The Public Option in Housing Finance

Adam J. Levitin[†*] *and Susan M. Wachter*[**]

The U.S. housing finance system presents a conundrum for the scholar of regulation because it defies description using the traditional regulatory vocabulary of command-and-control, taxation, subsidies, cap-and-trade permits, and litigation. Instead, since the New Deal, the housing finance market has been regulated primarily by government participation in the market through a panoply of institutions. The government's participation in the market has shaped the nature of the products offered in the market. We term this form of regulation "public option" regulation.

This Article presents a case study of this "public option" as a regulatory mode. It explains the public option's rise as a governmental gap-filling response to market failures. The public option, however, took on a life of its own as the federal government undertook financial innovations that the private market had eschewed, in particular the development of the "American mortgage" — a long-term, fixed-rate fully amortizing mortgage. These innovations were trend-setting and set the tone for entire housing finance market, serving as functional regulation.

The public option was never understood as a regulatory system due to its ad hoc nature. As a result, its integrity was not protected. Key parts of the system were privatized without a substitution of alternative regulatory measures. The consequence was a return to the very market failures that led to the public option in the first place, followed by another round of ad hoc public options in housing finance. This history suggests that an

* Bruce W. Nichols Visiting Professor of Law, Harvard Law School; Professor of Law, Georgetown University Law Center. This Article has benefitted from a presentation at the University of Pennsylvania's Conference on Regulatory Breakdown and at the Association for Public Policy Analysis and Management's annual conference and from comments by Elizabeth Renuart. The authors would like to thank Arthur Acoca-Pidolle, Igor Kleyman, and Justin Turner for research assistance.

** Richard B. Worley Professor of Financial Management, The Wharton School, University of Pennsylvania.

awareness of the public option regulatory mode in housing finance is in fact critical to its long-term success, and that the public option is a well-pedigreed regulatory mode that has historically been associated with stable housing finance markets.

TABLE OF CONTENTS

INTRODUCTION

The U.S. housing finance system presents a conundrum for the scholar of regulation, as it simply cannot be described using the traditional regulatory vocabulary. Regulatory cosmology has long had but a limited number of elements:[1] market self-regulation (regulation via reliance on private competition and self-interest);[2] direct command-and-control regulation;[3] disclosure regulation for consumer protection or market efficiency (a variation of command-and-control);[4] Pigouvian taxation and subsidization;[5] licensing (via chartering or merger approvals);[6] Coasean tradable quantity permits

[1] Astonishingly, the legal literature appears to be devoid of any broad comparative discussion of all of these regulatory options, apart from the occasional comparison between two approaches, generally command-and-control versus taxation or cap-and-trade. The economics and political science literatures have been only slightly more sensitive to the comparisons, but again, we are not aware of any overview.

[2] *See, e.g.*, Alan Greenspan, *The Evolution of Banking in a Market Economy*, Remarks at the Annual Conference of the Association of Private Enterprise Education, Arlington, Va. (Apr. 12, 1997), *available at* http://www.federalreserve.gov/boarddocs/speeches/1997/19970412.htm (providing a historical overview of, and calling for increased reliance on, private market regulation in the banking sector); John Hilsenrath, *Greenspan vs. the Greenspan Doctrine*, WALL ST. J. (Feb. 17, 2009), http://blogs.wsj.com/economics/2009/02/17/greenspan-vs-the-greenspan-doctrine (describing "The Greenspan Doctrine – a view that modern, technologically advanced financial markets are best left to police themselves").

[3] *See, e.g.*, 12 U.S.C. § 1464(t)(6)(B)(ii) (2006) (requiring any federal thrift institution not in compliance with the capital standards to comply with a capital directive issued by the OTS); 12 U.S.C. § 1831o(a)(2) (2006) (directing financial regulators to take "prompt corrective action" to resolve troubled financial institutions); 12 U.S.C. § 3907 (2006) (directing "each appropriate Federal banking agency shall cause banking institutions to achieve and maintain adequate capital by establishing minimum levels of capital").

[4] 15 U.S.C. § 77f(d) (2012) (requiring securities registration statements to be made publicly available); Consumer Credit Protection Act of 1968 § 1, 15 U.S.C. § 1601 (2006) ("The Congress finds that economic stabilization would be enhanced and the competition among the various financial institutions and other firms engaged in the extension of consumer credit would be strengthened by the informed use of credit. The informed use of credit results from an awareness of the cost thereof by consumers. It is the purpose of this subchapter to assure a meaningful disclosure of credit terms so that the consumer will be able to compare more readily the various credit terms available to him and avoid the uninformed use of credit, and to protect the consumer against inaccurate and unfair credit billing and credit card practices.").

[5] A Pigouvian tax (after economist Arthur Pigou) is a tax that imposes costs on negative externality-generating behavior with an aim of forcing an internalization of the externalities. *See* N. GREGORY MANKIW, PRINCIPLES OF ECONOMICS 203 (6th ed. 2012); William J. Baumol, *On Taxation and the Control of Externalities*, 62 AM. ECON. REV. 307, 307-08 (1972).

[6] *See, e.g.*, 12 U.S.C. § 26 (2006) (requiring charter approval for national banks); 12

(cap-and-trade, a variation on licensing);[7] public shaming;[8] moral suasion,[9] and private liability rules and litigation.[10]

U.S.C. § 321 (2006) (noting that application approval is required for Federal Reserve System membership for state banks); TEX. FIN. CODE ANN. § 31.004(a) (2011) (prohibiting any person from engaging in the "business of banking" without a license).

[7] *See generally* JOHN DALE, POLLUTION, PROPERTY AND PRICES (1968) (proposing tradable pollution permits); Ronald H. Coase, *The Problem of Social Cost*, 3 J. L. & ECON. 1, 1-2, 15, 17 (1960) (arguing that instituting a legal system of rights which can be modified by transactions on the market is a more preferable regulatory mode than taxation or direct government regulation); Thomas D. Crocker, *The Structuring of Atmospheric Pollution Control Systems*, *in* THE ECONOMICS OF AIR POLLUTION 61-86 (H. Wolozin ed., 1966) (proposing tradable pollution permits).

[8] *See, e.g.*, Joshua D. Blank, *What's Wrong with Shaming Corporate Tax Abuse,* 62 TAX L. REV. 539, 541 (2009) (arguing that public shaming would likely fail to deter corporate tax abuse and would have perverse effects on tax compliance); Usha Rodrigues & Mike Stegemoller, *Placebo Ethics*, 96 VA. L. REV. 1, 2 (2010) (examining effect of Sarbanes-Oxley Act section 406 disclosures of waivers of code of ethics); David A. Skeel, Jr., *Shaming in Corporate Law*, 149 U. PA. L. REV. 1811, 1811 (2001) (discussing private and judicial shaming sanctions for corporate offenders). Environmental and workplace safety regulators have also attempted to use shaming as a means of regulation. For example, the EPA publishes enforcement action maps. *See, e.g.*, *Enforcement in Your Community*, U.S. ENVTL. PROTECTION AGENCY, http://www.epa.gov/enforcement/index.html (last visited Jan. 22, 2013).

[9] *See, e.g.*, Albert Breton & Ronald Wintrobe, *A Theory of "Moral" Suasion,* 11 CAN. J. ECON. 210 (1978) (describing moral suasion where central bank facilitates collusion among commercial banks in exchange for their compliance with central bank's goals); Craig Furfine, *The Costs and Benefits of Moral Suasion: Evidence from the Rescue of Long-Term Capital Management*, 79 J. BUS. 593 (2006) (attempting to quantify effects of Federal Reserve's facilitation of rescue of failing hedge fund in 1998); J.T. Romans, *Moral Suasion as an Instrument of Economic Policy*, 56 AM. ECON. REV. 1220 (1966) (examining necessary conditions for successful moral suasion policy).

[10] *See, e.g.*, Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487, 1517 (1996) (exploring citizen-suit enforcement of federal securities laws); Jennifer Arlen, *Public Versus Private Enforcement of Securities Fraud*, *in* CONF. ON ENFORCEMENT OF CORPORATE GOVERNANCE 47 (2007) (proposing various limitations on private securities fraud actions); Pamela H. Bucy, *Private Justice*, 76 S. CAL. L. REV. 1, 52-53, 72 (2002) (exploring securities regulation via private enforcement); David F. Engstrom, *Harnessing the Private Attorney General: Evidence from* Qui Tam *Litigation*, 112 COLUM. L. REV. 1244, 1286-1318 (2012) (offering initial findings from empirical study of post-1986 False Claims Act qui tam regime); Jill E. Fisch, *Class Action Reform, Qui Tam, and the Role of the Plaintiff*, L. & CONTEMP. PROBS., Autumn 1997, at 198-202 (explaining how qui tam principles can inform class action reform); Myriam Gilles, *Reinventing Structural Reform Litigation: Deputizing Private Citizens in the Enforcement of Civil Rights*, 100 COLUM. L. REV. 1384, 1384 (2000) (exploring the power of private citizens to enforce civil rights); Geoffrey Christopher Rapp, *False Claims, Not Securities Fraud: Towards Corporate Governance by Whistleblowers*, 15 NEXUS 55, 62 (2009) (proposing to treat false and misleading statements about securities as false "claims" against the federal government as shareholder and allowing qui tam enforcement); Heidi Mandanis Schooner, *Private Enforcement of Systemic Risk Regulation*, 43 CREIGHTON L. REV. 993, 1012 (2010)

None of these traditional regulatory approaches, however, is adequate to describe the regulation of housing finance in the United States. Indeed, the governmental agencies involved in the $11 trillion housing finance sector are simply absent from classic accounts of the U.S. regulatory state.[11] Instead, to understand U.S. housing finance regulation, it is necessary to conceive of a distinct regulatory approach, namely that of the "public option" — having the government compete in the marketplace for the provision of goods and services. Understanding the use of the public option in housing finance regulation — and its limitations — is critical to understanding the regulatory failures that precipitated the financial collapse in 2008, and holds lessons for a revised housing finance regulatory system and for regulation by public options in general.

Since the New Deal (and with roots going back to at least World War I), the fundamental approach of the U.S. housing finance regulation has been the "public option" — having the federal government compete in the market against private enterprises.[12] By having the government as a market participant with substantial market presence, the government has been able to set the terms on which much of the market functions.

In particular, the federal government has assumed a variety of secondary market or insurance roles that have allowed it to regulate the mortgage origination market upstream while avoiding direct transactions with consumers.[13] The federal government has leveraged its presence and power in the insurance and secondary markets, including its unparalleled ability to assume risk, to encourage the standardization of the products offered and associated risks in the secondary mortgage market. The government's presence in the market has also enabled mortgages to be offered to consumers in the primary market on terms that would not otherwise exist, such as long terms

(suggesting that reforms addressing systemic risk include a private enforcement mechanism); Dennis J. Ventry, Jr., *Whistleblowers and* Qui Tam *for Tax*, 61 TAX LAW 357, 358-59 (2008) (exploring tax whistleblower provisions).

[11] *See, e.g.*, LISA HEINZERLING & MARK V. TUSHNET, THE REGULATORY AND ADMINISTRATIVE STATE: MATERIALS, CASES, COMMENTS (2006) (giving wide-ranging thematic history of federal regulatory system but omitting discussion of regulation of housing finance); BARAK ORBACH, REGULATION: WHY AND HOW THE STATE REGULATES (2012) (same); Robert L. Rabin, *Federal Regulation in Historical Perspective*, 38 STAN. L. REV. 1189 (1986) (same).

[12] *See infra* Part II.

[13] *See* Adam J. Levitin, *Hydraulic Regulation: Regulating Credit Markets Upstream*, 26 YALE J. ON REG. 143, 146-47 (2009) (discussing concept of hydraulic regulation of primary markets through regulation and manipulation of secondary markets).

with fixed interest rates and full amortization, which have positive social externalities. In short, the public option in housing finance allows government to realize social benefits through standard-setting.

Government involvement in the market is hardly unique to housing finance, and it is often used as a form of regulation, even if not conceived of as a "public option." Government participation in the market appears, in various forms, throughout government, from the most quotidian local government functions such as trash collection and policing to the provision of public pools, recreation facilities, parks, schools, universities, mass transit, and roads. Nationally, the government provides payment systems, pensions (Social Security), deposit insurance, medical insurance for the elderly, disabled, and indigent (Medicare and Medicaid), title insurance (Torrens land registration systems), power generation (Tennessee Valley Authority), medical research (National Institutes of Health and Center for Disease Control), national security, and, most recently, the controversial (and ultimately abandoned) proposed "public option" for universal health insurance.

In some of these cases, the government competes directly with private parties, such as the U.S. military competing for national security work (e.g., security for U.S. embassies and government personnel) against private contractors like Xe (formerly Blackwater). This situation is not unlike medieval and early modern Europe, where royal armies had to compete against mercenary or baronial forces or 17th-19th century public navies competing against privateers for taking prizes.[14]

In other cases of public options, there is a segmentation of the market, with the government competing in (or as the sole competitor in) one part of the market, while ceding other parts of the market to private parties. For example, in the District of Columbia, the municipality handles trash collection for one-to-three-family residences, while private contractors handle larger multi-family structures and non-residential structures.[15]

[14] *See, e.g.*, Gary M. Anderson & Adam Gifford, Jr., *Privateering and the Private Production of Naval Power*, 11 CATO J. 99 (1991) (stating that many countries' naval power came from privateers until the nineteenth century); Nicholas Parrillo, *The De-Privatization of American Warfare: How the U.S. Government Used, Regulated, and Ultimately Abandoned Privateering in the Nineteenth Century*, 19 YALE J.L. & HUMAN. 1, 3-4 (2007) (stating that, in 1856, the European powers banned privateering by treaty but the United States refused to sign because of its reliance on privateering); Matthew Underwood, Note, *"Jealousies of a Standing Army": The Use of Mercenaries in the American Revolution and Its Implications for Congress's Role in Regulating Private Military Firms*, 106 NW. U. L. REV. 317, 324 (2012) (stating that, as early as 1215, there were calls to the King to banish mercenary forces).

[15] GOV'T OF D.C., EXEC. OFFICE OF THE MAYOR, DIST. DEP'T OF ENV'T, PUBLIC REPORT

Note that the municipality could simply require residents, under penalty of law, to have their trash picked up and leave it to residents to figure out how, or it could tax those who failed to have their trash picked up, or it could subsidize residents who had their trash removed. Or the municipality could do nothing at all and rely on the market to encourage trash removal via property prices; properties buried in trash would see their value eroded (with obvious externalities on neighbors and public health). Whatever the reasons for the municipality handling trash removal, the point is that it is hardly the only regulatory option for a municipality that wishes to have trash removed.

Relatedly, the use of a "public option" may be segmented by locality; municipal fire departments exist in some (predominantly urban) communities, while others (often suburban or rural communities) have private (volunteer) fire companies. Historically, however, the fire company market was completely private, and rival fire companies would compete violently for the right to put out blazes; the development of municipal fire departments represents a displacement of private competitors.[16] In related ambulance services, however, private companies continue to compete with the ambulances provided by municipal fire departments. Segmentation can occur as the result of monopoly-granting legislation, such as in states or counties with a state monopoly on liquor sales, where the state or county monopoly still competes with private liquor stores in neighboring jurisdictions, or because of private market failures that cede the field to public participants in some market segments.

Sometimes the "public option" exists in a complementary relationship to private firms, such as the employment of private police forces by universities to supplement public police resources. And sometimes the public option is the provision of a public good — meaning that the good is non-rival, so its consumption by one does not diminish its availability to others, and non-excludable, so that the provider of the good cannot control who consumes it — such as the provision of lighthouses.[17]

ON RECYCLING, FISCAL YEAR 2009 2 (2009), *available at* http://rrc.dc.gov/green/lib/green/fy09_recycling_report.pdf.

[16] *See, e.g.*, Tina Dupuy, *Firefighting in the 1800s: A Corrupt, Bloated, Private For-Profit Industry*, HUFFINGTON POST (July 30, 2009, 1:12 PM), http://www.huffingtonpost.com/tina-dupuy/firefighting-in-the-1800s_b_247936.html (describing transition from private firefighting companies to public municipal fire departments).

[17] PAUL A. SAMUELSON, ECONOMICS: AN INTRODUCTORY ANALYSIS 45 (6th ed. 1964) (lighthouse as example of public good); *see also* Elodie Bertrand, *The Coasean Analysis of Lighthouse Financing: Myths and Realities*, 30 CAMBRIDGE J. ECON. 389, 394-95

There are many other examples of public options that could be adduced, and obviously there are significant differences among these arrangements. One could rightly question whether they are in fact all manifestations of the same phenomenon or distinct phenomena. As it stands, we lack the regulatory vocabulary to have a taxonomy of public options and government-in-the-market. Despite the widespread existence of various types of "public options," they remain a virtually untheorized phenomenon.[18]

This Article does not attempt to present a general theory of public options as a form of regulation.[19] Instead, having noted the phenomenon of the public option as a regulatory approach, this Article examines the use of public options in housing finance, presenting a detailed case study of a major set of public options that shapes a critical sector of the U.S. economy. It does so by tracing the arc of housing finance regulation from the Depression to the present. In so doing, it shows how public options were adopted during the Depression.[20] Many of these public options were intended to be short-term measures, filling what were hoped to be temporary gaps in the market. Yet they endured and

(2006) (questioning "private" nature of lighthouses discussed by Coase and noting that some "private" lighthouses were in fact charitable entities); David E. Van Zandt, *The Lessons of the Lighthouse: "Government" or "Private" Provision of Goods*, 22 J. LEGAL STUD. 47, 48 (1993) (finding that private British lighthouses in fact had various forms of government support). *But see* Ronald H. Coase, *The Lighthouse in Economics*, 17 J. L. & ECON. 357, 362-72 (1974) (noting that there were privately operated British lighthouses between 1513 and 1898); William Barnett & Walter Block, *Coase and Van Zandt on Lighthouses*, 35 PUB. FIN. REV. 710, 715-18 (2007) (arguing that lighthouses *could* have been provided by the private sector).

[18] JEAN-JACQUES LAFONT & JEAN TIROLE, A THEORY OF PROCUREMENT AND REGULATION 637-53 (1993) (modeling public private competition incentives); DAVID A. MOSS, WHEN ALL ELSE FAILS: GOVERNMENT AS THE ULTIMATE RISK MANAGER 15 (2004); Adam J. Levitin, *Public-Private Competition in Payments: The Role of the Federal Reserve* 5 (Georgetown Law and Economics Research Paper No. 1420061, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1420061 (identifying public options as a distinct regulatory tool); Adam J. Levitin, Public-Private Risk Sharing in Financial Regulation 48 (Dec. 12, 2012) (unpublished manuscript) (on file with author).

[19] The constitutionality of public options as a general matter is also beyond the scope of this Article. The Necessary and Proper Clause of the Constitution combined with specifically enumerated powers (not least of which is the power to regulate interstate commerce) provides the federal government with tremendous authority to enter the market. *See* McCulloch v. Maryland, 17 U.S. 316, 412 (1819) (upholding the constitutionality of the Bank of the United States); *see also* Ashwander v. Tenn. Valley Auth., 297 U.S. 288, 326-40 (1936) (upholding the constitutionality of the Tennessee Valley Authority's construction of the Wilson Dam and sale of hydro-electric power generated on the basis of the war power, the commerce power, and the power to dispose of property belonging to the United States).

[20] *See infra* Part II.

remained the major regulatory framework for housing finance for decades. Starting in the late 1960s, however, the public option regulatory approach began to be undermined, first by the privatization of Fannie Mae and creation of Freddie Mac, then by the relaxation of the remaining command-and-control regulations on mortgage lending, and then by the emergence of a private securitization market.[21] The result was that when a wholly private market in housing finance emerged, there was simply no effective regulatory framework in place to address the risks attendant to the market.

The collapse of the housing finance market in 2008 returned us to a world of inadvertent public options. Going forward, as we rebuild the housing finance market, it is important to consider how the combination of the traditional regulatory tools of command-and-control, Pigouvian taxation, quantity limitations, and litigation might be best deployed to ensure a stable, liquid housing finance market.

A consciousness of the public option as a regulatory mode is in fact important to the success of regulation through public options. The failure to see the public option in housing finance as a regulatory move, rather than merely as a temporary market gap-filler, meant that it was easy to overlook and then fail to protect the critical parts of the public option regulation system. While the public option in housing finance was primarily an ad hoc response to market failures, it nonetheless pioneered important new financial innovations, principally the long-term, fixed-rate mortgage and standardized mortgage-backed securities. This pioneering behavior had a trend-setting effect that shaped private parties' subsequent behavior and functionally regulated the U.S. housing finance market. Yet because of the ad hoc, reactionary nature of the public option in housing finance, it was not seen as a regulatory system, which left its collapse unnoticed until too late.

This Article commences in Part I with a discussion of the housing finance crisis that was part of the Great Depression. It then turns in Part II to a consideration of the Hoover and Roosevelt regulatory response, which was to create government institutions in the market, rather than engaging in direct regulation or Pigouvian taxation. Part III traces the fate of the public option approach through the privatization of the public options and the emergence of a new form of private competition. It shows that while the market developed, the regulatory framework did not; housing finance regulation continued to rely on a public option approach even as there was no longer a

[21] *See infra* Part III.

public option. The result was a functionally unregulated space in which housing finance's endemic information and agency problems returned in a déjà vu of the Depression-era mortgages during the housing bubble. A conclusion addresses the future of the public option in housing finance and the lessons its history holds for public options as a regulatory mode.

I. HOUSING FINANCE CRISIS DURING THE DEPRESSION

The shape of the U.S. housing market was substantially different before the Great Depression. First and foremost, prior to the Depression, homeownership rates were substantially lower than today. From 1900 to 1930, homeownership rates hovered around 45% and then declined slightly during the Depression.[22] Renting, rather than owning, was pre-Depression norm, and those who owned their homes often owned them free and clear of liens.[23] The prevalence of renting and of free and clear ownership was largely a function of the scarcity of mortgage finance.

Mortgage finance was scarcer in pre-Depression America because of the structure of U.S. financial markets. Pre-Depression mortgages were funded by primarily by non-institutional lenders — that is, by individuals.[24] The institutional segment of the market was comprised mainly of depository institutions (national and state-chartered banks and state-chartered savings institutions) and life insurance companies.[25] Pre-Depression mortgages were not funded by capital markets, and no secondary market of scale existed.

A. Non-Geographically Diversified Funding and Lending

The funding of mortgages through depositaries, life companies, and individuals meant that pre-Depression housing finance market was intensely local, yet still vulnerable to national waves in the availability

[22] *Historical Census of Housing Tables*, U.S. CENSUS BUREAU (last revised Oct. 31, 2011), http://www.census.gov/hhes/www/housing/census/historic/owner.html (showing homeownership rate in 1900 of 46.5%).

[23] *Id.*

[24] *See* LEO GREBLER ET AL., CAPITAL FORMATION IN RESIDENTIAL REAL ESTATE 468-71, tbl.N-2 (1956); Kenneth B. Snowden, *The Evolution of Interregional Mortgage Lending Channels, 1870-1940: The Life Insurance-Mortgage Company Connection*, *in* COORDINATION AND INFORMATION: HISTORICAL PERSPECTIVES ON THE ORGANIZATION OF ENTERPRISE 209, 220 (Naomi R. Lamoreaux & Daniel M.G. Raff eds., 1995) [hereinafter *The Evolution of Interregional Mortgage Lending Channels*] (showing that financial intermediaries held 30% of mortgage debt in 1890–1893).

[25] GREBLER ET AL., *supra* note 24, at 468-71, tbl.N-2.

of financing. Interest rates and the availability of financing varied significantly by locality and region.[26] This variation was due to the local nature of the lending base. Interstate banking restrictions limited the geographic scope of banks' activities,[27] and individuals — who held a third of all mortgage debt as late as 1939 — only lent locally.[28] Life companies lent on a more national scale using correspondent relationships, but they were a limited part of the market.[29] Accordingly, there was much greater mortgage availability in capital-rich regions like the East than in capital-poor regions like the South and West.[30] The result was that mortgage financing was geographically based.

B. Flighty Funding

Compounding the local nature of funding for many mortgage lenders was its flighty nature, which exposed them to a large asset-liability duration mismatch. The duration of lenders' assets — mortgages — was longer than the duration of their liabilities — short-term or demand deposits. This exposed lenders to a liquidity risk if their liabilities could not be rolled over.

Both deposits and life insurance policies are particularly flighty forms of funding. Depositors can rapidly withdraw their funds from banks and thrifts, and life insurance policyholders can often demand the cash value of their policies. Moreover, both deposits and life insurance policies have shown themselves to be vulnerable to runs, in which one depositor's withdrawal of funds will trigger other depositors to withdraw their funds,[31] or panics, in which the travails of

[26] *Id.* at 229; Lance Davis, *The Investment Market, 1870 – 1914: The Evolution of a National Market*, 25 J. ECON. HIST. 355, 392 (1961) (finding empirical confirmation of regional interest rate differentials for both short-term and long-term capital); Kenneth A. Snowden, *Mortgage Lending and American Urbanization, 1880-1890*, 48 J. ECON. HIST., 273, 285 (1988) [hereinafter *American Urbanization*]; Kenneth A. Snowden, *Mortgage Rates and American Capital Market Development in the Late Nineteenth Century*, 47 J. ECON. HIST. 671, 688-89 (1987) [hereinafter *American Capital Market*] (finding regional home and farm mortgage interest rate variation in excess of predicted risk premia).

[27] *See* McFadden Act, ch. 191, § 7, 44 Stat. 1224, 1228-29 (1927) (codified as amended at 12 U.S.C. §§ 36, 81 (2006)).

[28] John H. Fahey, *Competition and Mortgage Rates*, 15 J. LAND & PUB. UTIL. ECON. 150, 150-51 (1939) (reporting as Chairman of the Federal Home Loan Bank Board and exploring the rate of lending by individuals).

[29] *See* RAYMOND J. SAULNIER, URBAN MORTGAGE LENDING BY LIFE INSURANCE COMPANIES 2 (1950); Snowden, *The Evolution of Interregional Mortgage Lending Channels*, *supra* note 24, at 220.

[30] *See* Snowden, *American Capital Market*, *supra* note 26, at 688-89.

[31] Perhaps the best illustration of a bank run is in the movie MARY POPPINS (Disney

one institution will spread to others. The result is the problem George Bailey faced in *It's a Wonderful Life* when the Bailey Building and Loan Association's depositors demand their money back.[32] George tries to explain to them that the money isn't in the B&L's vault — it's in their homes and can't be immediately liquefied.[33]

The problem of flighty funding was a familiar one to U.S. housing finance prior to the New Deal, but none of the solutions adopted were particularly effective. Consortiums of financial institutions attempted to arrange private cross-guarantees of each other's obligations, such as that done by the New York Clearing House Association during the Panic of 1907, but these private arrangements only covered the institutions that were party to them.[34] Thus, in 1907, the New York trust companies were not Clearing House members and did not benefit from the cross-guarantee.[35] The result was the failure of the trust companies during the Panic as depositors transferred their funds to what they believed were safer institutions.[36]

Individual states had guaranteed some types of bank obligations, such as notes, from as early as 1829,[37] and federal deposit insurance was proposed in Congress starting in 1893.[38] By 1908, deposit insurance proposals were part of the Democratic presidential platform, while the alternative of postal banking (a public option for deposit-taking), was part of the Republican platform and endorsed as a second-base by the Democrats.[39] Individual states began to adopt

1964).

[32] IT'S A WONDERFUL LIFE (Liberty Films 1947).

[33] *Id.*

[34] Jon Moen & Ellis W. Tallman, *The Bank Panic of 1907: The Role of Trust Companies*, 52 J. ECON. HIST. 611, 620-21 (1992).

[35] *See* ROBERT F. BRUNER & SEAN D. CARR, THE PANIC OF 1907: LESSONS LEARNED FROM THE MARKET'S PERFECT STORM 59-63, 85, 107-08 (2007).

[36] *Id.*

[37] Carter H. Golembe, *The Deposit Insurance Legislation of 1933: An Examination of Its Antecedents and its Purposes*, 75 POL. SCI. Q. 181, 182-83 (1960); *see also* Charles W. Calomiris, *Is Deposit Insurance Necessary? A Historical Perspective*, 50 J. ECON. HIST. 283, 286-87 (1990) (describing the New York Safety Fund regulated by the state).

[38] Golembe, *supra* note 37, at 187; Eugene Nelson White, *State-Sponsored Insurance of Bank Deposits in the United States, 1907 – 1929*, 41 J. ECON. HIST. 537, 538 (1981).

[39] *See Democratic Party Platform of 1908 (July 7, 1908)*, THE AMERICAN PRESIDENCY PROJECT, http://www.presidency.ucsb.edu/ws/index.php?pid=29589#axzz1rOCGesIN (last visited Feb. 25, 2013) ("We pledge ourselves to legislation under which the national banks shall be required to establish a guarantee fund for the prompt payment of the depositors of any insolvent national bank, under an equitable system which shall be available to all State banking institutions wishing to use it. [¶] We favor a postal savings bank if the guaranteed bank can not be secured, and that it be constituted so as to keep the deposited money in the communities where it is established. But we condemn the

deposit insurance (the Democratic proposal to address the flightiness problem) starting in 1907, but its effectiveness was limited by the extent and structure of the guarantee (including the moral hazard it created) and the fiscal strength of states.[40] In 1911, the federal government had authorized the U.S. Postal Service to offer passbook savings accounts, which were guaranteed by the government.[41] Postal savings accounts ended up being used primarily by immigrant populations and had the ironic effect of exacerbating runs on private banks during the Depression because of their government guarantee and statutorily fixed 2% interest rate, which was well above market during much of the Depression.[42]

C. Thin Secondary Markets

Before the Depression there was no national secondary home mortgage market. While individual lenders could contract with private investors, the norm was for originators to retain mortgages on their books. This practice meant that originators bore a liquidity risk, even if it was mitigated by the short duration of the loans. The liquidity and lending capacity problems were particularly acute for lenders with short-term liabilities like deposits, as a run on the bank would leave a balance-sheet solvent institution unable to cover its liabilities as they came due.

Attempts had been made prior to the Depression to establish secondary mortgage markets in the United States based on European models.[43] By the mid-nineteenth century, deep secondary mortgage

policy of the Republican party in providing postal savings banks under a plan of conduct by which they will aggregate the deposits of the rural communities and redeposit the same while under Government charge in the banks of Wall street, thus depleting the circulating medium of the producing regions and unjustly favoring the speculative markets."); *Republican Party Platform of 1908 (June 16, 1908)*, THE AMERICAN PRESIDENCY PROJECT, http://www.presidency.ucsb.edu/ws/index.php?pid=29632 (last visited Feb. 25, 2013) ("We favor the establishment of a postal savings bank system for the convenience of the people and the encouragement of thrift.").

[40] *See* White, *supra* note 38, at 551-55.

[41] Postal Savings Depositary Act of June 25, 1910, Pub. L. No. 61-268, § 1, 36 Stat. 814, 814.

[42] *Id.* §§ 7-8 (2% APY); Patricia Hagan Kuwayama, *Postal Banking in the United States and Japan: A Comparative Analysis*, 18 MONETARY & ECON. STUD. 73, 75, 79-80, 86 (2000) (describing use by immigrants of institutions); Maureen O'Hara & David Easley, *The Postal Savings System in the Depression*, 29 J. ECON. HIST. 741, 742 (1979) (describing the exacerbation of bank runs).

[43] Kenneth A. Snowden, *Mortgage Securitization in the United States: Twentieth Century Developments in Historical Perspective*, *in* ANGLO-AMERICAN FINANCIAL SYSTEMS: INSTITUTIONS AND MARKETS IN THE TWENTIETH CENTURY 263 (Michael D. Bordo & Richard Sylla eds., 1995) [hereinafter *Mortgage Securitization*].

markets were well-established in both France (the state-chartered joint-stock monopoly *Crédit Foncier*) and the German states (cooperative borrowers' associations called *Landschaften* and private joint-stock banks in Prussia and Bavaria), and "[b]y 1900 the French and German market for mortgage-backed securities was larger than the corporate bond market and comparable in size to markets for government debt."[44] Although there were significant design differences in the European systems, they all operated on a basic principle — securities were issued by dedicated mortgage origination entities.[45] Investors therefore assumed the credit risk of the origination entities. Because these entities' assets were primarily mortgages, the real credit risk assumed by the investors was that on the mortgages.

The European systems survived because they ensured that investors perceived them as free of default risk. This perception was created through two mechanisms. First, there existed close links between the mortgage origination entities and the state.[46] Mortgage investors thus believed there to be an implicit state guarantee of payment on the securities they held. Second, and relatedly, the state required heavy regulation of the mortgage market entities, including underwriting standards, overcollateralization of securities, capital requirements, dedicated sinking funds, auditing, and management qualifications.[47]

A series of attempts were made between the 1870s and 1920s to create secondary mortgage markets.[48] Generally these secondary market efforts focused on farm or commercial mortgages.[49] No major attempt was made at developing a secondary market for residential real estate. All failed, resulting in ever-larger scandals.[50] The details of these attempts and their failures need not concern us here; it is enough to note a few commonalities. First, all were purely private enterprises; there was no government involvement whatsoever.[51] Second, they were virtually unregulated, and what regulation existed was wholly inadequate to ensure prudent operations.[52] Third, they all

[44] *Id.* at 270.

[45] *Id.*

[46] *Id.*

[47] *Id.* at 271-73.

[48] The 1870s saw a 44% increase in farm acreage and a 54% increase in the number of farms in the mid-continent states near the frontier. H. Peers Brewer, *Eastern Money and Western Mortgages in the 1870s*, 50 BUS. HIST. REV. 356, 357-58 (1976); Snowden, *Mortgage Securitization*, *supra* note 43, at 274-79.

[49] Snowden, *Mortgage Securitization*, *supra* note 43, at 274-75.

[50] *See id.* at 279.

[51] *Id.* at 275.

[52] *Id.*

failed because of an inability to maintain underwriting standards, as the loan originators had no capital at risk in the mortgages themselves, regulation was scant, and investors in the mortgage-backed bonds lacked the ability to monitor the origination process or the collateral.[53] In contrast, successful European structures "were either publicly financed or sponsored and were subject to intense regulatory scrutiny."[54]

The failure of the United States to develop a secondary mortgage market prior to the New Deal compounded the problem of locality in mortgage lending. A national secondary market would have mitigated lenders' lack of geographic diversification in funding and lending and enhanced lenders' liquidity. In the absence of a secondary market, lenders were forced to manage risk through loan products.

D. The Unavailability of Long-Term Financing, High LTV Lending, and Fully-Amortized Loans

The funding base for pre-Depression mortgages dictated the terms of the mortgages because of the risks that lenders — and their regulators — could tolerate. The typical pre-Depression mortgage was a short-term, non-amortizing loan.[55] The ratio of the loan amount to the value of the collateral property (the loan-to-value ratio, or "LTV"), at least for first-lien loans, was relatively low, meaning a high down payment was required for a purchase.[56] Less than 50% down payments were rare except in large cities where down payments might go down to 33%.[57] (See Figure 1.) Thus, the average mortgage loan in 1894 was for between 35% and 40% of the property's value.[58] Junior mortgages, however, were common.[59]

---

[53] *See id.* at 279-80.

[54] *Id.* at 263.

[55] ALLAN G. BOGUE, FROM PRAIRIE TO CORN BELT: FARMING ON THE ILLINOIS AND IOWA PRAIRIES IN THE NINETEENTH CENTURY 176 (1963) ("Most loans were repayable at the end of five years or by installments over a short term of years. The long-term amortized loan was not common in this period."); Richard H. Keehn & Gene Smiley, *Mortgage Lending by National Banks*, 51 BUS. HIST. REV. 474, 478-79 (1977); *see also* Richard Green & Susan M. Wachter, *The American Mortgage in Historical and International Context*, 19 J. ECON. PERSP. 93, 94 (2005).

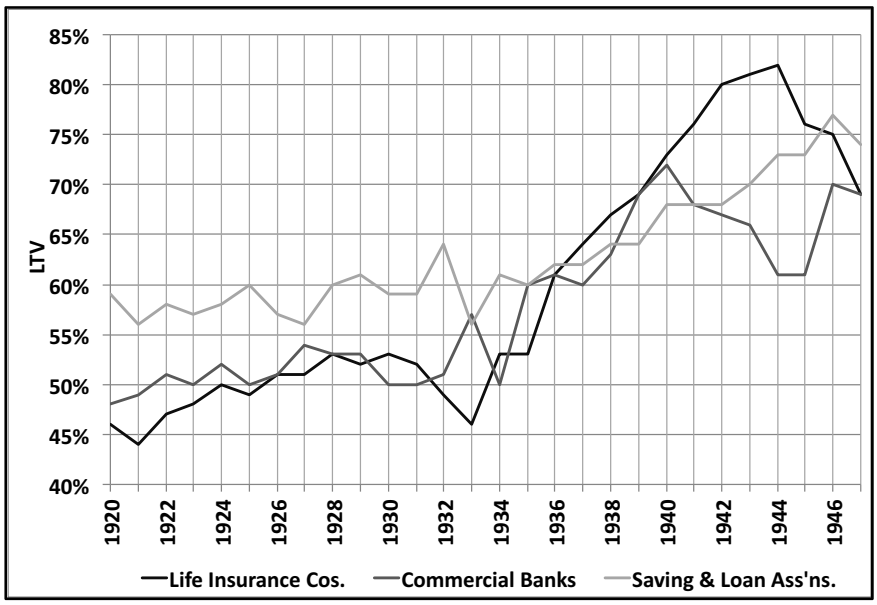
[56] *See* GREBLER ET AL., *supra* note 24, at 233-35.

[57] George A. Hurd, *Mortgage Loans of Trust Companies; What Constitutes Conservatism,* 1 TRUST CO. 991, 992 (1904); *The Federal Housing Administration*, U.S. DEP'T OF HOUS. & URBAN DEV. (Jan. 26, 2013, 4:33 PM), http://www.hud.gov/offices/hsg/fhahistory.cfm.

[58] D. M. Frederiksen, *Mortgage Banking in America*, 2 J. POL. ECON. 203, 204-05 (1894).

[59] C. LOWELL HARRISS, HISTORY AND POLICIES OF THE HOME OWNERS' LOAN

Figure 1. Average Mortgage Loan to Value Ratio (LTV), 1920-1947[60]



The pre-Depression mortgage was generally a short term, albeit fixed-rate, loan. The typical loan term was three to ten years.[61] Frederiksen reported in 1894 an average loan lifespan was 4.81 years.[62] There appears to have been some variance, however, based on type of lending institution; savings and loan associations extended longer-term credit, with contract lengths averaging around ten years. (See Figure 2). Adjustable-rate products were virtually unknown prior to the 1970s, so lenders were exposed to interest rate risk because of the fixed rate.[63] If rates went up, the lender would find itself holding a below-market asset, while if rates fell, the borrower would refinance. The short term of the mortgage, however, limited lenders' exposure to rate fluctuations while increasing the borrowers' exposure. The short-term mortgage thus bore significant similarities in risk profile to an adjustable-rate mortgage (or "ARM"). Given monetary instability in

CORPORATION 35 (1951).

[60] GREBLER ET AL., *supra* note 24, at 503, tbl.O-6.

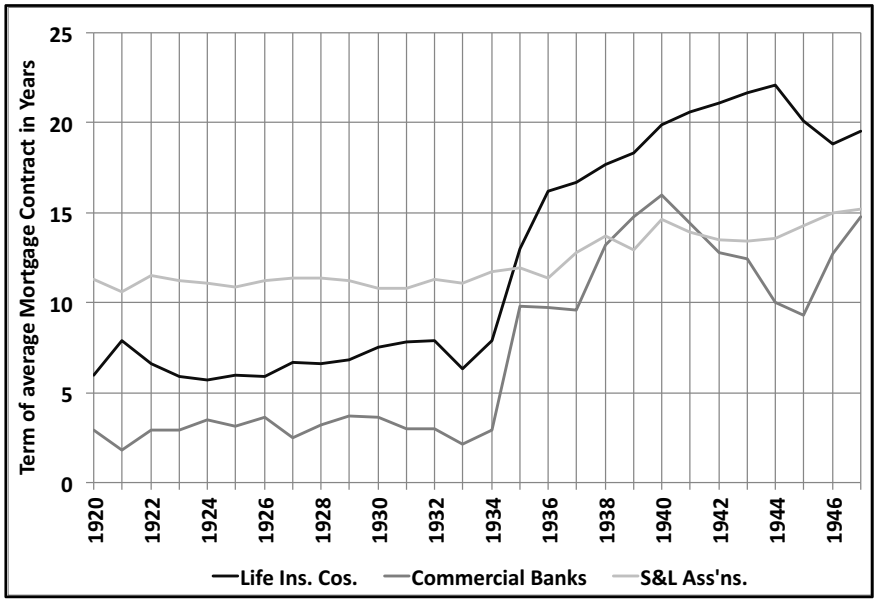
[61] *See id.* at 234, tbl.67; Green & Wachter, *supra* note 55, at 94.

[62] Frederiksen, *supra* note 58, at 204-05.

[63] *See* GREBLER ET AL., *supra* note 24, at 468-71, tbl.N-2 (showing that the magisterial monograph on the residential real estate market prior to 1956 does not even discuss adjustable-rate lending). We note, however, that Green & Wachter state that "most loans carried a variable rate of interest." Green & Wachter, *supra* note 55, at 94.

pre-Depression America, this was a significant risk, as inflation could quickly make a mortgage obligation unaffordable.

Figure 2. Average Contract Length of Mortgages on 1-4 Family Residences, 1920-1947[64]



The pre-Depression mortgage was also typically not fully amortizing — the borrower would make only periodic interest payments during the term of the mortgage, with the most or all of the principal due in a lump sum (a "balloon" or a "bullet") at the end.[65] Again, savings and loan associations were more likely to make amortized mortgages than other lenders, "an adaptation of the concept of a continuing savings plan."[66] Most mortgaged homeowners did not have the cash to pay off the balance, so they would simply refinance the loan, frequently from the same lender.[67] This structure lowered the interest rate risk for the lending institution while raising it for the borrower, who had little ability to hedge against it.

[64] GREBLER ET AL., *supra* note 24, at 234 tbl.67.

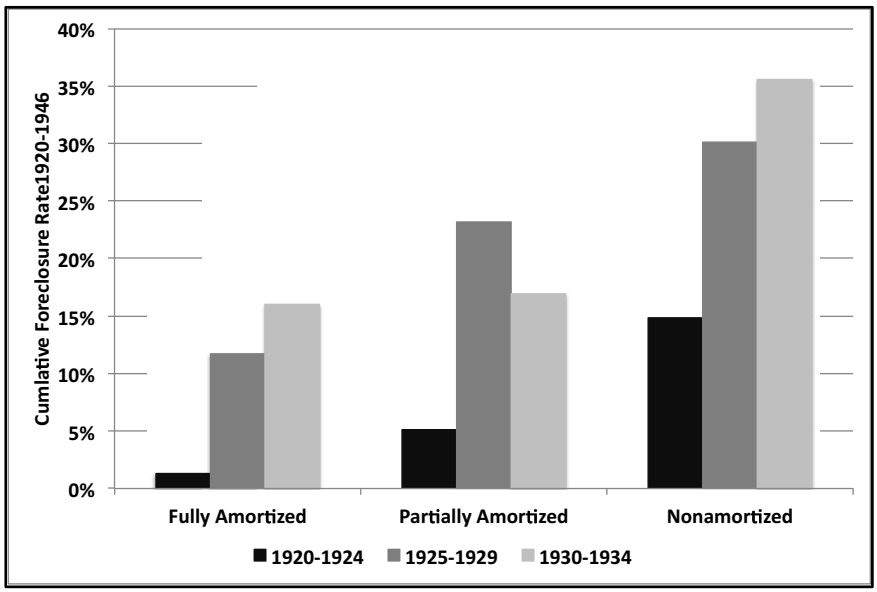
[65] *See* Green & Wachter, *supra* note 55, at 94.

[66] Marc A. Weiss, *Marketing and Financing Home Ownership: Mortgage Lending and Public Policy in the United States, 1918-1989*, *in* 18 BUS. & ECON. HIST. 109, 111 (2d ser. 1989).

[67] *See* HARRISS, *supra* note 59, at 7.

The bullet loan structure made periodic mortgage payments more affordable. Yet because the bullet loan was designed to be rolled over into a new loan, it always carried the risk that refinancing would not be possible. Not surprisingly, foreclosure rates were substantially higher on nonamortized or partially amortized loans.[68] (See Figure 3.)

Figure 3. Cumulative Foreclosure Rates 1920-1946 by Amortization and Loan Origination Year for Life Insurance Company Mortgages[69]



In the pre-Depression mortgage system, individual credit risk was fairly low because of the high down payments required. Even if the homeowner defaulted, the low loan-to-value ratio ensured that the lender would likely get a full recovery in a foreclosure. This ratio made mortgage interest rates more affordable while making the home purchase less affordable. Although the homeowner might default due to a decline in income or disruption to cash flow or inability to refinance, there was likely to be a significant equity cushion in the property that would ensure that the lender would be able to get a full recovery in the event of a foreclosure, thus reducing the credit risk premium in the mortgage interest rate.

[68] *See* SAULNIER, *supra* note 29, at 83, 85 (noting also that "[a]mortization provisions are of most importance on loans made sufficiently long before a period of mortgage distress to permit repayments to reduce the principal substantially").

[69] *See id.* at 140, tbl.B11.

In the event of a severe market downturn, such as the Great Depression, borrowers could find themselves with a depleted equity cushion, such that they would not be able to refinance. In such a case, the borrowers would be faced with having to make the large balloon payment out of pocket and likely default. Moreover, because many loans had adjustable rates, a sudden increase in rates could leave many borrowers unable to afford their monthly payments. Borrowers' exposure to interest rate risk increased lenders' exposure to credit risk. The default risk engendered by adjustable rates, particularly in a volatile monetary environment, offset the protection of high LTV ratios.

E. Lack of an Effective Market-Clearing Mechanism

A final problem in the pre-New Deal mortgage market was not patent until the Great Depression: the lack of an effective market-clearing mechanism for underwater mortgages. The Great Depression brought with it a foreclosure crisis, a decline in home construction, and a precipitous drop in mortgage finance availability due to financial institution failure and retrenchment. New housing starts dropped 90% from their peak in 1925 to 1933,[70] contributing to unemployment in home building and related industries. As unemployment soared, many homeowners found themselves strapped to make mortgage payments.

Moreover, the Depression's credit contraction left homeowners with bullet loans unable to refinance and facing unaffordable balloon payments. The predominant mortgage structure exposed homeowners to interest rate risk. Interest rate risk metastasized into credit risk. Home prices dropped as much as 50%, half of all residential mortgages were in default in 1933,[71] and during the worst of the Depression, nearly 10% of homes were in foreclosure.[72]

The fall in home prices during the Depression was a problem because the only way for the market to clear was through foreclosure. Absent foreclosure, lenders continued to carry nonperforming assets on their books, making creditors (such as depositors) unsure of the lenders' real financial position and unwilling to extend credit to them. Similarly, the lenders themselves retrenched in the face of nonperforming, underwater assets. Foreclosures cut through the fog of nonperforming assets, but they were — and are — a slow clearing

[70] Weiss, *supra* note 66, at 112.

[71] *Id.*

[72] Green & Wachter, *supra* note 55, at 93-95.

mechanism with many potential externalities, and states' Depression-era legislation aimed to make them even slower.

II. THE NEW DEAL AND THE INADVERTENT RISE OF THE PUBLIC OPTION

The New Deal response to the market failures in the housing finance market was for the federal government to create new institutions that were active as market participants, offering liquidity and insurance to financial institutions. This was done through several new institutions that completely remade the housing finance market: the Federal Home Loan Banks ("FHLBs"), the Federal Deposit Insurance Corporation ("FDIC"), the Federal Savings and Loan Insurance Corporation ("FSLIC"), the Home Owners' Loan Corporation ("HOLC"), the Federal Housing Authority ("FHA"), the Reconstruction Finance Corporation ("RFC"), the Federal National Mortgage Association (or Fannie Mae), and later the Veterans Administration ("VA").

These institutions assisted in the provision of adequate housing. They helped to spur economic recovery by encouraging the residential construction industry, and rejuvenated financial institutions by improving their balance sheets and providing the liquidity to enable additional lending. And yet their creation was entirely reactionary. Each of these institutions was created as a response to a specific perceived market problem, and most were intended to be temporary stabilization devices that would hold the gap until the private market revived. Despite the inadvertent creation of a set of public options in housing finance, they remained the dominant regulatory mode, although their effectiveness started to erode by the 1990s.

The New Deal regulatory response to the market failures in the housing market is notable for what it did *not* do. It did not proceed through command-and-control regulation. For example, it did not prohibit nonamortizing mortgages. Nor did it contain individual mandates for the purchase of private mortgage insurance. Similarly, it did not proceed through the Internal Revenue Code by taxing disfavored mortgage products (such as nonamortized or uninsured mortgages). Instead, the Hoover-Roosevelt response was to use government as a gap-filler in the market: where the market did not produce services and products, the government would.[73] The New Deal approach to housing finance was interstitial government.

[73] There was some precedent to this action in the housing space: during World War I, the industrial boom in war production lead to a rapid influx of rural residents to urban industrial areas, where there was inadequate housing stock. U.S. Housing

The Hoover-Roosevelt response involved the creation of four distinct public options.[74] These pieces were not part of a master plan devised beforehand. The initial two components were responses to different exigencies and interest groups, while the later two were responses to the problems created by the first two components.

A. Liquidity and Diversification: Federal Home Loan Banks

First, in 1932, Congress created the FHLB system, a credit reserve system modeled after the Federal Reserve with twelve regional FHLBs mutually owned by their member institutions and a central Federal Home Loan Bank Board ("FHLBB") to regulate the system.[75] Membership in the regional FHLBs was initially limited to safe and sound savings and loan associations, building and loan associations, savings banks, and insurance companies that were in the business of making long-term loans.[76] Thus, commercial banks — which could join the Federal Reserve's discounting system — were excluded from the FHLB system until 1989.[77] The Federal Reserve at this time could not make advances against mortgage collateral.[78]

The FHLBs provided liquidity to mortgage lenders through the rediscounting of mortgages, meaning lending against mortgage collateral (in FHLB parlance, these loans are called "advances").[79]

Corporation was created to build affordable housing stock for war production workers. *See Housing by the United States Department of Labor*, 8 MONTHLY LAB. REV. 564, 564-65 (1919).

[74] This statement is not meant to imply that these four pieces were the entirety of federal involvement in the housing market. For example, the Emergency Relief and Construction Act of 1932 authorized the Reconstruction Finance Corporation to make loans to corporations formed to provide low income housing or urban renewal. *See* Emergency Relief and Construction Act of 1932, Pub. L. No. 72-302, § 201(a)(2), 47 Stat. 709, 711 (July 21, 1932).

[75] *See* Federal Home Loan Bank Act, Pub. L. No. 72-304, § 2, 47 Stat. 725, 726 (July 22, 1932).

[76] *See id.* at 726. The FHLBs were originally capitalized in part by the U.S. government. *See id.* at 728.

[77] *See* Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub L. No. 101-73, § 704, 103 Stat. 183, 416 (codified at 12 U.S.C. § 1424(a)) (expanding FHLB membership).

[78] *See* Paul Matthew Stoner, *The Mortgage Market — Today and After World War I*, 19 J. OF LAND & PUB. UTIL. ECON. 224, 227 (1943). Starting in 1974, the Federal Reserve was permitted to rediscount mortgages, like the FHLBs. *See* Federal Reserve Act Amendment, Pub. L. 93-449, § 5, 88 Stat. 1368, 1368 (1974) (codified at 12 U.S.C. § 347b(a)).

[79] *See* Dirk S. Adams & Rodney R. Peck, *The Federal Home Loan Banks and the Home Finance System*, 43 BUS. LAW. 833, 846-49 (1988); Mark J. Flannery & W. Scott

FHLB rediscounting was originally restricted to lending against long-term mortgages with maturities between five and fifteen years[80] and up to the lesser of 60% of the mortgage loan principal or 40% of the property value for amortizing, first lien loans, and 50% of outstanding principal or 30% of appraised value for other loans.[81] Maximum property values were also prescribed for eligible collateral.[82] The FHLBs funded their own operations by issuing bonds, for which all twelve FHLBs were jointly and severally liable.[83] The FHLBs' debt was not formally backed by the federal government, although an implicit guarantee might well have been assumed,[84] and the FHLBs and their securities were (and are) exempt from state and federal taxation.[85]

The FHLB system created a secondary market for mortgages in the United States, solving the problems of locality in mortgage lending. Whereas mortgage lenders were geographically constrained in both their lending and funding bases, the FHLB system provided a method

Frame, *The Federal Home Loan Bank System: The "Other" Housing GSE*, 91 FED. RES. BANK OF ATLANTA ECON. REV. 33, 33 (2006). The FHLBs may also rediscount the notes of FHLB members. *See* 12 U.S.C. § 1431(f) (2010).

[80] 12 U.S.C. § 1424(a)(1)(C) (2012) (restricting FHLB membership eligibility to institutions making long-term loans, and deferring to Federal Home Loan Bank Board discretion on what is long-term); Federal Home Loan Bank Act, Pub. L. No. 72-304 §10(b), 47 Stat. 725, 732 (1932) (establishing that mortgages with more than fifteen years remaining to maturity are ineligible as collateral for FHLB advances); 12 C.F.R. § 925.1 (2010) (defining long-term as longer than five years). The fifteen-year limit was gradually extended to thirty years and then abolished by the Garn-St. Germain Depositary Institutions Act of 1982. *See* Federal Home Loan Bank Act, Pub. L. No. 74-76, § 6, 49 Stat. 293, 295 (1935) (extending term to twenty years); Federal Home Loan Bank Act, ch. 431, 61 Stat. 714, 714 (1947) (extending term to twenty-five years); National Housing Act, Pub. L. No. 88-560, § 906, 78 Stat. 769, 805 (1964) (extending term to thirty years); Garn-St. Germain Depositary Institutions Act of 1982, Pub. L. No. 97-320, § 507, 96 Stat. 1469, 1529 (1982) (abolishing term limitation).

[81] *See* Federal Home Loan Bank Act, Pub. L. No. 72-304 §§ 2(6) (defining home mortgage), 2(8) (defining amortizing), 10(a)(1)-(2), 47 Stat. 725, 731-32 (1932) (codified as amended at 12 U.S.C. §§ 1422(2), (6), 1430(a)(2)-(3) (1934)).

[82] *See* Federal Home Loan Bank Act, Pub. L. No. 72-304, § 10(a)(1); 47 Stat. 725, 731 (1932) (codified as amended at 12 U.S.C. § 1430(a)(2) (1934)).

[83] *See id.* § 11(f), 47 Stat. 725, 734 (1932) (codified at 12 U.S.C. § 1431(b)-(c) (2010)).

[84] *See id.* § 15, 47 Stat. 725, 736 (1932) (codified at 12 U.S.C. § 1435 (2008)) ("All obligations of Federal Home Loan Banks shall plainly state that such obligations are not obligations of the United States and are not guaranteed by the United States."). Such an implicit guarantee seems to have been assumed in 2007–2008. *See* ADAM B. ASHCRAFT ET AL., FED. RESERVE BANK OF N.Y., STAFF REPORT NO. 357, THE FEDERAL HOME LOAN BANK SYSTEM: THE LENDER OF NEXT-TO-LAST RESORT? 3 (2008), *available at* http://www.newyorkfed.org/research/staff_reports/sr357.pdf.

[85] *See* § 13, 47 Stat. at 735 (codified as amended at 12 U.S.C. § 1433).

for diversifying geographic risk in lending and tapping a national (or international) funding base.

Starting in 1933, the FHLB system also assumed regulatory oversight of the new federal savings and loan associations (S&Ls") authorized by the Home Owners' Loan Act ("HOLA").[86] This new type of lending institution was to promote mutual thrifts for savings and mortgage lending. HOLA limited lending activity of federal savings and loan associations: all lending had to be against real estate, and loans beyond 15% of total assets had to be secured by first liens on properties located within fifty miles of the S&L's home office and with a property value cap.[87] Federal thrifts were also restricted to making only fixed-rate loans.[88]

B. Federal Deposit Insurance: FDIC and FSLIC

Oversight authority over the federal S&Ls included resolution authority for failed institutions.[89] Resolution authority was bolstered in 1934 with the creation of the FSLIC.[90] FSLIC provided deposit insurance for savings and loans, just as the FDIC, created in 1932, provided for commercial banks.[91] Deposit insurance was critical because it helped depositary institutions address the duration mismatch between their assets (often long-term) and liabilities (short-term deposits). Deposit insurance helped make deposits less flighty and thereby enabled depositaries to better manage maturities without keeping significant liquid assets on hand.

The combination of federal chartering, federal insurance, and concomitant regulation amounted to a public option.[92] While the federal thrift industry and national bank system are not typically thought of as federal instrumentalities, the combination of chartering, insurance, and regulation renders them such, and jurisprudence on national banks' rights has long recognized them as such.[93] This

[86] *See* Home Owners' Loan Act of 1933, Pub. L. No. 73-43, § 5(c), 48 Stat. 128, 132 (1933).

[87] *Id.* at 132-33.

[88] *Id.* at 130.

[89] *Id.* at 133.

[90] *See* National Housing Act, Pub. L. No. 73-479, § 402, 48 Stat. 1246, 1256 (1934).

[91] *See* Adams & Peck, *supra* note 79, at 836.

[92] *See* Levitin, *supra* note 18, at 48.

[93] *See* McCulloch v. Maryland, 17 U.S. 316, 412 (1819); *see also* Roderick M. Hills, Jr., *Exorcising* McCulloch*: The Conflict-Ridden History of American Banking Nationalism and Dodd-Frank Preemption* (N.Y. Univ. Law Sch. Pub. Law & Legal Theory Working

particular combination is, in fact, precisely what exists presently for Fannie Mae and Freddie Mac. We recognize that the first-loss private risk capital in federal thrifts and national banks as well as independent management distinguishes them from wholly owned government entities such as FHA, but their powers and duties are a determined by federal regulatory action.

C. Market Clearing: HOLC

Faced with a growing mortgage default problem, Congress responded in 1933 by authorizing the FHLBB to create the HOLC, a U.S. government corporation authorized to refinance troubled mortgages.[94] HOLC purchased defaulted mortgages from financial institutions in exchange for tax-exempt 4%, eighteen-year bonds.[95] The financial institutions had to take a haircut on the refinancing, as HOLC would loan up to the lesser of 80% of LTV (but using a generous appraisal standard) or $14,000.[96] HOLC then restructured the mortgages into fifteen- to twenty-year, fixed-rate, fully amortized obligations at 5% interest rates.[97] This action significantly reduced mortgage payments by allowing borrowers to pay off the mortgages over a long term.[98] HOLC originated and serviced all of its mortgages in-house.[99]

HOLC received refinancing applications from no less than 40% of all residential mortgagors in its first year of operation and refinanced half of them.[100] HOLC resulted in a sudden and massive government entrance into the mortgage market. Thus by 1934, the HOLC held $2.379 billion in mortgages, or over 10% of a $22.811 billion market.[101] Nonetheless, "[i]t was well understood that in the H.O.L.C. no permanent socialization of mortgage lending was intended and no

Grp., Paper No. 12-45, 2012), *available at* http://ssrn.com/abstract=2131266.

[94] *See* Home Owners' Loan Act of 1933, Pub. L. No. 73-43 § 4(a)-(b); 48 Stat. 128, 129 (1933).

[95] *See id.* § 4(d), 48 Stat. at 130; HARRISS, *supra* note 59, at 11.

[96] *See id.* § 4(d), 48 Stat. at 130; HARRISS, *supra* note 59, at 12; Snowden, *Mortgage Securitization*, *supra* note 43, at 291.

[97] HARRISS, *supra* note 59, at 12.

[98] § 4(d), 48 Stat. at 130; HARRISS, *supra* note 59, at 12. The interest rate on all HOLC loans was originally 5% but was reduced in October 1939 to 4.5%. GREBLER ET AL., *supra* note 24, at 257.

[99] *See* HARRISS, *supra* note 59, at 65-66.

[100] HARRISS, *supra* note 59, at 16; Snowden, *Mortgage Securitization*, *supra* note 43, at 292.

[101] GREBLER ET AL., *supra* note 24, at 469, tbl.N-2. In 1935, the HOLC's holdings had increased to over 13% of the market. *Id.*

attempt to preserve home ownership irrespective of public cost."[102] Because HOLC was understood to be a temporary measure, it did not create a major political controversy about the role of government in the market.[103] Lenders were relieved to have liquidity while borrowers were able to obtain extremely favorable loan terms.[104] HOLC, then, represented a deliberately temporary public option to help mortgage finance markets clear other than through foreclosure. Yet the standards it set — long-term, fixed-rate, fully amortized mortgages — became ingrained in U.S. housing finance.

Because HOLC would not refinance at 100% LTV, HOLC refinancings required consent of the existing mortgagee.[105] At first, the federal government guaranteed only the timely payment of interest on HOLC securities, but not repayment of principal.[106] Lenders were reluctant to accept HOLC refinancing, as they were both taking an instant haircut and assuming the credit risk of HOLC, whose assets were, by definition, a bunch of lemon loans.[107] Therefore, in order to facilitate HOLC refinancings, the federal government began to guarantee the principal on HOLC securities too,[108] and HOLC securities eventually traded at par.[109]

HOLC wound down by 1951, but it had changed the facts on the ground in four major ways. First, it had forced a market clearing in the U.S. housing market. Through its massive refinancing of underwater loans at 80% of appraised prices, HOLC helped the market eliminate the problem of large scale negative equity preventing transactions. Second, it had turned a large pool of mortgages into marketable securities.[110] Third, it had set the long-term, fully amortized, fixed-rate mortgage as the federal government standard and demonstrated its feasibility.[111] The HOLC use of the long-term, fully amortized, fixed-

---

[102] David M. French, *The Contest for a National System of Home-Mortgage Finance*, 35 AM. POL. SCI. REV. 53, 54 (1941).

[103] *See id.*

[104] *See id.*

[105] HARRISS, *supra* note 59, at 25-26 (describing mortgagees in general); *id.* at 36-37 (describing junior liens).

[106] *Id.* at 11.

[107] *See* Snowden, *Mortgage Securitization*, *supra* note 43, at 291-92.

[108] *See* Home Owners' Loan Act of 1933, Pub. L. No. 73-43, § 4(c), 48 Stat. 128, 129-30 (1933) (including guarantee as to interest); Home Owners' Loan Act of 1933, ch. 168, 48 Stat. 643, 643 (1934) (including guarantee as to principal and interest).

[109] *See* 48 Stat. at 643.

[110] Snowden, *Mortgage Securitization*, *supra* note 43, at 292.

[111] *See* KENNETH T. JACKSON, CRABGRASS FRONTIER: THE SUBURBANIZATION OF THE UNITED STATES 196 (1985).

rate mortgage, along with the creation of the FHLB system, marked the government's practice of supporting "the practice of the savings and loan associations of making long-term amortized first mortgage loans with relatively small down payments and modest monthly payments."[112] As Marc A. Weiss has noted, HOLC, along with "other New Deal programs[,] adapted the S&L model and vastly extended it to a large number and wide range of financial institutions, increasing the length of first mortgage loans from [three] to [thirty] years, decreasing the down payments from 50% to 10% or less, and significantly lowering interest rates."[113] And fourth, HOLC standardized many mortgage lending procedures, including standardized national appraisal methods, mortgage forms, and origination, foreclosure, and REO management processes.[114] The government's entrance into the mortgage market as direct lender via HOLC radically reshaped the U.S. mortgage market.

The HOLC created the template for a national mortgage market out of necessity, not forethought. HOLC rapidly made the federal government the largest single mortgagee in the United States. The federal government did not want to hold the HOLC-modified mortgages long-term because of the default and interest rate risk, as well as the political liability of the government having to conduct foreclosures on defaulted HOLC loans.[115] Therefore the government hoped to sell the HOLC-modified loans back into the private market.

There was little market appetite for this risk on these new long-term, fixed-rate, fully amortized products featuring borrowers with recent defaults, especially in the Depression economy. Therefore, to make the mortgages marketable, the federal government had to provide credit enhancement. The government was thus willing to assume the credit risk on these mortgages, if private investors would assume the interest rate risk.

---

[112] MARC A. WEISS, OWN YOUR OWN HOME: HOUSING POLICY AND THE REAL ESTATE INDUSTRY 5 (1988) (paper presented to the Conference on Robert Moses and the Planned Environment, Hofstra University, June 11, 1988).

[113] *Id.*

[114] Peter M. Carrozzo, *A New Deal for the American Mortgage: The Home Owners' Loan Corporation, the National Housing Act, and the Birth of the National Mortgage Market*, 17 U. MIAMI BUS. L. REV. 1, 23 (2008).

[115] HOLC exercised extreme forbearance on defaults, was slow to foreclose, and rarely took or sought to collect deficiency judgment. HOLC default management was social work-inspired with the aim of rehabilitating the homeowner, rather than maximizing value for HOLC. *See* HARRISS, *supra* note 59, at 86.

D. Mortgage Insurance: FHA and VA

The vehicle through which the government assumed mortgage credit risk while leaving lenders with interest rate risk was federal mortgage insurance from FHA. FHA, a government agency created in 1934, was authorized to insure payment of principal and interest on mortgages in exchange for a small insurance premium charged to the originator and passed on to the borrower.[116] As one contemporary article explained, the object of FHA mortgage insurance was "[t]o do away with the short term mortgage evil."[117]

Because of the credit risk assumed by FHA, FHA insurance was only available for loans meeting certain characteristics. FHA underwriting terms were modeled on the terms of HOLC refinanced mortgages, but were later liberalized. The maximum interest rate permitted on FHA-insured mortgages (exclusive of the insurance premium) was originally 5%.[118] FHA also required that mortgages be fixed-rate and fully amortized.[119] FHA was also willing to insure long-term and (for the time) high LTV mortgages. At first, FHA would insure loans with terms up to twenty years and 80% LTV,[120] but after the 1937 recession, terms were liberalized to provide construction stimulus.[121] FHA was willing to insure up to 97% LTV and 30-year terms (and even 40 years on certain property types),[122] thereby creating a market in long-term and high LTV loans.

Significantly, FHA insurance was only available for institutional lenders, not individuals.[123] The long-term impact of FHA's exclusion of noninstitutional lenders was to almost fully institutionalize the mortgage market.[124] Indeed, the institutionalization of mortgage lending is perhaps the most striking change to have occurred in the U.S. mortgage market in the past century.

---

[116] 12 U.S.C. § 1709 (2011).

[117] *National Housing Act*, 51 BANKING L.J. 628, 630 (1934).

[118] *See* National Housing Act, Pub. L. No. 73-479, § 203, 48 Stat. 1246, 1248 (1934). FHA's authority to restrict maximum interest rates of FHA-insured loans lapsed in 1983. *See* 12 U.S.C. § 1709–1 (repealed 1983). It was later reduced to 4.5% and then 4%, and then raised back to 4.5%. *See* GREBLER ET AL., *supra* note 24, at 257.

[119] *See* 12 U.S.C. § 1709(b)(4) (2012); 24 C.F.R. § 203.17(c)(2) (2012) (describing amortization); *see also* 24 C.F.R. § 203.49 (2012) (permitting insurance of adjustable-rate mortgages, but only as of June 6, 1984).

[120] National Housing Act, Pub. L. No. 73-479, § 203(b)(2)-(3), 48 Stat. 1246, 1248 (1934).

[121] French, *supra* note 102, at 63.

[122] GREBLER ET AL., *supra* note 24, at 257-58.

[123] *Id.* at 246.

[124] *Id.*

In order to deal with credit risk, FHA had to continue the work of HOLC in developing standard national appraisal and underwriting standards and property management procedures.[125] The methods that FHA developed acquired widespread acceptance in the mortgage industry as a whole.[126]

FHA-insured loans were designed to assist in housing affordability. They were not designed to expand homeownership to the poor, but they were designed to be a *middle-class* affordability product. Low down payment requirements and long terms offset the monthly payment increase from full amortization, and rate caps further ensured affordability. The government's assumption of credit risk created a cross-subsidy among riskier and less risky borrowers. Although FHA-insured loans were geared toward affordability, they offered benefits to both borrowers and lenders. Borrowers were insulated against mortgage payment risk since rates would not be impacted by market shocks, while lenders were protected against default risk because of the government guarantee. FHA insurance, then, reallocated the bundle of risks attendant to a mortgage loan. The government and the borrower split the credit risk, while the lender took the interest rate risk. Of course, the taxpayer stood behind the government risk retention.

In order to ensure realization of the affordability benefits of FHA-insured mortgages, it was necessary to free financial institutions from legal restrictions on their lending activities. Thus, FHA-insured loans were exempt from the LTV and maturity restrictions of the National Bank Act.[127] FHA also embarked on a successful campaign to get all forty-eight state legislatures to amend their banking and insurance regulations to permit state-chartered institutions to originate and hold all FHA-insurable loans.[128]

Notably, the removal of state mortgage lending restrictions was done in concert with the creation of new federal restrictions and standards. Thus, HOLA's exemption of federally chartered thrifts from

---

[125] *See* Frederick M. Babcock, *Developments Under the National Housing Act in the Analysis of Mortgage Risk*, 1939 A.B.A. SEC. REAL PROP. PROB. & TR. L. PROC. 50, 52 (1939).

[126] Ernest M. Fisher, *Changing Institutional Patterns of Mortgage Lending*, 5 J. FIN. 307, 311 (1950).

[127] GREBLER ET AL., *supra* note 24, at 246-47.

[128] *See* Adam Gordon, Note, *The Creation of Homeownership: How New Deal Changes in Banking Regulation Simultaneously Made Homeownership Accessible to Whites and Out of Reach for Blacks*, 115 YALE L.J. 186, 188-89, 194-95, 224 tbl.1 (2005). The authors know of no parallel situation in which a federal program necessitated the revision of all states' laws.

state usury laws[129] must be seen in the context of the FHA-insurance interest rate cap. The FHA-insurance interest rate cap served as a federal usury law for mortgages. It directly limited rates on FHA-insured loans,[130] and it indirectly limited rates on conventional loans through competition between FHA and conventional products. HOLA pre-emption was not a policy statement against usury laws, but a harmonization of them to enable a new federal mortgage product that had its own functional usury limit in FHA underwriting terms.

FHA rate caps functionally kept interest rates down in the entire market, not just the FHA-insured market. While the borrowers with FHA loans had to pay for the insurance, the total cost of the loan plus insurance set the price private lenders had to meet when they competed with FHA. (Indeed, because of FHA's low down payment requirements, it put even more pressure on private lenders' rates.)

Functionally, then, FHA rate caps acted like a national usury law for mortgages, but without the credit rationing side effect of usury laws because of FHA's willingness to lend to more marginal borrowers. By limiting interest rates, FHA insurance terms functionally kept predatory lending out of the market because it simply was not possible to develop a profitable and competitive predatory loan product as long as rates were held down.[131] FHA insurance requirements functionally regulated the entire mortgage market.

The FHA insurance system was a response to several problems. First, it was a reaction to the government finding itself a major mortgagee as the result of the HOLC refinancings. The government hoped to be able to sell the HOLC refinanced mortgages to private investors, but no investors would take the credit risk on the HOLC mortgages. Offering a credit guarantee of the mortgages was the only way to move them off the government's books. Second, the government was hoping to attract more capital into the battered mortgage sector. The FHLB system and FSLIC insurance encouraged S&L mortgage lending, but to encourage commercial bank capital deployment in the mortgage sector, more was needed. Commercial

[129] *See* 12 U.S.C. § 1463(g) (2012).

[130] Fees were not covered, however.

[131] A side-effect of FHA's rate limit is the American mortgage phenomenon of "points" — prepaid interest that was not counted against the FHA rate cap — but even points and other up-front fees seem to have been insufficient to offset lower rates. *See* William M. Taylor et al., *An Intertemporal Analysis of the Shifting of FHA Discount Points to Buyers*, 5 MANAGERIAL & DECISION ECON. 242, 243 (1984). Points were prohibited on FHA loans, but appear to have developed as a workaround to FHA rate limits that then spread to the rest of the market. Eileen Shanahan, *F.H.A. Mortgage Interest Raised from 5¼ to 5½%*, N.Y. TIMES, Feb. 7, 1966, at 1, 21.

banks were reluctant to become deeply committed to mortgages not least because of the illiquidity of mortgage assets.

Standardization via FHA insurance was intended to transform mortgages into more liquid assets. Notably, FHA insurance was not originally intended as a long-term federal liability. Instead, it was designed to operate as a mutual insurance fund with federal seed money. This intent can be seen from the structure of FHA claims payments. When an FHA-insured mortgage defaults, the lender is able to make a claim for FHA insurance. FHA insurance payments were originally made solely in the form of FHA-issued debentures that matured three years after the original maturity date of the mortgage.[132] In the original FHA legislation, FHA's debentures were only backed by the full faith and credit of the United States for four years.[133] The expectation appears to be that, thereafter, FHA would have a viable mutual insurance pool for which explicit federal support was not necessary.

FHA insurance requirements along with HOLC refinancings played a major role in standardizing mortgage terms. The importance of standardization cannot be overstated because it was the precondition for the development of a secondary mortgage market. Secondary markets are built around liquidity, and nonstandard instruments are not liquid because each individual instrument must be examined, which adds transaction costs.

FHA insurance also supplied a second necessary precondition for a secondary market: the elimination of credit risk for investors. A secondary mortgage market cannot function unless credit risk is perceived as negligible or monitorable. Elimination, or at least standardization of credit risk, is itself part of standardizing the instruments to trade in a secondary market; as long as there is heterogeneous credit risk among mortgages, secondary market liquidity will be impaired. As economic historian Kenneth Snowden has observed, "[t]he key to successful securitization is to issue marketable assets only on the default-free cash flow implicit in the underlying mortgage pool — for uninformed investors will be

[132] National Housing Act, Pub. L. No. 73-479, § 204(b), 48 Stat. 1246, 1249 (1934). FHA would also issue claim certificates to cover the costs of foreclosure. *See id.* § 204(c). Today, FHA pays insurance claims in cash, debentures, and claim certificates. 24 C.F.R. § 200.156 (2012).

[133] *See* § 204(b), 48 Stat. at 1249. FHA debentures are currently explicitly guaranteed by the Treasury from non-appropriated funds, but are not explicitly full faith and credit. 12 U.S.C. § 1710(d) (2012). The importance of this distinction, if any, is unclear.

unwilling to share any of the risk associated with default."[134] There is much more limited market appetite for mortgage credit risk than there is for mortgage interest rate risk, because credit risk analysis involves a level of diligence that most investors are unwilling to undertake.[135] It is not clear how deep of a housing market can be supported if credit risk is borne by private parties rather than by government.

Accordingly, every attempt at private mortgage securitization has striven to create the perception of the elimination of credit risk. This effort was done through all types of credit enhancements, such as the use of sureties and overcollateralization as with the mortgage guarantee participation certificates or the single-property real estate bond houses of the 1900s and 1920s, or, more recently, through senior-subordinate tranching and bond insurance. Yet credit enhancements do not eliminate credit risk; they shift it (and sometimes concentrate it). This unpleasant truth was recognized as early as 1943 by Paul Matthew Stoner, FHA's Assistant Director for Statistics and Research. Stoner argued that FHA insurance was necessary to replace the discredited private mortgage guarantee certificate system that had collapsed in scandal with the Depression.[136] For capital markets to fund mortgages on a large scale, credit risk had to be largely neutralized (or at least perceived as such).

Federal assumption of credit risk through FHA insurance meant that credit risk was standardized on FHA mortgages. Consequently, FHA mortgages were sufficiently standardized in their terms and credit risk to allow for an institutional market in them.[137] Thus, as economists Leo Grebler, David Blank, and Louis Winnick have noted:

> Government insurance of residential mortgage loans has created a debt instrument that can be shifted easily from one lender to another. From the lender's point of view, government insurance endows mortgage loans with greater uniformity of quality that has ever been the case before, and it reduces the necessity for detailed examination that usually accompanies the transfer of loans from one mortgagee to another. As a result, an active "secondary market" for FHA and VA loans has developed, which in turn has widened the

[134] Snowden, *Mortgage Securitization*, *supra* note 43, at 266.

[135] *See id.*

[136] Stoner, *supra* note 78, at 228.

[137] *See* French, *supra* note 102, at 63.

> geographical scope of the market for mortgage loans and given it some of the characteristics of national capital markets.[138]

FHA insurance alone, however, was not sufficient for a secondary mortgage market to develop. For that, the final New Deal innovation, Fannie Mae, was required.

E. Liquidity Again: FNMA

Investors had little appetite for buying individual mortgages in the secondary market, even if insured, because of the liquidity and interest rate risk involved, as well as the transaction costs of diligencing individual mortgages.[139] Therefore, the National Housing Act of 1934 also contained the fifth element of the housing finance overhaul. It provided for a federal charter for national mortgage associations to purchase these insured mortgages at par and thus create a secondary mortgage market.[140] The goal was to create a secondary market that would encourage mortgage originators to make new loans by allowing them to capitalize on future cash flows through a sale of the mortgages to the mortgage associations, which would fund themselves by issuing long-term fixed-rate debt with maturities similar to those of the mortgages.

The federal national mortgage association charter was made available to all comers; the hope was to attract private risk capital to make a secondary market. There were no applications for the federal national mortgage association charter, however.

Therefore, the Roosevelt administration proceeded to create its own secondary market entity. This creation was first done through the RFC. The RFC was a government corporation known as the "fourth branch" of government during the New Deal.[141] The RFC served as a government financing instrumentality in many areas of the market in which private capital was not forthcoming to meet market demand.[142] In 1935, in order "[t]o assist in the reestablishment of a normal mortgage market" the RFC was authorized to subscribe for or make

---

[138] GREBLER ET AL., *supra* note 24, at 252-53.

[139] Diligence was still necessary even for FHA/VA mortgages to make sure that the mortgages were in fact eligible for insurance.

[140] National Housing Act of 1934, Title III, Pub. L. No. 73-479 § 402, 48 Stat. 1246, 1252 (1934).

[141] *See Brother Can You Spare a Billion? The Story of Jesse H. Jones*, PBS, http://www.pbs.org/jessejones/jesse_bio3.htm (last visited Jan. 24, 2013).

[142] JAMES S. OLSON, SAVING CAPITALISM: THE RECONSTRUCTION FINANCE CORPORATION AND THE NEW DEAL, 1933 – 1940, 128 (1988).

loans upon the stock of any federal national mortgage association or mortgage loan companies, savings and loan associations, and trust companies.[143] Using this authority, in March 1935 the RFC created a subsidiary, the Reconstruction Finance Corporation Mortgage Company ("RFCMC"), a Maryland state-chartered corporation.[144] Notably, the RFCMC did not utilize the federal national mortgage association charter created by the National Housing Act. The RFCMC purchased FHA-insured mortgages, but only on existing properties.[145] The reasons for this limitation in activity are not clear.

When still no applications for a federal national mortgage association charter were forthcoming by 1938, the RFC, on presidential directive, created another subsidiary under the federal charter provisions, the Federal National Mortgage Association of Washington.[146] Two months later it simply became the Federal National Mortgage Association and is now known colloquially as Fannie Mae or in older usage, Fanny Mae.[147] Fannie Mae's original

[143] Act of Jan. 31, 1935, Pub. L. No. 74-1, § 5, 49 Stat. 1, 3 (1935) (adding section 5(c) to the Reconstruction Finance Corporation Act, Pub. L. No. 72-2, 47 Stat. 5 (1932).

[144] SECRETARY OF THE TREASURY, FINAL REPORT ON THE RECONSTRUCTION FINANCE CORPORATION 93 (1959) [hereinafter FINAL REPORT], *available at* http://fraser.stlouisfed.org/docs/publications/rcf/rfc_19590506_finalreport.pdf.

[145] OLSON, *supra* note 142, at 196. The RFCMC was intended to make loans against income producing properties, like hotels and apartment complexes, as well as to support a market in FHA-insured loans. *See* CAROL ARONOVICI & ELIZABETH MCCALMONT, CATCHING UP WITH HOUSING 88 (1936); DIV. OF PUB. INQUIRIES, OFFICE OF WAR INFO., UNITED STATES GOVERNMENT MANUAL 435-36 (1945), *available at* http://ibiblio.org/hyperwar/ATO/USGM/index.html#contents. In 1946, the RFC was authorized to purchase VA-guaranteed mortgages, and the RFCMC did create a secondary market in VA-guaranteed loans. FINAL REPORT, *supra* note 144, at 94-95.

[146] FINAL REPORT, *supra* note 144, at 95.

[147] *Id.*; *see also* 12 U.S.C. § 1716 (2012) (listing purposes of Fannie Mae charter 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 (including activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing;
>
> (4) promote access to mortgage credit throughout the Nation (including central cities, rural areas, and underserved areas) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing; and

name indicated the Roosevelt Administration's lingering hope that private capital would emerge to support other federal national mortgage associations. Fannie Mae was originally a wholly owned subsidiary of the RFC, itself a U.S. government corporation. Unlike RFCMC, Fannie Mae originally purchased FHA-insured mortgages on new construction.[148]

As a government corporation, Fannie purchased mortgages from financial institutions in exchange for its debt securities. Fannie would either keep the mortgage loans in its own portfolio, against which it issued bonds to fund its operations, or resell the loans whole to private investors.[149] Consequently, Fannie was able to pass on some of the interest rate risk on the mortgages to its bondholders, as their bonds had fixed-rate coupons. Functionally, however, neither the Fannie bondholders nor the lenders that sold mortgages to Fannie in exchange for its debt securities assumed any credit risk because Fannie was a government corporation. To be sure, Fannie's securities during this period were never explicitly backed by the full faith and credit of the United States government. The RFC's debt was backed by full faith and credit,[150] but Fannie was a subsidiary of the RFC prior to September 1950, when RFC was transferred to the Housing and Home Finance Agency (which in turn was superseded in 1965 by the Department of Housing and Urban Development).[151] As a RFC subsidiary, Fannie's debt was not explicitly guaranteed, and when Fannie was rechartered by Congress in 1948, there was no mention of a guarantee. Nonetheless, it is hard to imagine that Fannie's debt obligations were perceived in this period as anything but government debt.

Fannie's activities before World War II were fairly limited. In 1938, it purchased $38 million worth of mortgages, compared with $36 million purchased by RFCMC.[152] Its pre-war activity peak was in 1939,

(5) manage and liquidate federally owned mortgage portfolios in an orderly manner, with a minimum of adverse effect upon the residential mortgage market and minimum loss to the Federal Government).

[148] OLSON, *supra* note 142, at 196. Fannie was also authorized to make direct housing loans in Alaska. *See* Reorganization Plan No. 22 of 1950, 15 Fed. Reg. 4,365, 4,366 (July 10, 1950), *reprinted in* 64 Stat. 1277 (1950).

[149] *See* Act of July 1, 1948, Pub. L. No. 80-864, § 301, 62 Stat. 1206, 1207-08 (1948).

[150] *See* Reconstruction Finance Corporation Act, Pub. L. No. 72-2, § 9, 47 Stat. 5, 9 (1932).

[151] Reorganization Plan No. 22 of 1950, 15 Fed. Reg. at 4,365 (detailing provisions pursuant to the Reorganization Act of 1949).

[152] OLSON, *supra* note 142, at 196.

when it purchased $88 million in mortgages.[153] Not until a decade later did Fannie surpass this level of activity.[154]

During World War II, Fannie Mae largely ceased purchase operations. In 1942, RFCMC and Fannie seem to have assumed the same (limited) activities.[155] The U.S. mortgage market was moribund during the war, and did not need government support because the wartime demand for mortgage finance was extremely limited and private funds were eager for wartime outlets.[156] Fannie purchased almost no mortgages between 1943 and 1947 (none in 1944), and let its holdings dwindle to almost nothing.[157]

Fannie Mae's pre-war accumulation of mortgages (as well as the RFCMC's) "were expected to decrease as soon as the FHA type mortgage had proved itself."[158] The RFCMC was even dissolved in 1947.[159] Lack of wartime construction created an acute post-war housing shortage, but the immediate post-war period was also flush with lots of pent-up funds that could finance construction and mortgages.[160] By 1948, however, other more attractive investment outlets had become available, and the mortgage market was strapped for funds.[161]

In 1944, aiming to make housing more affordable to discharged servicemen, Congress had authorized the VA to guarantee mortgages for veterans.[162] The VA would originally guarantee up to 50% of the loan, and required no down payment and capped interest rates at a level equal to or below FHA-insurance eligibility caps.[163] VA-guaranteed mortgages were fixed-rate, fully amortized loans with terms of as long as thirty years.[164] The increase in the amortization period from fifteen to twenty and then to thirty years made housing even more affordable to servicemen, and FHA soon adopted the 30-

[153] R.W. Lindholm, *The Federal National Mortgage Association*, 6 J. FIN. 54, 56 (1951).

[154] *Id.*

[155] OLSON, *supra* note 142, at 217.

[156] Miles L. Colean, *A Review of Federal Mortgage Lending and Insuring Practices*, 8 J. FIN. 249, 252 (1953).

[157] Lindholm, *supra* note 153, at 56.

[158] *Id.* at 56-57.

[159] George W. McKinney, Jr., *Residential Mortgage Lenders*, 7 J. FIN. 28, 42 (1952).

[160] *See* Lindholm, *supra* note 153, at 56-57.

[161] *See* McKinney, *supra* note 159, at 40.

[162] *See* Servicemen's Readjustment Act of 1944, ch. 268, § 501, 58 Stat. 284, 292 (1944).

[163] McKinney, *supra* note 159, at 40.

[164] *See* § 501, 58 Stat. at 291.

year fixed as its standard as well. Thus, by the 1950s, most mortgages were 30-year fixed with down payments of 20%.[165]

Fannie Mae was virtually reborn in 1948, when Congress rechartered it under the authority of the Federal Housing Administrator.[166] The rechartered Fannie Mae was authorized to purchase FHA-insured as well as VA-guaranteed mortgages.[167] Fannie Mae entered the VA-guaranteed market in force. From June 30, 1948 to June 30, 1949, Fannie Mae's holdings increased 809%(!), as Fannie Mae extended purchase commitments in order to stimulate the construction market.[168]

While Fannie played an important part in establishing the VA market, Fannie's activities overall were still on a small scale compared with FHA and VA. FHA and VA provided the main "public option" after HOLC went into wind-down; Fannie provided the market with the comfort of potential liquidity, but was not extensively used until the 1960s.

Nonetheless, Fannie Mae thus laid the ground for three longer-term structural features of the mortgage market. First, it provided liquidity for mortgage originators by creating a secondary market that linked capital market investors to mortgage lenders to mortgage borrowers. This liquidity seems to have contributed to an institutional change in mortgage investment, as life insurance companies entered the market in force, becoming the leading holders of FHA-insured and VA-guaranteed loans by 1950.[169] As the life insurers often purchased loans in the secondary market or via correspondent agents, rather than originate the loans themselves,[170] by 1950 a third of FHA-insured loans and a quarter of VA-guaranteed loans had been acquired by

---

[165] Ben S. Bernanke, Chairman, Fed. Reserve, Speech at the Federal Reserve Bank of Kansas City's Economic Symposium, Jackson Hole, Wyoming (Aug. 31, 2007), *available at* http://www.federalreserve.gov/newsevents/speech/Bernanke20070831a.htm.

[166] *See* Act of July 1, 1948, Pub. L. No. 80-864, § 301, 62 Stat. 1206, 1207-08 (1948).

[167] *See id.* § 301, 62 Stat. at 1207, *amended by* Housing Act of 1948, ch. 832, 62 Stat. 1268, 1275 (1948); *see also* Lindholm, *supra* note 153, at 58. VA-guaranteed mortgages originally differed from FHA-insured mortgages in that there is no cost to the borrower for the VA-guaranty, whereas FHA administers a mutual insurance fund in which the borrowers pay an insurance premium for the insurance on their loans. Since 1982, however, the VA has charged a guaranty fee. *See* Omnibus Budget Reconciliation Act of 1982, Pub. L. No. 97-253, Title IV, § 406(a)(1), 96 Stat. 763, 805 (codified as amended at 38 U.S.C. § 3729 (2012)).

[168] Lindholm, *supra* note 153, at 56-57.

[169] SAUL B. KLAMAN, THE VOLUME OF MORTGAGE DEBT IN THE POSTWAR DECADE 62-63 tbl. 10, 66-67 tbl.12 (1958) [hereinafter VOLUME OF MORTGAGE].

[170] *See* SAULNIER, *supra* note 29, at 30-33.

purchase rather than origination, compared with only 11% of conventional loans.[171]

Second, the Fannie Mae secondary market reduced regional discrepancies in interest rates and financing availability.[172] Fannie was able to harness capital of investors from capital-rich regions to purchase or invest in mortgages from capital-poor regions. This transfer helped smooth out the impact of regional economic booms and busts on the housing sector.

And third, Fannie continued the work of the HOLC in establishing the "American mortgage" — the 20% down, self-amortizing, 30-year fixed-rate mortgage as the national standard.[173] To be sure, the "American mortgage" was subsidized by having the government's credit on the line via Fannie Mae, and this feature helped crowd out other mortgage products; outside of the United States the long-term fixed-rate mortgage remains a rarity.[174]

When the long-term fixed-rate self-amortizing mortgage was first introduced during the Depression, it was an exotic product. The product was introduced at a time of tremendous market uncertainty about future incomes and the economy, and markets were reluctant to take up a new, exotic product. Even with FHA insurance many lenders were initially reluctant to make long-term, fixed-rate loans because of the interest rate and liquidity risk. Fannie relieved the liquidity problem by offering to buy any and all FHA-mortgages at par. By buying long-term, fixed-rate, self-amortizing mortgages and issuing bonds, Fannie Mae transformed what were then exotic mortgage products into plain vanilla, government-backed corporate bonds — something for which the market had a strong appetite. Knowing that liquidity was available through Fannie Mae, even if not used, made the "American mortgage" more attractive to lenders.

The "American mortgage" was a product of a moment when the entire financial system was at risk, but it had advantages that gave it staying power. The long term of the mortgage made it possible to borrow against their long-term earnings. Indeed, the advent of the 30-

---

[171] GREBLER ET AL., *supra* note 24, at 253.

[172] *Id.* at 260.

[173] *See* Green & Wachter, *supra* note 55, at 96-97.

[174] Denmark and Germany are the only two other countries with widespread availability of long-term fixed-rate mortgages. *Housing Finance Reform: Should There Be a Government Guarantee?: Hearing Before the S. Comm. on Banking, Hous. & Urban Affairs*, 112th Cong., Sept. 13, 2011 (statement of Adam J. Levitin, Professor of Law, Georgetown University Law Center) (CIS No.: 2012-S241-30), *available at* http://www.law.georgetown.edu/faculty/faculty-webpages/adam-levitin/upload/levitin-senate-banking-testimony-9_13_11-1.pdf.

year fixed-rate mortgage arguably established the middle class as a class of property owners — and as a class of debtors. Individuals are no longer able to secure credit by indenturing themselves, but the long-term mortgage serves as a proxy for long-term payment commitment. The fixed rate allows families to avoid interest rate shocks against which they have little ability to hedge. Adjustable-rate products, in contrast, leave homeowners exposed to inflation, much like renters. Self-amortization protects against overleverage by constantly reducing the loan to value ratio. Self-amortization also serves as the perfect hedge for families who do not want to be exposed to payment shocks, the way they would be as renters.

By stabilizing consumer finances, the 30-year fixed also helped guard against the systemic risk that can result from mass defaults due to payment reset shock on variable rate mortgages. Thus, the 30-year fixed not only stabilized individual consumers' finances, but also communities and the entire economy.

Taking stock of this all, we see a largely unprecedented regulatory response to the failure of the housing market during the Great Depression. While the creation of the Federal Reserve System, the farm mortgage system, and the U.S. Housing Corporation during WWI had pioneered the *federal* public option model in financial services, the scope of federal intervention in housing finance markets during the New Deal was unparalleled. The federal intervention was somewhat haphazard and uneven, responding to particular problems and building on the splintered nature of U.S. financial regulation, with multiple-chartering options and regulators, rather than effectuating a comprehensive overhaul of housing finance. The federal intervention was also largely intended to be temporary in its nature. Nonetheless, by the late 1940s, the U.S. housing finance system was one run through and by public options. Some command-and-control regulations remained, both on the state and federal level, but there was no command-and-control regime that covered the entire market. Different regulatory regimes applied to different types of institutions, but public options substituted as a type of market-wide regulatory regime.

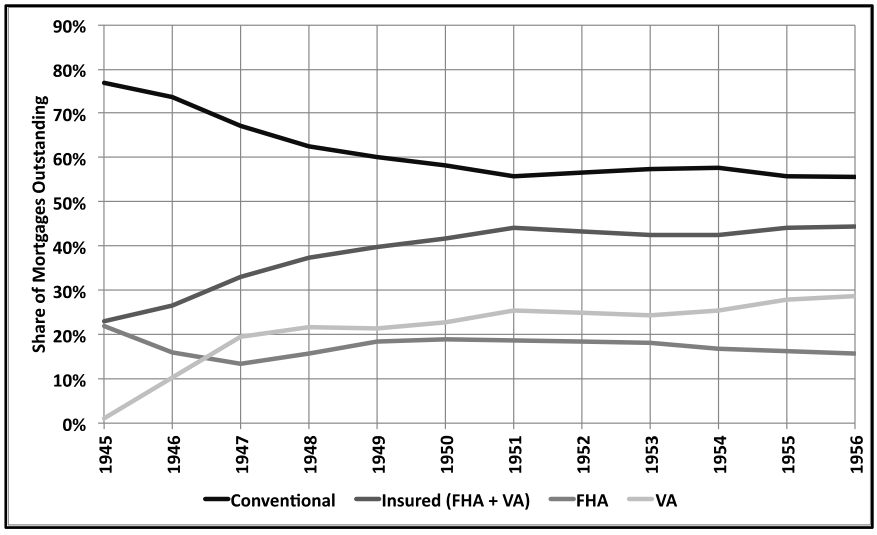
III. THE DECLINE OF THE PUBLIC OPTION

Coming out of the New Deal, the primary mode of regulation of the U.S. housing finance system was through public options in the insurance market, rather than the secondary market. Fannie Mae's holdings in the post-war years were minimal.[175] Fannie's importance at

[175] *See* KLAMAN, VOLUME OF MORTGAGE, *supra* note 169, at 38, tbl.1.

the time lay in providing a put option for mortgage lenders, rather than its actual operations. FHA and VA, however, insured or guaranteed a sizable percentage of the market, peaking at 45% for combined share. (See Figures 4 and 5 below.) While FHA/VA loans were never a majority of the market, they set the standard for the market. The "American mortgage" prevailed,[176] whether insured/guaranteed by FHA/VA or originated by S&Ls without insurance.

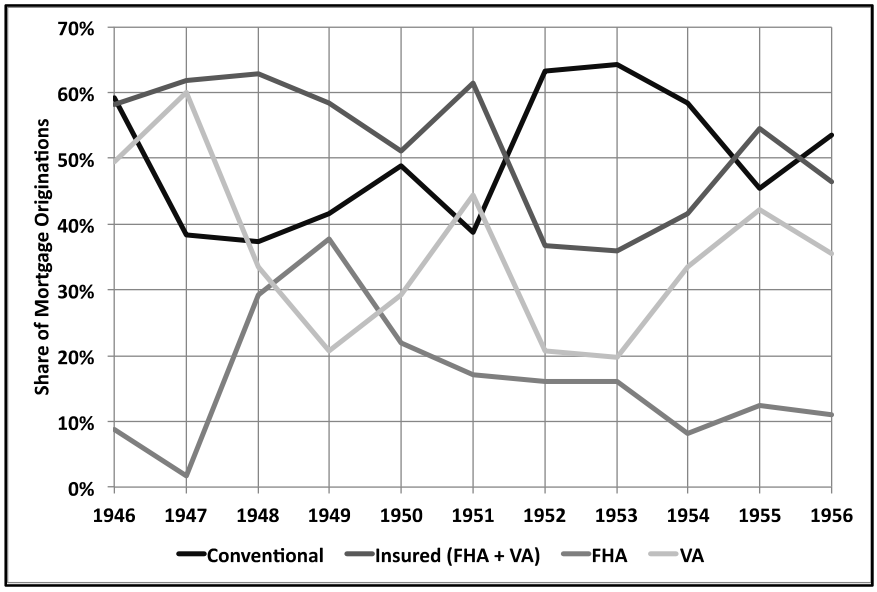
Figure 4. Share of Mortgages Outstanding in Post-war Years[177]



[176] For a discussion of this product in historical and international perspective, see Green & Wachter, *supra* note 55.

[177] KLAMAN, VOLUME OF MORTGAGE, *supra* note 169, at 38, tbl.1.

Figure 5. Share of Mortgage Origination Activity in Post-war Years[178]



There were differences, to be sure, between FHA/VA products and conventional loans. FHA/VA was always the lower down payment/higher LTV option, but at higher cost. Moreover, lending standards evolved and differed between FHA/VA and conventional loans, most particularly in regard to alleged redlining. FHA/VA redlining ended in the late 1960s as the agencies reversed course and began high LTV urban lending initiatives.[179] S&L lending patterns shifted later in response to anti-redlining legislation like Fair Housing Act of 1968,[180] the Equal Credit Opportunity Act of 1974,[181] the Home Mortgage Disclosure Act of 1975,[182] and the Community Reinvestment Act of 1977.[183]

[178] *Id.* at 98, tbl. 22.

[179] *See* Michael H. Schill & Susan M. Wachter, *Housing Market Constraints and Spatial Stratification by Income and Race*, 6 HOUSING POL'Y DEBATE 141, 151, 155-56 (1995).

[180] *See* Fair Housing Act of 1968, Pub. L. No. 90-284, §§ 801-819, 82 Stat. 73, 81-89, (codified at 42 U.S.C. §§ 3601-3619 (2006)).

[181] *See* Equal Credit Opportunity Act, Pub. L. No. 93-495, §§ 701-707, 88 Stat. 1500, 1521-25, (codified at 15 U.S.C. § 1691 (2006)).

[182] *See* Home Mortgage Disclosure Act of 1975, Pub. L. No. 94-200, §§ 301-310, 89 Stat. 1124, 1125 (1975) (codified at 12 U.S.C. §§ 2801-2810 (2006)).

[183] *See* Community Reinvestment Act of 1977, Pub. L. No. 95-128, §§ 801-806, 91 Stat. 1111, 1147, 1148 (codified at 12 U.S.C. §§ 2901-2908 (2006)). Performance

The basic contours of the "American mortgage," however, permeated into the entire market because of the influence of FHA/VA standards. While S&Ls, the dominant mortgage origination institution, eschewed FHA lending (but not VA lending),[184] there was channel competition between S&Ls and FHA/VA originators such as mortgage banks (which often then sold to life insurance companies) and commercial banks. Among the S&Ls themselves, competition seems to have been more limited both because of regulatory restrictions on the rate of return they could offer depositors (Reg Q)[185] and the local nature of the institutions.[186]

Regulation also played a significant role in the prevalence of the "American mortgage." Most importantly, federal thrifts and national banks were prohibited from making adjustable-rate loans,[187] and some

under the Community Reinvestment Act was incorporated into the standard for eligibility for FHLB advances in 1989. *See* Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub L. No. 101-73, § 710, 103 Stat. 183, 418-19 (codified at 12 U.S.C. § 1430(g) (2006)).

[184] SAUL B. KLAMAN, THE POSTWAR RESIDENTIAL MORTGAGE MARKET 163-65 (1961) [hereinafter POSTWAR RESIDENTIAL].

[185] 12 C.F.R. pt. 526 (1978) (setting return rate limits on Federal Home Loan Bank members and FSLIC-insured non-member thrifts). Formally, Regulation Q only refers to the parallel Federal Reserve regulation for Federal Reserve member institutions. *See* Regulation Q, 12 C.F.R. pt. 217 (1978).

[186] *See* Thomas F. Cargill, *Disintermediation*, *in* BUSINESS CYCLES AND DEPRESSIONS: AN ENCYCLOPEDIA 164, 164-65 (David Glasner ed., 1997).

[187] Prior to 1979, federal regulations permitted federally chartered thrifts to make "installment loans", 12 C.F.R. § 545.6-1 (1979), the definition of which included the requirement that "no required payment after the first shall be more, but may be less, than any preceding payment." 12 C.F.R. § 541.14(a) (1979). The FHLBB bruited the idea of permitting ARMs in 1971 and 1974, but backed down in the face of congressional opposition. Joe Peek, *A Call to ARMs: Adjustable Rate Mortgages in the 1980s*, NEW ENGLAND ECON. REV., Mar./Apr. 1990, at 47, 48 (1990). In 1978, however, the FHLBB permitted federal thrifts in California to make ARMs in order to compete with state-chartered institutions, and the authority was expanded nationally as of June 5, 1979. Variable Rate Mortgages, 44 Fed. Reg. 32,199, 32,200 (June 5, 1979); *see* Federal Savings and Loan System, Reduction and Simplification of Regulations, 44 Fed. Reg. 39,108, 39,122 (July 3, 1979). The ARMs permitted, however, allowed only for upward rate (and payment) adjustments. Variable Rate Mortgages, 44 Fed. Reg. at 32,200; Federal Savings and Loan System, Reduction and Simplification of Regulations, 44 Fed. Reg. at 39,122. The Federal Register notice states that "[t]he Bank Board believes such investment authority is necessary to offset the costs of paying higher interest rates on savings accounts and to allow a variable rate on a portion of an association's loans just as variable rates are allowed for certain savings instruments." Variable Rate Mortgages, 44 Fed. Reg. at 32,199. Under the 1979 regulations, S&Ls' ARMs were limited to rate increases to half a percentage point per year, with a maximum aggregate rate change of 2.5% for ARM and 5% for renegotiable rate mortgages. Also, S&Ls offering ARMs had to also offer a FRM alternative to the

states prohibited all lenders from making adjustable-rate loans.[188] Federal thrifts and national banks were restricted in the LTV[189] and geographic scope of their lending,[190] and required to make amortizing

buyer — a precursor, as it were, to the ill-fated "plain vanilla" proposal for the Consumer Financial Protection Bureau. Adjustable Rate Mortgages, 45 Fed. Reg. 79,493, 79,494 (Dec. 1, 1980); 12 C.F.R. § 545.6-4(a) (1980). As of 1979, sixteen states had regulations specifically authorizing ARMs, while six states prohibited at least some forms of ARMs. Adjustable Rate Mortgages, 45 Fed. Reg. 64,196, 64,198 (Sept. 29, 1980).

Federal law for national banks was quiet on the issue of ARMs, leaving federally chartered lenders free to make ARMs, if state law permitted. Adjustable Rate Mortgages, 45 Fed. Reg. at 64, 196, 64,198 (describing Office of the Comptroller of the Currency proposed ARM rules). In 1980, federal banking regulators — the Office of the Comptroller of the Currency, the FHLBB, and the National Credit Union Administration — all passed preemptive regulations on ARM lending. Adjustable Mortgage Loan Instruments, 46 Fed. Reg. 24,148, 24,149 (Apr. 30, 1981) (permitting ARMs for federal savings and loans and mutual savings banks), upheld by Conference of State Bank Supervisors v. Conover, 710 F.2d 878 (D.C. Cir. 1983); *see also* Alternative Mortgage Transactions Parity Act of 1982, Pub. L. No. 97-320, § 804(a), 96 Stat. 1469, 1545-48 (preempting state regulation prohibiting adjustable-rate mortgages); *cf.* Adjustable Rate Mortgages, 46 Fed. Reg. 18,932 (granting ARM authority to national banks), Graduated Payment Adjustable Mortgage Loan Instruments, 46 Fed Reg. 37,625 (July 22, 1981) (permitting federal savings and loans and mutual savings banks to make graduated payment adjustable mortgage loans, such as payment option ARMs), and Adjustable Rate Mortgage Loans, 46 Fed. Reg. 38,669 (July 29, 1981) (describing NCUA regulations granting ARM authority for Federal credit unions).

[188] Prior to 1980, fixed-rate first-lien mortgage products were subject to state usury laws. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 501, 94 Stat. 132, 161 (codified as amended at 12 U.S.C. § 1735f-7a (2006)) (preempting state usury laws for first lien mortgages loans that meet certain consumer protection requirements). Starting in 1980, federal thrifts were permitted to make junior lien mortgages. *Id.* sec. 401 § 5(c), 94 Stat. at 151 (codified as amended at 12 U.S.C. § 1464(c) (2006)) (authorizing mortgage lending without including first lien requirements); Revision of Real Estate Lending Regulations, 45 Fed. Reg. 76,095, 76,906 (Nov. 18, 1980) (explicitly authorizing junior lien lending). Prior to 1982, state laws often prevented the enforcement of due-on-sale clauses, which prevented assumable mortgages from being transferred along with properties, thus keeping the S&L locked into below market interest rate loans. Thrift Institutions Restructuring Act, Pub. L. No. 97-320, § 341(b), 96 Stat. 1469, 1505-08 (1982) (preempting state law on due-on-sale clauses).

[189] *See, e.g.*, 12 U.S.C. § 371 (1970) (setting national bank LTV limits); 12 C.F.R. § 545.6-1 (1976) (setting LTV restrictions). Thrift LTV limits were generally regulatory, but there were statutory LTV limits from 1980 to 1982. *See* Depositary Institutions Deregulation and Monetary Control Act of 1980, sec 401, § 5(c), 94 Stat. at 151 (creating statutory LTV limits); Thrift Institutions Restructuring Act, sec. 322, § 5(c), 96 Stat. at 1499 (repealing statutory LTV limits set in 1980).

[190] 12 U.S.C. § 1464(c) (1976) (setting geographic restrictions on lending); Emergency Home Finance Act of 1970, Pub. L. No. 91-351, sec. 706, § 5(c), 84 Stat.

or partially amortizing loans, with greater LTVs allowed for amortizing loans.[191] In addition, mortgage underwriting was impacted by what FHA/VA would insure and what Fannie Mae would buy or the mortgage collateral against which the FHLBs would advance funds. Prior to 1982, the FHLBs were restricted by statute in terms of the mortgage collateral against which they could make advances.[192] These restrictions pressured the S&Ls to adopt the American mortgage, as the FHLBs were the primary source of liquidity for S&Ls, and the FHLBs were permitted to make larger advances against amortizing loans with minimum term lengths.

Originally, the FHLBs were permitted to advance up to 60% of the amount of the mortgage loan (capped at 40% of the appraised value of the collateral property) for amortizing, first lien, one- to four-family mortgages with terms of at least eight years, but no longer than fifteen years.[193] Advances on all other mortgages were capped at the lower of 50% of the loan or 30% of the appraised value of the property.[194] Mortgages with terms over fifteen years were ineligible as collateral for advances.[195]

The statutory restrictions on FHLB advances were amended several times, keeping pace with changes in FHA/VA term limits.[196] Eventually the terms of advances settled at limits of 90% for FHA/VA loans and 65% of amount and 60% of appraised value for conventional amortizing, first lien, one- to four-family mortgages with terms of at least six years, but no longer than thirty years.[197] Advances on other

450, 462 (granting statewide lending authority); 12 C.F.R. § 545.6-6 (1963) (setting a fifty mile lending radius from headquarters); Lending Area, 30 Fed. Reg. 826, 827 (Jan. 27, 1965) (increasing the lending radius to one hundred miles from headquarters); Lending Area, 36 Fed. Reg. 2,912, 2,912 (Feb. 12, 1971) (establishing a statewide or one hundred mile lending radius from headquarters or branches).

[191] 12 C.F.R. § 541.14(b) (1976) (defining partial amortization as having a maximum thirty-year amortization schedule, but with a shorter term); 12 C.F.R. § 545.6-1 (detailing LTV and amortization restrictions).

[192] Thrift Institutions Restructuring Act sec. 352, § 10, 96 Stat. at 1507 (codified at 12 U.S.C. § 1430(a)(1) (2006)) (giving each FHLB discretion about the amount and type of collateral necessary to fully secure advances).

[193] Federal Home Loan Bank Act, ch. 522, Pub. L. No. 72-304, §§ 2(6), 2(8), 10(a)(1), 47 Stat. 725, 725, 731-32 (1932) (codified as amended at 12 U.S.C. §§ 1422(2), (6), 1430(a)(2) (1934)) (defining "home mortgage" and "amoritized" and setting LTV limits).

[194] *Id.* § 10(a)(2), 47 Stat. at 31-32, (codified as amended at 12 U.S.C. § 1430(a)(3) (1932)).

[195] *Id.* § 10(b), 47 Stat. at 732 (codified as amended at 12 U.S.C. § 1430(b) (1934)).

[196] *See supra* note 80 and sources therein.

[197] 12 U.S.C. § 1430(a)(1)-(2), (b) (1976).

loans were limited to 50% of the loan or 40% of appraised value, and the maximum term permitted was thirty years.[198] The effect of these tiered limitations on advances was to favor longer-term, amortizing mortgages over nonamortizing or shorter-term mortgages. Thus, the terms of FHLB advances helped established the American mortgage outside of the FHA/VA market.

While it was formally possible for lenders to make loans other than the American mortgage, there was no secondary market for these loans and more limited liquidity provision against them. Lenders were therefore generally unwilling to assume the risks on these loans themselves. Thus, the federal government was able to effectively regulate the mortgage market through the domination of the insurance market by public options, as well as traditional command-and-control prohibitions on adjustable-rate loans, limitations on the interest rates paid to depositors, and restrictions on FHLB advances.

Between the late 1960s and the 2000s, however, the housing finance system underwent a series of further changes that undermined the effectiveness of the public option approach.[199] The full details of these changes are beyond the scope of this Article[200] and need not concern us here, as the main point is that regulation via public options remained the mode of regulation despite its declining effectiveness. One point that is relevant, however, is the changing make-up of the institutions that made up the primary mortgage market.

A. The Changing Face of the Mortgage Origination Market

The mortgage origination market changed significantly in the post-war years. While a range of secondary market institutions had been developed during the New Deal, they still played a relatively small role in the mortgage market. Most mortgages were still held either by their originators or by institutional lenders that worked through origination agents.[201] While secondary market institutions were able to provide liquidity and stability to the market, they were seldom used between the Depression and the late 1960s, excepting a brief window in the late

---

[198] *Id.* § 1430(a)(3), (b).

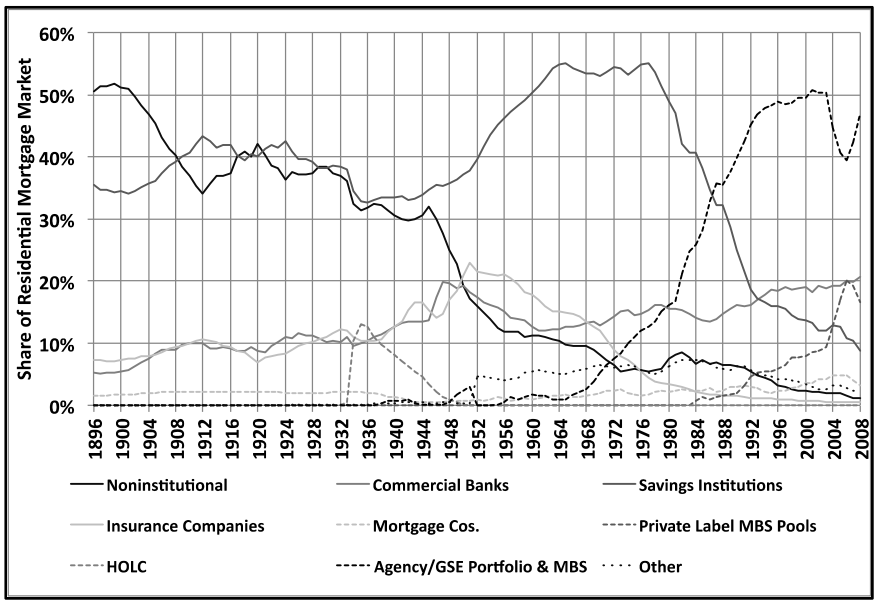
[199] The rebirth of the private mortgage industry in the late 1950s due to changes in Wisconsin insurance regulation also contributed to the undermining of the public option mode of regulation. *See* Quintin Johnstone, *Private Mortgage Insurance*, 39 WAKE FOREST L. REV. 783, 807-08 (2004); Gordon, *supra* note 128, at 212.

[200] *See generally* Adam J. Levitin & Susan M. Wachter, *Explaining the Housing Bubble*, 100 GEO. L.J. 1177 (2012), *available at* http://ssrn.com/abstract=1669401 (detailing the market conditions leading up to the 2008 crisis).

[201] *See* KLAMAN, VOLUME OF MORTGAGE, *supra* note 169, at 40-41, tbl.2.

1940s. As Figure 6 below shows, the market share of the Government National Mortgage Association ("Ginnie Mae"), Fannie Mae, and Freddie Mac (Agency/Government Sponsored Enterprises Portfolios & MBS ("mortgage-backed securities")) was negligible until the late 1960s.

Figure 6. Residential Mortgage Market Share by Institution Type, 1952-2010[202]



Even before the secondary market took off, other changes were occurring in the institutional make-up of the mortgage market. Noninstitutional lenders largely disappeared from the mortgage market in the post-war years.[203] While the market was becoming increasingly institutionalized prior to World War II, FHA's restriction on insurance endorsements to institutional lenders and Fannie Mae's refusal to deal with noninstitutional parties drove the individual mortgage lender out of the market.

The makeup of institutional lenders also changed. While today one might think of "banks" as being the primary mortgage lenders, the

[202] Federal Reserve Statistical Release Z.1, tbls. L.218-219 (providing data for 1952–present); GREBLER ET AL., *supra* note 24 at 468-71, tbl.N-2 (providing data for 1896–1951).

[203] *See supra* Figure 6.

term "bank" covers a broad range of financial institutions with varying business models and regulation. Most important for our purposes is the difference between commercial banks (be they state or federally chartered), S&Ls and other savings institutions (collectively "thrifts"), and mortgage banks (also known as "mortgage companies"). While today the U.S. financial landscape overall and especially in consumer finance is dominated by large commercial banks, historically commercial banks were limited players in residential mortgage lending, not least because of legal limitations upon their investment in home mortgages.[204] Instead, two types of institutions dominated the post-war mortgage origination market: S&Ls and mortgage banks. (See Figure 6.)

S&Ls and mortgage banks had very different business models and market specialization. S&Ls were originally associations of savers in a single geographic area who banded their money together to invest in home purchase and home construction loans to each other.[205] The S&L business model, then, was to originate loans and retain them on their books, making a profit on the spread between what they paid their depositors for funds and what they earned on their mortgage investments.[206]

Mortgage banks, in contrast, largely emerged with the development of FHA/VA insurance/guarantees. They originated insured loans with the goal of selling them into the secondary market, either to Fannie Mae or to other institutional investors, like life insurance companies,[207] while retaining the servicing;[208] the mortgage banks were the original originate-to-distribute business model. Because the mortgage companies did not retain the credit risk on the mortgages they originated, they do not appear as a large part of the market in Figure 6, which reflect the levels of titular holders of mortgages at the time of reporting, rather than flows of mortgages.

Given the mortgage banks' reliance on FHA/VA insurance to cover credit risk, they focused primarily on the FHA/VA market, while the S&Ls dominated the conventional mortgage market.[209] Thus, there

---

[204] *See, e.g.*, CARL F. BEHRENS, COMMERCIAL BANK ACTIVITIES IN URBAN MORTGAGE FINANCING 1 (1952) (describing the "severe limitations" on commercial banks operating in the real estate market).

[205] *See* DAVID L. MASON, FROM BUILDING AND LOANS TO BAIL-OUTS: A HISTORY OF THE AMERICAN SAVINGS AND LOAN INDUSTRY, 1831-1995 12 (2004).

[206] *Id.*

[207] Snowden, *The Evolution of Interregional Mortgage Lending Channels*, *supra* note 24, at 209.

[208] SAUL B. KLAMAN, THE POSTWAR RISE OF MORTGAGE COMPANIES 5-13 (1959).

[209] *See* Richard W. Bartke, *Fannie Mae and the Secondary Mortgage Market,* 66 NW.

was essentially a bifurcation of the origination side of the mortgage market, which mapped onto the secondary market side as well. The S&Ls originated conventional loans and obtained liquidity through the FHLBs. Because of interstate branch banking restrictions, their lending remained highly localized, leaving them exposed to local credit conditions. The mortgage banks, in contrast, originated FHA/VA loans and obtained liquidity through Fannie Mae, which tapped into national credit markets. Commercial banks and rapidly disappearing noninstitutional lenders rounded out the post-war origination market. (See Figure 6.)

B. Privatization of Public Options

In 1966, the United States encountered its first post-war credit crisis.[210] The interest rate that depositary institutions could pay on deposit accounts was limited, however, by federal regulation,[211] whereas Treasury bond rates were not. The economy was expanding more rapidly than the Federal Reserve Board ("the Fed") believed to be prudent, so the Fed refused to raise the Regulation Q ceiling on interest rates payable by depositaries to keep pace with the unregulated interest rates on commercial paper and Treasury securities.[212] As a result, capital flowed from depositary institutions into Treasury bonds and commercial paper, creating a capital shortage in the private market financed by bank loans.[213] The capital shortage for lending institutions caused by this disintermediation hit large ticket items (like mortgage loans) the hardest, and mortgage originators found themselves without the resources to make new loans. Residential construction declined by 23% between the first quarter of 1966 and the first quarter of 1967.[214] Fannie, however,

UNIV. L. REV. 1, 13 (1971) (noting S&L preference for conventional loans over FHA/VA loans). The S&Ls did in fact purchase VA loans, but eschewed FHA loans, having historically been opposed to FHA insurance. KLAMAN, POSTWAR RESIDENTIAL, *supra* note 184, at 163-65.

[210] *See* Saul B. Klaman, *Public/Private Approaches to Urban Mortgage and Housing Problems*, 32 LAW. & CONTEMP. PROBS. 250, 250 (1967).

[211] Regulation Q, 12 C.F.R. pt. 217 (1978) (limiting national banks and Federal Reserve state member banks); 12 C.F.R. pt. 329 (1978) (limiting FDIC insured state nonmember banks); 12 C.F.R. pt. 526 (1978) (limiting rate of returns for Federal Home Loan Bank members and FSLIC-insured non-member thrifts).

[212] *See* Albert E. Burger, *A Historical Analysis of the Credit Crunch of 1966*, FED. RESERVE BANK ST. LOUIS ECON. REV., Sept. 1969, at 13, 24.

[213] *Id.* at 25-27 (discussing the impact on municipal bond and business lending markets).

[214] Bernanke, *supra* note 165.

continued to buy FHA/VA mortgages, which helped stabilize the housing market.[215]

Fannie's market share soared as a result, but its profitability suffered, and concerns arose about its future viability. In 1968, the Johnson administration, eager to clear room in the federal budget for Great Society spending and the Vietnam War,[216] split up Fannie Mae into two entities.[217] One entity, continuing to bear the name Fannie Mae (or Fanny May), was privatized.[218] The other remained government-owned and was christened the Government National Mortgage Association or "Ginnie Mae."[219] Ginnie Mae's mission was restricted to the securitization of FHA-insured and VA-guaranteed mortgages.[220] Fannie Mae, under a revised federal charter, became privately capitalized, but under government regulation and with a third of Fannie's board of directors appointed by the President of the United States.[221] At the time, the Department of Housing and Urban Development had to approve Fannie's securities issuance and authorized the HUD Secretary to require Fannie to engage in mortgage purchase "related to the national goal of providing adequate housing for low and moderate income families, but with reasonable economic return to the corporation."[222]

The new privatized Fannie Mae continued to conduct secondary market activities. It was originally restricted, however, to purchasing only FHA/VA mortgages, even as Ginnie Mae, the new governmental entity, took over Fannie Mae's affordable housing functions.[223] Ginnie Mae also began the first mortgage securitization in the United States by securitizing FHA-insured mortgages. FHA insured the mortgage,

---

[215] *See, e.g.*, *Fanny May Buys a Record Number of Home Mortgages*, N.Y. TIMES, Aug. 26, 1966, at 43 (describing Fannie's efforts to "pump needed money into the mortgage market").

[216] *Cf.* Edwin L. Dale, Jr., *Fanny May Notes to Retain Status,* N.Y. TIMES, Feb. 5, 1968, at 49 (noting that a newly privatized Fannie Mae would operate outside the federal budget).

[217] Housing and Urban Development Act of 1968, Title VIII, Pub. L. No. 90-448, § 801, 82 Stat. 476, 536 (1968) (codified at 12 U.S.C § 1719 (2012)).

[218] *Id.* § 802(c), 82 Stat. at 536-37 (codified at 12 U.S.C § 1718 (2012)).

[219] *Id.* (codified at 12 U.S.C § 1717 (2012)).

[220] *Id.* § 804(b), 82 Stat. at 542-43 (codified at 12 U.S.C § 1721(g) (2012)).

[221] *Id.* § 802(y), 82 Stat. at 539, (codified at 12 U.S.C § 1723 (2012)).

[222] *Id.* § 802(ee), 82 Stat. at 541-42 (codified at 12 U.S.C § 1723A (2012)) (requiring HUD Secretary approval for securities issuance); *see also id.* § 804(a), 82 Stat. at 542 (codified at 12 U.S.C. § 1719) (requiring Treasury Secretary approval for mortgage-backed securities).

[223] 12 U.S.C. § 1720(j) (1970); Housing and Urban Development Act §§ 801, 804(b), 82 Stat. at 536, 542-43.

but Ginnie Mae guaranteed the timely payment of principal and interest on the bonds backed by FHA-insured or VA-guaranteed mortgages;[224] like most consumer insurance policies, FHA insurance and VA guarantees do not promise prompt payments. The additional Ginnie Mae guarantee added relatively little to FHA insurance in terms of credit-worthiness, but the transformation of federally insured mortgages into liquid, federally insured securities had the effect of lowering FHA borrowing rates by sixty to eighty basis points at a time when mortgage rates were 4%-5%.[225] The market was willing to pay a premium for the liquidity provided by bonds over insured whole loans.

C. Creation of Private Public Option: FHLMC

In 1969–1970, another interest rate spike caused a further round of disintermediation, resulting in a decline in funding for depositaries and a substantial decline in housing starts. As interest rates (and inflation) rose and construction declined, home prices rose and mortgages became less and less affordable.[226] Congress responded in 1970 with the Emergency Home Finance Act. The Act authorized Fannie Mae to purchase conventional (non-FHA/VA) mortgages and also created the Federal Home Loan Mortgage Corporation, or Freddie Mac, which was similarly authorized to purchase conventional mortgages.[227] Freddie Mac began to purchase conventional mortgages in 1971, and Fannie began to do so in 1972.[228] FHA and then Fannie

[224] Housing and Urban Development Act § 804(b), 82 Stat. at 542-43 (guaranteeing the "the timely payment of principal of and interest").

[225] Susan Woodward & Robert Hall, *What to Do About Fannie Mae and Freddie Mac*, ECONOMONITOR (Feb. 3, 2009), http://www.rgemonitor.com/financemarkets-monitor/255401/what_to_do_about_fannie_mae_and_freddie_mac. It appears that Ginnie was able to produce a significant drop in the cost of funds for FHA/VA not by creating a secondary market as Fannie had already done, but by making a much larger secondary market. Ginnie Mae MBS accounted for a much larger share of FHA/VA mortgages than Fannie's portfolio holdings had. Greater market share meant more liquidity and resulted in a lower cost of funds.

[226] Peter M. Carrozzo, *Marketing the American Mortgage: The Emergency Home Finance Act of 1970, Standardization, and the Secondary Market Revolution*, 39 REAL PROP., PROB. & TR. J. 765, 768-70 (2005).

[227] Emergency Home Finance Act of 1970, Pub. L. No. 91-351, sec. 201(a)(2), § 801(b), 84 Stat. 450, 450-51 (authorizing Fannie Mae); *id.* § 305(a), 84 Stat. 454-55 (authorizing Freddie Mac) (1970).

[228] *See* Edwin L. Dale, Jr., *Fanny May to Buy Regular Mortgages*, N.Y. TIMES, Dec. 2, 1970, at 73.

and Freddie also started to lower their down payment requirements in the early 1970s to help support the housing market.[229]

The move to create a secondary market in conventional loans was an acknowledgement of the stresses that financial disintermediation were placing on S&Ls. The FHLBs were concerned that they could not provide sufficient financing for the conventional mortgage market simply by rediscounting S&L loans.[230] Congress could have simply expanded Fannie Mae's mandate to include the conventional market, but Fannie Mae was viewed with suspicion by the S&Ls, which saw Fannie as dominated by the interests of mortgage banks because of their FHA-insured business and unsympathetic to their concerns of savings and loans, which had traditionally avoided the FHA-insured market in which Fannie had operated.[231] The S&Ls, therefore, lobbied for their own secondary market organization under the aegis of the FHLB system, membership in which was, at the time, still limited to S&Ls.[232] Accordingly, Fannie Mae was given authority to deal in conventional mortgages *and* Freddie Mac was created to do the same, but for S&Ls. Thus, Freddie Mac was not created to generate competition for Fannie Mae, but rather to placate the concerns of a power interest group.

Freddie Mac was originally a subsidiary of the FHLB system, which still restricted membership to S&Ls. Freddie Mac was initially capitalized through a sale of nonvoting stock to the FHLBs, which were, in turn, owned by their member thrift institutions.[233] Freddie Mac was, therefore, not originally a publicly traded company, unlike post-1968 Fannie Mae. Instead, Freddie Mac was originally designed

---

[229] Douglas W. Cray, *5% Down Payment on Home Allowed*, N.Y. TIMES, Aug. 20, 1971, at 43; *Fanny May Adding 95% Mortgages*, N.Y. TIMES, Sept. 9, 1972, at 32.

[230] *See* Carrozzo, *supra* note 226, at 773-74.

[231] KLAMAN, POSTWAR RESIDENTIAL, *supra* note 184, at 163-65 (noting S&L avoidance of FHA, but not VA loans); Bartke, *supra* note 209, at 13 (noting S&L preference for conventional loans over FHA/VA loans); Richard W. Bartke, *Home Financing at the Crossroads — A Study of the Federal Home Loan Mortgage Corporation*, 48 IND. L.J. 1, 11 (1972) (describing mortgage bank domination of Fannie Mae).

[232] *See* Carrozzo, *supra* note 226, at 772-97 (describing the Emergency Home Finance Act as a compromise between a bill expanding Fannie Mae authority and a bill creating Freddie Mac). FHLB membership was opened to commercial banks in 1989. Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub L. No. 101-73, sec 704(a), § 4(a), 103 Stat. 183, 415-16 (codified at 12 U.S.C. § 1424(a) (2006)).

[233] Edwin L. Dale, Jr., *A New Mortgage Venture Enters Housing Markets*, N.Y. TIMES, Sept. 2, 1970, at 47.

to provide a secondary market for thrifts, enabling them to expand lending even when deposit growth slowed or declined.[234]

Although both Fannie and Freddie were authorized to issue MBS, as well as to hold loans in portfolio,[235] Freddie Mac operated quite differently from Fannie Mae. Freddie Mac operated primarily as a securitization operation, like Ginnie Mae, offering guaranteed pass-thrus, but for conventional rather than FHA/VA mortgages.[236] Freddie Mac did not originally hold loans in portfolio in order to avoid competing with the thrifts from which it bought mortgages (and which owned it indirectly). Through the 1970s, Fannie, in contrast, held loans in portfolio and issued long-term bonds and short-term notes. This difference meant that Fannie was exposed to both interest rate risk and credit risk, while Freddie only had credit risk.

As rates rose dramatically in 1974–1975 and 1979–1981, Fannie's long position on mortgage debt placed it under severe financial pressure. It had to finance itself at higher rates than the yield on the mortgages it held.[237] Freddie Mac did not face this interest rate risk because it was only issuing participation certificates and had no portfolio beyond what was in its securitization pipeline. As a result of interest rate pressures, Fannie Mae began to engage in securitization in 1981.[238] With the rechartering and privatization of Freddie Mac in 1989 as part of the reform of the thrift industry and the FHLBB, the Fannie and Freddie models converged.[239]

The critical move presented by both Fannie and Freddie (both government-sponsored enterprises, or "GSEs") was the division of credit risk from interest rate risk. Investors in the GSEs' MBS assumed interest rate risk on the securitized mortgages, but not credit risk on them. Instead, they assumed the GSEs' credit risk, which was

---

[234] Weiss, *supra* note 66, at 113.

[235] Emergency Home Finance Act of 1970, Pub. L. No. 91-351, § 305, 84 Stat. 450, 454-55 (codified at as amended at 12 U.S.C. § 1454 (2006)) (describing Freddie Mac MBS); Housing and Urban Development Act of 1968, Title VIII, Pub. L. No. 90-448, § 804(a), 82 Stat. 476, 542 (codified at 12 U.S.C § 1719 (2012)) (describing Fannie Mae MBS).

[236] Indeed, Freddie Mac purchased very few FHA/VA mortgages compared to conventional mortgages.

[237] *See* Richard K. Green & Ann B. Schnare, *The Rise and Fall of Fannie Mae and Freddie Mac: Lessons Learned and Options for Reform* 17 (Lusk Ctr. for Real Estate Working Paper No. 2009-1001, 2009), *available at* http://www.usc.edu/schools/sppd/lusk/research/pdf/wp_2009-1001.pdf.

[238] Dwight M. Jaffee & Kenneth T. Rosen, *Mortgage Securitization Trends*, 1 J. HOUS. RESEARCH 117, 122 (1990).

[239] JEFFREY CARMICHAEL & MICHAEL POMERLEANO, THE DEVELOPMENT AND REGULATION OF NON-BANK FINANCIAL INSTITUTIONS 182 (2002).

implicitly backed by the federal government. Similarly investors in GSE debt were really investing in interest rate risk plus an implied government security.

Congress's goal in creating secondary market institutions authorized to deal in conventional mortgages was to create a marketable standardized conventional mortgage instrument.[240] Thus, the standardization move expanded from the government owned or guaranteed market to the conventional mortgage market. The creation of a robust secondary market for non-FHA/VA mortgages under the then-privatized Fannie Mae and the eventually privatized Freddie Mac, appreciably loosened regulatory control over housing finance. The significance of this deregulation through privatization was not immediately apparent, but it set the stage for later developments in the 2000s.

The privatization of Fannie Mae and Freddie Mac meant that their management would be subject to pressure from shareholders, who were not particularly concerned with the policy goals embodied in the GSEs. The privatized GSEs were subject to some command-and-control regulation. They were required to maintain minimum capital levels of 2.5% for on-balance sheet and .45% for off-balance sheet obligations.[241] The GSEs' loan purchases were also subject to single exposure limitations (conforming loan limits) and LTV limitations absent mortgage insurance.[242] Otherwise, however, underwriting was left up to the GSEs. The potential menu of loans that the GSEs could purchase was determined by what was possible in the loan origination market, so the GSEs were in effect constrained by state and federal regulation of the primary market.

Into the late 1980s, however, the GSEs still had fairly small market share; most mortgages were still held in portfolio, particularly by savings and loans.[243] The deleterious effects of GSE competition were only to be felt two decades later, as ruinous competition emerged from the private market.[244] The main effect of the GSEs prior to the 1980s was to provide reassuring liquidity — if the market needed it. It was only with the collapse of the S&L industry in the 1980s that the GSEs — now both privatized — truly emerged as market giants. As this emergence happened, a shift occurred in the nature of the public

[240] *See* Dale, *supra* note 228, at 73.

[241] 12 U.S.C. § 4612(a) (2012).

[242] *See* 12 U.S.C. § 1717(b) (2012) (addressing Fannie Mae); *id.* § 1454 (2012) (addressing Freddie Mac).

[243] *See supra* Figure 6.

[244] *See infra* section III.F-H.

option, which moved from regulating the market primarily through insurance and thrift regulation to regulation of the primary market through regulation of the secondary market via the GSEs.

D. The S&Ls

As Figure 6, above shows, the late 1940s to the late 1970s the U.S. mortgage market was dominated by S&Ls, which at their height held 55% of the residential mortgage loans outstanding.[245] The first half of this period was one of relative stability in U.S. housing finance markets and saw the massive suburbanization of America.[246]

The S&Ls were unequipped to handle rising interest rates in the late 1960s and especially the 1970s. As rates rose with inflation, depositors sought rates of return that kept pace with inflation. The advent of money market instruments[247] resulted in a tremendous disintermediation from the depositary system into the securities system. In order to retain their deposit base in the face of disintermediation, the S&Ls were forced to offer ever-higher interest rates. The S&Ls' assets, however, were long-term, fixed-rate mortgage loans. The result of paying higher interest rates on liabilities than those received on assets was the decapitalization of the S&Ls.

Congress and federal regulators responded to this problem through S&L deregulation. Prior to the 1980s, the S&Ls were still subject to a battery of command-and-control regulations. State-chartered S&Ls were subject to state regulations; the HOLA had preempted state regulations for federal thrifts, but the FHLBB had its own set of command-and-control regulations that limited the type of products S&Ls could originate.

In 1980, as part of the Depository Institutions Deregulation and Monetary Control Act,[248] Congress abolished all interest rate ceilings on first-lien mortgage loans on residences and mobile homes,

---

[245] *See supra* Figure 6.

[246] JACKSON, *supra* note 111, at 232-34, 238.

[247] Here we do not mean money market mutual funds, which were in their infancy, but investments such as Treasuries, certificates of deposit, and corporate commercial paper.

[248] Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, tit. v, § 501, 94 Stat. 132, 161 (codified at 12 U.S.C. § 1735f-7a (2012)). Prior to 1980, Congress preempted state usury caps for FHA and VA loans. *See* Cathy Lesser Mansfield, *The Road to Subprime "HEL" Was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market*, 51 S.C. L. REV. 473, 484-92 (2000). By 1983, all interest rate caps on FHA loans were effectively removed. *Id.* at 483.

including FHA-insured loans, as well as limitations on points, brokers and closing fees, and other closing costs.[249] The effect of this abolition was to eliminate the functional national mortgage usury law that was in place via FHA interest rate limits. Congress also extended national banks' "most favored lender" status to other depository institutions, enabling them to select between a federal and a state maximum applicable rate for their transactions.[250]

The congressional abolition of rate caps on first-lien mortgages combined with the Supreme Court's 1978 *Marquette National Bank* decision and reactive state laws to functionally end meaningful interest rate regulation in the United States. The *Marquette* decision, based on a plain language reading of the 1864 National Banking Act, permitted national banks to export interest rate limitations (or lack thereof) from their home state to other states.[251] States responded by enacting parity laws to protect their state-chartered institutions by giving them the right to charge whatever rate a national bank could charge.[252] The result of this regulatory race was the evisceration of usury laws.

In 1982, Congress passed legislation that preempted state laws prohibiting adjustable-rate mortgages, balloon payments and negative amortization.[253] The 1982 legislation further prohibited "due-on-sale" clauses in mortgages that had prohibited second mortgages absent the first mortgagee's permission.[254] The FHLBB also rewrote its regulations for federal thrifts, allowing them to underwrite adjustable-rate

[249] § 501, 94 Stat. at 161. States can, however, opt out of the deregulation provisions of this act by passing a law to that effect. *Id.* § 501(b)(2) (codified at 12 U.S.C. § 1735f-7a(b)(2) (2012)).

[250] *See* 12 U.S.C. § 1463(g) (2011) (addressing federal savings and loan associations); *id.* § 1785(g) (2011) (addressing federal credit unions); *id.* § 1831d(a) (2012) (addressing state-chartered banks and savings banks). Under federal law, states still have the ability to opt out of the most favored lender preemption.

[251] Marquette Nat'l Bank of Minneapolis. v. First of Omaha Serv. Corp., 439 U.S. 299, 313-15, 318 (1978).

[252] *See* ELIZABETH RENUART & KATHLEEN E. KEEST, THE COST OF CREDIT: REGULATION, PREEMPTION, AND INDUSTRY ABUSES § 3.14 (3d ed. 2005 Supp. 2008). Almost every state has enacted some form of parity provision. John J. Schroeder, *"Duel" Banking System? State Bank Parity Laws: An Examination of Regulatory Practice, Constitutional Issues, and Philosophical Questions*, 36 IND. L. REV. 197, 202 (2003).

[253] *See* Alternative Mortgage Transactions Parity Act of 1982, Pub. L. No. 97-320, §§ 801-807, 96 Stat. 1545-48 (codified at 12 U.S.C. § 3801 *et seq.* (2012)). Six states — Arizona, Maine, Massachusetts, New York, South Carolina, and Wisconsin — timely opted out of AMPTA preemption. RENUART & KEEST, *supra* note 252, §§ 3.10.1, 3.10.2 n.664.

[254] Garn-St. Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, § 341, 96 Stat. 1469, 1505 (codified at 12 U.S.C. § 1701j-3 (2012)).

mortgages.[255] Congress additionally expanded the range of assets in which S&Ls could invest ("direct investment rules"), which enabled S&Ls to invest in assets with *potentially* higher yields than home mortgages, thereby relieving their borrowing-return mismatch.[256]

The result was that the decapitalized S&Ls doubled down on their bets and expanded into markets in which they lacked experience — commercial real estate, junk bonds, race horses, etc. This expansion plus a regulatory environment in which both Congress and the FHLBB engaged in playing ostrich significantly increased the damage done to the S&Ls.

E. The Rise of the GSEs and the Reassertion of the American Mortgage

The lesson from the S&L crisis was that depositories were poorly suited for making long-term fixed-rate loans. Instead, they could either make adjustable-rate loans or they needed to sell their loans into the secondary market. While adjustable-rate lending grew, consumers have evinced a strong taste for fixed-rate loans, around which they can budget. The result, then, was the rapid growth of the secondary market, which, in the 1980s consisted primarily of the GSEs.[257]

The initial response to the rising interest rate environment was a turn to adjustable-rate lending. Regulatory restrictions on ARMs were removed between 1979 and 1981,[258] and by 1982 ARMs accounted for 40% of all mortgage originations, rising to 68% of mortgage originations in August 1984.[259] ARM market share then fell as interest rates fell, but again rose in 1987–1989, peaking at 69% of originations in 1987.[260] ARMs grew, too, as a share of outstanding mortgage debt, comprising just 9% of all residential debt at the end of 1983, but rising to 20% by 1985 and estimated at 25% in 1990.[261]

Notably, as soon as the regulatory carapace was lifted to permit ARMS, they started to advertise "teaser rates" — lower initial fixed

---

[255] *See supra* note 187 and accompanying text.

[256] The FHLBB disastrously widened this expansion by permitting the S&Ls to invest up to 11% of their assets in junk bonds, rather than the 1% permitted by statute, by allowing junk bonds to be counted as both "corporate loans" and non-investment grade securities. *See* William W. Bratton & Adam J. Levitin, *A Transactional Genealogy of Scandal: From Michael Milken to Enron to Goldman Sachs*, 86 S. CAL. L. REV. (forthcoming 2013) (manuscript at 15 at n.35).

[257] *See supra* Figure 6.

[258] *See supra* note 187 and accompanying text.

[259] Peek, *supra* note 187, at 47, 49 Chart 1.

[260] *Id.*

[261] *Id.* at 48.

rates, followed by adjustment to an indexed rate.[262] While the interest rates on fully indexed ARMs were not significantly lower (on a non-option-adjusted basis) than fixed-rate mortgages, the spread between the teaser rates and fixed-rate mortgages made them very attractive to borrowers both in the first ARM boom in 1982–1983, and then in the second boom from 1987–1989.[263] The ARM with a teaser rates was functionally a return to the pre-Depression bullet loan, as borrowers would seek to refinance upon the expiration of the short teaser rate, much like the bullet loan borrower's need to constantly rollover or refinance the loan. The immediate emergence of teaser rate ARMs upon deregulation suggests that, when left to its own devices, the market will produce some version of the bullet loan, rather than the American mortgage. Indeed, outside of the United States, adjustable-rate products, often with short-term fixed teaser periods, are the prevailing mortgage product.[264]

While fixed-rate lending had previously prevailed worldwide, inflationary pressures in the 1970s caused a shift to adjustable-rate lending. The United States started down that path in the 1980s, but reversed course due to the rise of the GSEs, which assumed the interest rate risk that depositaries were ill-equipped to handle. As Figure 5, *supra*, shows, the GSEs rose from having around 20% of the market in terms of outstandings in 1982 to 45% by 1992. The GSEs' market share rose as the S&Ls' declined. In part, this ascension was due to the implosion of the S&L industry in the 1980s, but it was mainly due to a change in the S&L business model from originate and hold to originate and sell to Fannie and Freddie.

The shift of interest rate risk to the GSEs relieved depositaries of the need to engage in large-scale adjustable-rate lending. Instead, they could cater to the strong consumer taste for fixed-rate loans, around which one can budget. The result was the heyday of the GSEs and a rebirth of the American mortgage. While the GSEs were regulated much more loosely than the S&Ls had been prior to the 1980s, they maintained their own underwriting standards, and long-term, self-amortizing products continued to prevail. Through their power in the secondary market, the GSEs were able to exert considerable influence over the terms that prevailed in the primary market, much like FHA

[262] *See id.* at 56.

[263] *See id.* at 56, 59 Chart 3.

[264] *See* Green & Wachter, *supra* note 55, at 101; *see also* Levitin, *supra* note 174 (discussing government support for mortgage markets in Germany and Denmark, which are the other two countries where long-term fixed-rate mortgages are widely available).

insurance previously. This influence could be witnessed as late as 2004, when the GSEs refused to purchase loans with binding mandatory arbitration provisions.[265] As a result, these provisions never became common in mortgages, unlike other types of consumer debt.

F. Emergence of Private Secondary Market: PLS

While the GSEs dominated the secondary market until 2003–2006, a completely private, unregulated secondary mortgage market emerged starting in 1977.[266] This new market was the private-label securitization ("PLS") market. In the PLS market, investors incurred both interest rate risk *and* credit risk on the MBS they purchased, a sharp distinction from Agency MBS, in which investors only incurred interest rate risk. Consequently, MBS investors had to price additionally for credit risk for the first time.

The early PLS market consisted largely of prime "jumbos" — high quality mortgages that were too large to meet the GSEs' conforming loan limits. Numerous credit enhancements were included in the deals to assuage investors' concerns over credit risk.[267] While the PLS market remained quite small for many years, it began to take off in the mid-1990s as a result of the S&L crisis and to experiment in the securitization of loans to ever riskier borrowers, with rapid growth starting in the early 2000s, particularly after 2003.[268] (See Figure 6

[265] *See, e.g.*, Peter G. Miller, *Arbitration Clauses Blocked by Fannie Mae & Freddie Mac*, REALTYTIMES.COM (Feb. 10, 2004), http://realtytimes.com/rtpages/20040210arbitration.htm (describing how arbitration provisions help poor or credit-challenged borrowers, while refusing to allow arbitration provisions favoring wealthier people or mortgage lenders).

[266] The first private-label mortgage-securitization deal is often dated to 1977, with credit being awarded to a $150 million Bank of America deal issued on Sept. 21, 1977. *See* Bank of America National Trust & Savings Assoc.; SEC No-Action Letter, 1977 SEC No-Act. LEXIS 1343, at *5-10 (May 19, 1977) (describing Bank of America MBS transaction); Michael D. Grace, *Alternative Mortgages Instruments and the Secondary Market*, AM. BANKER, Oct. 13, 1982. It appears that this deal was in fact the third mortgage securitization, but the first true private pass-thru securitization. The first modern private mortgage bond appears to have been the California Federal Savings and Loan's September 25, 1975, $50 million bond issuance secured by FHA-insured/VA-guaranteed mortgages by. Grace, *supra*; *Mortgage Bonds*, U.S. NEWS & WORLD REPORT, Oct. 13, 1975, at 86. The second private-label deal was a $200 million bond issuance by the Home Savings and Loan Association (Los Angeles, California) on June 23, 1977, secured by conventional mortgages. The Bank of America deal was a true pass-thru; the prior deals appear to have been secured bonds, meaning that the revenue to pay the bondholders was not necessarily from the mortgages in the first instance.

[267] *See* Levitin & Wachter, *supra* note 200, at 1189-92.

[268] *See supra* Figure 6. We have detailed the rise of PLS extensively elsewhere. *See*

above.) Investors became increasingly comfortable with the credit risk on PLS, not least because of the AAA-rating borne by many of them. By 2006, almost one-half of all mortgage originations were nontraditional products, and private label securitization had grown to 56% of the securitization market.[269]

G. Reregulation and Deregulation via Preemption

The early growth, albeit limited, in subprime lending led to a national legislative response: the Home Ownership and Equity Protection Act of 1994 ("HOEPA"), which prohibited certain predatory lending practices for "high-cost" refinancing loans.[270] HOEPA regulated balloon payments, negative amortization, post-default interest rates, prepayment penalties, due-on-demand clauses, lending without regard to the borrower's ability to repay, and payments to home improvement contractors.[271] It also required special additional Truth in Lending disclosures and imposed assignee liability that trumps state Uniform Commercial Code Article 3 holder-in-due-course status,[272] enabling (among other things) rescission of loans made in violation of Truth in Lending Act requirements.[273] Finally, HOEPA directed that the Federal Reserve Board:

> shall prohibit acts or practices in connection with —
>
> > (A) mortgage loans that the Board finds to be unfair, deceptive, or designed to evade the provisions of this section; and
> >
> > (B) refinancing of mortgage loans that the Board finds to be associated with abusive lending practices, or that are otherwise not in the interest of the borrower.[274]

HOEPA's narrow scope limited its effectiveness as lenders could avoid its application by pricing loans just under the HOEPA rate triggers. Moreover, the Federal Reserve, under Alan Greenspan's

id. at 1189.

[269] INSIDE MORTGAGE FINANCE, MORTGAGE MARKET STATISTICAL ANNUAL (2012).

[270] Home Ownership and Equity Protection Act (HOEPA) of 1994, 15 U.S.C. § 1639 (2012).

[271] *Id.* § 1639(c)-(i).

[272] *See id.* § 1640(a) (2012); 12 C.F.R. §§ 226.32, 226.34 (2012). Holders of HOEPA loans are "subject to all claims and defenses . . . that the consumer could assert against the creditor of the mortgage." 15 U.S.C. § 1641(d)(1) (2012).

[273] *See* 15 U.S.C. § 1635 (2012).

[274] *Id.* § 1639(l) (2012).

chairmanship, engaged in a studious policy of inaction or "nonfeasance," refusing to engage in HOEPA rulemakings despite repeated requests from consumer groups and in derogation of its statutory duty.[275] Many states, however, passed their own "mini-HOEPA" statutes.[276] Yet between 1996 and 2007, federal banking regulators pursued a single-minded campaign of deregulation via preemption, unraveling both state consumer protection laws and state attempts to enforce federal laws.[277] This campaign included both preemption via regulation (arguably exceeding the federal agency's statutory authority) and via litigation. The litigation culminated in the Supreme Court's 2007 ruling in *Watters v. Wachovia*, which upheld the Office of the Comptroller of the Currency's preemption of Michigan's attempt to regulate a subprime lender that was an unregulated operating subsidiary of a national bank.[278]

Unlike with HOLA preemption, which was undertaken to enable FHA-insured lending that came with national standards, federal preemption was not coupled with substitute federal regulation. Instead, a regulatory vacuum replaced disparate state regulation. Thus, in the 1980s, the market-wide regulation system of public options was being undermined, and in an effort to protect the S&L industry from the problems created by rising interest rates, Congress dismantled significant parts of federal and state command-and-control regulation.[279] Federal regulators then followed up in the 1990s and 2000s by undercutting the remaining state command-and-control regulatory systems through preemption and by refusing to vigorously implement the new (albeit limited in scope) federal command-and-control regulatory system of HOEPA.[280] The result, by 2004, was a

[275] *See* KATHLEEN C. ENGEL & PATRICIA A. MCCOY, THE SUBPRIME VIRUS: RECKLESS CREDIT, REGULATORY FAILURE, AND NEXT STEPS 194-96 (2011).

[276] Patricia A. McCoy & Elizabeth Renuart, *The Legal Infrastructure of Subprime and Nontraditional Home Mortgages*, *in* BORROWING TO LIVE: CONSUMER AND MORTGAGE CREDIT REVISITED 110, 119-20 (Nicolas P. Retsinas & Eric S. Belsky eds., 2008). By 2007, only six states — Arizona, Delaware, Montana, North Dakota, Oregon, and South Dakota – did not regulate any of the most troublesome subprime loan terms: prepayment penalties, balloon clauses, or mandatory arbitration clauses. Raphael W. Bostic, et al., *State and Local Anti-Predatory Lending Laws: The Effect of Legal Enforcement Mechanisms*, 60 J. ECON. & BUS. 47, 49, 55-58 (2008).

[277] *See generally* ENGEL & MCCOY, *supra* note 275, at 157-87 (detailing the increase of preemption laws created and enforced and the devastating results of the federal regulators' failure to fill in the gaps left by such preemption).

[278] Watters v. Wachovia Bank, N.A., 550 U.S. 1, 18-19 (2007); *see* McCoy & Renuart, *supra* note 276, at 120-21.

[279] *See supra* section III.D.

[280] *See* ENGEL & MCCOY, *supra* note 275, at 157-66.

multi-trillion dollar national mortgage market with little remaining regulation.

H. Return of the Bullet Loans and the Debacle

Freed of its post-Depression regulations, the U.S. mortgage market quickly reverted to Depression-era "bullet" loans, shifting interest rate and refinancing risk back to borrowers. Nonamortizing, and even negatively amortizing loans, proliferated in the private-label market, as did loans like so-called 2/28s and 3/27s — nominally 30-year loans with short-term fixed-rate teaser periods of two or three years before resetting to much higher adjustable rates. These mortgages were designed to be refinanced upon the expiration of the teaser period, just like bullet loans, and they carried the risk that the borrower would not be able to refinance either because of a change in the borrower's finances, a decline in the value of the property, or a market freeze. As these new bullet loans were at high LTVs, only a small decline in property values was necessary to inhibit refinancing. As noted above, the teaser rate bullet loans had reappeared before in the 1980s with the initial emergence of adjustable-rate mortgages.[281]

The new bullet loans were also tied into a global financing system that amplified their performance but lessened market discipline on underwriting. Meanwhile, securitization separated economic ownership from underwriting, which created agency and information problems that encouraged riskier underwriting and underpricing for risk.[282] The result was disaster.

The post-New Deal U.S. mortgage market was built around regulation by public option, not command-and-control regulation. The public option was eroded through privatization and market developments, while the existing pieces of command-and-control regulation were removed by Congress and then by federal regulators. The end result was that no regulator exercised complete power over the market and agency and information problems encouraged a rapid and unsustainable race to the bottom in lending standards.

CONCLUSION: WHITHER THE PUBLIC OPTION?

The history of the public option in housing finance holds several lessons for about public options in general. The public option arose as a gap filler to address market failures. Indeed, the political will for

[281] *See* Peek, *supra* note 187, at 56.

[282] *See* Levitin & Wachter, *supra* note 200, at 1228-32.

doing so occurred only after truly spectacular market collapses. The history of this accordion-like government involvement in the market is consistent with the government as the ultimate insurer of society, bearing the risk and responsibility of market collapse. The government's involvement in the market did not, of course, prevent market collapse in 2008 because of the deterioration of public-option regulation.

After the market collapsed in both 1929 and 2008, the government served as a stand-in, but also more. It also innovated the 30-year fixed-rate mortgage during the New Deal and standardized mortgage-backed securities and insurance products. Post-2008, the government also played a standardization role for loan modifications. The federal government assumed (and subsidized) the credit risk on the initial capital outlay in order to demonstrate the safety of the standardized products. This move suggests that there is a role for government as innovator and standard-setter because of its superior ability to coordinate and bear risk as long as standardized mortgage products prevail in the marketplace.

To this end, the ability of government to be an innovator also creates the opportunity for regulation by trendsetting. As innovator, the government can shape market norms (for better or worse) that then remain via path dependency and network effects. Yet the effectiveness of public option regulation both with government as pioneer and government as competitor depends very much on a consciousness of the role. Ad hoc entrances of government into the market cannot be relied upon to produce a coherent regulatory policy.

While we have come full circle back to a public option in housing finance as an ad hoc solution once again, not surprisingly, a coherent federal housing regulatory policy is noticeably absent. As of 2008, the U.S. housing finance system had returned to a public option model. The private-label securitization market was dead. Fannie and Freddie were in federal conservatorship. The remaining public entities, FHA/VA, Ginnie Mae, and the FHLBs continued to function, but the mortgage market had become almost an entirely government-supported market. Public option regulation once again maps with a public option market. And once again, the public option is an inadvertent, reactionary approach adopted in response to a crisis, rather than a deliberate, methodical approach.

Going forward, however, it is not clear that public option regulation will continue to be the order of the day. The Dodd-Frank Wall Street

Reform and Consumer Protection Act,[283] the major legislative response to the financial crisis, signaled a different regulatory approach, namely that of command-and-control regulation. The Dodd-Frank Act creates a new set of command-and-control rules for both mortgage origination and mortgage securitization. First, the Dodd-Frank Act created a new Consumer Financial Protection Bureau ("CFPB"), which has broad powers to regulate all mortgage origination and mortgage insurance markets.[284]

The Dodd-Frank Act also has a specific title dealing with mortgage origination. Most critically, the Act prohibits residential mortgage loans if the lender has verified the borrower's ability to repay.[285] Failure to do so is a defense against foreclosure.[286] The Act provides a safe harbor for lenders to the ability to repay requirement. "Qualified mortgages" ("QMs"),[287] as defined by a CFPB regulation that becomes effective in 2014, are conclusively deemed to meet the ability to repay requirement, unless they are "high-cost" loans.[288] Under the QM rulemaking, a mortgage may either be underwritten to certain regulatory specifications or may instead comply with GSE or FHA/VA underwriting standards.[289] Non-QMs do not benefit from a presumption that the borrower was able to repay[290] and are also prohibited from bearing prepayment penalties.[291]

The Dodd-Frank Act also undertakes a reform of the securitization market by requiring that securitizers have "skin-in-the-game," meaning that they retain some risk exposure to their securitized assets.[292] Under regulations promulgated by a consortium of federal financial regulators, securitizers must retain a certain portion of credit risk on assets securitizations (or retain near identical deals) unless the securitized assets fall into certain exempt categories. The most important of those exemptions is for "qualified residential mortgages"

[283] Dodd Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 *et seq.* (2010) (codified at scattered sections of 15 U.S.C.).

[284] *See* Consumer Financial Protection Act of 2012, Pub. L. No. 111-203, §§ 1001-1100, 124 Stat. 1376, 1955-2113 (codified at scattered sections of 12 U.S.C. (2012), 15 U.S.C. (2012), and 20 U.S.C. (2012)).

[285] *Id.* § 1411 (codified at 15 U.S.C. § 1639c(a) (2012)).

[286] *Id.* § 1413 (codified at 15 U.S.C. § 1640 (2012)).

[287] *Id.* § 1412 (codified at 15 U.S.C. § 1639c(b) (2012)).

[288] 12 C.F.R. § 1026.43(e) (2013), 78 Fed. Reg. 6407, 6586-87, Jan. 30, 2013.

[289] 12 C.F.R. § 1026.43(e)(4).

[290] *See* Dodd Frank Act, Pub. L. No. 111-203, § 1412, 124 Stat. 1376 (codified at 15 U.S.C. § 1639c(b) (2012)).

[291] *Id.* § 1414 (codified at 15 U.S.C. § 1639c(c) (2012)).

[292] *See id.* § 941 (codified at 15 U.S.C. § 780-11 (2012)).

("QRMs"), again a term left to definition by the federal financial regulatory consortium.[293]

The Dodd-Frank Act's reforms aside, it remains to be seen what will happen to the public options that today *are* the mortgage market. How long will this ersatz arrangement continue? Will Fannie and Freddie be nationalized, privatized, or recapitalized as hybrid entities? What role, if any, will government guarantees have? Will the market segment to a public option (like FHA/VA) for the poor and private for others? Or will the public option taken as a temporary measure in 2008 – present end up lasting for decades, just like those of the New Deal? If so, will this return to the public option be followed by its erosion and substitution by a private option that is initially stable before it implodes?

The experience of the U.S. housing finance market teaches us that public options can only succeed as a regulatory mode in certain circumstances. A public option that coexists with private parties in the market is only effective at shaping the market if all parties in the market have to compete based on the same rules and standards. Without basic standards applicable to all parties, the result can quickly become a race to the bottom that can damage not only private parties, but also public entities.

The public option has been associated with long-standing structural changes that transformed the shape of American homeownership and mortgages. It created the long-term, fixed-rate, fully amortized mortgage as the standard American housing finance product. In so doing, it made possible sustainable homeownership for two generations of American households.[294] Its unraveling led to the greatest destruction in household wealth in history. For public options to succeed as policy tools and not turn into liabilities, they need to function in a market that has standards for all. Market standards must accompany market participation.

[293] *See id.* § 941(e)(4) (codified at 15 U.S.C. § 780-11(e)(4) (2012)).

[294] *See* JACKSON, *supra* note 111, at 195-96, 203-05.