

## FANNIE MAE, FREDDIE MAC, AND THE HOME MORTGAGE FORECLOSURE CRISIS

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### I.

For nearly sixty years following the Great Depression, the federal government was the primary architect and sponsor of a secondary mortgage market infrastructure that shaped the contours of American housing finance.<sup>1</sup> In the years prior to the subprime crisis, two government sponsored enterprises (GSEs), the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), were the foremost twin pillars of federal housing policy. Generations of Americans lived in homes purchased with mortgages assigned to these two quasi-public companies. Like ordinary corporations, Fannie and Freddie issued stock to profit-seeking investors and were managed by profit-seeking executives and directors. Unlike other companies, bonds and mortgage-backed securities issued by the companies carried a peculiarly informal, but nonetheless now demonstrably present, federal guarantee.<sup>2</sup> While the federal government did not involve itself in the day-to-day business of making loans, it chartered the two companies and maintained a

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1. This essay draws on and updates my prior research on subprime mortgage finance. See generally Christopher L. Peterson, *Predatory Structured Finance*, 28 CARDOZO L. REV. 2185 (2007), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=929118](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=929118).

2. Richard Scott Carnell, *Handling the Failure of a Government-Sponsored Enterprise*, 80 WASH. L. REV. 565, 630-31 (2005) (discussing perception of federal guarantee); David Reiss, *The Federal Government's Implied Guarantee of Fannie Mae and Freddie Mac's Obligations: Uncle Sam Will Pick Up the Tab*, 42 GA. L. REV. 1019, 1025 (2008) (“[I]nvestors in Fannie and Freddie securities would likely not have any legally enforceable claim of a guarantee against the federal government should Fannie and Freddie default.”); Press Release, Federal Housing Finance Agency, Statement of FHFA Director James B. Lockhart (Sept. 7, 2008) (on file with author), available at <http://www.fhfa.gov/webfiles/23/FHFAStatement9708final.pdf> (“Therefore, in order to restore the balance between safety and soundness and mission, FHFA has placed Fannie Mae and Freddie Mac into conservatorship”).

tradition of exercising a distant but firm hand mandating relatively uniform and sound underwriting.<sup>3</sup> In addition to their market power, Fannie and Freddie used their successes, generous political contributions, and aggressive government relations to create tremendous political capital.<sup>4</sup>

Still, Fannie and Freddie also became lightning rods drawing the ire of libertarians, government minimalists, and other opponents of public participation in the marketplace. Critics of the agencies argued that the need for a public secondary market infrastructure had disappeared when Wall Street investment banks learned to channel world capital markets into home mortgages through securitizing mortgage backed securities.<sup>5</sup> Investment bankers' securitization conduits created the first purely private secondary market infrastructure with the size and resources to displace GSE market share.<sup>6</sup> Other critics argued that the GSEs' traditionally standardized underwriting of vanilla mortgage products hindered low income and minority access to homeownership by stifling innovation and alternative mortgage loans.<sup>7</sup> But perhaps foremost among these criticisms was the claim that the implicit government guarantee of the GSEs' bonds and securities created a lucrative, yet inefficient, subsidy captured by the companies' management and shareholders, rather than the American public.<sup>8</sup>

Since 2007 a deflating housing bubble, widespread foreclosures, and losses in derivatives investments have crushed many hedge funds,

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3. 12 U.S.C. § 1716 *et seq.*; Henry T. Greely, *Contracts as Commodities: The Influence of Secondary Purchasers on the Form of Contracts*, 42 VANDERBILT L. REV. 133, 169-70 (1989); Julia Patterson Forrester, *Fannie Mae/Freddie Mac Uniform Mortgage Instruments: The Forgotten Benefit to Homeowners*, 72 MO. L. REV. 1077, 1078 (2007).

4. Julie Creswell, *Long Protected by Washington, Fannie and Freddie Ballooned*, N.Y. TIMES, July 13, 2008, at A1 ("In Washington, Fannie and Freddie's sprawling lobbying machine hired family and friends of politicians in their efforts to quickly sideline any regulations that might slow their growth or invite greater oversight of their business practices. Indeed, their rapid expansion was, at least in part, the result of such artful lobbying over the years").

*Id.*; Ralph Nader, *How Fannie and Freddie Influence the Political Process*, in SERVING TWO MASTERS YET OUT OF CONTROL: FANNIE MAE AND FREDDIE MAC 110, 115-18 (Peter J. Wallison, ed., 2004) ("Fannie and Freddie back up their lobbying with significant campaign donations, particularly in the form of soft money to both major political parties.").

5. Panos Konstas, *Privatizing Fannie Mae and Freddie Mac: An Operating Restriction May be Enough to Increase Competition and Efficiency*, 114 BANKING L.J. 943 (1997).

6. Charles Duhigg, *Pressured to Take More Risk, Fannie Reached Tipping Point*, N.Y. TIMES, Oct. 8, 2008, at A1 (quoting Daniel Mudd, former Fannie Mae CEO on lost market share to private label securitization: "Fannie Mae faced the danger that the market would pass us by.").

7. Charu A. Chandrasekhar, *Can New Americans Achieve the Dream? Promoting Homeownership in Immigrant Communities*, 39 HARV. C. R.-C.L.L. REV. 169, 184-85 (2004).

8. *See, e.g.*, Robert S. Seiler, Jr., *Estimating the Value and Allocation of Federal Subsidies*, in SERVING TWO MASTERS YET OUT OF CONTROL: FANNIE MAE AND FREDDIE MAC (Peter J. Wallison, ed., 2004).

investment banks, and a few depository banks.<sup>9</sup> A loss of faith in securitization spurred by hemorrhaging in securitized home mortgage investments has eliminated demand for private label consumer and commercial asset backed securities.<sup>10</sup> Cash strapped depository banks, afraid to make loans in such a volatile market, have drained the fuel tanks of the nation's corporate merger and acquisition market. Manufacturers and retailers have circled the wagons but left millions of families on the outside looking in—further swelling unemployment insurance rolls, food banks, and homeless shelters.<sup>11</sup> The specter of uncontrollable deflation looms and has prompted Congress to borrow unprecedented billions upon billions to restart the economy.<sup>12</sup> But, most importantly for purposes of this brief essay, Fannie Mae and Freddie Mac collapsed under the weight of millions of loan defaults.<sup>13</sup>

Longtime housing GSE critics have taken this cave in as validation of their previous opposition. Some have gone so far as to suggest that the housing crisis and the severe recession triggered by it were actually caused by the GSEs, rather than foreclosure on privately originated and securitized subprime mortgages or risky speculation in the derivatives. For example, in 2008, Alaska Governor Sarah Palin, the Republican Party's nominee for the Vice Presidency, argued that the solution for the nation's economic woes was reform of oversight of quasi-government agencies like Fannie Mae and Freddie Mac.<sup>14</sup> In contrast, the Obama administration has announced plans to use Fannie and Freddie to help millions of families refinance unaffordable home mortgages, and has promised to buttress confidence in the solvency of the recently nationalized companies with \$200 billion in

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9. Jonathan R. Laing, *Garbage in, Carnage Out: As Borrowers Default, Investors in Securitized Subprime-Loan Instruments such as CDOs could Face Losses Exceeding \$100 Billion. Echoes of the S&L Mess*, BARRON'S, July 9, 2007.

10. Floyd Norris & Eric Dash, *In a Spiraling Credit Crisis, Large Mortgages Grow Costly*, N.Y. TIMES, Aug. 12, 2007, at A1.

11. Bob Erlencusch, et al., National Coalition for the Homeless, *Foreclosure to Homelessness: The Forgotten Victims of the Subprime Crisis* 4-5, 15-16 (April 15, 2008) available at [http://www.nationalhomeless.org/housing/foreclosure\\_report.pdf](http://www.nationalhomeless.org/housing/foreclosure_report.pdf); Louis Uchitelle, *Outlook Darker as Jobs are Lost and Wages Stall*, N.Y. TIMES, July 4, 2008, A1.

12. Peter S. Goodman, *Specter of Deflation Lurks as Global Demand Drops*, N.Y. TIMES, Nov. 1, 2008, at A1; Joseph E. Stiglitz, *A \$1 Trillion Answer*, N.Y. TIMES, Nov. 30, 2008, at A9.

13. Press Release, Federal Housing Finance Agency, Statement of FHFA Director James B. Lockhart (Sept. 7, 2008) (on file with author), available at <http://www.fhfa.gov/webfiles/23/FHFASStatement9708final.pdf>

14. *ABC News*, Sept. 12, 2008, (Charlie Gibson: "What [would] you change in the Bush economic plans?" Governor Palin: "We have got to make sure that we reform the oversight also of the agencies including the quasi-government like Freddie and Fannie. Those things that have created an atmosphere here in America where people are fearful of losing their homes . . . . We have got to reform the oversight of these agencies that have such control over Americans' pocketbooks.").

additional capital.<sup>15</sup>

This essay attempts to mediate the debate over the part the GSEs played in the housing finance crisis and reflects on the future of federal secondary mortgage market policy. First, Part II of this essay provides historical context necessary for understanding the debate over the GSEs' responsibility. Part III explains the development of the private, subprime home mortgage market. Part IV recounts recent events including a radical change in the GSEs investment and underwriting policy in the mid-2000s, the eventual collapse and nationalization of the agencies, and then summarizes the current legal status of the Fannie and Freddie. Part V argues that although the GSEs began to engage in unacceptably risky investment decisions, allegations that the financial crisis is attributable to the GSEs are both an oversimplification and a falsehood. Instead, this article argues that while the GSEs became an important part of the problem, the cause of the financial crisis is a much more complex amalgam of factors that also included monetary policy, regulatory dereliction, judicial passivity, ill-advised borrowing, and reckless (or dishonest) brokering, appraising, lending, servicing, and securitizing by private financial services companies.

## II.

Fannie Mae and Freddie Mac are products of the financial trauma, lessons learned, and market infrastructure produced by the Great Depression. After the 1928 stock market collapse, the American economy entered a spiral of deflation.<sup>16</sup> Excess capacity for production and falling demand for goods and services left farmers and manufacturers unable to sell their products.<sup>17</sup> In the home mortgage market, millions of borrowers defaulted on their loans, flooding the real estate market with cheap

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15. Press Release, The White House, Remarks by the President on the Mortgage Crisis (Feb. 18, 2009) [http://www.whitehouse.gov/the\\_press\\_office/remarks-by-the-president-on-the-mortgage-crisis/](http://www.whitehouse.gov/the_press_office/remarks-by-the-president-on-the-mortgage-crisis/) ("Through its existing authority, Treasury will provide up to \$200 billion in capital to ensure that Fannie Mae and Freddie Mac can continue to stabilize markets and hold mortgage rates down. And we're also going to work with Fannie and Freddie on other strategies to bolster the mortgage markets, like working with state housing finance agencies to increase their liquidity. And as we seek to ensure that these institutions continue to perform what is a vital function on behalf of middle-class families, we also need to maintain transparency and strong oversight so that they do so in responsible and effective ways").

16. Edwin F. Gay, *The Great Depression*, 10 FOREIGN AFFAIRS 529, 530 (1932); Ben S. Bernanke, *The Macroeconomics of the Great Depression: A Comparative Approach*, in ESSAYS ON THE GREAT DEPRESSION 5, 6 (Ben S. Bernanke, ed., 2000).

17. ROLF NUGENT, CONSUMER CREDIT AND ECONOMIC STABILITY 208-09 (1939); Ben S. Bernanke, *Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression*, 73 AM. ECON. REV. 257, 260 (1983); HOWARD ZINN, A PEOPLE'S HISTORY OF THE UNITED STATES: 1492-PRESENT 378-80 (1995).

foreclosures.<sup>18</sup> The banks and insurance companies that had been investing in residential mortgages turned off the spigots out of fear that they would never recoup their investments.<sup>19</sup>

Eventually the federal government seized control of the secondary mortgage market in an attempt induce home mortgage lending. Federal efforts unfolded in a series of initiatives and agencies that ultimately led to the creation of Fannie Mae and, later, Freddie Mac. These efforts began during the Hoover administration, when Congress created the twelve regional Federal Home Loan Banks (FHLBs).<sup>20</sup> Analogous to the Federal Reserve Banks, the FHLBs loaned money to thrifts, which in turn lent these funds to consumers.<sup>21</sup> Although started with government capital, the FHLBs gradually accumulated private funds and eventually became wholly owned by their member thrifts.<sup>22</sup> The FHLBs gave thrifts a reliable and inexpensive source of funds to supplement consumer deposits, which allowed thrifts to develop into the most significant source of home mortgage credit in the mid-twentieth century.<sup>23</sup> Nevertheless, as the savings and loan bailout of the 1980s eventually demonstrated, the FHLBs and thrifts were ultimately backstopped by the federal government.

Despite the newly created FHLBs at the beginning of the Roosevelt administration, lenders were still reluctant to re-enter the market in sufficient numbers and volume to address the unprecedented financial crisis. President Roosevelt, in speeches such as his April 13, 1933 address entitled *A Message Asking for Legislation to Save Small Home Mortgages from Foreclosure*, exhorted Congress to further, more direct action.<sup>24</sup> Responding, Congress created the Home Owners Loan Corporation (HOLC). HOLC used taxpayer funds to buy mortgages owed by financially distressed families.<sup>25</sup> HOLC then refinanced these borrowers into more

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18. THOMAS B. MARVELL, *THE FEDERAL HOME LOAN BANK BOARD* 19 (1969).

19. Gay, *supra* note 16, at 533.

20. DAN IMMERGLUCK, *CREDIT TO THE COMMUNITY: COMMUNITY REINVESTMENT AND FAIR LENDING POLICY IN THE UNITED STATES* 36 (2004).

21. MARVELL, *supra* note 18, at 20-21.

22. Thomas H. Stanton, *Federal Supervision of Safety and Soundness of Government-Sponsored Enterprises*, 5 ADMIN. L. J. 395, 409 (1991); Alvin C. Harrell, *Deposit Insurance Issues and the Implications for the Structure of the American Financial System*, 18 OKLA. CITY U L. REV. 179, 184-85 (1993).

23. Michael J. Lea, *Innovation and the Cost of Mortgage Credit: A Historical Perspective*, 7 HOUSING POL'Y DEBATE 147, 157 (1996).

24. See Franklin D. Roosevelt, *A Message Asking for Legislation to Save Small Home Mortgages from Foreclosure* (Apr. 13, 1933), in 2 THE PUBLIC PAPERS AND ADDRESSES OF FRANKLIN D. ROOSEVELT, at 135 (1938) (illustrating FDR's vision for government leadership in mortgage lending markets).

25. MARVELL, *supra* note 18, at 24.

affordable government loans with longer terms.<sup>26</sup> In about two years HOLC refinanced over a million loans amounting to approximately ten percent of the country's outstanding residential non-farm mortgages.<sup>27</sup> Taxpayers initially funded the HOLC's refinance mortgages, but homeowners eventually paid back the seed money in full.<sup>28</sup> HOLC was created as a temporary agency to help the country out of the depression. It stopped refinancing loans in 1936 and, having finished its mission, was altogether out of business by the early 1950s.<sup>29</sup>

In 1934 Congress created a more permanent federal mortgage market participant in legislation establishing the Federal Housing Administration (FHA). Congress tasked the FHA with offering federally guaranteed insurance to private home mortgage lenders.<sup>30</sup> For loans that met FHA's underwriting criteria, the government agreed to pay mortgage lenders the difference between the price fetched by a repossessed home and its outstanding loan balance.<sup>31</sup> In effect, this insurance protected the lender from the borrower's credit risk and from downward movement in realty prices. FHA's insurance facilitated mortgage loans with much longer durations, down payments of only 20% of the home value, and more affordable monthly installments.<sup>32</sup> With loan terms of up to thirty years, families could now purchase a home over the duration of an adult's working life. FHA's underwriting guidelines also created industry standards which encouraged cautious and professional behavior in loan origination.<sup>33</sup>

Even with the prospect of a federal guarantee on mortgage loan terms, the housing crisis of the 1930s continued. In 1938 Congress created Fannie Mae to simply buy up mortgages that met federal underwriting guidelines and public policy objectives.<sup>34</sup> Qualifying mortgages could be guaranteed, but even more, lenders could assign the loan to Fannie Mae for cash and

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26. Steven A. Ramirez, *The Law and Macroeconomics of the New Deal at 70*, 62 MD. L. REV. 515, 560 (2003).

27. Kenneth T. Jackson, *Race, Ethnicity, and Real Estate Appraisal: The Home Owners Loan Corporation and the Federal Housing Administration*, 6 J. URB. HIST. 419, 421 (1980).

28. MARVELL, *supra* note 18, at 24.

29. MARVELL, *supra* note 18, at 25.

30. Robin Paul Malloy, *The Secondary Mortgage Market—A Catalyst for Change in Real Estate Transactions*, 39 SW. L.J. 991, 992 (1986); IMMERGLUCK, *supra* note 18, at 38.

31. Malloy, *supra* note 30, at 992. *See also* Quintin Johnstone, *Private Mortgage Insurance*, 39 WAKE FOREST L. REV. 783, 785-87, 823-825 (2004) (describing operation of mortgage insurance).

32. IMMERGLUCK, *supra* note 20, at 38.

33. FHA did not, however, encourage equal treatment of all groups. Like HOLC, FHA not only tolerated but encouraged exclusion of ethnic minorities. IMMERGLUCK, *supra* note 18, at 93-95.

34. Malloy, *supra* note 30, at 993.

quickly recoup their initial investment.<sup>35</sup> After the second World War Congress had the Veterans Administration begin purchasing mortgage loans as well.<sup>36</sup> These “unconventional” government sponsored mortgages, along with loans made by FHLB sponsored thrifts, ultimately became the standard mechanism for entry into the American middle class.<sup>37</sup> As Charles Sivesind explained, “[s]ince low-risk FHA-VA loans could be sold to investors across the country, the programs facilitated the early development of an integrated, national mortgage market at little direct cost to the government.”<sup>38</sup> With their fears of illiquidity assuaged, capital markets returned to home mortgage lending investment in force, sponsoring the construction of millions and millions of homes in suburbs surrounding all of America’s major cities.<sup>39</sup>

In the post-war years the two circuits provided historically unprecedented levels of secured credit to Americans. The larger thrift circuit focused primarily on conventional mortgages that were either uninsured or underwritten with private mortgage insurance.<sup>40</sup> The second circuit became increasingly reliant on mortgage companies that focused on nonconventional FHA and VA insured loans which were then assigned to Fannie Mae.<sup>41</sup> By the 1960s, growth in the Fannie Mae circuit was limited by the policy objectives of government insurance programs.<sup>42</sup> The federal government directed its mortgage insurance programs with policy objectives in mind, such as “increasing military housing, national defense housing, urban renewal housing, nursing homes, mobile home parks, and housing for the elderly, among others.”<sup>43</sup> Many mortgage bankers wanted to penetrate into the conventional market dominated by the thrifts, but lacked the reliable, inexpensive capital necessary to do so.<sup>44</sup> The result was pressure on the federal government to provide a source of liquidity for

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35. *Id.* at 992-93

36. Douglas B. Diamond, Jr. & Michael J. Lea, *The Decline of Special Circuits in Developed Country Housing Finance*, 3 HOUSING POL’Y DEBATE 747, 756-61 (1992).

37. DALTON CONLEY, BEING BLACK, LIVING IN THE RED: RACE, WEALTH, AND SOCIAL POLICY IN AMERICA 37-42 (1999).

38. Charles M. Sivesind, *Mortgage-Backed Securities: The Revolution in Real Estate Finance*, in HOUSING AND THE NEW FINANCIAL MARKETS 311, 312-13 (Richard L. Florida ed., 1986).

39. KENNETH T. JACKSON, CRABGRASS FRONTIER: THE SUBURBANIZATION OF THE UNITED STATES 195, 200 (1985).

40. Diamond & Lea, *supra* note 36, at 56-61.

41. Malloy, *supra* note 30, at 994.

42. IMMERGLUCK, *supra* note 20, at 39

43. *Id.* (citing Kerry Vandell, *FHA Restructuring Proposals: Alternatives and Implications*, 6 HOUSING POL’Y DEBATE 299, 311 (1995)).

44. Richard S. Landau, *The Evolution of Mortgage Backed Securities*, in THE SECONDARY MORTGAGE MARKET: A HANDBOOK OF TECHNIQUES AND CRITICAL ISSUES IN CONTEMPORARY MORTGAGE FINANCE 135, 135-36 (Jess Lederman ed., 1987).

conventional loans made by non-depository mortgage lenders.

Once again the federal government responded by facilitating the development of new home mortgage finance infrastructure. In 1968 Congress partitioned Fannie Mae into two separate organizations.<sup>45</sup> The first organization retained the original function, but operated under a new name: The Government National Mortgage Association.<sup>46</sup> "Ginnie Mae," as it became known, continued to purchase nonconventional FHA and VA insured mortgages.<sup>47</sup> The second organization kept the old name, but received a new mission. Fannie Mae became a private federally chartered corporation whose primary function would be to purchase conventional home mortgages from private lenders.<sup>48</sup> At this point Fannie Mae, now referred to as a Government Sponsored Enterprise (GSE), still held home mortgages in its own portfolio, and in turn borrowed money in its own name to finance its operations. The hope was that this new private incarnation of Fannie Mae would provide a reliable low-cost source of funds for lenders wishing to offer conventional, non-government insured mortgages.<sup>49</sup> In 1970, Congress created "Freddie Mac" to serve a similar role as Fannie Mae.<sup>50</sup> By creating a second Government Sponsored Enterprise, Congress hoped to help diversify and promote modest competition in the secondary market.<sup>51</sup> Although Ginnie Mae securities continued to be explicitly guaranteed by the full faith and credit of the U.S. government, federal backing of the new GSEs was more subtle. No federal law explicitly guaranteed the performance of Fannie Mae and Freddie Mac bonds.<sup>52</sup> But, investors nevertheless regarded Fannie and Freddie bonds as functionally indistinguishable from treasury bonds on the theory that the two GSEs were "too big to fail."<sup>53</sup>

A short time later, a new method of obtaining funds for mortgage loans developed: securitization. Rather than holding mortgages themselves, both Ginnie Mae and then Freddie Mac began issuing mortgage-backed securities that "passed through" interest income to investors.<sup>54</sup> The

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45. Malloy, *supra* note 30, at 993.

46. Sivesind, *supra* note 38, at 317.

47. *Id.*

48. *Id.* at 315-16.

49. Malloy, *supra* note 30, at 993.

50. Sivesind, *supra* note 38, at 318-19.

51. Lea, *supra* note 23, at 163-64.

52. Carnell, *supra* note 2, at 571-72.

53. *Id.* at 630-31.

54. STEVEN L. SCHWARCZ, STRUCTURED FINANCE: A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION 609 (Adam D. Ford ed., 3d. ed. 2002 & Supp 2005). *See also* Linda Lowell, *Mortgage Pass-Through Securities*, in THE HANDBOOK OF MORTGAGE-BACKED SECURITIES 25,



agencies would purchase home mortgages, deposit large numbers of them in "pools," and sell participations in the pools to investors on Wall Street.<sup>55</sup> With these new pass-through investment vehicles, investors could hold a share of large (and diversified) numbers of mortgages insured by the government in the case of Ginnie Mae, or guaranteed by the large stable government sponsored enterprises (GSEs) in the case of Freddie Mac and Fannie Mae (who also began securitizing shortly thereafter).<sup>56</sup> Because the agencies still guaranteed the principal and interest income of their securities even when mortgagors defaulted, investors saw the securities as a low risk investment even without the assurances of a rating organization, such as Standard and Poor's or Moody's.<sup>57</sup> Investors could buy and easily resell their investments in order to best suit their portfolios and investment strategies.<sup>58</sup> These mortgage-backed securities had stability and liquidity which generated greater spreads over comparable term treasury obligations than securities of similar risk.<sup>59</sup> Fannie Mae and Freddie Mac required that loan originators meet relatively strict underwriting guidelines and use standardized forms in order to qualify for purchase by the two GSEs.<sup>60</sup> These procedures helped homogenize the risk from different loans with agency loan pools, and in turn alleviated the concerns of all but the most risk averse investors. Securitization of mortgage loans by the GSEs allowed the larger capital markets to directly invest in American home ownership at a lower cost than older models of business.<sup>61</sup>

### III.

Like the GSEs, purely private institutions saw the potential benefits of pooling home mortgages into mortgage-backed securities and soon began attempting to channel capital into home mortgage lending in similar ways.<sup>62</sup> In the early 1970s the baby boom generation was just reaching the age and

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26 (Frank J. Fabozzi ed., McGraw-Hill 5th ed. 2001) ("Pass-through securities are created when mortgages are pooled together and undivided interests or participations in the pool are sold.").

55. Stephen J. Cosentino, *Swimming in the New Waters: Bank Participation in Securitized Loan Pools*, 65 UMKC L. REV. 543, 543-44 (1997).

56. Richard S. Landau, *The Evolution of Mortgage-Backed Securities*, in THE SECONDARY MORTGAGE MARKET: A HANDBOOK OF STRATEGIES, TECHNIQUES AND CRITICAL ISSUES IN CONTEMPORARY MORTGAGE FINANCE 135, 135 (Jess Lederman ed., Merrick New York 1987).

57. Carnell, *supra* note 2, at 630-31.

58. Sivesind, *supra* note 38, at 313.

59. Anand K. Bhattacharya et al., *Overview of the Mortgage Market*, in THE HANDBOOK OF MORTGAGE-BACKED SECURITIES 3, 22 (Frank J. Fabozzi ed., McGraw Hill 5th ed. 2001).

60. *Id.*

61. Joseph C. Shenker & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1369, 1383 (1991).

62. Sivesind, *supra* note 38, at 320.

means necessary to buy homes.<sup>63</sup> Private financiers wanted to mobilize capital to serve this enormous potential demand for credit.<sup>64</sup> Moreover, because the GSEs invested in mortgages with specific middle class oriented policy objectives in mind, they would not purchase unusually large (“jumbo”) mortgages, mortgages with variable interest rates, home equity loans, or—most importantly for our purposes—subprime mortgages.<sup>65</sup> Unmet demand in these market segments left enticing (and large) niches for private investors.<sup>66</sup>

In 1977, Bank of America and Salomon Brothers (with some limited cooperation from Freddie Mac) moved to take advantage of these potential markets by issuing a security where outstanding loans were held in trust, with investors as beneficiaries.<sup>67</sup> The trust itself was entirely passive—it had no employees or assets aside from the home mortgages themselves.<sup>68</sup> Participations in these trusts are generally recognized as the first mortgage-backed securities issued by the private sector—now called “private label” mortgage-backed securities.<sup>69</sup>

Initially, investment in these “securitized” mortgages suffered from legal and pricing problems stemming in part from the novelty of the new method of finance.<sup>70</sup> For instance, some large public investment funds were effectively precluded from investing in mortgage-backed securities by laws meant to prevent purchases of undiversified or risky investments.<sup>71</sup> Also, investors and brokers alike had difficulty comparing the present value of bundles of thirty year home mortgages.<sup>72</sup> Since few investors were willing

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63. Lewis S. Ranieri, *The Origins of Securitization, Sources of Its Growth, and Its Future Potential*, in A PRIMER ON SECURITIZATION 31, 31 (Leon T. Kendall & Michael J. Fishman, eds., 1996).

64. *Id.* at 31-32.

65. MEIR KOHN, FINANCIAL INSTITUTIONS AND MARKETS 623-24 (1994).

66. Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 WA. U. L.Q. 1061, 1121 (1996).

67. Ranieri, *supra* note 63, at 33-34; Sivesind, *supra* note 38, at 321.

68. Ranieri, *supra* note 63, at 32-33.

69. Richard A. Brown & Susan E. Burnhouse, *Implications of the Supply-Side Revolution in Consumer Lending*, 24 ST. LOUIS U. PUB. L. REV. 363, 392 (2005). Private label mortgage-backed securities are also sometimes called non-agency securities in contrast to the older “agency” securitized mortgage loans issued by the GSEs. ANDREW DAVIDSON ET AL., SECURITIZATION: STRUCTURING AND INVESTMENT ANALYSIS 288-89 (2003). Some commentators also refer to private label mortgage-backed securities as “nonconforming,” since they do not meet the underwriting standards of the GSEs. *Id.*

70. Ranieri, *supra* note 63, at 36.

71. *Id.* at 33. The New York State Retirement System, for example, could not invest in mortgages of less than a million dollars on the theory that the risks from smaller individual consumer home mortgages were too great. *Id.*

72. See, e.g. Patric H. Hendershott & Robert Van Order, *Pricing Mortgages: An Interpretation*

to keep their money tied up for thirty years, they needed a relatively reliable method for predicting what actual yields would be, so investors could compare those yields to yields of other potential investments.<sup>73</sup> Without such a method, mortgage-backed securities suffered from liquidity problems and were accordingly artificially undervalued.<sup>74</sup>

Eventually, the market, along with some help from Congress in the mid-1980s,<sup>75</sup> succeeded in developing financial tools to overcome these hurdles. In particular, investment banking firms developed pricing models that allowed prospective investors to anticipate the value and liquidity of private-label mortgage backed securities.<sup>76</sup> Investment banks also began partitioning risk into different investments types with a variety of credit risks, all drawing on the same income stream from a pool of mortgages.<sup>77</sup> Where earlier residential mortgage backed securities would merely pass through income to investors, *tranche*d securities divided payments into different income streams suited to the time and risk preferences of investors.<sup>78</sup> Thus, investment bankers learned to tailor securities to the needs of different investors, making investment in mortgage-backed securities desirable to a broader range of potential investors.<sup>79</sup> Eventually, private label, subprime mortgage backed securities were typically offered in tiers of credit risk where pool income was distributed to the highest risk profile (usually with the highest possible rating) first, and would then

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*of the Models and Results*, 1 J. OF FIN. SERVICES RES. 77, 77 (1987) (discussing the difficulty of pricing residential mortgage backed securities).

73. *Id.*

74. Shenker & Colletta, *supra* note 61, at 1380.

75. Following lobbying efforts of investment bankers, Congress passed legislation to clear out the legal obstacles to private securitization of home mortgages. Ranieri, *supra* note 63, at 37. The most important legal development was passage of the Secondary Mortgage Market Enhancement Act of 1984 (SMMEA) in which Congress preempted a variety of state laws that inhibited private home mortgage securitization, including state retirement fund laws which prevented public pension funds from investing in private home mortgage securities. 15 U.S.C. §77r-1 (2009). SMMEA also preempted state blue sky laws to allow securitizers to avoid registering under state securities laws to the same extent that securities issued by Fannie Mae, Freddie Mac, or Ginnie Mae were exempt. *Id.* 15 U.S.C. § 77r-1(c) (2009). In addition to preempting state laws, SMMEA authorized delayed delivery of home mortgage-backed securities in order to facilitate forward trading. *Id.* 15 U.S.C. §§ 78g(g), 78h(a), 78k(d)(1) (2009). And, it permitted national banks, federal credit unions, and federal savings and loans associations to invest in privately issued home mortgage-backed securities. 12 U.S.C. §§ 24, 1757 (2009). See Shenker & Colletta, *supra* note 61, at 1386 (summarizing key SMMEA provisions).

76. Hendershott & Van Order, *supra* note 72, at 77-78 (providing brief literature review of mortgage securities pricing models).

77. Leon T. Kendall, *Securitization: A New Era in American Finance*, in A PRIMER ON SECURITIZATION 1, 8-9 (Leon T. Kendall & Michael J. Fishman eds., MIT Press 1996).

78. *Id.*

79. *Id.*

“waterfall” down to each subsequent subordinated risk tier.<sup>80</sup> The lowest risk tier, called an “equity piece,” would absorb all losses before the next level absorbed any loss at all.<sup>81</sup>

By the 1990s, the private label securitization market specializing in subprime mortgages, jumbo mortgages, and an expanding array of alternative mortgage products with non-amortizing features were rapidly capturing market share from more traditional GSEs.<sup>82</sup> With the new access to large pools of capital, unscrupulous and thinly capitalized mortgage brokers and lenders began to aggressively market a new crop of questionable subprime and manufactured home mortgage loans.<sup>83</sup> Legal aid attorneys, consumer advocates, and the press began to see an increase in the volume of what America would soon come to call predatory mortgages.<sup>84</sup>

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80. Eric Elvers, *Regulatory Capital Standards for Securitization in Basel II*, in *SECURITIZATION OF DERIVATIVES AND ALTERNATIVE ASSET CLASSES: YEARBOOK 2005*, at 472 (Jan Job de Vries Robbe & Paul A. U. Ali, eds. 2005).

81. See, e.g., JANET M. TAVAKOLI, *CREDIT DERIVATIVES & SYNTHETIC STRUCTURES: A GUIDE TO INSTRUMENTS AND APPLICATIONS* 259 (John Wiley & Sons, Inc. 2d ed. 2001) (“Virtually anything can be securitized. Even the first loss pieces of CLOs can be securitized. Hedge fund purchasers of certificates in SLT structures sometimes seek to perform just this type of securitization. The first loss equity piece is combined with either a Treasury zero-coupon bond or a corporate zero-coupon bond”).

82. EDWARD M. GRAMLICH, *SUBPRIME MORTGAGES: AMERICA’S LATEST BOOM AND BUST* 1-4 (2007).

83. Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 546 (2002); Kathleen Engel & Patricia McCoy, *Predatory Lending: What Does Wall Street Have to Do with It?*, 15 HOUSING POL’Y DEBATE 715, 741-2 (2004); Peterson, *supra* note 1, 2213-21.

84. A small sample of headlines that now seem prescient includes: Editorial, *Curb Lending Predators*, DENV. POST, Mar. 10, 2002, at E6 (“Predatory lenders often target the elderly, minorities and those in low-income neighborhoods, charging astronomical interest rates – even for those with good credit.”); Robert K. Heady, *Greedy Lenders Continue to Pitch Their Predatory Loans*, HARRISBURG PATRIOT, Apr. 24, 2002, at D2 (“Predatory loans . . . have been exploding across America since the 1990s, fueled by greedy lenders who, with their fast pitches, particularly exploit women, the elderly, the less-creditworthy and low-income neighborhoods.”); Mary Kane, *Subprime Mortgage Loans Raise Concerns: High Rates, Fees Leave Little Equity, Lots of Risk*, NEW ORLEANS TIMES-PICAYUNE, Apr. 9, 2000, at F1 (“In a record economy . . . it might seem odd for anyone to worry about home ownership problems. But the growth of subprime lending—high rate, high-fee loans—along with loans that require no down payments or allow for huge debts, is raising concern.”); Mary Meehan, *Loan Wolves: Kentuckians Lose Homes to Predatory Lending*, LEXINGTON HERALD-LEADER, Apr. 10, 2002, at C1 (“Targeted at borrowers who often don’t have access to more-mainstream financial institutions, [predatory lending is] a growing problem in Kentucky and across the country.”); Editorial, *Predatory Lending a Shameful Practice that Must be Ended*, THE STATE (Columbia, S.C.), Feb. 24, 2002, at D2 (“[J]ust because someone is a credit risk does not mean they should be taken advantage of.”); *CBS Evening News: Predatory Lenders Driving Foreclosures*, (CBS television broadcast, July 18, 2002), available at 2002 WL 6517143 (statement of Cynthia Bowers, CBS News Correspondent) (“[I]n Chicago alone over the last decade, the number of foreclosures has jumped from about 100 a year to nearly 5,000.”).

In 1994 Congress recognized the trend of growing dishonesty and harsh practices in these new breed of aggressive private mortgages. Moreover, it responded with the Home Ownership and Equity Protection Act (HOEPA), a statute that amended the Truth in Lending Act.<sup>85</sup> The new laws purported to provide enhanced price disclosures and limit some of the most abusive practices in loans that exceeded price thresholds that triggered the act.<sup>86</sup> Unfortunately, the price thresholds were set so far above the bulk of the subprime market, the statute was functionally irrelevant.<sup>87</sup> Moreover, the price disclosures were ill-suited to capturing the risks associated with the dazzling variety and increasing complexity of new types of mortgage loans.<sup>88</sup> Substantive protections in the statute were so riddled with loop holes, that the law did little or nothing to impede subprime mortgage lending. While the Federal Reserve Board had the broad administrative discretion to strengthen HOEPA regulations,<sup>89</sup> Chairman Alan Greenspan and his staff chose not to exercise that power in a way that would stanch the rising tide of fraudulent and ill-advised mortgages that gathered volume and momentum in the new century.<sup>90</sup>

#### IV.

Early on, Fannie Mae and Freddie Mac were not involved in the growing subprime mortgage market. Indeed, throughout the 1990s, industry insiders referred to loans that qualified for purchase by the GSEs as “conforming” in order to highlight the differences between subprime loans

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85. Home Ownership and Equity Protection Act of 1994, Subtitle B of Title I of the Riegle Community Development and Regulatory Improvement Act, Pub. L. No. 103-325 (1994), *codified at* 15 U.S.C. § 1639 (2009).

86. 15 U.S.C. § 1602(aa)(1)(A) (2009); DEE PRIDGEN, CONSUMER CREDIT AND THE LAW § 9:25 (2006).

87. Transcript of the Federal Reserve Board Public Hearing on Home Equity Lending, at 12 (Aug. 16, 2000) (statement of William Darr) (estimating that HOEPA provisions apply to less than one percent of the mortgage market), *available at* <http://www.federalreserve.gov/Events/PublicHearings/20000816/20000816.htm> (last visited Mar. 29, 2009); GRAMLICH, *supra* note 82, at 88.

88. Joshua Buch et al., *The Usefulness of the APR for Mortgage Marketing in the USA and the UK*, 20 INT'L J OF BANK MARKETING 76, 76-85 (2002); Lauren E. Willis, *Decisionmaking and the Limits of Disclosure: The Problem of Predatory Lending: Price*, 65 MD. L. REV. 707, 778 (2006).

89. 15 U.S.C. § 1639(l) (“Discretionary regulatory authority of Board . . . The Board, by regulation or order, 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 interests of the borrower”).

90. Edmund L. Andrews, *Fed and Regulators Shrugged as the Subprime Crisis Spread*, N.Y. TIMES, December 18, 2007, A1.

and the prime market served by Fannie and Freddie.<sup>91</sup> Moreover, in the first years of private label residential mortgage securitization, Fannie and Freddie also avoided the growing market in “alt-A” loans with a range of non-amortizing, variable interest rate, documentation, and prepayment penalty features that were made to borrowers with a variety of credit profiles.<sup>92</sup> Critics of the GSEs complained that Fannie and Freddie only purchased “vanilla” loans based on relatively conservative and strict automated underwriting systems.<sup>93</sup> In contrast, subprime mortgage lenders sold their loans to many different large mortgage companies or investment bankers, who then passed much of the risk on to investors through securitization. As a result “rates, fees, and program guidelines [varied] drastically depending on which broker or lender a consumer visit[ed].”<sup>94</sup>

Nevertheless, the management of the GSEs had the ability to expose the companies, and in turn, taxpayers, to risks in the subprime and alt-A market through something of a back door. While traditionally the role of the GSEs was purchasing mortgage loans from retail lenders, the GSEs also maintain significant investments independent of their directly purchased mortgage loans. For example, both companies purchase a large volume of derivatives to protect the companies against the risk that rising short-term interest rates will increase their cost of funds and render their long term, fixed-interest rate mortgages unprofitable.<sup>95</sup> Prior to 1997, the two companies purchased relatively few mortgage backed securities from third parties. However, since then, both Fannie Mae and Freddie Mac drastically increased their purchases of private label mortgage back securities. While in 1998 Freddie Mac owned only \$25 billion of securities issued by others, by the end of 2007 it increased its holdings slightly more than 10 times to \$267 billion in securities.<sup>96</sup> Similarly, in 1997 Fannie Mae owned only \$18.5

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91. See Glossary of Finance and Economic Terms, A-F - Freddie Mac, [http://www.freddie.com/smm/a\\_f.htm](http://www.freddie.com/smm/a_f.htm) (last visited July 22, 2008) (defining “conforming mortgage”).

92. Michael Quint, *A Mortgage Penalty, or a Plus?*, N.Y. TIMES, Oct. 25, 1994, at D1.

93. Carlos Tejada, *Fannie Mae and Freddie Mac Scramble for New Mortgages*, WALL ST. J., June 22, 1999, at B6.

94. Neil J. Morse, *Coping with a Wild Market*, 62(4) MORTGAGE BANKING 107 (Jan. 2007). Conforming loans are also distinguishable from “jumbo” prime loans that exceed the maximum loan principal Fannie and Freddie are authorized to invest in.

95. See generally Dwight Jaffee, *The Interest Rate Risk of Fannie Mae and Freddie Mac*, 24 J. FIN. SERVICES RES. 5 (2004) (evaluating the bailout risks associated with the GSEs interest rate risk hedging strategies). For instance, the core mission of Fannie and Freddie exposes the companies to interest rate risk. Because much of their working capital is raised through issuing short term bonds, and much of their assets are held in long term fixed interest rate mortgage loans, a rise in interest rates would increase the companies’ cost of funds and could dramatically affect the profitability of the companies. Accordingly, both GSEs hedge their interest rate risk by purchasing derivatives. *Id.*

96. *Fannie Mae and Freddie Mac: End of Illusions*, THE ECONOMIST, July 19, 2008.

billion in securities issued by others and by the end of 2007 it increased almost seven times to \$127.8 billion in securities.<sup>97</sup> Unlike directly purchased mortgage loans, these residential mortgage backed securities were investments in large pools of mortgage loans issued by private investment banks and mortgage lenders.<sup>98</sup>

In 2003 Fannie and Freddie used both their direct mortgage purchasing programs and their ability to purchase investments for their retained portfolio to quietly take aggressive positions in the—at that time—highly profitable private label subprime and alt-A mortgage markets.<sup>99</sup> Although purchasing risky securities had never been the mission of the two special companies, management justified this significant shift in their method of and standards for acquiring mortgage loans by explaining that the investments were profitable and furthered their mission of providing support for home ownership.<sup>100</sup> These changes occurred against the backdrop of the Bush administration's ideologically driven opposition to virtually any regulatory oversight of any kind.<sup>101</sup> In only the two years between 2003 and 2005, the GSEs' combined private-label mortgage backed securities holdings more than doubled from 9.9% of their total combined mortgage portfolio to 22%.<sup>102</sup> OFHEO, a relatively underfunded and weak regulator even in a climate amenable to oversight, was essentially silent as the GSEs shifted investment into the controversial subprime and risky Alt-A private securities.<sup>103</sup> The *Washington Post* later reported “constant discussion” among employees at one of the companies on the

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97. *Id.*

98. OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT, MORTGAGE MARKETS AND THE ENTERPRISES at 39, figure 37 (July 2008 & Supp. Feb. 2009) available at <http://www.ofheo.gov/media/research/MME2007revised.pdf>.

99. *Id.*

100. See, e.g., Federal Home Loan Mortgage Corporation, *Form 10-Q: Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 For the Quarterly Period Ended June 30, 2008*, at 6 (Filed August 6, 2008) (justifying purchase of private label mortgage backed securities on the grounds that it took “advantage of favorable investment opportunities [that] not only helped to serve our mission, but also benefited our customers and the secondary mortgage market.”)

101. Jo Becker et al., *White House Philosophy Stoked Mortgage Bonfire*, N.Y. TIMES, Dec. 21, 2008, at A1.

102. OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT, MORTGAGE MARKETS AND THE ENTERPRISES, *supra* note 98, at 39

103. In the body of OFHEO's 2007 Report to Congress, the word “subprime” is not mentioned one single time. OFFICE OF HOUSING ENTERPRISE OVERSIGHT, REPORT TO CONGRESS 2007 *passim* (2007). In a bit of ironic understatement, the director of OFHEO's cover letter included in the annual report does state that “[t]his year will be one of challenges for the housing markets. OFHEO is working with the Enterprises to provide guidance on subprime and non-traditional mortgages.” James B. Lokhart, III, Letter to Congress, Mar. 30, 2007, available at <http://www.fhfa.gov/webfiles/1222/OFHEOReporttoCongress07.pdf>.

subject of when regulators would notice the radical shift in policy.<sup>104</sup> “It didn’t take a lot of sophistication to notice what was happening to the quality of the loans. Anybody could have seen it. . . . But nobody on the outside was even questioning us about it.”<sup>105</sup> By January of 2007, when OFHEO first started to raise a tentative red flag, it was too late.<sup>106</sup>

Throughout the period of the GSE’s growing exposure to subprime and Alt-A mortgages, the companies also maintained their traditional prime mortgage loan purchasing mission. For these more traditional prime loan purchasing programs Fannie and Freddie maintained relatively cautious underwriting and thus had foreclosure rates approximately one-sixth those of subprime loans.<sup>107</sup> In the wake of the financial collapse, unlike private-label subprime securities, the GSE-issued securities with prime features have retained their liquidity and have not suffered the same high default rates.<sup>108</sup> The extent to which the GSEs suffered losses on their prime mortgage loan holdings had less to do with underwriting problems, than it did the deflation in the housing price bubble that was created by subprime and Alt-A loans in the first place.<sup>109</sup>

Even though in comparison to their prime holdings, the GSEs’ subprime and alt-A investments were relatively a small portion of their portfolios,<sup>110</sup> these newer, more aggressive loans and securities were a significant potential risk to the solvency of the agencies. The Congressional Research Service has explained that “as highly leveraged financial intermediaries Fannie Mae and Freddie Mac have limited resources against losses.”<sup>111</sup> Although their exposure to the more risky private label mortgage-backed securities was small compared with their total portfolios, its impact was devastating because the two companies they had so little equity

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104. Binyamin Appelbaum et al., *How Washington Failed to Rein in Fannie, Freddie*, WASH. POST, Sept. 14, 2008, at A01, available at [http://www.washingtonpost.com/wp-dyn/content/article/2008/09/13/AR2008091302638\\_pf.html](http://www.washingtonpost.com/wp-dyn/content/article/2008/09/13/AR2008091302638_pf.html)

105. *Id.*

106. *Id.*

107. Souphala Chomsisengphet & Anthony Pennington-Cross, *The Evolution of the Subprime Mortgage Market*, FED. RES. BANK OF ST. LOUIS REV. 31, 32 (Jan./Feb. 2006) available at <http://research.stlouisfed.org/publications/review/06/01/ChomPennCross.pdf>.

108. OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT, MORTGAGE MARKETS AND THE ENTERPRISES, *supra* note 98, at 5.

109. OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT, MORTGAGE MARKETS AND THE ENTERPRISES 1 (July 2008 & Supp. Feb. 2009) available at <http://www.ofneo.gov/media/research/MME2007revised.pdf>.

110. Fed. Home Loan Mortgage Corp. (Freddie Mac), Annual Report (Form 10-Q), at 76 (Aug. 6, 2008); Fed. Nat’l Mortgage Ass’n. (Fannie Mae), Annual Report (Form 10-K), at 89 (Feb. 27, 2008).

111. N. Eric Weiss, *Fannie Mae’s and Freddie Mac’s Financial Problems: Frequently Asked Questions*, CRS Report for Congress, RS22916, at 1 (July 15, 2008).



as a cushion.<sup>112</sup> Congress' desire to promote homeownership translated into thin capitalization requirements where "banks that held \$100 could spend \$90 buying mortgage loans, Fannie Mae and Freddie Mac could spend \$97.50."<sup>113</sup> This thin margin of error had been satisfactory in the relatively stable and once universally appreciating home mortgage market. But, it was not sufficient to maintain solvency in the market for securities—particularly securities in shady subprime and non-amortizing mortgages that Fannie and Freddie in more traditional years would never have purchased directly.

In late 2006 and early 2007 borrowers encumbered by the unprecedented volume of subprime and alt-A mortgages underwritten in the mid-2000s began defaulting in stunning numbers generating a national media firestorm.<sup>114</sup> By June of 2007 the rating agencies began to come around to the problematic credit ratings they had assigned to private label subprime mortgage backed securities.<sup>115</sup> In the fall of 2007, the stampede away from subprime securities was in full force with, for example, Standard and Poor's downgrading ratings on over 1400 different subprime mortgage securities classes in one (rather embarrassing) fell swoop.<sup>116</sup> By the spring

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112. *Fannie Mae and Freddie Mac: End of illusions*, THE ECONOMIST, July 17, 2008, available at [http://www.economist.com/finance/displaystory.cfm?story\\_id=11751139](http://www.economist.com/finance/displaystory.cfm?story_id=11751139).

113. Appelbaum et al., *supra* note 104.

114. Laing, *supra* note 9; Harold Brubaker, *Effects of a Decade of Aggressive Lending: Local Homeowners Wrestle with Costs of Subprime Loans: Local Homeowners Rocked by Subprime Loans*, PHIL. INQUIRER, Apr. 4, 2007, at A01; Editorial, *Reckless Industry Must Disclose Loan Data: Record Number of Ohioans Losing Homes*, DAYTON DAILY NEWS, Mar. 26, 2007, at A12; Sue Kirchoff & John Waggoner, *Subprime Storm Winds Will Keep Blowing*, USA TODAY, June 19, 2007, at 1B available at [http://www.usatoday.com/money/economy/housing/2007-06-18-subprime-usat\\_N.htm](http://www.usatoday.com/money/economy/housing/2007-06-18-subprime-usat_N.htm); Mark Whitehouse, "Subprime" Aftermath: *Losing the Family Home*, WALL ST. J., May 30, 2007, A1 (part I of *Debt Bomb: Inside the "Subprime" Mortgage Debacle – Three Part Series*); Michael Hudson, *How Wall Street Stocked the Mortgage Meltdown*, WALL ST. J., June 27, 2007, at A1 (part II of *Debt Bomb: Inside the "Subprime" Mortgage Debacle – Three Part Series*); Ruth Simon, *Mortgage Mess Shines Light on Broker's Role*, WALL ST. J., July 5, 2007, at A1 (part III of *Debt Bomb: Inside the "Subprime" Mortgage Debacle – Three Part Series*); Sam Ali, *Subprime Time Bomb: Rising Interest Payments Detonate Foreclosure Flood*, STAR LEDGER (Newark, NJ), July 1, 2007, 1; Jim Buchta, *Rising Home Rates Can Hit Like a Fist: A New Mortgage Crisis Could Lie Ahead As Adjustable-Rate Loan Payments Shoot Up*, MINNEAPOLIS STAR TRIB., June 7, 2007, 1A; *Risky Loans Set to Implode: America's Riskiest Mortgages About to Implode*, ST. PETERSBURG TIMES, Feb. 20, 2007, at 13A.

115. OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT, MORTGAGE MARKETS AND THE ENTERPRISES, *supra* note 98, at 9. The *New York Times* has pointed out that the rating agencies have continued to provide misleading advice long after the subprime bubble burst:

Moody's rated Lehman Brothers' debt A2, putting it squarely in the investment-grade range, days before the company filed for bankruptcy. And Moody's gave the senior unsecured debt of the American International Group, the insurance behemoth, an Aa3 rating — which is even stronger than A2 — the week before the government had to step in and take over the company in September [2008] as part of what has become a \$170 billion bailout.

David Segal, *Buffet Is Unusually Silent on Rating Agencies*, N.Y. TIMES, Mar. 17, 2009, at B1.

116. See, e.g., Standard & Poor's, *Ratings cut on 1,413 1<sup>st</sup>-Lien Subprime RMBS Classes From*

of 2008 Fitch Ratings predicted that between 40 and 50% of all subprime mortgages originated since 2006 would end in foreclosure.<sup>117</sup> It was losses on precisely these investments that were the primary driver of the GSEs ultimate insolvency. One observer of the agencies noted that toward the end of 2008: the two companies together reported losses of \$14 billion in the last year.

[But,] Their actual losses . . . [were] much worse. As of mid-2008, the two had lost about \$45 billion due to the decline in the value of their mortgage-backed securities, mostly those backed by subprime and Alt-A mortgages.<sup>118</sup>

As tens of thousands of families facing foreclosure grew to hundreds of thousands, communities all around the country began to see the stark results of massive numbers of economic refugees not seen in America since the dust bowl of the Great Depression.<sup>119</sup>

While the Bush administration had refused to regulate subprime and alt-A mortgages in any meaningful way, it was relatively quick to support legislation dismantling the Office of Federal Housing Enterprise Oversight. In the summer of 2008, Congress had passed, with the support of the President, the Housing and Economic Recovery Act of 2008.<sup>120</sup> This statute combined all regulation of federal housing GSEs, including not only Fannie and Freddie, but also the twelve Home Loan Bank Boards that provide capital to thrifts, in one new agency: the Federal Housing Finance Agency

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*Forth-Quarter 2005 And 2006 Vintages*, STANDARD & POOR'S RATINGS DIRECT 1, 2, Oct. 19, 2006, available at <http://www.spviews.com/ratingsActions/Oct.19RatingAction2006vintage.pdf> (last visited Apr. 13, 2009) ("Standard & Poor's Ratings Services today lowered its ratings on 1,413 classes of U.S. residential mortgage-backed securities (RMBS) backed by first-lien subprime mortgage loans from 325 transactions issued from the beginning of the fourth quarter of 2005 through the fourth quarter of 2006. . . . These rating actions bring the total number of classes issued during this period and downgraded to date to 1,671").

117. Grant Bailey et al., *Revised Loss Expectations for 2006 and 2007 Subprime Vintage Collateral*, [www.fitchratings.com](http://www.fitchratings.com), Mar. 25, 2008, at 2.

118. Fred Mosely, *The Bailout of Fannie Mae and Freddie Mac*, DOLLARS & SENSE (Sept./Oct. 2008), <http://www.dollarsandsense.org/archives/2008/0908moseley.html>.

119. See, e.g., Erik Eckholm, *Foreclosures Force Suburbs to Fight Blight*, N.Y. TIMES, Mar. 3, 2007, at A1 ("Many of the houses are filled with smelly trash and mattresses used by vagrants. They have been stripped of aluminum siding, appliances, pipes and anything else that scavengers can sell to scrap dealers."); Pat Brennan, *Vacancies Breed Mosquito Boom: Housing Crisis Means More Stagnant Swimming Pools*, ORANGE COUNTY REG., Mar. 5, 2008 ("The sudden surge in foreclosed and abandoned homes is proving to be a jackpot for one unlikely sector of the community: mosquitoes. The county's animal disease trackers say that pools in many Orange County houses emptied by foreclosures become perfect mosquito breeding grounds as they grow stagnant.").

120. Pub. L. 110-289, stat. 2654, July 30, 2008.

(FHFA).<sup>121</sup> As the scope of Fannie and Freddie's losses in subprime and alternative mortgage backed securities became apparent, the Bush administration, with the urging of the Federal Reserve Board of Governors, directed FHFA to seize the two stumbling GSEs.<sup>122</sup> In September of 2008, FHFA placed both companies in receivership, hired new CEOs, replaced their boards of directors, halted all stock dividends, and terminated all their lobbying activities.<sup>123</sup> The division between the two GSEs and the federal government, at least for the time being, became purely nominal.

## V.

At the turn of the century, Congress and the Bush Administration chose not to gradually raise the GSE's conforming loan principal limits to keep pace with modest single family home values in several of the nation's most expensive and important housing markets.<sup>124</sup> The absence of cheap, stable government backed prime loans was filled with private capital. Some of these private loans were reasonable prime jumbo loans that reflected the traditional pricing, underwriting, and durational terms first created by the federal government in the wake of the Great Depression. But private mortgage industry also aggressively marketed a variety of other, more profitable and often less suitable products as well. The void of prime GSE financial infrastructure in these markets left an un-policed vacuum that was largely filled by ill-advised alt-A and subprime loans.

Fannie and Freddie ultimately invested in these markets anyway; they just did so by purchasing private label mortgage backed securities issued by investment banks such as Lehman Brothers and Meryl Lynch, and large aggressive subprime lenders such as Countrywide.<sup>125</sup> That is to say, the GSEs invested in higher home value markets after allowing a long stream of aggressive, commission maximizing private financial services companies to feed on the stream of commerce first.<sup>126</sup> Even if one puts aside the festering boil that is our chimerical regulation of the private label securitization system for a moment, from a purely business perspective, the

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121. FEDERAL HOUSING FINANCE AGENCY, PERFORMANCE AND ACCOUNTABILITY REPORT 2008, at 3 (Nov. 17, 2008).

122. Press Release, Fed. Hous. Fin. Agency, Statement of FHFA Dir. James B. Lockhart (Sept. 7, 2008) (on file with author), available at <http://www.fhfa.gov/webfiles/23/FHFAStatement9708final.pdf> (last visited Apr. 13, 2009).

123. FEDERAL HOUSING FINANCE AGENCY, PERFORMANCE AND ACCOUNTABILITY REPORT 2008, at 4-5 (Nov. 17, 2008).

124. Fannie Mae, Historical Conventional Loan Limits, Nov. 27, 2007, available at <https://www.efanniemae.com/sf/refmaterials/loanlimits/pdf/historicalloanlimits.pdf>.

125. OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT, MORTGAGE MARKETS AND THE ENTERPRISES *supra* note 98, at 26, figure 28.

126. Peterson, *supra* note 1, at 2208 figure A.

management and regulatory guidance of the GSEs was strategically shoddy. By abandoning their time tested underwriting practices and scrutiny of individual mortgage loans, the GSEs lost the ability to monitor their investments. Adrift from their core competence and chartered mission, the agencies blundered into bad bets. In the words of Marc Gott, a former director in Fannie's loan servicing department: "We didn't really know what we were buying . . . This system was designed for plain vanilla loans, and we were trying to push chocolate sundaes through the gears."<sup>127</sup> As soon as the GSEs abandoned direct monitoring, the profit-seekers (including the credit rating agencies) the GSEs relied on arranged to sell them garbage and harvest massive bonuses, commissions, and fees in the process. Like so many others, Fannie and Freddie's core failing was this: they were suckers.

This being said, despite out-dated demagoguery to the contrary, Fannie and Freddie did not cause the financial crisis.<sup>128</sup> Subprime and alt-A

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127. Charles Duhigg, *Pressured to Tame More Risk, Fannie Reached Tipping Point*, N.Y. TIMES, Oct. 5, 2008, at A1.

128. For example, on January 7, 2009 the radio talk show host Rush Limbaugh asserted that Representative Barney Frank, the Chair of the House Financial Services Committee, caused the financial crisis because "his definition of affordable housing was to make sure that people who couldn't pay the loans back got the loans, the mortgages. He forced Fannie Mae and Freddie Mac to do this." Media Matters for America, *Limbaugh Falsely Asserted "Banking Queen" Barney Frank "Created" Subprime Mortgage Crisis*, Jan. 8, 2009, available at [www.mediamatters.org/items/200901080014](http://www.mediamatters.org/items/200901080014). Never mind the fact that the subprime crisis developed and the real estate bubble popped before Representative Frank became the Financial Services Committee chair, while his party was in the minority, and while his party did not hold the Presidency. Furthermore, even if Representative Frank did somehow force the GSEs to lend to poor people, the evidence suggests that well managed, community based lending, using traditional fixed interest rate loans to consumers with poor credit histories have default rates comparable to prime loans. A study by University of North Carolina researchers found that the default of borrowers that take subprime loans is over 70% more likely than default of borrowers with comparable credit risks that receive traditional loans. Lei Ding et al., Center for Community Capital, *Risky Borrowers or Risky Mortgages: Disaggregating Effects Using Propensity Score Models*, at 16 (Dec. 2008) available at [http://www.ccc.unc.edu/documents/RiskyMortg\\_Final\\_Dec11.pdf](http://www.ccc.unc.edu/documents/RiskyMortg_Final_Dec11.pdf) (last visited Apr. 13, 2009). This study suggests that the default is driven more by revenue generation terms in subprime loans, such as yield spread premiums, teaser rates, origination costs, and prepayment penalties, than by the credit risk of borrowers. *Id.* at 19-20. The mortgage foreclosure crisis was driven not by lending to poor people, but by lending to poor people with terms designed to extract short term profits through abusive fees. The problem was *the combination* of subprime loan products and subprime borrowers, not merely lending to subprime borrowers. Finally, Mr. Limbaugh's argument ignores that fact as instability overcame private label subprime and alt-A backed securities, capital fled to the safety, stability, and predictability of securities backed by the GSE prime loans. OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT, REPORT TO CONGRESS: 2008 at 6 (Apr. 15, 2008) ("The fear of exposure to residential mortgage credit risk spilled over into the markets for PLS backed by Alt-A and jumbo mortgages. Investors became less willing to invest in any mortgage-related securities not guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae. . . . The Enterprises' combined share of all mortgage-backed securities (MBS) issuances rose

mortgage loans were the primary drivers of the housing bubble and the primary drivers of its collapse.<sup>129</sup> With relatively few exceptions, these loans were marketed, originated, securitized, and serviced by private companies—not Fannie and Freddie. Although government minimalists hope to use the subprime crisis as evidence of President Reagan’s mantra that “government is not the solution to our problem; government is the problem,”<sup>130</sup> any fair appraisal of events demonstrates otherwise. It was the absence of a legislative response to shape and facilitate the rapidly emerging patterns of housing financial commerce. It was a sleeping judiciary that neglected to lay down a relevant common law in the absence of legislation. It was captive federal banking regulators that interpreted their “consumer protection” obligations to mean protecting banks from consumers. It was the erosion of deposit insurance as a useful tool in preserving bank solvency. It was massive speculation in derivatives. It was media and scholarly academies that did not find a way to tell the stories and marshal the arguments to show what was about to happen. And, it was an indulgent, indifferent American public that let itself be misled. Fannie Mae and Freddie Mac—part of the problem, rather than the solution—were but one factor in much larger and more genuinely disappointing picture of letdown.

In the public debate over the struggling American financial system, opponents of federal involvement in housing have persisted in asserting that Fannie Mae and Freddie Mac caused the home foreclosure crisis. This essay has attempted to provide a short rebuttal to this surprisingly persistent oversimplification. It is certainly true that Fannie and Freddie’s poor investing decisions drew the federal government into one of many costly financial system bailouts. However, when proponents of unfettered private markets have asserted that the GSEs caused the financial crisis, they tend to omit the fact that the GSEs’ crippling losses came from purchasing overvalued securities produced by *unfettered private markets*. Both today,

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from less than 50 percent in the second quarter of 2007 to more than 75 percent in the fourth quarter.”).

129. OFHEO, MORTGAGE MARKETS AND THE ENTERPRISES IN 2007, at 4-5 (July 2008, Revised Feb. 2009). (“Deterioration in the performance of subprime loans was the primary driver of the worsening performance of the whole market. The serious delinquency rate for subprime mortgages increased from 3.13 percent in the fourth quarter of 2006 to 5.42 percent four quarters later, while the serious delinquency rate for prime loans rose from 0.33 percent to 0.65 percent in that period (Figure 4)”).

130. President Ronald Reagan, First Inaugural Address, White House, Washington, D.C., (Jan. 21, 1981), available at <http://www.reaganlibrary.com/reagan/speeches/first.asp> (last visited Apr. 13, 2009). On the other hand, closer adherence to President Reagan’s advice of “trust, but verify,” would have served Fannie and Freddie well. Ronald Reagan, Interview with Alastair Burnet of ITN Television, (Mar. 10, 1988), available at [http://www.reagan.utexas.edu/search/speeches/speech\\_srch.html](http://www.reagan.utexas.edu/search/speeches/speech_srch.html) (last visited Apr. 13, 2009).

and as political tides change in future years, America's powerful strain of libertarian government minimalists should not be allowed to use failings of private mortgage origination and structured finance markets in sophistic attacks on the mainstream, New Deal institutions that did so much to house the American middle class in the latter-twentieth century. In moving forward, the federal government will have difficult decisions about whether to restore Fannie Mae and Freddie Mac to their pre-conservatorship status of quasi-public for-profit companies. While this essay is neutral on that important question, the failings of the GSEs in their retained portfolio investment decisions should not be used to indict the indispensable traditional prime mortgage market successes of the two agencies.