, the following changes should be made.

First, the GSEs themselves should be prohibited from lobbying the executive or legislative branches of the Federal government. Although it appears this change has not been proposed directly, it is implicit in all criticism of the GSEs. This change will have the likely effect of helping to neutralize the moral hazard inherent in the GSE structure. By eliminating excessive input to the executive and legislative branches of government, the GSEs can be regulated more objectively. Second, it is not enough to prohibit only the GSEs themselves from lobbying Congress or the FHFA. The shareholders themselves should also be prohibited from lobbying. This is especially true for large or preferred shareholders. Finally, the GSEs should not be allowed to contribute to congressional or presidential campaigns.

Indeed, this exact suggestion has already been tried.¹⁸⁸ Since the initiation of the conservatorship, FHFA has stopped GSE lobbying activity on a temporary basis with positive results. Consequently, FHFA has made several significant changes that may not have been possible had the GSEs been able to lobby strongly. For example, FHFA appointed new CEOs and boards of directors to both GSEs, while also developing a compensation structure designed to benefit productive employees while not rewarding poor performance.¹⁸⁹ FHFA has also been able to focus

¹⁸⁵ See, e.g., Wallison & Calomiris, *supra* note 55, at 3–4 (describing the uncontrollable nature of GSE lobbying activity); Arnold Kling, *Freddie Mac and Fannie Mae: An Exit Strategy for the Taxpayer*, CATO BRIEFING PAPERS NO. 106, 4 (2008), available at <http://www.cato.org/pubs/bp/bp106.pdf> (describing how GSE lobbying prevented regulators from responding to risky behavior).

¹⁸⁶ Pinto, *supra* note 31, at 138, 142–43, 148.

¹⁸⁷ See *Fannie Mae and Freddie Mac Hearing*, *supra* note 34, at 151–53 (statement of James B. Lockhart III, Director, Federal Housing Finance Agency).

¹⁸⁸ See *id.* at 142.

¹⁸⁹ See *id.* at 143.

the GSEs on foreclosure prevention programs.¹⁹⁰ FHFA has also set new affordable housing goals.¹⁹¹

Sanctions for violations of the restrictions should mirror the scheme set out in HERA for misstatements on the GSEs' reports to Congress.¹⁹² The Act should impose a penalty of \$1,000,000 for each intentional violation committed "knowingly or with reckless disregard" of the law, and \$500,000 for each negligent violation of the law.

In sum, Congress should amend HERA to require FHFA to prohibit all lobbying by the GSEs and by large shareholders. The massive coercive power of the GSE lobbying machine is well documented by legislators, academics, think tanks, and the press. GSE management, operating under a complex moral hazard, should not be tempted to repeat the mistakes of the past. The likely effects of this change would be to allow the GSEs' regulator to ensure that they operate responsibly. Indeed, much has already been proven; FHFA has already demonstrated the positive results that come from a prohibition on GSE lobbying.

B. The GSEs' Affordable Housing Mission Should Be Restricted

As previously noted, HERA contains very few specifics regarding the GSEs' affordable housing program. In reality, the Act contains no concrete provision that prevents a repeat of the excessive acquisition of subprime mortgages and securities that took place between 2000 and 2007.¹⁹³ Accordingly, this Section proposes an explicit governmental guarantee on core market securities, and limitations on the GSEs' affordable housing goals.

1. Explicit Government Guarantees of "Core Market" Securities

The secondary market represents three distinct income streams. One stream represents the "core market of routine products" associated with most borrowers.¹⁹⁴ The second stream

¹⁹⁰ *See id.*

¹⁹¹ *See id.* at 142; *see also* Bruce Arthur, *Housing and Economic Recovery Act of 2008*, 46 HARV. J. ON LEGIS. 585, 605 (2009) (noting that FHFA's conservatorship seems to be stabilizing the GSEs).

¹⁹² *See* 12 U.S.C.A. § 4514(c) (West 2009).

¹⁹³ *See* Pinto, *supra* note 31, at 18 ("Fannie and Freddie will still be subject to the same unrealistically high affordable housing goals set by HUD (temporarily suspended) and now the responsibility of their safety and soundness regulator.").

¹⁹⁴ *Fannie Mae and Freddie Mac Hearing, supra* note 34, at 88 (statement of Michael D. Berman, Vice Chairman, Mortgage Bankers Association).

represents government-backed mortgages associated with affordable housing finance.¹⁹⁵ Finally, the third comes from mortgage markets “such as nonprime, jumbo, alt-A mortgages and other single-family and multifamily products.”¹⁹⁶

The GSEs’ charters should be amended to allow them to offer an explicit governmental guarantee on core securities.¹⁹⁷ For example, securities backed by conforming prime loans could be explicitly guaranteed. This change will likely ensure a stable real estate finance system.¹⁹⁸ The core market is the most important, functioning as “a central nervous system for the entire real estate finance system.”¹⁹⁹ “The core market was the last sector of the market to experience liquidity shortages in the recent downturn. It is also likely that the [economy as a whole] will not recover completely until this sector is [stabilized].”²⁰⁰

As a corollary to this change, the Secretary of the Treasury should state “loudly and at frequent intervals” that all noncore securities are not guaranteed by the federal government, and investors will have to bear all of the risk associated with the investment.²⁰¹ This will force the secondary market to accurately price securities backed by subprime loans.²⁰² An implicit governmental guarantee distorts the secondary market by shifting risk from investors to the government.²⁰³

¹⁹⁵ *See id.*

¹⁹⁶ *Id.*

¹⁹⁷ *See id.*; see also Thomas E. Plank, *Regulation and Reform of the Mortgage Market and the Nature of Mortgage Loans: Lessons from Fannie Mae and Freddie Mac*, 60 S.C. L. REV. 779, 805 (2008); MORTGAGE BANKERS ASSOC., PRINCIPLES FOR ENSURING MORTGAGE LIQUIDITY 8 (2009), available at <http://www.mbaa.org/files/ResourceCenter/GSE/PrinciplesonEnsuringMortgageLiquidity.pdf>.

¹⁹⁸ *See Fannie Mae and Freddie Mac Hearing*, *supra* note 34, at 88 (statement of Michael D. Berman, Vice Chairman, Mortgage Bankers Association).

¹⁹⁹ *Id.*

²⁰⁰ *Id.*

²⁰¹ *See* Lawrence J. White, *Fannie Mae, Freddie Mac, and Housing Finance: Why True Privatization Is Good Public Policy*, CATO INST. POL’Y ANALYSIS NO. 528, Oct. 7, 2004, at 16 (2004), available at <http://www.cato.org/pubs/pas/pa528.pdf>.

²⁰² *See Financial Crisis Hearing*, *supra* note 47, at 3 (statement of Dr. Alan Greenspan, Former Chairman, Federal Reserve) (“It was the failure to properly price such risky assets that precipitated the crisis.”).

²⁰³ *See* MORTGAGE BANKERS ASSOC., *supra* note 197.

2. Limitations on Affordable Housing Goals

The GSEs' affordable housing mission is poorly defined under HERA²⁰⁴ and still poses a risk of abuse. Despite the risks, it is reasonable for the government to use the GSEs to pursue social and policy goals in exchange for its explicit guarantee.²⁰⁵ Indeed, the GSEs have demonstrated a remarkable capacity for increasing the availability of mortgage credit to low-income borrowers.²⁰⁶ And underwriting standards do not necessarily have to be sacrificed to facilitate the financing of affordable housing. But, as recent events illustrated, when achieving social goals takes priority over the GSEs' financial safety, the entire real estate finance system comes under threat.

Instead of prohibiting affordable housing finance, legislation should reach a compromise:

The government should balance and coordinate any pursuit of social policy goals through the secondary mortgage market operations of [the GSEs] with their implications for safety and soundness, the efficient operation of the secondary mortgage market and their consistency with primary mortgage market and / or other requirements. Such policy goals should be limited to residential housing in a way that does not contain market distortions.²⁰⁷

Accordingly, the following changes should be made. First, the GSEs should not be allowed to purchase private label mortgage backed securities as a means of satisfying affordable housing goals.²⁰⁸ This change will discourage the creation of

²⁰⁴ See John Eggum, Katherine Porter & Tara Twomey, *Saving Homes in Bankruptcy: Housing Affordability and Loan Modification*, 2008 UTAH L. REV. 1123, 1135 (discussing how "affordable housing" is, at best, "a flexible and nebulous concept").

²⁰⁵ See MORTGAGE BANKERS ASSOC., *supra* note 197.

²⁰⁶ See *Fannie Mae and Freddie Mac: Hearing*, *supra* note 34, at 180 (statement of Dr. Susan M. Wachter, Professor of Financial Management, Real Estate, and Finance, The Wharton School, The University of Pennsylvania) (noting that the current GSE model "worked fairly well" until the creation of private-label RMBS).

²⁰⁷ See MORTGAGE BANKERS ASSOC., *supra* note 197.

²⁰⁸ See *Fannie Mae and Freddie Mac Hearing*, *supra* note 34, at 182 (statement of Dr. Susan M. Wachter, Professor of Financial Management, Real Estate, and Finance, The Wharton School, The University of Pennsylvania) ("The demand for securitized mortgages fed the demand for recklessly underwritten loans."); *id.* at 140 (statement of James B. Lockhart III, Director, Federal Housing Finance Agency) ("There is evidence that Enterprise efforts to meet previous housing goals, especially through the purchase of PLS, purchases of Alternative-A (Alt-A) mortgages, and

private label RMBS backed by poorly-underwritten loans, and it will place the content of GSE portfolios under the direct control of FHFA. However, this is admittedly a nonessential change, as subprime PLS are unlikely to find willing investors for some time.²⁰⁹

Second, affordable housing goals must not take priority over the GSEs financial safety. Rather, “affordable housing goals should . . . promote sustainable mortgage options for low- and moderate-income families and neighborhoods.”²¹⁰ Congress should limit the amount of affordable loans that the GSEs should be allowed to purchase. For example, a cap of no more than twenty-five percent of the loans purchased in a year could be “affordable.” This change will have likely prevent the GSEs from enabling another subprime crisis. However, the change may likely decrease the availability of affordable loans available to consumers. However, Congress has other options for supporting affordable housing and need not rely so heavily on the GSEs for affordable housing finance. This may be for the best, as some commentators have even argued that GSE affordable housing projects represent “a new and extra constitutional way for Congress to dispense funds.”²¹¹

HERA contains adequate enforcement mechanisms to ensure that the GSEs comply with whatever affordable housing goals FHFA establishes. No additional enforcement mechanisms or sanctions are necessary.

In sum, these proposed changes reflect the need for a more moderate approach to GSE sponsored affordable housing finance. The GSEs are inherently conflicted and will always be under pressure to engage in risky behavior in the name of increased shareholder returns.²¹² Voluntary efforts are not enough to

overall loosening of underwriting guidelines, contributed to the unsustainable buildup of credit risk that led to the conservatorships.”)

²⁰⁹ *Financial Crisis Hearing*, *supra* note 47, at 4 (statement of Dr. Alan Greenspan, former Chairman, Board of Governors, Federal Reserve System) (“Structured investment vehicles, Alt-A mortgages, and a myriad of other exotic financial instruments are not now, and are unlikely to ever find willing investors.”).

²¹⁰ *Fannie Mae and Freddie Mac Hearing*, *supra* note 34, at 140 (statement of James B. Lockhart III, Director, Federal Housing Finance Agency).

²¹¹ *See* Wallison & Calomiris, *supra* note 55, at 3–4.

²¹² *Fannie Mae and Freddie Mac Hearing*, *supra* note 34, at 18–19 (statement of James B. Lockhart III, Director, Federal Housing Finance Agency) (“[I]t is often difficult in a political environment to . . . resist pressure to broaden the mission.”)

discourage risky behavior.²¹³ The longstanding federal goal of increasing home ownership is not always realistic. “[N]o matter how high ownership rates [climb], there [will] always [be] a group below the norm that need[s] help.”²¹⁴ The federal government can only do so much to enable homeownership before it begins wreaking havoc in the real estate finance system.

²¹³ *Financial Crisis Hearing*, *supra* note 47, at 2 (statement of Dr. Alan Greenspan, former Chairman, Board of Governors, Federal Reserve System). (“[T]hose of us who have looked to the self-interest of lending institutions to protect shareholder’s equity (myself especially) are in a state of shocked disbelief.”)

²¹⁴ Steven Malanga, *Obsessive Housing Disorder*, 19 CITY J. NO. 2, at 14, 23 (2009), available at http://www.city-journal.org/2009/19_2_homeownership.html.