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From the Editor-in-Chief

The Future of the Federal Role in Housing Finance

James J. Kelly, Jr.

James J. Kelly, Jr.

Over the last thirty-five years, the role of the federal government and its affiliates in the financing of single-family home purchases has grown enormously. For more than two decades, the overwhelming majority of mortgage loans given to homebuyers in the United States have come from lenders partnering with government agencies such as the Veterans' Administration (VA) and the Fair Housing Administration (FHA) or with quasi-public institution such as the Federal National Mortgage Association (FNMA or Fannie Mae), the Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac), and the Government National Mortgage Association (GNMA or Ginnie Mae). Even as the mortgage crisis pushed Fannie Mae and Freddie Mac into conservatorship, the all-important role of the federal government in making credit available to homebuyers has continued with the FHA significantly expanding its role.

Nevertheless, the upheavals in the nation's financial infrastructure caused, at least in part, by lax lending practices have led to a thorough re-examination of our country's housing finance system and the role of the federal government. Experts across the ideological spectrum have called into question many fundamental assumptions underlying the ends and means of federal housing finance policy. Even with the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010, these questions have not been resolved in any significant way by congressional action.

In our first issue of this new volume, three articles delve into the complexities and conundrums of the federal role in the residential mortgage market. The first part of this federal housing finance trilogy comes courtesy

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of the *Georgetown Journal of Law and Public Policy*. In *Bringing the GSEs Back In?*, Richard Boyd, Associate Professor of Government at Georgetown University, looks to the past and present of Fannie Mae, Freddie Mac, and Ginnie Mae to see how these government-sponsored entities (GSEs) should function in the future. Drawing upon political theory works grouped under the banner of the New Institutionalism, Professor Boyd provides an outline of the lending standards that the GSEs could develop to foster those citizen virtues strongly associated with homeownership.

Our next contribution to this discussion of federal participation in the secondary mortgage market claimed this year's prized in the Forum's Student Writing Competition. In *Balancing Risk and Opportunity*, Sierra Sterling examines the Mutual Mortgage Insurance Fund (MMIF), the source of the loan guarantees offered by the Federal Housing Administration to enhance credit opportunities for households not fully served by the conventional mortgage market and to respond to cyclical changes in the economy of residential lending. The article provides a thorough analysis of this complex institution, the structural details of which are as crucial to the largest financial institutions as they are to homebuyers of the most modest means.

In concluding this trio, Alyssa Baskam returns to the questions facing policymakers shaping the future of the GSEs. In *Determining the Sweet Spot for the Federal Government in Residential Mortgage Finance*, her comprehensive look at the rise and fall of the GSEs as housing mortgage market makers acting independently of their governmental creators is followed by a structured look at the "sweet spot" for federal participation in the nation's mortgage lending market. Her recommendations touch upon a wide array of issues including the key features of a conventional mortgage loan and the role of loan purchases and loan guarantees in making credit available to a broad variety of borrowers without sacrificing consumer protections.

Reprinted from *Clearinghouse Review*, the national journal for legal services lawyers, this issue of the *Journal* includes *Contract for Deed: Charting Risks and New Paths for Advocacy*. In the midst of the articles about these major public players in housing finance, Professors Heather Way and Lucy Wood, both of the University of Texas School of Law, focus on contracts for deed, sometimes referred to as installment land contracts, at a time where a severely constricted credit market has forced more and more homebuyers to look to real estate sellers as sources of finance. After outlining the basic legal aspects of the contract-for-deed transaction, Professors Way and Wood present the results of empirical research they have conducted in Texas on this all too frequently abused form of seller-financed land transfer. They then use the data collected to make the case for a set of legislative reforms and an agenda for legal advocates.

Rounding out the issue, we have two contributions about two vital elements of the Department of Housing and Urban Development. In

Resident Health and HUD's Choice Neighborhoods Initiative, Brian Sheffield articulates and advocates for a reform of HUD's Choice Neighborhoods funding allocation process that will encourage communities to seek superior public health outcomes in their community development programming. This issue also marks the long overdue return of the *Heard from HUD* column, which, thanks to Sharon Wilson Géno, will once again be a regular feature of the *Journal*. This volume's installment features an interview with Kathie Soroka of HUD's Office of General Counsel.

Heard from HUD

RADical Changes at HUD

The Robert C. Weaver Building, headquarters to the U.S. Department of Housing and Urban Development, has been undergoing a major renovation. Once described by former HUD Secretary Jack Kemp as "10 floors of basement," the Weaver Building renovation is reportedly designed to create more environmentally friendly, collaborative workspaces for HUD employees. Staff have been moving to temporary quarters both within and outside of the building. Some long time HUD staffers say that, due to the upheaval, they are now going to parts of the building that they have never seen before, given that the programs have traditionally been in segregated spaces, separated by long, dark corridors and slow elevators.

It is ironic (and perhaps not entirely an accident) that at the very time the HUD building is being reconfigured, so too are some of HUD's business practices through the recently implemented Rental Assistance Demonstration Program (RAD). At its core, RAD is a vehicle for up to 60,000 public housing units and other HUD assisted units in smaller programs to convert their properties to project-based subsidy models and, at the same time, leverage much needed private capital for repairs. RAD seeks to accomplish this by providing a variety of tools to finance units that could, but do not have to, include a combination of resources from HUD's public housing, multi-family and Federal Housing Administration (FHA) programs, together with Treasury's Low Income Housing Tax Credit program. The statute that authorizes the RAD provides the Department with broad authority to waive both statutes and regulations for the purpose of facilitating the demonstration.

The HUD Office of General Counsel (OGC) is playing a key role under RAD. OGC is working to identify areas where the applicable HUD programs conflict and find solutions that will help them work better together. OGC is also part of an effort streamline internal processes for obtaining HUD approval of RAD transactions. Kathie Soroka, Senior Counsel at HUD, kindly agreed to answer a few questions about this effort:

Kathie Soroka, Senior Counsel at the U.S. Department of Housing and Urban Development, talked with Sharon Wilson Géno, who has been long active in the Forum of Affordable Housing & Community Development. Ms. Géno is a partner in the Washington, D.C., office of Ballard Spahr LLP.

JAHCD: Can you describe how RAD transactions have been processed to date and responsibilities of HUD lawyers in both Headquarters and in Field Offices?

KS: An important goal of the RAD initiative is to break down HUD silos. I think HUD has made a lot of progress in this regard through RAD, but we still face many challenges. In terms of the process for getting this done, there are a lot of people within the HUD building that need to weigh in on various pieces of a RAD transaction. The main point people for applicants are the Transaction Managers. The Transaction Managers do a good deal of coordinating the different parts of the approval process, but a number of different program offices weigh in.

Once the deal is fully "cooked" and the financing plan is approved, OGC is brought in. This is just before the RAD Conversion Commitment (RCC), which is HUD's final approval of the financing, is issued. If there are unique legal questions, we can be involved earlier. Headquarters OGC staff reviews the RAD transactions first and flags any items of concern like compliance with the RAD statute or issues that could have broader program implications. After this initial review, the Field Office OGC staff receives the closing package and does a more thorough review of the deal. The Field Counsel really "owns" the transaction from the legal perspective.

However, the scope of HUD's legal review of a RAD transaction is designed to be limited. We have borrowed heavily from the streamlined legal review process used in public housing mixed finance deals. We focus our legal review on a few documents, where it is most appropriate. We attempt to make our legal review proportional and appropriate to HUD's interest. For example, we may have a greater need to review a ground lease if that's how the PHA is maintaining control over the property but we may not need to review the private financing from a legal perspective.

JAHCD: Has RAD changed how the Department approaches its approval processes for transactions generally?

KS: I'm not sure that the Department has changed its broader approval process under RAD. We are still ensuring that HUD's interests and, in turn, the taxpayers' interests are being protected by making sure that all program requirements are met. What is different with RAD is that RAD cuts across different silos and program areas. More coordination among is needed to achieve its goals than may have been necessary in other programs.

JAHCD: What have been the most challenging legal issues your office has faced in implementing RAD?

KS: There are many novel and challenging questions raised by RAD. As the program develops, we continue to face new questions. One of the

most challenging legal questions we face involves the statute's mandates to preserve public ownership.

The RAD statute requires that "ownership or control" of the project be held by a public or nonprofit body, or to facilitate tax credits, that the PHA must preserve "its interest" in the property. The statute also contemplates foreclosure and requires that preference in a foreclosure scenario be given to a public body. This is new. These are not mandates that we had in mixed finance, for example. Therefore, there are additional complications that need to be thought through and worked out. For example, some lenders have expressed concern regarding how the RAD program requirements affect their ability to foreclose. They have asked a lot of good questions. HUD is in the process of working through these questions and providing additional guidance as to acceptable methods for a PHA to preserve its interest and/or control in a project.

In interpreting the RAD statute, there is a tension between ensuring the affordability of the units and ensuring that the program is able to attract other financing. Oversight by public bodies is an important component of the program. But, the program recognizes that public funds alone are insufficient to address the capital needs faced by public housing. The program is designed to leverage public subsidies with private capital. Private capital is often necessary to accomplish the needed repairs and preserve habitable, affordable units.

JAHCD: Given that the program has relatively thin legislative authorization, are there elements of other HUD programs that the Department is looking to for guidance in implementing RAD?

KS: Yes, we are borrowing heavily from the lessons learned in other contexts. We have already developed approaches to addressing some of the difficult legal issues that come up when private lenders and investors participate in HUD programs. The primary model from my perspective is the public housing mixed finance program, but there are also other models. For example, our experience in the FHA Tax Credit Pilot program has also been helpful in thinking through transactions with tax credits.

JAHCD: The RAD authorizing legislation anticipates pretty broad flexibility in the form of waivers that could be approved by the Secretary under certain circumstances. How are waivers being processed? Will the waivers that have been approved be made available to others?

KS: The RAD notice, issued in 2012 and revised in 2013, set forth a number of programmatic waivers. To my knowledge, HUD does not anticipate granting a lot of deal-by-deal waivers in RAD. Of course, in every program, there may be special circumstances requiring a deal-specific waiver, but we are trying to build a program, not just do a series of deals.

Our goal is to create a coherent and consistent program with clear requirements, so doing individual waivers cuts against this idea. Consistency

is especially important because we are crossing silos between HUD programs. HUD staff across the country in the different programs need to be able to administer the program and private participants need to be able to rely on their guidance. There may be some unusual situations where we do grant one-off waivers, but I expect those to be the exception and not the rule.

That being said, there may eventually be another revision to the RAD notice and that revision may include changes to the waivers. As more deals come in, we are learning more and more about how the theories in the notice play out in reality. It wouldn't surprise me if there were some situations that required more flexibility or others than required greater structure.

JAHCD: Are there additional things that Department is considering to streamline its RAD approval processes?

KS: We are learning a lot as we go about how best to streamline our processes. It's hard to anticipate in advance the places where a deal will get hung up. RAD is designed to be flexible and HUD's interest in each of the programs (public housing, FHA, multifamily, etc.) is a little different, so we are trying to structure our review by category and by deal and tailor our review to protect HUD's interests while avoiding duplication. To the extent possible, we are accepting review of other parties on issues that are important to them. For example, if other lenders and an LIHTC investor or housing finance agency has looked at certain elements of the deal and HUD doesn't have a particularly compelling interest protected by that item, we are increasingly trying to minimize and streamline our review of such items. One way we do that for some items is by accepting them in the formats prepared for these other parties, instead of making the PHA resubmit the same or very similar information in a different format.

JAHCD: Do you have any suggestions for deal counsel in RAD transactions to ensure that their deals are reviewed and closed as efficiently as possible?

KS: My main suggestion is to get ahead of the game. While HUD has provided milestones for when things must be submitted, there is no reason to wait until one milestone is reached before figuring out what the next milestone is. PHAs should take time early on to preview what will be required throughout the process. It would be incredibly helpful for counsel to help PHAs get this sort of an overview and anticipate long-lead items to the extent possible. For example, housing authorities often have to get approval of their boards for certain items and those boards may only meet once a month. There are lots of examples of long-lead items—capital needs assessments; procurement of vendors; 2530s clearance, which ap-

plies to PBRA transactions; and title and survey matters that need to be cleared, to name a few. Getting ahead of these items makes the process run much smoother.

JAHCD: Is there anything else you would like to share with *Journal* readers about RAD?

KS: RAD is a great program that tries to be flexible and responsive to individual project needs by making the most of available resources and maintaining the public's interests. RAD can be a valuable tool to preserve quality, sustainable affordable housing for future generations. We do need to balance flexibility with adequate protection against risks and the program may not be for every property.

We are still learning and constantly trying to improve the program. We welcome attorneys reaching out to HUD OGC with your RAD questions. If you think your deal has a novel legal issue, we would really appreciate your raising it with us early. If you have a question, ask it!

JAHCD: Again, many thanks to Kathie and the RAD team for all of their work in implementing RAD.

Articles

Bringing the GSEs Back In?: Bailouts, U.S. Housing Policy, and the Moral Case for Fannie Mae

Richard Boyd

Introduction

The so-called "government-sponsored enterprises" (GSEs) or "agencies"—Fannie Mae and Freddie Mac—are chimerical creatures. Like the mythical Greek beast, they are oddities, distinguished by their hybridity and mysteriousness. Government-chartered, but privately owned and managed until their spectacular collapse led to their conservatorship by the Federal Housing Finance Agency (FHFA) in September of 2008, the GSEs have ended up right back where they began in the Great Depression—as public entities tasked with bolstering a sagging housing market.[1] Politicians, taxpayers, and their erstwhile private competitors would love to be rid of them, but in the wake of the financial crisis, more than at any time in the recent past, the GSEs dominate the U.S. housing market, underwriting more than 75 percent of single family home mortgages taken out in 2011.[2]

1. For a more detailed history of the GSEs—as well as a critique of their past and present roles—see especially Viral Arychya, Matthew Richardson, Stijn Van Nieuwerburgh, and Lawrence J. White, *Designed to Fail: Fannie Mae, Freddie Mac, and the Debacle of Mortgage Finance* (Princeton: Princeton University Press, 2011).

2. Kerri Ann Panchuk, "GSE market share increases in 1Q," Housingwire, July 1, 2011, www.housingwire.com/news/gse-market-share-increases-1q (last visited Dec. 5, 2012).

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Much of the frustration stems from the GSEs' running tab with taxpayers. As of October 26, 2012, the bailout of the two agencies has cost U.S. taxpayers nearly $190 billion.[3] To their many critics, Fannie Mae and Freddie Mac exemplify not only the excesses of the housing bubble and bust, but the conflicts of interest, moral hazard, and regulatory privilege inherent to any "public-private" partnership where gains are pocketed by investors while losses are socialized.[4] As more information comes to light about their aggressive political lobbying, dodgy foreclosure practices, and rampant risk-taking in the years leading up to the financial crisis, the GSEs have become poster children for everything wrong with U.S. housing finance policy in the last two decades.[5]

Let me say at the outset that I am sympathetic to many criticisms of the GSEs. Their risk management was abysmal, the losses they have incurred are unconscionable, and it is a travesty that U.S. taxpayers are stuck with the bill. At the same time, however, I want to argue here that the activities of these evil twins remain woefully undertheorized, even willfully mischaracterized, both by critics of their alleged role in precipitating the financial crisis and defenders who cling to them as a lifeline out of the current economic malaise. In particular, I want to examine more critically the narrative whereby GSE losses were the result of congressional affordable housing mandates—the "Barney Frank made them do it" line proffered by many free-market critics of the GSEs.[6] In this by-now familiar story,

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3. Press Release, FHFA Updates Projections of Potential Draws for Fannie Mae and Freddie Mac, Oct. 26, 2012, www.fhfa.gov/AboutUs/Reports/ReportDocuments/2012-10_Projections_508.pdf (last visited Nov. 25, 2012).

4. For an even-handed discussion of the past and future role of the GSEs in light of the literature on regulatory privilege, see especially David Reiss, "Fannie Mae, Freddie Mac, and the Future of Federal Housing Finance Policy: A Study of Regulatory Privilege," Cato Institute: Policy Analysis 674 (Apr. 18, 2011): 1–35.

5. On the magnitude of the GSEs' regulatory capture, see the journalistic work of Gretchen Morgenson, especially *Reckless Endangerment: How Outsized Ambition, Greed, and Corruption Led to Economic Armageddon* (New York: Times Books, 2011) and Bethany McLean and Joe Nocera, *All the Devils Are Here: The Hidden History of the Financial Crisis* (New York: Penguin, 2010), Chs. 3 and 12.

6. First and foremost among these critics is the American Enterprise Institute's Peter J. Wallison, who is single-minded in laying blame for the housing bubble solely at the feet of the federal government and the GSEs and in rejecting any explanation of the financial crisis that implicates the unregulated private sector. On this version of the story, see especially Wallison, "Dissent from the Majority Report of the Financial Crisis Inquiry Commission," AEI Online (Jan. 26, 2011), www.aei.org/papers/economics/fiscal-policy/dissent-from-the-majority-report-of-the-financial-crisis-inquiry-commission-paper/ (last visited Dec. 30, 2012). Wallison's thesis draws extensively, if not exclusively, on the work of his colleague Edward Pinto. See especially Pinto, "Government Housing Policies in the Lead-up to the Financial Crisis: A Forensic Study," AEI Online (Feb. 5, 2011), http://www.aei.org/papers/

the GSEs relaxed credit standards and issued mortgages to millions of undeserving borrowers, resulting in a housing bubble and titanic losses when those marginal homeowners defaulted. The GSEs did so kicking and screaming, of course, strong-armed by their HUD regulators and against all their native business instincts. Unlike their purely private competitors on Wall Street who blithely followed them off a cliff, the downfall of the GSEs (and the housing crisis itself) was an artifact of misguided state intervention in the market.[7]

This rendition of the behavior of the GSEs in the decade leading up to the housing crisis has undeniable elements of truth.[8] Like other guilty parties, the GSEs deserve their share of the blame. And yet the familiar trope of rational and efficient markets being disrupted by ill-advised state intervention is only half the story. Much as we might like to lay responsibility for the housing crisis on their affordable housing overseers (a cast of characters, we should not forget, that includes the likes of President George W. Bush and his "ownership society"), this narrative radically simplifies their activities, incentives, and relationship with regulators.[9] Making sense of what happened to the GSEs is more than just a matter of setting the historical record straight or assessing the merits of free markets versus state intervention. Unless we come to some understanding of what went wrong with the GSEs, it is impossible to make clear-headed moral

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economics/financial-services/housing-finance/government-housing-policies-in-the-lead-up-to-the-financial-crisis-a-forensic-study/ (last visited Dec, 30, 2012).

7. See, for example, Mark Calabria, "Fannie, Freddie, and the Subprime Mortgage Market," Cato Institute Briefing Papers 120 (Mar. 7, 2011), http://www.cato.org/sites/cato.org/files/pubs/pdf/bp120.pdf (last visited Dec. 30, 2012).

8. Here I want to distinguish my criticisms of the Wallison-Pinto thesis from those of Joe Nocera, who goes to the opposite extreme in blaming the market and characterizes the free market version of the narrative as a "lie." See especially, Nocera, "The Big Lie," New York Times Op-Ed, Dec. 24, 2011: A21. As I hope should be clear by now, my own position is that there are elements of truth in both of these stories and that the historical reality resides somewhere in between: both state and market; liberals and conservatives; Wall Street, Main Street, and K Street were all complicit in the events leading up to the financial crisis. More importantly, Wallison, Pinto, and others in the free-market community deserve credit for proving to be early, discerning, and ultimately prescient critics of the systemic dangers posed by the GSEs.

9. We tend to forget that the concept of an "ownership society" was originally a conservative idea, borne from Margaret Thatcher's privatization of the Council flats and explicitly adopted as part of the goals of the second Bush Administration. On the history of the "ownership society," see especially Colin Jones and Alan Murie, *The Right to Buy: Analysis and Evaluation of a Housing Policy* (London: Wiley, 2006); Peter King, *Housing Policy Transformed: The Right to Buy and the Desire to Own* (Oxford: Policy Press, 2010); Stephen Moore, *Bullish on Bush: How George W. Bush's Ownership Society Will Make America Stronger* (Lanham, MD: Madison Books, 2004); McLean and Nocera, All the Devils are Here, 46, 168–69.

judgments about our collective responsibilities to investors, homeowners, and fellow citizens.

A starting point for these questions is the moral incongruity between the narratives many critics offer and their professed views of whether bailouts are defensible. That is, if the pro-market rendition of events were correct, and Fannie and Freddie's losses were incurred in pursuit of their public mandate to make housing affordable, then it would seem to follow that the U.S. taxpayer has a legitimate obligation to bail them out. Public mandate equals public responsibility, after all. We might fault our elected officials for having erred in their judgments (and certainly for their brazen hypocrisy after the fact), and we should hold them accountable for this mistake by voting them out of office. But as creatures of the state, driven by policies originated by our duly elected or appointed public officials, the failure of Fannie and Freddie is a collective national error for which all Americans bear responsibility.

This reasoning is premised on the assumption that the conventional story of the GSEs as hapless victims of liberal activism holds water. However, a closer look at the GSE business model in the years leading up to the financial crisis of 2008 reveals that a disproportionate share of losses were incurred not from their quasi-public (and congressionally mandated) activities of buying, standardizing, and securitizing mortgages, but rather from their massively leveraged proprietary trading portfolios. As I will suggest, Fannie and Freddie's failure was a consequence of profit-seeking activities that were virtually indistinguishable from their private competitors. From this vantage, the bailout of Fannie Mae and Freddie Mac is no more or less justifiable than that of Bear Stearns, Lehman, Merrill, Citi, AIG, or other Wall Street firms that gambled and failed.

At the end of the day, the motivations of the GSEs in the decades of the 1990s and 2000s—and, hence, their degree of moral culpability for the financial crisis—are empirical questions. As a political theorist, I claim no special expertise in quantifying the magnitude of the GSEs' impact on the housing market or the precise economics of their failure. Above and beyond raising questions about the popular free-market narrative of the GSEs' behavior, however, political theorists do have something to contribute to our understanding of the financial crisis by raising normative questions about the past, present, and future roles for the GSEs. Insofar as the GSEs set standards for conforming loans, they have a potentially justifiable civic function that transcends strictly economic metrics of profit and loss. Building on the "new institutionalism" in political science and its appreciation of the effects of state policy on citizen character, I suggest how the GSEs might be reconfigured to encourage a specific and desirable set of citizen virtues.[10]

10. For an introduction to the "new institutionalism" and "policy feedback" literature, see especially *Bringing the State Back In* (Peter Evans, Dietrich Ruesche-

Historical Background of the GSEs

The GSEs—the Federal National Mortgage Association (henceforth "Fannie Mae") and its sibling the Federal Home Loan Mortgage Company (hereafter "Freddie Mac")—are enigmatic creatures that have always created challenges for pundits and policy makers. Their hybrid status, simultaneously creatures of the state and market, complicates efforts to arrive at any consistent moral position with respect to the ongoing commitment of U.S. taxpayers to support them. The GSEs had their roots in 1938 amendments to Roosevelt's National Housing Act, which gave birth to Fannie Mae as an institution charged with channeling funds to thrifts and small lenders. The goal was to provide liquidity to the U.S. housing market by purchasing loans on a secondary market and thereby making housing more affordable. Originally a wholly owned agency of the U.S. government, the Federal National Mortgage Association Charter Act of 1954 transformed Fannie Mae into a "mixed ownership corporation," with the U.S. government retaining control by means of its preferred stock. The Housing and Urban Development Act of 1968 fully privatized ownership of Fannie Mae and separated it from its cousin the Government National Mortgage Association, or "Ginnie Mae," which remained wholly owned (and explicitly backed) by the U.S. government. In order to stimulate competition with Fannie Mae, its younger sibling Freddie Mac was created in 1970. In the four decades leading up to the financial crisis, the GSEs operated as stand-alone economic firms, owned by shareholders and managed privately, but still subject to a congressional mandate to "provide stability in the secondary market for residential mortgages" and "promote access to mortgage credit."[11]

As long as their mandate was understood loosely as "increasing liquidity" by purchasing privately originated mortgages, or in terms of vague ovations to the goods of homeownership, the potential conflict between their public and private imperatives remained latent. Beginning with the first Bush administration, however, and further advanced by the Clinton and second Bush administrations, a series of federal initiatives put more concrete emphasis on their affordable housing mission. The Housing and Community Development Act of 1992 amended the GSE charters

meyer & Theda Skocpol eds., 1985); Theda Skocpol, *Protecting Soldiers and Mothers: The Political Origins of Social Policy in the United States* (1992); *The New Institutionalism in Organizational Analysis* (Walter W. Powell & Paul DiMaggio eds., 1991); Andrea Louise Campbell, *How Policies Make Citizens: Senior Citizen Activism and the American Welfare State* (2003); and Susan Mettler, *Soldiers to Citizens: The G.I. Bill and the Making of the Greatest Generation* (2007).

11. Federal National Mortgage Association Charter Act, As Amended Through July 30, 2008 (Title III of the National Housing Act, 12 U.S.C. § 1716 et seq.), www.fanniemae.com/resources/file/aboutus/pdf/fm-amended-charter.pdf (last visited Nov. 25, 2012).

and specified that the GSEs had to meet "affordable housing" targets set by the Department of Housing and Urban Development. The Clinton administration in 1999 further extended this mandate to increase the percentage of GSE owned loans in inner city areas and for less credit-worthy borrowers. By 2000, the GSEs were required to devote at least 50 percent of their lending to families with incomes no greater than an area's median income.[12]

These affordable housing mandates—and the increased credit risk they generated—have been a touchstone in debates over the housing crisis. Undoubtedly these initiatives contributed to the fact that the GSEs (and eventually the federal government) ended up on the hook for billions of dollars of mortgages that defaulted (for which U.S. taxpayers are still paying the bill). However, the details of these events are poorly understood, and the ethical narrative surrounding the GSEs elides key details that make this a harder case than just a good old-fashioned example of unintended consequences or moral hazard.

In what follows, I want to challenge or complicate four key assumptions made by critics of the GSEs. First, there is the assumption that the GSEs were compelled by Congress and their federal regulators into buying and securitizing loans that they would otherwise not have touched if left to the imperatives of the free market. Second, and relatedly, there is a widespread impression that it was this federally mandated behavior that led to the progressive degradation of lending standards in the United States with GSEs leading the race to the bottom. Third, and most crucially, there is a systematic failure on the part of critics to distinguish between losses tied to the GSEs' purchase, securitization, and guarantee of mortgages and those stemming from their leveraged proprietary trading operations. Lastly, the fact that many of their Wall Street competitors behaved even more recklessly seems to belie the allegation that the GSEs took outsized risks because of their implied government guarantee.

"Barney Frank Made Them Do It . . ."

Indignation toward the GSEs hinges on the assumption that the preponderance of GSE losses were a result of publically mandated affordable housing goals that saddled taxpayers with credit risk. Put bluntly, the GSEs blew up (and blew up the rest of us) because liberal members of Congress forced them to loan money to deadbeats. The problem with this criticism, however, is that it misunderstands the nature of the GSEs' losses (and indeed their basic business model). In point of fact, the lion's share of GSE initial losses was not a simple artifact of having securitized

12. U.S. Dep't of Housing & Urb. Dev., Issue Brief, HUD's Affordable Lending Goals for Fannie Mae and Freddie Mac, Jan. 2001, www.huduser.org/Publications/PDF/gse.pdf (last visited Dec. 12, 2012).

sketchy loans that would later go on to default. Even granting that some fraction of the loans the GSEs underwrote were marginal, attempts to conflate GSE and subprime overstate the case. There is simply no comparison between a conforming GSE-underwritten mortgage and the plethora of no-doc, low-doc, pick-a-pay, or negative amortizing products pioneered in the late 1990s by the likes of Ameriquest, Long Beach Mortgage, New Century Financial, Washington Mutual, and other dodgy subprime mortgage lenders and securitizers.

While prominent critics such as Peter J. Wallison and Edward Pinto of the American Enterprise Institute have correctly identified the proliferation of so-called non-traditional mortgages, or NTMs, as a major factor in the housing bubble and financial crisis, they conveniently ignore two key facts that complicate the free-market narrative, First, these NTMs would never have come into existence were it not for the deregulation of the mortgage industry in the 1980s with the Depository Institutions Deregulation and Monetary Control Act and the Alternative Mortgage Transaction Parity Act, both of which paved the way toward new and more creative forms of mortgage finance. Second, while Fannie and Freddie eventually began accumulating NTMs in the early 2000s, they had nothing to do with the development of these and other experimental NTM products in the 1990s.[13]

The case against the GSEs rests on allegations that many "conforming" mortgages that they bought and securitized would more appropriately be classified as Alt-A or even subprime.[14] For example, Fannie Mae had a program in which they purchased high quality, previously securitized Alt-A mortgages and reissued these securities under a "wrap," that is,

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13. In an ironic twist, before the advent of the financial crisis, subprime mortgages were defended (albeit half-heartedly) by market-oriented think tanks such as the American Enterprise Institute, whose Michael S. Greve dismissed calls in 2003 for preemptive federal regulation of the subprime mortgage industry and mocked attempt by states, local communities, and state attorneys general to put a lid on precisely those "non-traditional mortgage products" or "NTMs" now reviled by market-oriented critics. While acknowledging that, "as in every emerging market, there are lots of false starts, errors, and reckless players in search of a quick buck," Greve credits the proliferation of experimental subprime products for bringing about a "stupendous democratization of mortgage credit." Conspicuously absent is any mention of the role of the GSEs in stimulating this Wild West world of subprime. Rather, the villain is the "cowboy socialism" of federal regulation. See Michael S. Greve, "Subprime—but not Half-Bad: Mortgage Regulation as a Case Study in Preemption," *AEI Online* 19 (Sept. 1, 2003). http://www.aei.org/article/economics/financial-services/subprime-but-not-half-bad/ (last visited Dec. 30, 2012).

14. Calabria, "Fannie, Freddie, and the Subprime Mortgage Market"; Wallison, "Dissent from the Majority Report of the Financial Crisis Inquiry Commission"; Pinto, "Government Housing Policies in the Lead-Up to the Financial Crisis: A Forensic Study."

with its own credit guarantee.[15] But even in cases where underwriting standards were relaxed, it is important to emphasize that the GSEs were prohibited by their charter from purchasing mortgages where the loan represented more than 80 percent of the value of the home, except in cases where the borrower purchased credit insurance to cover the first losses, or jumbo mortgages in amounts greater than $417,000.[16] Unlike their private-label peers, which during the throes of securitization were willing to securitize loans with virtually no redeeming characteristics in terms of credit scores, homeowner equity, documentation, or income, the GSEs steadfastly refused to engage in what was known in structured finance parlance as "risk-layering," that is, buying and securitizing loans with multiple risk characteristics.[17] The shallow end of the subprime pool into which the GSEs reluctantly—and belatedly—dipped their toes included no more than a single risk characteristic, i.e., good credit but no documentation, interest only but strong LTV ratios, and so forth.

One can quibble about the definition of subprime or Alt-A. But regardless of how one labels the marginal loans purchased and securitized by the GSEs, the best evidence of the GSEs' relatively prudent underwriting is their overperformance: at the peak of the crisis, agency mortgages defaulted at much lower rates than their private label peers. Whereas between 28 percent and 45 percent of true subprime loans went on to default, the riskiest subset of GSE securitized mortgages—Freddie Mac's "toxic" subprime on which critics have focused so much attention—defaulted at between 8.5 percent and 10 percent, or only slightly worse than the overall default rate for prime or conforming Freddie Mac mortgages of 6.8 percent.[18] Serious delinquencies did occur among

15. This program seems to have amounted at its peak to no more than $10 billion or so in exposure. See U.S. Securities and Exchange Commission, FNMA 10-Q, 3rd Q. 2009, at 58.

16. 12 U.S.C. 1717 §302(b)(2); Federal National Mortgage Association Charter Act, As Amended Through July 30, 2008 (Title III of the National Housing Act, 12 U.S.C. § 1716 et seq.), www.fanniemae.com/resources/file/aboutus/pdf/fm-amended-charter.pdf (last visited Nov. 25, 2012).

17. McLean and Nocera, *All the Devils Are Here*, at 143–44, 184, 254.

18. Mortgage Bankers Association, National Delinquency Survey Q2 2010 (2010), as cited in David Min, "Faulty Conclusions Based on Shoddy Foundations: FCIC Commissioner Peter Wallison and Other Commentators Rely on Flawed Data from Edward Pinto to Misplace the Causes of the 2008 Financial Crisis," Center for American Progress (Feb. 2011), http://www.americanprogress.org/wp-content/uploads/issues/2011/02/pdf/pinto.pdf (last visited Dec, 30, 2012). These numbers are borne out by figures from Doubleline Capital, whose proprietary data suggests that serious delinquencies among subprime loans peaked at nearly 50 percent in early 2010, compared to roughly 25 percent for Alt-A loans and just over 10 percent for prime non-agency mortgages. See Doubleline Funds investor presentation, "Mirror, Mirror on the Wall," Sept. 11, 2012, webcast, at 44, http://advisorperspectives.com/pdfs/Mirror_Mirror_webcast_9-11-12.pdf. Regardless of how they

loans purchased and securitized by the GSEs, but the vision of their portfolios as festering cesspools of subprime grossly overstates the reality. In point of fact, serious delinquency rates on Fannie Mae securities accelerated from 1.15 percent in the first quarter of 2008 to reach 1.72 percent in the third quarter of 2008 (at which point the GSEs were taken into conservatorship); rose rapidly in 2009 before peaking at 5.47 percent in the first quarter of 2010; then receded throughout 2011 and 2012 to stabilize at 3.41 percent in the third quarter of 2012.[19] Of Fannie Mae's overall portfolio of credit guarantees, only its 2005–08 vintages are currently unprofitable, with SDRs by vintage of 7 percent (2005), 11.5 percent (2006), and 12.5 percent (2007).[20] Higher defaults in these vintages arguably have as much to do with macroeconomic trends such as the nationwide decline of home prices, protracted unemployment, inflated appraisals, and outright mortgage fraud as with relaxed underwriting on the part of the GSEs.

No matter how one defines subprime or rewrites history, it was their private-label peers—and not Fannie and Freddie—that issued and securitized the lion's share of the very worst performing subprime mortgages made during the peak of the housing bubble in 2004–06. In 2006, according to Federal Reserve Board data, 84 percent of subprime mortgages were issued by private lenders. Of the top twenty-five leading subprime lenders, only one was subject to the oft-berated 1977 Community Reinvestment Act, which is frequently blamed for the deterioration in lending standards.[21] Moreover, among GSE mortgages that eventually did go on to default, many were purchased from lenders such as Countrywide and which, upon closer examination, failed to meet the terms of their original representation and warranties. Thus, it is virtually impossible to disaggregate what part of the failure of GSE-underwritten loans was due to a generalized economic collapse that sank all boats, to relaxed GSE standards, or to lenders that sold defective loans to the GSEs, either due to incompetence or fraud. Ongoing litigation between the GSEs and Bank of

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are classified, by almost any imaginable metric, even the worst of the GSE-underwritten mortgages performed considerably better than comparable non-agency mortgages.

19. U.S. Sec. & Exchange Comm'n, Fannie Mae 10-Q, 3rd Q. 2009 (Sept. 30, 2009), Table 1: Credit Statistics, Single Family Guaranty Book of Business, at 5; FNMA 10-Q, 3rd Q. 2011 (Sept. 30, 2011), Table 5: Credit Statistics, Single Family Guaranty Book of Business, at 15; FNMA 10-Q, 3rd Q. 2012 (Sept. 30, 2012), Table 3: Credit Statistic, Single Family Guaranty Book of Business, at 8.

20. U.S. Sec. & Exchange Comm'n, Fannie Mae 10-Q, 3rd Q. 2001 (Sept. 30, 2011), at 6–8.

21. Data as cited in David Goldstein and Kevin Hall, "Private Sector Loans, Not Fannie or Freddie, Triggered Crisis," *McClatchy Newspapers*, Oct. 12. 2008 (last visited Dec. 13, 2012).

America (successor to Countrywide) over so-called "put-back claims" hinges on precisely this issue.[22]

It is also debatable whether the impetus to relax underwriting standards was really something Congress imposed upon the defenseless GSEs against their will. Many have argued that the migration of the GSEs into riskier slices of the credit market was driven as much by their desire to compete with the debased standards of their private-label competitors on Wall Street that began in 2005–06 to take market share away from the GSEs. Given the unprecedented lobbying resources of the GSEs and the magnitude of regulatory capture, others have doubted that Congress had the power to impose anything on Fannie Mae and Freddie Mac that they were not prepared—at least tacitly—to do anyway.[23] It is tempting in hindsight to attribute coercion to behavior that ultimately proved self-destructive, but the conjunction of a powerful profit motive to migrate down the credit scale, the complex and adversarial relationship between the GSEs and their regulators, and the unprecedented degree of regulatory capture, suggests a more negotiated movement toward these much-vilified affordable housing goals.

Single Family Guaranty Versus Proprietary Trading

Any discussion of the moral hazard of state sponsorship (and concomitantly, the ethics of the GSE bailouts) must begin by distinguishing between two discrete functions of the GSEs. There is, first, the GSEs' "primary" (i.e., expressly contemplated in its charter) activity of buying, standardizing, and securitizing so-called "conforming" whole loan mortgages into mortgage backed securities. Fannie Mae accounts for these activities on their balance sheet as their "Single Family Guaranty Book of Business." This is the part of the GSE business model with which the public is most familiar, and it is also most self-evidently related to the GSEs' "public" mandate. It consists in buying conforming whole home loans from banks and lenders and reissuing mortgage backed securities that can be purchased in the secondary market by other banks, mutual funds,

22. Ben Protess, "U.S. Accuses Bank of America of a 'Brazen' Mortgage Fraud," *New York Times: Dealbook* (Oct. 24, 2012), http://dealbook.nytimes.com/2012/10/24/federal-prosecutors-sue-bank-of-america-over-mortgage-program/ (last visited Dec. 30, 2012).

23. For a more extensive discussion of the GSEs as a quintessential case of regulatory capture, see Morgenson, *Reckless Endangerment*; Nocera and McLean, *All the Devils Are Here*, Chs. 3 and 12; John C. Weicher, "Setting GSE Policy through Charters, Laws, and Regulations," in Peter Wallison, ed., *Serving Two Masters, Yet Out of Control: Fannie Mae and Freddie Mac* (Washington, D.C.: American Enterprise Institute, 2001): 120–37; Jonathan G. S. Koppell, *The Politics of Quasi-Government: Hybrid Organizations and the Dynamics of Bureaucratic Control* (Cambridge: Cambridge University Press, 2003).

insurance companies, fixed income investors, and, even when necessary, Fannie Mae or Freddie Mac themselves.

This "guaranty" or securitization function is crucial for the U.S. housing market. There are inevitable mismatches between homebuyers and lenders in terms of capital availability, regional demand, types of products offered, and interest rate sensitivity. Without some way for banks and lenders to securitize mortgages into a secondary market, mortgages in the United States would carry a higher interest rate—probably floating or adjustable as is the norm in other countries—and penalties for prepayment. This securitization and guaranty function should obviously be done according to sensible underwriting standards, and fees collected must be sufficient to compensate the guarantor for the credit risks, but there is nothing intrinsically wrong with having this function performed by a single entity.

Indeed the GSEs operate much like the "market for lemons" described by George Akerlof.[24] That is, in a world of asymmetric information, having a centralized clearinghouse to standardize products and backstop risk can be a prerequisite for the very existence of a market. Not only does this securitization function free up capital for banks and lenders to make more loans, it also addresses some of the intrinsic problems with mortgages. Few institutional investors or pension funds want to have anything to do with servicing individual mortgages, particularly given the perverse tendency of mortgages to pre-pay when rates go down and extend when rates go up.[25] The GSEs take an illiquid commodity and transform it into a product that investors find desirable, creating a bridge between homebuyers who need capital and investors willing to provide it. By creating pools of mortgages or structured products based on these mortgages with specified characteristics, they increase investor demand and lower borrower costs. One can quarrel about whether this function is better provided by the market or the state, but at the end of the day there is a strong presumptive case that something like the GSEs needs to exist.

The securitization or "Single Family Guaranty Business" of the GSEs attracts the most attention—and criticism—for allegedly underwriting lousy mortgages. But missing from this narrative is a recognition of second and for a time much more lucrative side of the GSE business model: namely, the "Capital Markets Book of Business." The original idea behind Capital Markets was that during tough times the GSEs would buy up and hold on their own books any surplus MBS that the private market could not absorb. Over time, however, the proprietary books

24. George Akerlof, "The Market for Lemons: Quality Uncertainty and the Market Mechanism," Quarterly Journal of Economics 84 (Aug. 1970): 488–500.

25. On the birth of securitization in the United States and the many problems that mortgage backed securities overcome, see Michael Lewis, *Liar's Poker: Rising Through the Wreckage on Wall Street* (New York: Penguin, 1989).

of the GSEs grew to mammoth size, and the combined proprietary portfolios of Fannie Mae and Freddie Mac exceeded $1.6 trillion at the time of their conservatorship.[26]

The GSEs assembled these gargantuan portfolios with borrowed money, leveraging their razor-thin capital base with low-cost debt and profiting handsomely from the "spread," or difference between the short term cost of borrowing and higher yielding MBS. At the outset, these proprietary portfolios were almost exclusively agency MBS, for which Fannie Mae and Freddie Mac already carried the credit risk of the insured loans. The only additional risk—considerable though it was—was that interest rates would rise. Over time, however, the proportion of their portfolio represented by non-agency (i.e., private label and non-guaranteed), Alt-A, and even subprime loans issued by Wall Street grew larger. At the time of its collapse into conservatorship, Fannie Mae held over $54 billion of mortgage backed securities (or 6.8 percent of its proprietary portfolio of $800 billion) classified as either Alt-A or subprime.[27] Worse still, Freddie Mac owned $125 billion of non-prime mortgages, with unrealized (and probably understated) losses of nearly $15 billion.[28] These loans issued by private label securitizers and purchased by the GSEs for their Capital Markets Business would go on to default in droves. Among formerly AAA-rated subprime and Alt-A securities, serious delinquencies for the 2006 and 2007 vintages owned by Fannie Mae exceeded 40 percent.[29]

Why would the GSEs buy up privately issued mortgage backed securities that carried additional credit risk? One explanation is that this behavior was compelled by their government mandate to fund affordable housing. Yet as Bethany McLean and Joe Nocera have suggested, the GSEs' migration into credit risk was a profitable but disingenuous way of satisfying their affordable housing goals. Owning subprime mortgages in their proprietary portfolio (rather than issuing loans to subprime borrowers) was what insiders referred to as a "stupid pet trick" by which the GSEs satisfied the letter—but certainly not the spirit—of their HUD mandates to devote a certain fraction of their lending activities to subprime borrowers.[30] Instead

26. U.S. Sec. & Exchange Comm'n, FNMA 10-Q, 3rd Q. 2008 (Nov. 2008), at 17; FHLMC 10-Q, 3rd Q. 2008 (Nov. 2008), at 26.

27. U.S. Sec. & Exchange Comm'n, FNMA 10-Q, 3rd Q. 2008 (Nov. 2008), Table 24: Investments in Private Label Mortgage Related Securities, at 77.

28. U.S. Sec. & Exchange Comm'n, FHMLC, 10-Q, 3rd Q. 2008 (Nov. 10, 2008), Table 2: Credit Statistics, Non-Agency Mortgage-Related Securities Backed by Subprime, Alt-A, and MTA Loans, at 8.

29. U.S. Sec. & Exchange Comm'n, FNMA10-Q, 3rd Q. 2012 (Sept. 30, 2012), Table 23: Credit State of Loans Underlying Alt-A and Subprime Private-Label Mortgage-Related Securities (Including Wraps), at 44.

30. See McClean and Nocera, All the Devils are Here, at 48. Even critics of the GSEs acknowledge that these were "financing shenanigans" (Reiss, "Fannie Mae, Freddie Mac, and the Future of Federal Housing Finance," at 9).

of relaxing their own standards and directing new funds toward the purchase of mortgages by marginal borrowers, the GSEs cherry-picked what they perceived to be the very best securities issued by private label firms who had already made and securitized subprime loans.[31] As a HUD statement noted (albeit self-servingly) on its website: "If Freddie Mac and Fannie Mae are holding securities backed by [subprime] loans, it is because they were attracted to their yields and not because of a public policy designed to promote affordable homeownership."[32]

In some nominal sense, of course, the GSEs were doing the bidding of their federal overseers when they bought up AAA-rated tranches of subprime and Alt-A securitizations issued by the private market. But this was a curiously backhanded way of fulfilling their mandate, and arguably one that devoted no new net monies to the subprime market that would not have gone in this direction anyway. The AAA slices of private label MBS that the GSEs began to accumulate in their portfolio were based on mortgages that had already been issued and securitized by the likes of Lehman, Bear Stearns, or Goldman Sachs. Presumably these securities would still have existed—and the mortgages would still have been issued—even if Fannie Mae had not ultimately chosen to purchase them. If not Fannie Mae, then one of Bear Stearns' own hedge funds, perhaps, or a German pension fund, would have bought these securities up and stashed them away in its portfolio. If Fannie Mae and Freddie Mac are to be held morally culpable for the housing crisis because they purchased MBS backed by subprime mortgages, every other private investor, bank, pension fund, insurance company, sovereign wealth fund, or hedge fund that invested in private label securities is complicit.

Critics have argued that the GSEs were the marginal conduit of liquidity into the subprime market. That is, if Fannie and Freddie hadn't gorged themselves on the AAA-rated slices, the whole subprime machine would have ground to a halt. According to this view, the AAA-rated tranches were the undesirable (and thus rate-determining) piece of subprime securitizations, and the GSEs' willingness to purchase billions of dollars of these securities fanned the flames of the bubble.[33] There is undoubtedly something to this marginal liquidity argument. The GSEs bought hundreds of billions of securities for their proprietary books, and ipso facto, anything they bought supplied liquidity. But in addition to discounting the demand of other institutional investors such as banks, pension funds, and insurers

31. Thus it is simply false to say, as does Mark Calabria, that the "vast majority of Fannie Mae and Freddie Mac activity in subprime was via the direct purchase of whole mortgages." (Calabria, "Fannie, Freddie, and the Subprime Mortgage Market," at 7).

32. Cited in Jody Shenn, "Fannie, Freddie Subprime Spree May Add to Bailout," Bloomberg News, Sept. 22, 2008 (last visited Dec. 12, 2012).

33. For a variation of this criticism, see Shenn, "Fannie, Freddie Subprime Spree May Add to Bailout."

whose mandate demanded that they hold only AAA-rated securities—and the allure of supposedly "riskless" premiums these securities offered over identically rated Treasuries—it is misleading to represent the AAA-rate tranches as the only rate-determining step in a subprime securitization. There were other undesirable slices of any MBS securitization—most decisively, the least credit worthy or "equity" piece—which Wall Street banks somehow found ways to recycle in the various pyramids of CDOs and synthetic CDOs they concocted.[34]

From Fannie's vantage, satisfying their affordable lending mandates in this way seemed like a conservative move. Rather than directly assuming the risk of subprime borrowers defaulting, Fannie and Freddie bought the presumably "riskless" AAA tranches of securitizations. Other MBS-holders below them in the credit stack assumed most if not all the credit risk, and the GSEs got points with HUD for subsidizing affordable housing. As we now know in hindsight, AAA was not really riskless, and not all AAA-rated securities were created equal. Large portions of the GSEs' formerly AAA securities were ultimately downgraded by the ratings agencies. In their defense, Fannie Mae and Freddie Mac seem to have been more discriminating than most buyers in the securities they purchased. As even their critics have acknowledged, Wall Street firms created special pools of subprime mortgages that would satisfy the more stringent rules that limited GSE purchases to loan with at least 80 percent LTV ratios.[35] Unlike the very worst subprime securities that became worthless as their credit support evaporated, Fannie and Freddie marked their non-agency book at 70 percent or so of par as of 2008—substantial losses, by any measure, but hardly worthless. Magnified by thirty times leverage, however, even negligible credit losses become deadly.

Focusing on affordable housing mandates doesn't get to the heart of the GSEs' decision to accumulate subprime and Alt-A securities in their proprietary portfolio. The mandate worked hand in hand with the profit motive. Although they carried the same ostensible AAA credit rating as agency or Treasury bonds, the senior tranches of private label securities purchased by the GSEs paid a modestly higher interest rate. It was a win-win for the GSEs to move into these securities, as this allowed them to increase the overall spread on their portfolio, thereby juicing earnings for shareholders.[36] The best evidence of the relative attractiveness of

34. For a general sense of this securitization process and the methods structured finance developed to dispose of the less desirable parts of the securitization, see *Michael Lewis, The Big Short: Inside the Doomsday Machine* (New York: Norton, 2010).

35. Calabria, "Fannie Mae, Freddie Mac, and the Future of Federal Housing Finance," at 4; Shenn, "Fannie, Freddie Subprime Spree May Add to Bailout."

36. As further evidence of the preponderance of the profit motive and the divergence of the GSE business model from its ostensible housing mission, Freddie Mac was caught red-handed in 1997 in a scheme to juice earnings for shareholders

these securities was the fact that the GSEs were in good company in buying them. As we now know, countless banks, pension funds, insurers, hedge funds, foreign investors, and other private sector investors were also duped by the AAA ratings and the promise of "riskless" returns.[37] As the Hudson Institute's John Weicher argues in *National Review Online*, while affordable housing goals make a "wonderful excuse," sometimes the "best explanation is the simplest: The GSEs badly misjudged the risk of subprime mortgages. So did other lenders. But the GSEs—because they were bigger, were required to hold less capital, and carried the implicit backing of the U.S. government—took the biggest risk and had the biggest fall."[38]

Leverage and Undercapitalization

Credit risk—and the motivations for incurring it—is the usual focus of GSE critics. But as Weicher suggests, the matter of credit risk cannot be treated in a vacuum. For it was not credit risk in and of itself but the hundred-fold magnification of these risks by leverage that spelled the GSEs' ultimate doom. Looking back at the GSEs' Capital Markets business, one can see that they were, for all intents and purposes, operating the world's largest and worst capitalized hedge fund—a pyramid of leveraged debt that was destined to collapse if either their ability to roll over short term borrowings was interrupted or their "riskless" portfolio experienced even modest losses. The GSEs' mandate might have directed them to dedicate a certain percentage of their lending to low- or middle-income borrowers, but it said nothing about the magnitude of leverage they had to use to do this, how much capital they needed to hold in reserve against potential credit losses, and hence the risks they undertook in pursuing their chartered mission. And yet it was this truly stupendous leverage—a feature they shared with their Wall Street brethren—that more than anything else contributed to their financial ruin.

As noted above, the proprietary trading business model of the GSEs consisted in borrowing to buy longer-dated MBS. The difference between the GSEs' cost of funds (mostly short-term debt, which had to be rolled over periodically) and the higher interest rates paid by the securities they purchased resulted in a spread, a kind of interest rate arbitrage.

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by buying $340 million of corporate bonds issued by the tobacco company Phillip Morris. Richard W. Stevenson, "House Banking Chief Wants Freddie Mac Bond Inquiry," New York Times (Apr. 17, 1997), http://www.nytimes.com/1997/04/11/business/house-banking-chief-wants-freddie-mac-bond-inquiry.html (last visited Dec. 30, 2012).

37. On the similar error committed by Germany's Landesbanks, see Michael Lewis, "It's the Economy, Dummkopf!" Vanity Fair (Sept. 2011).

38. John C. Weicher, "At the HUD of the Fall," National Review Online (Nov. 17, 2008). http://www.nationalreview.com/articles/226163/hud-fall/john-c-weicher# (last visited Dec. 30, 2012).

This spread, multiplied by the amount of leverage deployed, generated healthy profits. In the years leading up to the financial crisis, Fannie Mae's profits from its capital markets business dwarfed its guaranty business. What former Fed Chairman Alan Greenspan referred to disparagingly as the "big, fat gap" resulted in nearly $10.7 billion of revenues in 2005 for Fannie Mae's Capital Markets group, as against the $5.6 billion brought in by their Single Family Guaranty Business.[39] In 2002, the profit disparity was even more lopsided: $10.6 billion in profits from Capital Markets versus a mere $1.8 billion in Single Family Guaranty.[40] According to a 1996 Congressional Budget Office report, the profit margin on the GSE Capital markets business was four to five times greater than that on its mandated Single Family Guaranty Business, and not surprisingly, this accounted for the bulk of their profits in the 1990s and early 2000s.[41]

Interest rate arbitrage can be lucrative, but its profitability is directly proportional to leverage employed and assumed risks. In 2007, Fannie Mae held a proprietary portfolio of $800 billion, which was secured against a scant equity base of only $45 billion, resulting in an effective leverage of nearly 20 to 1.[42] To put this in perspective, a loss of even 5 percent in the value of the underlying securities in their proprietary portfolio was sufficient to wipe out all the tangible equity of Fannie Mae. Still more meager were capital ratios with respect to Fannie Mae's credit guaranty book. Fannie was required to hold only .45 percent in reserve capital over and against its potential credit exposure for outstanding guaranteed securities of more than $2.4 trillion. That amounts to more than 200 to 1 leverage. Put the other way around, if even one in 100 of Fannie and Freddie's securitized mortgages were to default, with 50 percent recoveries resulting from the foreclosures, the GSEs would be rendered insolvent. As we now know, default rates were much higher than this, and losses severe.

So who is ultimately responsible for the overleveraging and undercapitalization with which Fannie Mae operated? Did the federal government mandate that it leverage its proprietary portfolio to the hilt or fail to reserve sufficiently for losses in its guaranty business? To the contrary: driven by hard-charging CEOs Jim Johnson and Franklin Raines, Fannie Mae fought aggressively against regulatory attempts to limit its leverage or institute even modest capital requirements.[43] After allowing them to operate

39. Greenspan as cited in McLean and Nocera, *All the Devils Are Here*, at 47; U.S. Sec. & Exchange Comm'n, FNMA 10-K (fiscal year ended Dec. 31, 2006), Business Segment Summary Financial Information, at 5.

40. U.S. Sec. & Exchange Comm'n, FNMA 10-K (fiscal year ended Dec. 31, 2002), Item 6: Selected Financial Data, at 20. One might wonder about the degree of leverage required to generate these stupendous profits? The answer: 55 to 1.

41. See McLean and Nocera, *All the Devils Are Here*, at 47.

42. U.S. Sec. & Exchange Comm'n, FNMA 10-K (fiscal year ended Dec. 31, 2007), Balance Sheet Data, at 46.

43. McLean and Nocera, *All the Devils Are Here*, Chs. 3 and 12.

for years with minimal oversight, their toothless financial regulator the OFHEO stepped in only after accounting scandals rocked both Fannie and Freddie in the first few years of the 2000s. Regulators only belatedly instituted minimal capital requirements and buffers in 2006 and ordered them to bolster capital levels by issuing preferred shares in 2008. These modest capital controls proved too little, too late, as losses piled up not just from defaults on mortgages they had securitized, but also and especially in their own investment portfolios. Shortly before being taken into conservatorship, write-downs on Freddie's proprietary book exceeded $15 billion. Against a tangible common equity base of only $25 billion, and facing even more imminent write-downs, Freddie would almost certainly have been bankrupted outright even if not a single Freddie-underwritten mortgage had defaulted.[44]

Implicit Backing and Moral Hazard

Another prominent theme among critics is that Fannie and Freddie were lulled into reckless behavior by the knowledge that they enjoyed the "implicit guarantee" of the federal government due to their chartered status. On its face, this is highly plausible. There is no doubt that Fannie and Freddie enjoyed a competitive advantage in the mortgage market because of this "implicit guarantee," and they flaunted the "creative ambiguity" of their hybrid status whenever possible.[45] We know that their implicit government guarantee meant that Fannie and Freddie were able to borrow at a lower rate than private competitors and sell their securities at a premium. This "implicit subsidy" was estimated to add nearly $2 billion a year in profits and more than $80 billion dollars in value captured by GSE shareholders.[46] But does the fact that Fannie and Freddie enjoyed a competitive advantage necessarily translate into an incentive for them to engage in riskier behavior? One could just as easily argue the opposite point: that is, rather than stretching themselves by taking more risks than private competitors, they could afford to be more prudent due to their competitive advantage. As I have tried to suggest above, at least with respect to credit risk, this is exactly how the GSEs played their hand.

With respect to leverage, however, it does seem reasonable to think that creditors and counterparties in the market were willing to lend more money and tolerate higher degrees of risk-taking from Fannie and Freddie

44. U.S. Sec. & Exchange Comm'n, FHLMC 10-Q, 3rd Q. 2008 (Nov. 10, 2008) at 8.

45. McClean and Nocera, *All the Devils Are Here*, Chs. 3 and 12.

46. Congressional Budget Office, *Federal Subsidies and the Housing GSEs* (Washington, D.C.: Government Printing Office, 2001); Wayne Passmore, "The GSE Implicit Subsidy and the Value of Government Ambiguity," Finance and Economics Discussion Series, Divisions of Research & Statistics and Monetary Affairs (Washington, D.C.: Federal Reserve Board, 2005). http://www.federalreserve.gov/pubs/feds/2005/200505/200505pap.pdf (last visited Dec. 29, 2012).

on the assumption that if push came to shove, the federal government would make them whole. Particularly when it came to their mortgage backed securities, the premiums investors were willing to pay for agency over private label MBS, and the tight spreads of agencies relative to Treasuries of similar maturities, are strong empirical evidence that the market perceived Fannie and Freddie's implicit guarantee to be a reality. Notwithstanding explicit disclaimers carried by all agency MBS stating that "neither the certificates nor interest on the certificates are guaranteed by the United States, and they do not constitute a debt or obligation of the United States or any of its agencies or instrumentalities other than Fannie Mae," investors ignored the warnings and took the implicit backing as an explicit guarantee.[47]

But was this fact alone either necessary or sufficient to explain the GSEs' leverage and undercapitalization? The problem is that Fannie and Freddie were by no means the most egregious offenders in terms of reckless lending, woeful risk management, and overleveraging. Unless one wants to assume that all of the multitude of large American and foreign financial institutions that ultimately had to be bailed out (or in the case of Lehman, allowed to collapse), e.g., AIG, Merrill Lynch, Bear Stearns, Citi, WaMu, ING, Dexia, Royal Bank of Scotland, Lloyds, and so forth, operated under the assumption, pre-2008, that their systemically important status meant they were immune from the costs of their own bad decisions, then it seems implausible that Fannie Mae and Freddie Mac's quasi-public status, per se, is what caused the GSEs to gamble recklessly with taxpayer dollars. Indeed there were far worse offenders than the GSEs in this regard. That the GSEs' Wall Street competitors, which enjoyed no such "implicit guarantee," took even greater risks suggests that the GSEs' hybridity was neither necessary nor sufficient to explain their bad decisions. To give just one concrete example, in what would later stand out as the warning shot signaling the onset of the financial crisis, Bear Stearns' euphemistically named "Enhanced Leverage Fund," with a portfolio more than 60 percent backed by subprime mortgages and CDOs leveraged at 27 to 1, collapsed spectacularly into insolvency in July of 2007, eventually carrying the firm with it.[48]

47. Ironically, however, would-be creditors were wrong to assume this backstop in at least one respect. As Andrew Redleaf and Richard Vigilante point out in their thoughtful work *Panic: The Betrayal of Capitalism by Wall Street and Washington* (Minneapolis: Vigilante Book, 2010), Fannie and Freddie's preferred investors that bought stakes in the company in early 2008 were stiffed by the federal government. Along with the decision to let Lehman fail, the authors argue that this perverse decision to wipe out the preferred shareholders of FNMA and FHLMC only created further uncertainty by drawing an ambiguous between those who would be bailed out and those who would be left out in the cold.

48. McLean and Nocera, *All the Devils Are Here*, at 286–95.

Whatever the degree of risks taken, for both the GSEs and their strictly private brethren, the motivation seems to have been a desire to maximize profits for shareholders and bonuses for executives, plain and simple. Arguably even more than the moral hazard of the GSEs' quasi-public status and "implicit guarantee," the structural features of the modern publicly traded corporation played a role. Michael Lewis and other observers have identified the deeper structural causes of the financial crisis not in the consolidation of "too big to fail" financial institutions, but rather in the transformation of Wall Street firms from partnerships where the partners' own capital was at stake into publicly traded corporations where short-term profits accrue to executives and traders but catastrophic losses are absorbed by shareholders.[49] Whether the costs of failure are borne by shareholders or socialized by taxpayers, the problem of moral hazard exists anywhere that management and traders are rewarded for taking extraordinary risks with other people's money.

The Lessons of the GSEs and the Ethics of Bailouts

So what does this admittedly cursory post mortem of the GSEs have to tell us about the ethics of bailouts? First, and most importantly, the sad tale of the GSEs is often touted as an example of the problems of moral hazard and rent-seeking inherent to any hybrid or "public-private partnership." And surely the track record of Fannie and Freddie shows the incentives of firms so situated to lean on the "creative ambiguity" of their public charter. Yet even here, the story of the GSEs and their role in the financial crisis is mixed. Their most egregious risk-taking seems to have been driven mainly by the desire to compile impressive returns for shareholders. The rise and fall of Fannie Mae's ambitious CEO Franklin Raines, with his goal of doubling earnings per share in five years, is a case in point of how profit-maximization trumped prudent risk management. Likewise, even in retrospect it is hard to draw a bright line between the GSEs' implicit federal backing and the moral hazard it allegedly generated. While happy to profit from their privileged status, there is no evidence that failure was ever contemplated by the major players at Fannie Mae of Freddie Mac. Or, put differently, the risks they took do not appear to have been the consequences of some thinkable notion that taking excessive risk—and failing—would end in a government bailout. The looming counterfactual is the fact that so many private Wall Street firms such as Lehman Brothers, Bear Stearns, and Merrill Lynch; national mortgage lenders such as Countrywide, Indy Mac, or Ameriquest; and private mortgage arbitrageurs such as Bimini Capital and Thornburg Mortgage engaged in behavior that was far riskier with absolutely no expectation of government backing. Empirical evidence for the riskiness of hybrid or public-private models remains inconclusive.

49. Lewis, *The Big Short: Inside the Doomsday Machine.*

If my version of the story is correct—that is, that the preponderance of GSEs losses were attributable to aggressive portfolio arbitrage intended to increase earnings for shareholders—then losses at the GSEs cannot be laid at the feet of Bill Clinton, Barney Frank, or other liberal advocates of affordable housing. The financial crisis owes something both to misguided policy and market failure. But whatever the relative degree of culpability of state and market, there is still a moral disconnect within the popular narrative of events. If free marketeers are correct that the origins of the housing crisis and ensuing failure of the GSEs were the fault of congressional leaders—that is, of public officials duly elected by people—then it only seems right that U.S. taxpayers should be on the hook for their misguided policies. If congressional leaders led the country into a pointless war, an ill-advised health care reform, or some other misbegotten policy, there would be no question but that Americans are financially responsible. We might publicly castigate our leaders for their bad judgment. We should throw them out of office the next time they stand for reelection. But there would be no question that as citizens we are collectively responsible for what they have wrought. In this respect, the conservatorship of the GSEs is qualitatively different from the bailouts of AIG and Wall Street banks. Alternatively, it seems to me, the only moral narrative that would fully exonerate taxpayers of their legitimate moral obligation to bailout the GSEs is one that goes even further than what I have offered here in attributing the GSEs recklessness to the irrational exuberance of the free market.

Whither the GSEs?

Above and beyond just complicating the story of their failure, adjudicating moral culpability, and divvying up financial responsibility, what can be salvaged from the wrecks that are Fannie Mae and Freddie Mac? As might be gleaned from the title of this article, I am not averse to the idea of the GSEs, properly administered, continuing to operate as they did for many years as a wholly owned agency of the federal government. Political scientists and scholars of American political development will recognize in my title the reference to Theda Skocpol and the so-called "new institutionalism" in political science. This influential body of literature arose in the 1980s and 1990s as a way of looking beyond the pluralist view of the state as a "black box" overdetermined by societal interests and citizen preferences. Rather than taking citizen preferences as givens, new institutionalism invites us to consider the multitude of ways that state policy gives rise to those very preferences and generates (or potentially undermines) a specific set of citizen virtues.[50] Unlike the majority of commentators who have reckoned with

50. *See especially* Evans, Rueschemeyer, and Skocpol, eds. *Bringing the State Back In* and the literature referenced in note 10 above.

the GSEs in terms of their economic costs and benefits, I want to propose, very briefly, a new institutionalist framework for thinking about their prospective role.

As noted above, I do not think there is anything inherently wrong with having a single, centralized entity (or entities) that purchases, guarantees, and securitizes whole mortgage loans into investment grade mortgage backed securities, so long as (and this is key) that entity is sufficiently capitalized, employs responsible underwriting standards, and charges a guaranty fee commensurate to the actual risks it assumes in undertaking the activity. The GSEs were not destined to fail. They failed for the same reasons as many of their private competitors: they practiced poor risk management, were undercapitalized, and employed leverage that was unsustainable if at any point the market came to perceive them as uncreditworthy. For years the GSEs reaped huge profits for shareholders and artificially depressed the real costs of housing for homebuyers, but they did so only by taking upon themselves risks for which they were insufficiently compensated.

With or without the explicit backing of the U.S. government, putting the GSEs on sound financial footing and strictly regulating them so that their balance sheet is unimpeachable would restore confidence among investors that securities issued by the agencies are truly investment grade. There is, of course, no reason why responsibly operated private firms could not fulfill the same clearinghouse function and compete against the GSEs. Already there are intimations of this, with a handful of successful private securitizations of high-quality, jumbo or other non-conforming mortgages in the wake of the financial crisis. Until the private securitization market for mortgages in the United States revives, however, the GSEs are so dominant that there can be no realistic possibility of disposing of them. But rather than lamenting the fact that we are stuck with them for the foreseeable future, I want to offer a different perspective in which their dominance of the U.S. housing market could prove not just economically sustainable, but morally salutary by encouraging citizen character and personal responsibility.

Homeownership as a Legitimate Public Good

Critics of the GSEs point to the mounting losses for which U.S. taxpayers have to foot the bill—and with good reason. The $190 billion of losses from the GSEs (and more recently, from the FHA, which by all accounts has become the new subprime lender of last resort) is staggering by any stretch of the imagination. And yet against this backdrop of failure, mismanagement, and moral hazard, we lose track of the fact that the overarching mission of the GSEs—namely, promoting homeownership—is a legitimate public good that U.S. taxpayers happily subsidize in other contexts. We tend to forget just how heavily we subsidize housing in the United States—to the tune of $138 billion dollars annually in 2012, when taking into account mortgage interest deductions, property tax

deductions, and exclusions on capital gains from the sale of homes.[51] To put this in perspective, the total costs borne by U.S. taxpayers through the conservatorship of the GSEs amount to only about a year and a half of our homeowner-friendly tax code.

One might object that there is a qualitative difference between losses involuntarily incurred from bailouts of a privately owned corporation, on the one hand, and revenues deliberately foregone via a tax deduction, on the other. Perhaps this is right. And any moral equivalency between the two may just as easily give rise to an argument for gutting the mortgage interest tax deduction rather than for preserving the GSEs. But when one looks past the circumstances that distinguish the former from the latter, the bottom line is that both the GSEs (properly administered, even if operated at a loss) and the mortgage interest tax deduction are ways we might choose to subsidize housing in the United States. We can debate whether that subsidization is a worthy goal, or whether we want to continue subsidizing it to the same degree or in the same way, but if making housing more affordable is indeed a good to which citizens are committed, then there is no principled reason why the GSEs (even if operated by the taxpayers with a running loss) cannot remain an integral part of that strategy.

We might also consider the distributive consequences of funding housing through a GSE subsidy as opposed to a tax deduction. If critics of the GSE bailout are correct in their rendition of the financial crisis, what the GSEs did by making loans available to low-income borrowers for which taxpayers were ultimately responsible was to effect a progressive redistribution of wealth downward. This is in stark contrast to the distributional consequences of the mortgage interest tax deduction, which effectively subsidizes high-income homebuyers. Because the mortgage interest deduction is only available to taxpayers who itemize deductions, and because its benefits are greatest for those in the highest tax bracket, current policy is effectively a subsidy of conspicuous consumption by wealthy homebuyers. It is unequivocally regressive in its present form. As James Poterba and Todd Sinai have calculated, of the $94 billion in annual benefits provided by the mortgage interest deduction, the lion's share goes to households making more than $250,000 per year, whose tax savings are nearly ten times greater than those earning between $40,000 and $75,000 per year, and its benefits for low-income homebuyers are negligible.[52]

51. Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 2010–2014," (Dec. 15, 2010) (Washington, D.C.: Government Printing Office, 2010), at 39.

52. James Poterba and Todd Sinai, "Tax Expenditures for Owner-Occupied Housing: Deductions for Property Taxes and Mortgage Interest and the Exclusion of Imputed Rental Income," *American Economic Review Papers and Proceedings* 96 (2008), at 11, http://real.wharton.upenn.edu/~sinai/papers/Poterba-Sinai-2008-ASSA-final.pdf (last visited Dec. 30, 2012).

Regardless of one's views of distributive justice, or what one may think about the mortgage interest tax deduction, there is widespread consensus that homeownership is a kind of public good and that public policy ought to do something to encourage it. If that is indeed the case, then some form of public support for the GSEs might be able to address two issues for which the mortgage interest tax credit is ill-equipped, at least in its present form. The first is the subsidization of homeownership by lowering the cost of and access to mortgages. Even under the least sympathetic rendition of their critics, the GSEs have done more to make housing affordable to low-income borrowers than the current mortgage interest tax deduction. The second pertains not to encouraging homeownership, per se, as an unalloyed good for its own sake, but rather to the GSEs' potential for encouraging responsible homeownership on terms that are morally salutary. It is this path that I would like to recommend.

GSE Standards and the New Institutionalism

Putting aside the strictly economic dimensions of the GSEs, I want to sketch out a less-appreciated moral argument for "bringing them back in." In keeping with the considerable literature in political science, sociology, and political theory that has identified a potential role for the state in fostering citizen virtues, perhaps the single most important function of the GSEs is how their standards for conforming loans reflect moral ideals of responsible homeownership. At first blush it may seem odd to think of the state as encouraging virtue—and even stranger to contemplate the GSEs as having some role in this project. After all, liberalism is usually premised on governing ideals of neutrality. With its hostility to various forms of perfectionism, and its privileging of the right to the good, liberalism as a public philosophy is often regarded as necessarily indifferent to the character and purposes of its citizens. However, as William Galston and many others have pointed out, this governing ideal of liberal neutrality is a mirage that obscures a more complex reality in which tax codes, regulations, and legislation always and inevitably reflect certain "liberal purposes" or visions of the good.[53] Given that this is already implicitly the case, for better or worse, it is worthwhile considering how the GSEs could play a more salutary role in encouraging citizen virtues than they have done over the past two decades.

With the debate focused on the relative laxness or restrictiveness of GSE standards, less attention has been placed on their normative implications. And yet if we think about the process of buying a home not—as we were encouraged to think of it in the years leading up to the housing crisis—as a speculative investment reckoned in terms of profit and loss, but instead as a transformative decision to put down roots in a community, then the

53. William Galston, Liberal Purposes: *Goods, Virtues, and Diversity in the Liberal State* (Cambridge: Cambridge University Press, 1991).

standards set by the GSEs have the potential to exert significant influence. By specifying requisite down payments or percentage of equity in a home, qualifying credit scores, and weighing the effects of previous foreclosures, selective defaults, or short sales on one's ability to qualify for a new mortgage, the GSEs have unprecedented power to establish an institutional framework within which moral behavior is either fostered or discouraged. With respect to down payments, the ability to save up a significant down payment—say, 15 percent to 20 percent of the purchase price of a home—is not just an economic incentive or a guarantee of one's skin in the game (though it is both of those things). It is also and maybe more importantly a testament to discipline, frugality, self-restraint, commitment, and moral character. The fortitude to sacrifice and save, delay immediate gratification, and purchase a home one can truly afford, and the willingness to carry through on one's commitments even when it may become economically advantageous to walk away—all of these behaviors presuppose what my co-author Richard Avramenko and I have elsewhere called the "subprime virtues."[54] These are modest Franklinian virtues such as moderation, frugality, foresight, good judgment, truth-telling, commitment, and promise-keeping. They are "subprime" in the sense that they represent a bare minimum of moral character we expect from our fellow citizens. They may seem old-fashioned or hackneyed, but they are also bedrocks of a liberal society.

These subprime virtues were badly frayed in the years leading up to the housing crisis, as financial irresponsibility, immoderation, rampant speculation, institutionalized lying, and most recently, walking away from one's commitments, were incentivized both by the tax code and the housing finance industry. The GSEs were not themselves responsible for the proliferation of aggressive financial products such as "Pick-a-Pay," "Ninjas," and (worst of all) "Liar's Loans," but they and the federal government did precious little to stand in the way of the race to the bottom that characterized the Wild West of mortgage finance in the first decade of the twenty-first century.[55] In the age of securitization, flipping, cash-out refis, and mad speculation, we tended to forget something that was self-evident back in the days when most mortgages were underwritten by small town thrifts. Namely, that buying a home is not just an economic investment but a morally transformative event. Before the financial crisis turned responsible homeownership into house-marketeering and under-

54. Richard Avramenko and Richard Boyd, "Subprime Virtues: The Moral Dimensions of US Mortgage and Housing Policy," *Perspectives on Politics* (2013). In this section and throughout I draw freely on ideas and arguments that Avramenko and I have developed at greater length elsewhere.

55. For a first-hand account of the proliferation of these NTMs and the perverse race to the bottom that prevailed in the subprime industry, see Richard Bitner, *Confessions of a Subprime Lender: An Insider's Tale of Greed, Fraud, and Ignorance* (Hoboken, NJ: Wiley, 2008).

mined even the most remedial "subprime virtues," buyers were expected to scrimp and save to put together a substantial down payment, manifest sterling credit that demonstrated a track record of personal responsibility, exercise foresight and good judgment in buying a home that they could actually afford to pay for, and follow through on one's commitment rather than simply walking away when the value of one's home dropped.

There is no going back to these halcyon days, but the new model GSEs can certainly play a more productive role than they have for the past two decades. The insight that bad policy has deleterious consequences for citizen character has a more optimistic flip side: namely, that good policy may be morally salubrious. With their position at the epicenter of the U.S. housing market, the GSEs are uniquely positioned to impose a kind of moral discipline on the mortgage market. By strictly enforcing standards in terms of equity, income ratios, pristine credit, and lack of previous bankruptcies, foreclosures, or selective defaults, the GSEs can affirm and incentivize core liberal virtues such as prudence, moderation, promise-keeping, self-control, truth-telling, and commitment that took such a beating in the years leading up to the financial crisis. Not only is this function different from that they were tasked with performing in the era of the housing bubble—namely, putting all citizens in a house, regardless of whether they were well suited to shoulder the responsibilities of homeownership. It is also a substantially different charge from what they are currently being asked to do by propping up a sagging housing market at all costs; bailing out irresponsible homebuyers by writing down principal on underwater mortgages, and—in the case of the FHA—continuing to extend credit to would-be homebuyers with little or no skin in the game. This is emphatically (and here I agree wholeheartedly with critics of the GSEs) the wrong way to theorize their future role in U.S. housing finance policy. At the end of the day—and whether or not one accepts the moral vision of responsible homeownership I have sketched out here—any plans for the future of the GSEs must reckon not just with their financial viability, but also and maybe more importantly with the moral effects of their policies on citizen character.

Thinking about the GSEs as instruments for fostering these basic citizen virtues would of course require a novel understanding of their public role—one which rests neither on the strictly market-oriented goals of economic efficiency and profit-seeking, on the one hand, nor the liberal goals of affordable housing and social justice, on the other. Re-tasked in this way, the GSEs' mandate would no longer be—as it was in the past—to maximize homeownership per se. Instead it would be to cultivate responsible homeownership not as an end in itself but as a means toward moral development and citizen character. Using the GSEs' power in the marketplace to set conforming standards that are morally developmental (or at least not morally harmful) would go some distance toward repairing the moral costs that are—along with bailouts and public debt—the heretofore untallied legacy of the financial crisis.

Contracts for Deed: Charting Risks and New Paths for Advocacy

Heather K. Way and Lucy Wood

Despite the ongoing fallout from the foreclosure crisis, most families, rich and poor, still aspire to be homeowners.[1] In the informally settled communities of South Texas, where more than half the residents make less than $1,600 a month, thousands of low-income families share in this quest.[2] Despite the extreme poverty in these communities, the homeownership rate is close to 80 percent—notably higher than the national rate of 65 percent.[3]

Families living in poverty buy homes in spite of the fact that they receive little or no benefit from government homeownership subsidies, such as the federal income tax deduction for mortgage interest and property taxes.[4] And they buy homes even when they do not qualify for traditional mortgage financing. In high-poverty communities we surveyed in Texas, 73 percent of homebuyers relied on seller financing; only 11 percent secured mortgages from lending institutions such as banks or credit unions (another 15 percent paid in full up front).[5]

While seller financing has opened up the doors to homeownership for thousands of families throughout the country, this form of financing can be very risky for buyers, exposing them to harsh conditions on the path to homeownership. One of the most common forms of seller financing is the contract for deed, described by one court as the "poor man's mortgage,"

1. *See, e.g.*, FANNIE MAE NATIONAL HOUSING SURVEY—Q3 2012 DATA SUMMARY, t.q50 (June 6, 2013), http://bit.ly/18J5zp7.

2. PETER M. WARD, HEATHER K. WAY & LUCILLE WOOD, THE CONTRACT FOR DEED PREVALENCE PROJECT, tbl.5.1 (Aug. 2012), http://bit.ly/16f0lm8. These findings were drawn from surveys of more than 1,200 randomly selected households in more than sixty-five unincorporated Texas communities in Hidalgo, Webb, El Paso, Cameron, Maverick, Starr, Guadalupe, and Hays counties.

3. *Id.* at tbl.5.14; U.S. Census Bureau, Annual Homeownership Rates for the United States and Regions: 1997–2012 (2013), http://1.usa.gov/17Lr1eK.

4. Heather K. Way, *Informal Homeownership in the United States and the Law*, 29 ST. LOUIS U. PUB. L. REV. 113, 127 (2009).

5. WARD, WAY & WOOD, *supra* note 2, Appendix D.iv, http://bit.ly/1dGlV59.

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where homebuyers can acquire title only after they have finished paying for the home.[6] Lawyers for the poor in several states have responded to the long history of sellers' abusive contract for deed practices by promoting comprehensive legislative reforms. These reforms offer buyers with contracts for deed some of the same protections available to buyers with traditional mortgages.[7]

In this article, we focus on contract for deed reforms adopted in Texas to address what was once a common financing method for low-income buyers attempting to purchase a home. The Texas reforms, now on the books for more than ten years, are some of the most sweeping contract for deed reforms in the country. Drawing from a recent study of homebuyers utilizing seller financing, we then present several problems that still remain for buyers in the wake of these reforms. Looking ahead, we draw on the Texas story and parallel reform efforts in other states to chart a course for future advocacy and policies that will provide a safer path to homeownership for our nation's most vulnerable homebuyers.

Contracts for Deed

A contract for deed is a form of seller financing whereby the seller retains legal title until the homebuyer finishes making all the payments owed under the contract. These contracts are also referred to as installment contracts, bonds for deed, and executory contracts. The buyer promises to make regular monthly payments, usually with interest, toward the sales price over a set contract term. The down payments vary but can run in the thousands of dollars. The contract term may run as long as thirty years, although more unscrupulous sellers may use a shorter contract term with a large balloon payment after a few years, making it almost impossible for the buyer to complete the purchase.[8] During the contract term, the buyer is typically responsible for property maintenance, property taxes, and home insurance.

Once the buyer finishes making the payments on the contract, the seller is supposed to execute a deed transferring the legal title to the buyer, and either the seller or buyer is responsible for recording the deed in the real property records. Sellers typically include a forfeiture clause, authorizing the seller to terminate the contract, regain possession, and retain all of the buyer's prior payments as liquidated damages when the buyer misses a payment or otherwise violates the terms of the contract.

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6. Ellis v. Butterfield, 570 P.2d 1334, 1336 (Idaho 1977).

7. Contract for deed laws by state can be accessed at www.contractfordeed.uslegal.com.

8. *See, e.g.*, Jeffrey Meitrodt, *Contract for Deed Can Be House of Horror for Buyers*, MINNEAPOLIS STAR TRIB., Jan. 14, 2013, at 1A, http://bit.ly/15QLfz4.

Background

Contracts for deed have a long and widespread history in the United States.[9] Today, the contracts are still actively used in residential sales by investors in many states, including Illinois, Minnesota, West Virginia, South Dakota, Ohio, South Carolina, Florida, New Mexico, and Texas.[10] They are most popular in places where there is a limited supply of affordable rental housing, an ample supply of affordable land or homes (typically in substandard condition), and a pool of interested buyers ineligible for bank financing.[11] In East St. Louis, Illinois, for example, the use of installment contracts has been widespread in neighborhoods where houses are older, in substandard condition, and mortgage credit is hard to access.[12]

But why have professional investors relied on contracts for deed and not simply rented homes to the poor?[13] Money, of course, is the answer. A homebuyer will agree to pay more per month than a renter because the homebuyer believes that the monthly payments will go toward the purchase of the home. A homebuyer will agree to put down a larger amount up front as a down payment as compared to a renter's security deposit. A homebuyer is likely to take better care of the property than a renter, and a seller is off the hook for repairs he would otherwise have to make as a landlord. The contract for deed seller can also require the homebuyer to pay the property taxes and insure the property. Meanwhile, the seller—who seldom ends up transferring the title to the property and completing the sale—can quickly and cheaply get rid of a buyer who misses a payment.

In the wake of the recent foreclosure crisis, as more homebuyers have been shut out of traditional bank financing, some urban areas have seen dramatic upticks in home sales using contracts for deed. In the Twin Cities metro area, for example, recorded contracts for deed have increased by 50 percent over the past five years.[14] Contracts for deed are also common today in informal housing settlements located near cities throughout the United States (cheap land subdivided into residential lots with buyers using manufactured homes, trailers, or self-built structures as their housing

9. Way, *supra* note 4, at 129.

10. *Id.* at 130–31; Prashant Gopal, *Home sellers step up as last-resort lenders*, Chicago Daily Herald, May 20, 2011, at L1; N.M. Ctr. on L.& Poverty, Legal Issues in New Mexico's Colonia Communities: A Report (July 2010), http://bit.ly/1anrV1i; Meitrodt, *supra* note 8.

11. Way, *supra* note 4, at 129–30.

12. *Id*. at 130.

13. In contrast to professional investors, some contract for deed sellers are low-income owners who do not know of any other way to sell property. These transactions are just as risky to the buyers. However, the pecuniary benefits may not have been the primary reason for the seller's decision to use a contract for deed.

14. *See, e.g.,* Meitrodt, *supra* note 8.

without proper infrastructure), as low-income families expand their geographic search for affordable homeownership opportunities.[15]

The Risks

Contracts for deed and other forms of seller financing can offer important benefits to homebuyers in the form of low entry costs and open access.[16] However, these transactions lack many of the safeguards available to buyers in traditional third-party mortgages—with weaker legal protections and no bank, government agency, or title closing agent overseeing the transaction. As a result, homebuyers utilizing seller financing are prime targets for a host of abusive practices by unscrupulous sellers.[17] Absent state reforms, here is an abbreviated list of the central risks associated with contracts for deed:[18]

- **Losing Everything**: A major risk to buyers with contracts for deed stems from the use of forfeiture clauses and the seller's retention of title. With one missed payment, the seller can quickly terminate the contract and strip the homebuyer of all of the equity in the home.[19]
- **Bar on Assignments**: Because contracts for deed routinely bar assignments, a buyer who needs to move during the contract term is forced to choose between staying or terminating the contract and foregoing potentially tens of thousands of dollars in equity and the value of any improvements made to the property.
- **Substandard Property Conditions**: Contract for deed transactions provide investors with an easy way to circumvent repair obligations

15. Way, *supra* note 4, at 131. Through the use of geographic information systems analysis, it has been estimated that roughly three to five million people live in informal settlements across the United States (*id.* at 131).

16. *Id.* at 133–34.

17. *See, e.g.*, David S. Jones, *'Contract for Deed' Problems; Beware*, Real Estate Center, Tex. A&M Univ. (Aug. 13, 2008), http://bit.ly/14Dpy9h; Tex. Low Income Hous. Info. Serv., *Home Buyer Scams Prey on Poor Immigrant Families*, Hous. Matters Newsl. (March 2005), http://bit.ly/1gWrxrM.

18. For a more detailed elaboration of these pitfalls, see Way, *supra* note 4, at 135–49.

19. Most state legislatures have not extended to contract for deed buyers the full range of statutory protections afforded a mortgagor in the foreclosure process—such as the right to cure, recoupment of equity upon sale, and right of redemption (Way, *supra* note 4, at 139–43). State courts have issued a range of judicial protections shielding contract for deed buyers from the harsh impacts of forfeiture clauses on the ground that the clauses shock the conscience of the court. However, the scope of these judicial protections are often unclear and applied in an ad hoc manner (*see, e.g.,* Grombone v. Krekel, 754 P.2d 777, 778 (Colo. App. 1988) ("There are numerous Colorado decisions which have required that an installment land contract must be foreclosed as a mortgage. There are also many cases which have refused to treat such an agreement as a mortgage.")).

that ordinarily extend to landlords. An investor can place a contract for deed buyer in a substandard home without any obligations to repair the home—leading one newspaper to recently label contracts for deed a "house of horror" for buyers.[20]

- **Title Defects**: Seller-financed home sales typically do not involve title examinations, which places buyers at risk of buying homes with a range of preexisting title defects, such as tax liens.[21]
- **Post-Purchase Liens**: Contract for deed buyers are particularly vulnerable to title defects arising after the transaction is initiated, given the seller's retention of the title. For example, in more than half the states, a contract for deed property is not protected from judgment liens issued by the seller's creditors during the contract term.[22]
- **Balloon Payments**: In some areas of the country, contract for deed sellers routinely require balloon payments within three to five years. If the buyer cannot come up with the cash or bank financing to make the balloon payment, he or she will lose the home.[23]

The Texas Experience

In Texas, land investors began using contracts for deed in large volumes along the state's border with Mexico as early as the 1950s.[24] Working in unincorporated areas that became known as colonias, developers divided large tracts of land into individual lots with little or no infrastructure and then sold the lots via unrecorded contracts for deed to very poor families.[25] The lack of potable water and wastewater services, irregular platting, continual flooding, and unscrupulous sales tactics by many investors in the area contributed to a host of harsh living conditions.[26]

By the late 1980s, with the rapid proliferation of colonias, the land investors' abusive sales practices and plight of the residents had caught the attention of the Texas Legislature. Advocates for the poor pressed for regulation of contracts for deed as well as for reforms to address the substandard living conditions, unregulated subdivision practices, and lack of infrastructure within the colonias.[27]

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20. Meitrodt, *supra* note 8.
21. Way, *supra* note 4, at 136–38.
22. *See* 4-37 POWELL ON REAL PROPERTY § 37.21(1)(e)(ii) (2013).
23. Meitrodt, *supra* note 8 (finding that "not one of [the investor's] 160 buyers has been able to refinance their deals, which typically require six-figure balloon payments in three years").
24. Ray Thomas, *The Plight of Texas Colonias*, 62 TEX. B. J. 1045, 1045 (1999); Tex. Sec'y of State, Colonias FAQ's (n.d.), http://bit.ly/19BzqRg.
25. Tex. Sec'y of State, *supra* note 24.
26. *See* Tex. Dep't Hous. & Cmty. Affairs, Background on the Colonias (n.d.), http://bit.ly/1aYOQCS.
27. Tex. Low Income Hous. Info. Serv., *supra* note 17.

The Reforms

In 1995, on the heels of a legislative study describing the abusive use of contracts for deed, the Texas Legislature adopted its first, modest set of reforms to halt the victimization of buyers in the colonias, the Colonia Fair Land Sales Act.[28] Advocates for the poor continued to press for more comprehensive protections and, in 2001, the legislature responded with the adoption of a sweeping set of statewide reforms.[29] In 2005, the legislature adopted a final set of major reforms, providing contract for deed buyers with even greater protections and eliminating loopholes that investors had been using to work around the previous reforms.[30] A summary of the Texas reforms—seen as some of the most sweeping reforms in the country—are included below.

The Outcomes

After the adoption of the Texas contract for deed reforms, concerns were raised that the new laws would shut down homeownership opportunities for the poor.[31] At least one real estate lawyer familiar with Texas titling practices declared that contracts for deed are "all but dead" as a result of the reforms.[32]

In 2011, the Texas Legislature indicated its interest in learning what impact these sweeping reforms have actually had on the use of contracts for deed in residential transactions.[33] In response, the state housing agency commissioned a study from the University of Texas School of Law and Lyndon B. Johnson School of Public Affairs.[34] The study, which we co-directed with our colleague Peter Ward, included surveys of more than 1,200 residents of colonias and other informal settlements in eight Texas counties.[35]

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28. S.B. 336, 74th Reg. Sess. (enrolled) (Tex. 1995) (amending TEXAS PROP. CODE, Subchapter D, and adding a new Subchapter E).

29. S.B. 198, 77th Reg. Sess. (enrolled) (Tex. 2001) (amending TEXAS PROP. CODE, Subchapters D and E).

30. H.B. 1823, 79th Reg. Sess. (enrolled) (Tex. 2005) (adding TEX. PROP. CODE §§ 5.0621, 5.081–5.085; amending §§ 5.062, 5.073, 5.077). For a concise summary of the Texas legislative reforms, see Judon Fambrough, Real Estate Center, *2005 Updates: Rules for Contracts for Deed*, LEGAL ISSUES (Oct. 2005), http://bit.ly/16fDk2p.

31. Shelayne Clemmer, *Texas's Attempt to Mitigate the Risks of Contracts for Deed—Too Much for Sellers—Too Little for Buyers*, 38 ST. MARY'S L.J. 755, 768, 800 (2007).

32. David J. Willis, Owner Finance Homes, Owner Finance in Texas Residential Transactions (2010), http://bit.ly/1anv3ub.

33. Sunset Advisory Comm'n, Report to the 82nd Legislature 66 (Feb. 2011), http://bit.ly/1anvzZh.

34. Latin American Housing Network, Texas Housing Database, Texas Department of Housing and Community Affairs Project (Oct. 2012), http://bit.ly/17Vlazm (for complete study findings and databases).

35. The study was conducted with the support of the William Wayne Justice Center for Public Interest Law and the assistance of more than seventy-five stu-

The study provided a unique opportunity to examine not only the extent to which contracts for deed are still in use in Texas, but also (1) who is still using them; (2) how low-income buyers have fared under the new protections; and (3) what alternative transactions (if any) have supplanted the contract for deed.

We believe the following key findings from the study can help inform advocates' efforts in other parts of the country to address abusive seller-financing practices:

Finding 1: Substantial Reduction in Investors' Use of Contracts for Deed

One of the central findings of the Texas contracts for deed study is that the Texas reforms appear to have been quite successful in steering most land investors away from using contracts for deed. Whereas investors selling property in South Texas colonias prior to 1995 relied largely on unrecorded contracts for deed as the primary means for financing land sales, 73 to 83 percent of investor sales in the colonias after the 2003 legislative reforms utilized a deed and a deed of trust financing mechanism.[36] In contrast, the study found that consumer-to-consumer sales—transactions where low-income homeowners are selling their homes to new residents—are still relying heavily on contracts for deed, and many of these are unrecorded and out of compliance with state regulations.[37]

Finding 2: Long-Term Homeownership Still Alive in Poor Communities

Another central finding of the study is that, despite concerns to the contrary, the state legislative restrictions on contracts for deed have not shut down homeownership opportunities for the poor in Texas.[38] Of the homeowners we surveyed, more than half had purchased after 1996 (the year the reforms went into effect in the immediate border area), and nearly one-third had bought after 2003.[39] In subdivisions developed after 1996, 85 percent of the residents we surveyed were homebuyers and not renters.[40] The vast majority of these sales involved a deed and deed of trust with virtually no use of recorded contracts for deed. Finally, we found that roughly 65 percent of the new residents we surveyed (those who

dents and faculty coordinated by the University of Texas at Austin School of Law pro bono program. Information about the pro bono program and the center can be found at http://www.utexas.edu/law/centers/publicinterest/.

36. Ward, Way & Wood, *supra* note 2, at VIII. Our study methodology yielded both "conservative" and "liberal" estimates of how many unrecorded contracts for deed and traditional warranty deeds continue to be in use by investors (*id.* at Chapter 4).

37. *Id*. at VII.

38. The residents surveyed in our study were quite poor: more than a third live on less than $1,000 a month (*id.* at 5:3).

39. *Id.* at Appendix D.iii.

40. *Id.* at Appendix D.iv.

had moved into their current homes after the reforms) were homebuyers as opposed to new renters with three-quarters of the buyers using seller financing.[41]

Finding 3: Alternative Forms of Abusive Sales Practices

Not all homebuyers have experienced security after contracts for deed came under state regulation. As the Texas Legislature passed its protections and broadened and modified them over time, unscrupulous investors identified loopholes in these laws and developed a number of workarounds, perpetuating the predatory lending abuses that the legislature had sought to eliminate.

For example, in the early years after the Texas regulations, many sellers switched over to lease purchase options (aka rent-to-own contracts) to circumvent the reforms. These contracts are similar to contracts for deed in substance but were not expressly subject to the initial rounds of legislative reforms.[42] A subsequent legislative amendment resolved this issue by making lease purchase option contracts exceeding six months subject to most of the contract for deed restrictions.[43]

A second workaround that investors have used in Texas involves the misuse of deeds in lieu of foreclosure, or "security deeds." In these transactions, the seller utilizes traditional seller financing with a note and deed of trust, but then requires the buyer to waive the right to foreclosure proceedings and give the deed back to the seller to hold as "security" in the event the buyer defaults on the note. Advocates have since persuaded the Texas Legislature to ban this workaround.[44]

Our study found that investors in Texas have found additional ways to exploit unwitting low-income buyers. By purchasing in a market that lacks adequate oversight and consumer protections, buyers utilizing seller financing still face a range of exploitative practices. These practices include the use of extremely high interest rates, aggressive filing of foreclosure actions for missed payments, and negative amortization schedules created by aggressive late fee charges rolled over into the principal. In our surveys, we also came across cases of developers having charged special assessments to close out the contract and provide the final deed.[45]

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41. *Id.* at Excel Database.

42. In a typical lease purchase-option contract, the homebuyer pays a nonrefundable option fee up front and makes monthly payments under a lease for a set term. At the end of the lease term, if the buyer is able to secure financing (from a bank or the seller), the buyer is eligible to purchase the home and obtain title from the seller. Otherwise, the buyer forfeits all payments made under the contract.

43. Tex. Prop. Code § 5.062(a)(2) (2012).

44. Tex. Bus. & Commerce Code § 21.002 (2012).

45. Ward, Way & Wood, *supra* note 2, at 6:1–2. Interest rates ranging from 15 to 18 percent are typical; we found rates as high as 20 percent.

One of the most alarming findings from the study was a recent pattern of rapid and aggressive repossession by investors selling vacant lots in newly developed subdivisions in South Texas. The buyers in these transactions were some of the poorest residents we came across in our study.[46] In one new subdivision where the seller was utilizing deeds with deeds of trust as the financing mechanism, 45 percent of the lots sampled had been foreclosed upon at least once, and 44 percent of those foreclosures had occurred within a year of purchase.[47]

We found similar high rates of repossession in one Texas county where we found a small number of investors using recorded contracts for deed after the legislative reforms.[48] Close to one half of the contracts recorded between 1989 and 2011 had been canceled or foreclosed upon.[49] In short, many of today's homebuyers in seller-financed transactions are confronted with the same issues of volatility and loss that were rampant in the 1980s when Texas policymakers first began regulating these seller-financed transactions.

Looking Ahead: Charting Paths for Advocacy

The overall takeaway is that the sweeping Texas legislative reforms did a lot but not enough to address abusive seller financing practices. As in other parts of the country, low-income homebuyers in Texas are still routinely taken advantage of by unscrupulous land investors. Gathering lessons learned from the Texas reforms and from advocates in other states, what can advocates for the poor do to tackle these abusive practices around the country?

In charting a path for future advocacy in this arena, advocates should consider the following areas:

Legislative Reforms

A starting point for addressing the core risks with contracts for deed should be legislative reform. Here are some of the key legislative reforms that advocates for the poor have been working on in Texas and around the country:[50]

46. Of homebuyers who recently (2008–12) purchased from developers, 61 percent had a monthly household income of $1,600 or less (*id.* at 5:21).

47. *Id.* at 5:15–16.

48. As we mention above, use of recorded contracts for deed by investors in Texas after the legislative reforms is quite rare. We chose to examine the transactions in this community in detail, in part, because they were so unique.

49. Ward, Way & Wood, *supra* note 2, at 3:13. Fewer than one fifth of these contracts had led to the buyer's acquisition of title. *Id.*

50. This list includes examples of reforms; we have not listed all the state reforms in each of these areas.

- *Elimination of Contracts for Deed:* Oklahoma's legislature was the first in the country to treat all contracts for deed as mortgages.[51] Texas advocates proposed legislation in 2013 that would automatically treat a recorded contract for deed as a warranty deed and deed of trust, but the bill died in committee.[52]
- *Equity Protections:* Short of eliminating all contracts for deed, there are other mechanisms for providing contract for deed buyers with greater equity protections. In some states, contracts for deed must be foreclosed upon in the same fashion as mortgages.[53] In Texas, if the buyer has made the first forty-eight months of payments or paid at least 40 percent of the contract, the seller can no longer enforce the forfeiture clause. Instead, the buyer has a right to the same non-judicial foreclosure procedures available in traditional mortgages, whereby a trustee sells the property at public auction, with the sales proceeds exceeding the debt going back to the buyer.[54]
- *Right to Convert:* In Texas, buyers have a right at any time to convert the contract for deed, without penalties, into a deed with deed of trust, subject to the same interest rates and payment terms contained in the contract.[55] Maryland gives buyers a right to convert the contract for deed into a deed and mortgage after paying 40 percent of the purchase price.[56]
- *Right to Cure:* Providing buyers with a right to cure is essential for protecting buyers who default under the contract. Arizona is one state that provides a longer cure period for buyers with greater investments in the property.[57]
- *Interest Rate Caps:* Minnesota law sets stringent caps on interest rates charged in lower dollar contract for deed transactions with the rate cap tied to the Federal National Mortgage Association posted yields on thirty-year mortgage commitments, plus four percentage points.[58]

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51. Okla. Stat. Ann. tit. 16, § 11A (West 2013).

52. H.B. 2091, 83rd Reg. Sess. (Tex. 2013), http://bit.ly/15TmkuC.

53. *See, e.g.*, Fla. Stat. § 697.01 (2013).

54. Tex. Prop. Code § 5.066 (2013). Similar to Texas, Ohio follows a "threshold approach" (20 percent contract price or five years of payments) before the buyer has the right to recoup any remaining equity in the property in the event of default (Ohio Rev. Code Ann. § 5313.07 (West 2013)).

55. Tex. Prop. Code § 5.081 (2013).

56. Md. Code Ann., Real Prop. § 10-105(a) (LexisNexis 2013).

57. Ariz. Rev. Stat. Ann. § 33-742(D) (2013); *see also* N.D. Cent. Code § 32–18–04 (2013).

58. Minn. Stat. § 47.20, Subds. 3 & 4a (2013). This rate may be increased by three points if the contract has a duration of ten years or less, but the rate may not exceed 15.75 percent. *Id.*

- *Recording Requirements:* As part of comprehensive contract for deed reforms adopted in the 2010 Homeowner and Homebuyer Protection Act, North Carolina law requires both lease purchase contracts and contracts for deed to be recorded.[59]
- *Disclosures:* In Texas, sellers are required to provide the buyer with a number of pre-sale and post-sale disclosures, including a disclosure of property condition notice, a survey, a list of liens, and a disclosure of financing terms (similar to a Truth-in-Lending Act statement).[60] After the sale, the seller must provide a detailed annual accounting statement that includes a disclosure about any property taxes paid by seller.[61] All documents, including the contract and all disclosures, must be translated if negotiations are conducted in a language other than English.[62] This year, Minnesota also enacted detailed disclosure requirements.[63]
- *Ban Prepayment Penalties and Excessive Late Fees:* Texas bars sellers utilizing contracts for deed from charging a penalty for paying off a contract early and from charging excessive late fees.[64] North Carolina also bans pre-payment penalty fees except in the event that a property is encumbered by a deed of trust and the loan includes such a penalty.[65]
- *Require Seller to Hold Fee Simple Title:* In Texas, sellers utilizing contracts for deed are barred from selling property that is not free from prior liens and other encumbrances. During the term of the contract, the seller must continue to maintain the property free and clear of all liens, with a few exceptions.[66] North Carolina adopted similar reforms in 2010.[67]
- *Strict Sanctions for Noncompliance:* As a deterrent against violations, Texas law imposes harsh penalties on sellers who fail to follow the contract for deed laws. Penalties can run as high as $250 a day

59. 2010 Homeowner and Homebuyer Protection Act, S.B. 1015, N.C. Sess. Law 2010-164 (N.C. 2009) (adding Ch. 75, Art. 6 and Chs. 47G and 47H, N.C. GEN. STAT.); N.C. GEN. STAT. §§ 47G-2, 47H-2 (2013) (LexisNexis). Maryland and Texas laws also require sellers to record contracts for deed. MD. CODE ANN., REAL PROP. § 10-102(f) (LexisNexis 2013); TEX. PROP. CODE § 5.076 (2013).

60. TEX. PROP. CODE §§ 5.069–071(2013); *see also* IOWA CODE §§ 558.70–71 (2012).

61. TEX. PROP. CODE § 5.077 (2013).

62. TEX. PROP. CODE § 5.068 (2013).

63. 2013 Minn. Laws, 88th Leg., 2013 Reg. Sess., Ch. 85, H.F. No. 729, Art. 6, § 8 (adding MINN. STAT. ANN. § 559.202), http://bit.ly/1bDzBQ4.

64. TEX. PROP. CODE § 5.073(a)(3), (a)(1)(2013).

65. N.C. GEN. STAT. § 47H-2(b)(13)(2013) (LexisNexis).

66. TEX. PROP. CODE § 5.085 (2013).

67. N.C. GEN. STAT. § 47H-6 (2012) (LexisNexis). For other protections pertaining to liens, see Way, *supra* note 4, at 169.

and, in some cases, the buyer is entitled to unwind the transaction and obtain a refund of all payments made under the contract.[68]

Legal Assistance, Enforcement, and Community-Based Lending

Even the most expansive protections for buyers will not bring about meaningful improvements unless buyers have somewhere to turn to when their rights under these laws are violated. There is a strong need for state attorneys general, appropriate federal and state regulatory agencies, and legal justice advocates to engage in more proactive enforcement of laws to protect low-income homebuyers who fall prey to unscrupulous sellers. Seller-financed transactions are largely under the radar screen of government officials, and thus, abuses occur frequently without fear of prosecution.

As part of enforcement efforts, advocacy is needed to ensure that the protections in federal banking legislation such as the Secure and Fair Enforcement for Mortgage Licensing Act of 2008 and the Dodd–Frank Wall Street Reform and Consumer Protection Act extend to and are enforced against sellers utilizing contracts for deed, lease option contracts, and other forms of seller financing.[69] Support is also needed to allow for more community-based nonprofit lending institutions and community development corporations to assist low-income homebuyers with safer forms of home financing and avenues to homeownership. Creative, safer alternatives have been created in the payday lending field and should be explored as an alternative to predatory seller-financing in the low-income homebuyer market.[70]

Without more robust laws and enforcement, unsavory investors will continue to exploit the poor as they pursue the American dream of homeownership. We hope that the lessons from Texas's contract for deed reforms, including their impact and shortcomings, will spawn successful reform and enforcement initiatives in other states. America has created a path to homeownership for middle and upper-income families "that is quite remarkable, while leaving the poor at the mercy of predatory lenders and rip-off artists."[71] The time has come to ensure that the poor also have a path to homeownership that is well paved, sign-posted, and lit with sound safeguards and enforcement mechanisms.

68. *See, e.g.*, Tex. Prop. Code §§ 5.069(d), 5.070(b), 5.072(e), 5.077(c)–(d) (2013). For example, the failure to make an annual accounting statement can cause certain sellers to be liable for attorney fees and $250 per day in liquidated damages up to the fair market value of the property. *Id.* § 5.077(d).

69. *See generally* Secure and Fair Enforcement for Mortgage Licensing Act, 12 U.S.C. § 5100, et seq., and Subtitles A, B, and C of the Mortgage Reform and Anti-Predatory Lending Act, Title XIV of Dodd-Frank, 15 U.S.C. § 1602, et seq.

70. Tex. Low Income Housing Info. Serv., *supra* note 17.

71. *Id.*

Balancing Risk and Opportunity: The Status and Future of FHA's Mutual Mortgage Insurance Fund Following the Mortgage Crisis

Sierra Sterling

I. Introduction

The Federal Housing Administration (FHA) has insured over thirty-four million mortgages in the United States since 1934, when the loan insurance company was founded.[1] In the intervening decades, FHA's government-backed insurance program has expanded homeownership opportunities, served as a stabilizing factor in the mortgage market, and provided a means of obtaining mortgage financing for millions of Americans not traditionally well served by the private mortgage insurance market.[2] Remarkably, FHA managed to achieve these milestones without taxpayer assistance, instead relying on the income it generated from premiums to cover its costs.[3]

Despite FHA's resiliency and self-sufficiency, it was not immune from the far-reaching and devastating impacts of the financial and housing crisis and its concomitant effects on mortgagors. As mortgage defaults soared during the height of the crisis, FHA saw record numbers of mortgages in its insurance portfolio enter default, forcing it to pay out unprecedented insurance claims to mortgagees. As the effects of years of risky lending behavior on the part of mortgagees became clearer to FHA, it began to make changes to its policies in an attempt to protect its portfolio in the future. Nonetheless, mortgages from the mid-2000s books of business proved to be costly to the agency, and in September 2013 FHA announced that it would require a withdrawal from the U.S. Treasury for the first time in its seventy-nine-year history.

1. HUD, Federal Housing Administration, http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/fhahistory (last visited Dec. 13, 2013).
2. *Id.*
3. *Id.*

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This essay examines the current status and future of FHA's mutual mortgage insurance fund (MMIF) at a unique historical moment. FHA's recent withdrawal request from the Treasury has prompted many lawmakers to propose significant and, at times, sweeping reforms to FHA and the MMIF.

These reforms must be analyzed in light of the unique nature of FHA in the national mortgage market. FHA expands access to mortgage financing to low- and moderate-income homebuyers who might otherwise struggle to obtain mortgage financing, particularly when they are buying a home for the first time.[4] Because FHA's standards for insuring loans are generally less stringent than those of private mortgage insurance (PMI) carriers, FHA insurance acts as an alternative and often more viable option for many first-time homebuyers seeking mortgage financing.[5] The differences between FHA and private mortgage insurers are critical to understanding the relevant lens for viewing FHA reforms. "FHA[usually] plays a countercyclical role in the mortgage market."[6] This means that "it tends to insure more mortgages" when the availability of mortgage credit is more constrained "and fewer mortgages when mortgage credit is more widely available."[7] FHA stands in stark contrast to private mortgage insurers, whose behavior tends to be opposite: that is, when the economy is weak, private mortgage insurers are more likely to insure fewer loans.[8] Thus, FHA has two key characteristics that must be kept in mind when analyzing new reforms: (1) its role in providing access to mortgage financing for traditionally underserved homebuyers, and (2) its "countercyclical role in the [broader] mortgage [insurance] market."[9]

This essay begins with an overview of the current crisis affecting FHA generally and the MMIF in particular. It then provides a primer on FHA and the MMIF, explaining the structure and functions of FHA, with a particular focus on its governing statutes and regulations and how these regulations serve its fundamental purposes. This essay then describes FHA's policy changes in response to the financial crisis. Finally, it examines proposed legislative reforms, contrasting the reforms with FHA as it exists

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4. *Addressing FHA's Financial Condition and Program Challenges, Part II: Hearing Before the S. Comm. on Banking, Hous., & Urban Affairs*, 113th Cong. 1 (2013) (statement of Phillip L. Swagel, Prof., Univ. of Md. Sch. of Pub. Pol'y) [hereinafter *Senate Hearing*], http://www.banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=3baad7c9-434a-4489-b2da-5f0a919bd212.

5. Katie Jones, Cong. Research Serv., The FHA Single-Family Mortgage Insurance Program: Financial Status and Related Current Issues 2 (R42875) (2012).

6. *Id.* at 4.

7. *Id.*

8. *Id.*

9. U.S. Dep't of Hous. & Urban Dev., Annual Report to Congress Regarding the Financial Status of the FHA Mutual Mortgage Insurance Fund Fiscal Year 2012, at 7, 55 (2012) [hereinafter Annual Report].

now and focusing on whether those reforms will adequately preserve its role while at the same time bolstering its ability to protect its financial portfolio.

II. Overview of the Current Crisis

A. Financial Condition of the MMIF

On November 16, 2012, the U.S. Department of Housing and Urban Development (HUD) released its annual report to Congress regarding the financial status of the MMIF. The most significant and concerning aspect of this report was the finding that "the capital reserve ratio of the MMI Fund . . . ha[d] fallen below zero to *negative* 1.44 percent,"[10] far below the statutorily mandated ratio of 2 percent.[11] In addition, the MMIF's economic value was placed at negative $16.3 billion.[12] Most of the stress on the MMIF derives from loans insured prior to 2010 during the height of the recession and housing crisis.[13] For example, the 2007–09 books of business are responsible for "$70 billion in future claim payments."[14] HUD optimistically speculated that, despite the financial stress placed on the fund, it would not "need to call upon the [U.S.] Treasury for . . . special assistance" during FY2013.[15] However, on September 27, 2013, FHA announced that it "will require an infusion of . . . $1.7 billion from the U.S. Treasury," marking the first time in FHA history that it has required taxpayer support.[16]

FHA requires this infusion from the Treasury because the Federal Credit Reform Act of 1990 (FCRA) requires that "every credit agency . . . have sufficient reserves to cover one hundred percent of anticipated future losses."[17] Although "FHA ha[s] significant liquid assets," they are not sufficient "to cover . . . future losses for the next 30 years," which is required under the terms of the FCRA.[18] The amount requested by FHA is higher than the original estimate because FHA experienced "a decline in . . . endorsement volume" during the final months of FY2012.[19]

10. *Id.* at 2 (emphasis in original).
11. 12 U.S.C.A. § 1711(f) (2008).
12. ANNUAL REPORT, *supra* note 9, at 34.
13. *Id.* at 2.
14. *Id.*
15. *Id.* at 3.
16. Nick Tamaros, *FHA Will Require $1.7 Billion from Treasury*, WALL ST. J. (Sept. 27, 2013), http://online.wsj.com/news/articles/SB10001424052702304526204579101142224548428.
17. Letter from Carol J. Galante, Assistant Sec'y for Hous. & Fed. Hous. Admin. Comm'r, to Tim Johnson, Chairman, Senate Comm. on Banking, Hous., & Urban Affairs (Sept. 27, 2013).
18. *Id.*
19. *Id.*

Commissioner Carol J. Galante emphasized in her letter to Congress that the mandatory transfer is an "accounting transfer" and not necessarily indicative of "MMIF's performance, its long-term fiscal health, or its current cash position."[20] The calculated amount does not account for "recent performance improvements or [more] current economic conditions."[21] The $1.7 billion is an estimate "based on assumptions about loan performance and recoveries made in December 2012."[22] Since then, the performance of FHA's portfolio has improved, and the estimate can be recalculated after this year's budget cycle is completed,[23] a process somewhat complicated by the federal government shutdown that began on October 1, 2013. According to Commissioner Galante, FHA's portfolio has improved in several ways, including (1) "a 15 percent reduction in delinquency rates," (2) "a 91 percent reduction in Early Payment Defaults," (3) "a 20 percent reduction in foreclosure starts," and (4) "a 26 percent improvement in recovery rates on defaulted assets."[24] Additionally, the appropriation mandated by the FCRA is not needed to pay current claims. FHA currently has in excess of "$30 billion in liquid assets . . . on hand and generated an additional $17 billion in FY2013."[25] Thus, FHA has sufficient resources to cover current claims.[26]

B. Reaction to the FY2012 Annual Report and Subsequent Developments

Although FHA took numerous steps prior to the end of FY2012 to address the financial stress encountered by the MMIF, the release of the annual report prompted Congress to continue to take a hard look at FHA's financial condition. The Senate Committee on Banking, Housing, and Urban Affairs has held a series of hearings on the financial condition of the MMIF.[27] One hearing was held in December 2012, where Commissioner Galante testified, and a subsequent hearing was held on February 28, 2013.[28] The "spectrum of witnesses"[29] at the February 2013 hearing included policy experts and leaders from several groups, including the National Association of Realtors, the Urban Institute, and the Urban Bankers Association.[30]

20. *Id.*
21. *Id.*
22. *Id.*
23. *Id.*
24. *Id.*
25. *Id.*
26. *Id.*
27. *Senate Hearing*, *supra* note 4.
28. *Senate Takes Up FHA*, NATIONAL LOW INCOME HOUSING COALITION (Mar. 1, 2013), http://nlihc.org/article/senate-takes-fha.
29. *Id.*
30. *Senate Hearing*, *supra* note 4.

The comments raised at the Senate hearings reflect general concerns about FHA's program. In particular, comments and testimony focused on the degree to which FHA and the MMIF are risk averse and risk reactive, the nature of the loans that FHA should insure, and the relationship and role that FHA has with respect to broader mortgage insurance markets.[31]

The reactions of both FHA and Congress are explored more fully in Part IV, "Current and Proposed Reforms and Analysis." The reforms and proposed reforms focus on three main areas: (1) ensuring that FHA reduces risk to its financial solvency to the extent practicable, (2) eliminating risk factors that led to FHA's current solvency problems, and (3) placing more stringent demands on FHA to maintain a higher capital reserve ratio. To understand these reforms fully, however, it is necessary to understand FHA as it exists now, both in terms of authority and structure. A primer is presented below.

III. FHA and the MMIF: A Primer

"FHA was [originally] established by the National Housing Act of 1934, . . . and became part of HUD in 1965."[32] FHA "insures home mortgages [that are] made to individuals by private lenders," but does not make loans itself.[33] FHA, as a governmental mortgage insurance company, has created a system whereby mortgage lenders face reduced risk and are therefore willing to extend credit to low- to moderate-income and first-time homebuyers to whom they might not otherwise offer mortgage financing.[34]

FHA, as part of HUD, is headed by an Assistant Secretary who holds the title of Federal Housing Commissioner.[35] The Federal Housing Commissioner has received a delegation of authority from the Secretary of HUD to carry out the Secretary's "power and authority . . . with respect to all housing programs," including the authority under the National Housing Act to manage programs with respect to the MMIF.[36]

A. Mortgage Insurance Requirements

Mortgages must meet certain requirements to be eligible for FHA insurance.[37] The threshold requirement is that the mortgage is "made to[]

31. *Senate Takes Up FHA*, *supra* note 28.

32. Jones, *supra* note 5, at 1.

33. *Id.*

34. Federal Housing Administration Risk Management Initiatives: Reduction of Seller Concessions and New Loan-to-Value and Credit Score Requirements, 75 Fed. Reg. 41,218 (proposed July 15, 2010).

35. 42 U.S.C. § 3533(b) (1965).

36. Consolidated Delegation of Authority for the Office of Housing—Federal Housing Administration, 77 Fed. Reg. 37,234 (June 20, 2012) (delegating Secretary's authority under 12 U.S.C. § 1701 et seq. (National Housing Act) to the FHA Commissioner).

37. *See* 12 U.S.C.A. § 1709 (2011).

and . . . held by a mortgagee approved by [HUD] as responsible and able to service the mortgage properly."[38] Limitations are placed on the principal amount of a mortgage. The requirements vary based on the kind of property in question, but, as an example, a one-family residence mortgage cannot involve a principal amount in excess of "115 percent of the median 1-family house price in the area."[39] The principal cannot "exceed 100 percent of the appraised value of the property."[40]

Additionally, mortgagors must have made an initial cash investment, i.e., a down payment, to make the mortgage eligible for FHA insurance. The statutorily mandated minimum is a 3.5 percent down payment, although the statute also indicates that FHA may determine a "larger amount."[41] This larger amount has taken the form of higher down payment requirements for borrowers with credit scores between 500 and 579, who must make a down payment of at least 10 percent to be eligible for FHA insurance.[42]

To receive mortgage insurance, borrowers must also pay insurance premiums.[43] "Borrowers . . . pay both *upfront* [mortgage insurance premiums (UMIPs)] and *annual* mortgage insurance premiums" (AMIPs).[44] The UMIP is paid at the point of loan origination, and the AMIP is paid annually, usually in monthly installments.[45] These premiums are essential to the solvency of the MMIF and constitute "a large portion of the cash flow into the MMI Fund."[46]

The National Housing Act sets forth statutory maximum insurance premiums that FHA can charge, but FHA is allowed to administratively adjust premiums as long "as [they] do[] not exceed the statutory maximum."[47] The current statutory maximum for the UMIP is 3 percent,[48] and the UMIP currently charged is 1.75 percent.[49] The AMIP rates vary

38. 12 U.S.C. § 1709(b)(1).

39. 12 U.S.C. § 1709(b)(2)(A)(i).

40. 12 U.S.C. § 1709(b)(2)(B).

41. 12 U.S.C. § 1709(b)(9)(A).

42. *See* U.S. Dep't of Hous. & Urban Dev., FHA Mortgagee Letter 10-29, Minimum Credit Scores and Loan-to-Value Ratios (Sept. 3, 2010) [hereinafter FHA Mortgagee Letter 10-29], http://www.hud.gov/offices/adm/hudclips/letters/mortgagee/files/10-29ml.pdf.

43. *See* 12 U.S.C. § 1709(c).

44. Jones, *supra* note 5, at 21 (emphasis in original).

45. *Id.*

46. *Id.*

47. *Id.*

48. 12 U.S.C. § 1709(c)(2)(A).

49. *See* U.S. Dep't of Hous. & Urban Dev., FHA Mortgagee Letter 12-4, Single Family Mortgage Insurance: Annual and Up-Front Mortgage Insurance Premium—Changes (Mar. 6, 2012) (effective Apr. 9, 2012) [hereinafter FHA Mortgagee Letter 12-4].

Base Loan Amount	**LTV**	**Statutory AMIP Maximum***	**Current AMIP (by regulation)†**
≤ $625,500	≤ 95%	1.5%	1.20%
≤ $625,500	> 95%	1.55%	1.25%
> $625,500	≤ 95%	1.5%	1.45%
> $625,500	> 95%	1.55%	1.50%

* 12 U.S.C. §§ 1709(c)(2)(B)(i)–(c)(2)(B)(ii).
† FHA Mortgagee Letter 12-4, *supra* note 49.

according to loan-to-value (LTV) ratio and principal balance and are summarized in the chart above.[50]

B. The MMIF

1. MMIF Structural Overview

The MMIF was created to administer the FHA-insured mortgages program.[51] The MMIF is primarily funded through mortgage insurance premiums, sales of foreclosed property, and similar sources.[52] When FHA-insured mortgages default, claims are paid out to lenders from the MMIF.[53] "The MMI Fund is required to be self-supporting" and is thus not normally expected to require any kind of taxpayer support.[54] In addition, the MMIF must hold funds in excess of what it needs to pay for expected losses on insured loans to ensure that if there are increases in expected losses, it will have adequate resources to pay claims.[55] Currently, the MMIF must attain and maintain a capital ratio of at least 2 percent.[56] This means that the economic value of the MMIF ("the amount . . . remaining [in the MMIF] after paying all expected future losses") "must be at least 2% of the *total* dollar volume of [currently-insured FHA] mortgages."[57]

Calculation of the capital ratio also involves looking at the economic net worth of the MMIF, which refers to the "current cash available to the [MMIF], plus the net present value of all future cash inflows and

50. *Id.*
51. 12 U.S.C.A. § 1708 (2011).
52. Jones, *supra* note 5, at 7.
53. *Id.*
54. *Id.*
55. *Id.*
56. 12 U.S.C.A. § 1711(f)(2) (2011).
57. Jones, *supra* note 5, at 18 (emphasis added).

outflows expected to result from the outstanding mortgages in the MMIF."[58] Thus, the capital ratio is a measuring stick for the economic net worth of the MMIF, as well as a fairly straightforward measurement of whether the MMIF reserve funds are statutorily adequate. A negative economic value indicates that although FHA likely has cash on hand to pay current claims, it "does not . . . have enough funds . . . to pay for all . . . expected future losses over the life of the loans it currently insures."[59]

The MMIF "capital reserve account [is itself] a back-up fund," where funds are held to cover unexpected losses.[60] Normally, claims are paid out of the primary financing account, but funds can be and are moved from the reserve account to the primary financing account when FHA experiences unexpected losses.[61]

2. Management of the MMIF

Due to concerns with the financial stability of the MMIF, the Housing and Economic Recovery Act (HERA) significantly amended the National Housing Act and in particular created provisions aimed at strengthening and clarifying FHA's fiduciary responsibilities with respect to the MMIF.[62] FHA now has a fiduciary responsibility "to ensure that [MMIF] remains financially sound."[63] To accomplish this goal, the Secretary must annually "provide for an independent actuarial study" of the MMIF to analyze its financial position[64] and submit quarterly reports to Congress with detailed updates about the nature and performance of mortgages insured by FHA.[65] The financial soundness of the MMIF must be evaluated in light of its operational goals, which are to (1) "minimize the default risk to the [MMIF] and to homeowners" and (2) "meet the housing needs of the borrowers that the single-family mortgage insurance program is designed to serve."[66]

As amended, the National Housing Act now provides the Secretary (in actuality, the FHA Commissioner) the authority to institute policy changes aimed at reducing risk.[67] If the MMIF is not meeting its operational goals or there is a substantial probability that the MMIF will fail to meet "its established target subsidy rate," FHA may make

58. 12 U.S.C. § 1711(f)(4)(C).
59. Jones, *supra* note 5, at 18.
60. Federal Housing Administration Risk Management Initiatives: Reduction of Seller Concessions and New Loan-to-Value and Credit Score Requirements, 75 Fed. Reg. 41,218 (proposed July 15, 2010).
61. *Id.*
62. *Id.* at 41,218–19.
63. 12 U.S.C.A. § 1708(a)(3) (2011).
64. 12 U.S.C.A. § 1708(a)(4).
65. 12 U.S.C.A. § 1708(a)(5).
66. 12 U.S.C.A. § 1708(a)(7).
67. 12 U.S.C.A. § 1708(a)(6).

(1) "programmatic adjustments . . . as necessary to reduce the risk to the [MMIF]" or (2) make appropriate premium adjustments.[68] This authority is significant because it allows FHA to take actions to protect the fund; HUD has availed itself of this authority by adjusting premium rates[69] as well as making programmatic changes. Some examples of these programmatic changes are prohibiting seller-financed down payment assistance,[70] removing the exemption[71] from previously existing AMIPs,[72] and imposing minimum credit score requirements on borrowers seeking FHA-insured loans.[73]

In addition to taking actions pursuant to the National Housing Act to improve the financial soundness of the MMIF, FHA is authorized to use its "permanent and indefinite budget authority"[74] to draw on Treasury funds to ensure that it has adequate funds to cover its anticipated losses. FHA may do this because it is a federal loan guarantee program and is thus covered by the FCRA, which provides for this "permanent and indefinite budget authority."[75] In short, if FHA needs "to transfer more money than it has in its [c]apital [r]eserve [a]ccount to the [f]inancing [a]ccount [in order] to cover . . . expected losses," it can draw on the Treasury to acquire adequate funds without obtaining congressional approval.[76] The analysis that goes into FHA's determination about whether it would "need to draw on its permanent and indefinite budget authority"[77] is discussed below.

3. Economic Valuation of the MMIF

The statutory provisions make it clear that HUD has a fiduciary responsibility to "make sure that the MMI Fund [remains] financially sound,"[78] but this simple language does not reveal the complex factors

68. 12 U.S.C.A. § 1708(a)(6).

69. Federal Housing Administration Risk Management Initiatives: Reduction of Seller Concessions and New Loan-to-Value and Credit Score Requirements, 75 Fed. Reg. 41,218, 41,219 (proposed July 15, 2010).

70. *Id.*

71. Previously, "loans with terms of 15 years or less and LTV ratios less than or equal to 78 percent at origination" were not subject to an AMIP. U.S. Dep't of Hous. & Urban Dev., FHA Mortgagee Letter 2013-04, Revision of Federal Housing Administration Policies Concerning Cancellation of the Annual Mortgage Insurance Premium (MIP) and Increase to the Annual MIP 1 (Jan. 31, 2013), http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/letters/mortgagee.

72. *Id.*

73. FHA Mortgagee Letter 10-29, *supra* note 42.

74. JONES, *supra* note 5, at 17, 19.

75. *Id.* at 17.

76. *Id.*

77. *Id.* at summary.

78. *Id.* at 37.

and assumptions that govern very concrete decisions that HUD must make. Because programmatic adjustments are made in light of the MMIF's financial status and the current risks it faces, it is necessary to understand how those risks are calculated.

Several factors affect FHA's financial position and the health of the MMIF. Perhaps most obviously, economic and housing market conditions have a profound impact. Poor economic conditions can contribute directly to default and foreclosure rates and thus increase the likelihood that FHA will have to pay out insurance claims from the MMIF as more and more homeowners default on their mortgages.[79] If house prices are falling, the amount that FHA can recoup by selling a foreclosed property is diminished.[80]

Another key factor is projections of future economic conditions. The financial health of the MMIF is evaluated based on predictions about how currently insured loans will perform.[81] It is also evaluated based on assumptions about how many new loans FHA will insure in the future and how those loans will perform.[82] Clearly, inaccurate predictions can have a profound impact on the actions that FHA will have to take with respect to risk management.

4. The MMIF in a Budget Context

Because the MMIF is covered by the FCRA, that Act governs the way in which FHA-insured loans are recorded in the federal budget. Every year, in accordance with the FCRA, the amount that FHA expects to earn or lose is estimated and recorded in the federal budget.[83] This determination is important because it affects whether FHA will meet its capital reserve ratio. The process is explained more fully below.

a. Credit Subsidy Rates

"The FCRA requires that . . . the amount of money that FHA-insured loans are [estimated] to cost . . . or earn for the [federal] government . . . be recorded in the federal budget in the year that the loans are insured."[84] In the budget, this is reflected as a credit subsidy rate.[85] Credit subsidy rates can be either negative or positive. A negative credit subsidy rate means that "more money is expected to come into the insurance fund than . . . flow out of [it] [with respect] to loans insured in a given year."[86] In short, a negative credit subsidy rate means that the loans are

79. *Id.* at 11.
80. *Id.*
81. *Id.*
82. *Id.*
83. *Id.* at 12.
84. *Id.* at 11–12.
85. *Id.* at 12.
86. *Id.*

likely to make money for the government.[87] A positive credit subsidy rate means that FHA will lose money on loans it insures that year.[88]

FHA annually "estimate[s] the credit subsidy rate for . . . loans expected to be insured in the upcoming . . . year."[89] To make this estimate, FHA looks at several factors, including anticipated revenue from insurance premiums, the amount in claims that FHA will have to pay in the future related to those loans, and "how much money FHA will be able to recover [through] selling foreclosed properties."[90] Those factors depend on assumptions about the quality of the loans being insured (in terms of their riskiness), as well as future economic conditions (including housing prices).[91]

Based on these factors, it is clear that estimating the credit subsidy rate is a complex and arduous task. In addition to being a reflection of the financial health of FHA, the estimate can have profound impacts on that health. If FHA "estimated . . . a positive credit subsidy rate . . . , [for example,] it would require a [congressional] appropriation . . . to cover the difference between the amount . . . FHA expected to [earn] and pay out."[92] If Congress failed to make this appropriation, FHA would not be allowed to insure new loans that year.[93]

This crucial estimate is calculated according to FCRA methodology, which takes into account expected costs to FHA and gains by FHA with respect to loans in a given year.[94] The net present value of future cash flows is calculated "using interest rates on Treasury bonds as a discount rate."[95] It is important to note that the interest rate used does not take into account market risk.[96] If market risk is accounted for, it is referred to as fair-value accounting. There is debate as to whether fair-value accounting would be a more realistic way of assessing the financial health of FHA and the MMIF.[97] Possible reforms related to these differences in methodology are discussed in Part IV.

Clearly, the estimates made at the beginning of a fiscal year may not reflect what actually happens over the course of a year. Loans may perform better or worse, and economic conditions may change. As a result, FHA re-estimates the prior year's credit subsidy rates each year based on what actually occurred over the course of the year.[98] These re-estimates

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87. *Id.*
88. *Id.* at 14.
89. *Id.* at 12.
90. *Id.*
91. *Id.*
92. *Id.* at 13.
93. *Id.*; *see also* 12 U.S.C. § 1708(a)(2) (2011).
94. JONES, *supra* note 5, at 13.
95. *Id.*
96. *Id.*
97. *Id.*
98. *Id.* at 14.

may be positive or negative. If a re-estimate is positive and the amount FHA earns on loans insured in prior years is not enough to cover the losses, FHA may have to draw on its budget authority to draw money from the Treasury.[99]

The difficulty of accurate initial estimates in the face of a complex market and risk factors is reflected by the differences in estimated and re-estimated rates shown in the table below.[100]

Fiscal Year	Original Subsidy Rate	Re-Estimated Subsidy Rate
1992	−2.60	−3.22*
1993	−2.70	−2.67
1994	−2.79	−1.81
1995	−1.95	−0.76
1996	−2.77	−1.08
1997	−2.88	−1.05
1998	−2.99	−1.49
1999	−2.62	−1.33
2000	−1.99	0.16†
2001	−2.15	−0.08
2002	−2.07	0.31
2003	−2.53	1.29
2004	−2.47	1.80
2005	−1.80	5.21
2006	−1.70	6.42
2007	−0.37	9.28
2008	−0.25	6.36
2009	−0.05	1.07
2010	−0.86	−1.28
2011	−3.10	−4.53

* A negative re-estimated rate more negative than the original estimate indicates that the loans are anticipated to perform better than first thought.
† This positive re-estimate indicates that these loans are actually expected to lose money.

b. Effects of Credit Subsidy Rates on the MMIF

Because credit subsidy rates reflect expected losses, the rates affect the ways in which funds are held in the MMIF.[101] The financing account in

99. *Id.*
100. Table reproduced from *id.* at 15.
101. *Id.* at 15.

the MMIF covers expected losses, and the capital reserve account covers unexpected losses.[102] Funds are transferred between the two accounts based on the re-estimated credit subsidy rates to ensure that there are adequate funds in the financing account to cover expected losses.[103] This, in turn, affects the financial health of the MMIF: if the amount held in the capital reserve account is relatively lower than the amount held in the financing account, the MMIF is at a much higher risk of not having adequate funds to cover its losses. If the amount that FHA estimates it will need to cover expected losses exceeds the amount in the capital reserve account, FHA will have to draw on its permanent and indefinite budget authority. As discussed above, this occurred on September 27, 2013, when FHA requested $1.7 billion from the Treasury. Additionally, because the MMIF must maintain a mandated capital reserve ratio, having few or no assets in its capital reserve account makes it much less likely that it can meet its capital reserve requirement.

C. Conclusion

The FHA Commissioner and HUD have broad authority to make programmatic adjustments to ensure that the operation of FHA and the MMIF comply with their relevant statutory mandates. The HERA amendments to the National Housing Act reflect an increasing awareness on the part of Congress that FHA must have the ability to make policy adjustments to ensure that FHA is self-sufficient and financially healthy. The continuing struggles faced by FHA, despite an improving economy, more robust books of business, and programmatic adjustments, have led to proposals by both the House and the Senate to institute reforms of FHA. The proposed reforms range from incremental to profound and address with varying degrees of success the competing goals of providing mortgage financing to underserved homebuyers and financial solvency for FHA. These proposed reforms are discussed in Part IV and contrasted with the current range of possible improvements to FHA under the existing statutory and regulatory framework.

IV. Current and Proposed Reforms and Analysis

On September 27, 2013, FHA Commissioner Galante notified the Senate Committee on Banking, Housing, and Urban Affairs that FHA was required, as of that date, "to take a mandatory appropriation of approximately $1.7 billion on September 30, 2013."[104] Although Commissioner Galante emphasized that the appropriation, mandatory under the FCRA, "does not reflect an up-to-date view of the MMIF's performance, its long term fiscal health, or its current cash position," the news was

102. *Id.*
103. *Id.*
104. Galante Letter, *supra* note 17.

striking because it represented the first time in FHA's history that it had to make such an appropriation.[105]

Despite the historical significance of the Treasury draw, it does not necessarily indicate a need for comprehensive reform of FHA and the MMIF. Significantly, the withdrawal is not necessary to cover current payouts for losses to the MMIF but rather to ensure adequate capital reserves. In short, the withdrawal is a preventive measure and does not indicate a need for immediate cash. Nonetheless, the withdrawal provides an excellent opportunity to assess the reforms that FHA has made thus far to ensure it can operate in a fiscally sound manner, as well as reforms proposed by members of Congress. This section will first analyze reforms that have already taken place, their effects, and the potential policy consequences of these reforms. Then it will analyze the bills currently before Congress and the ramifications of those proposed reforms.

One of the challenges in making any reforms to FHA is that reforms must respect the several and often competing goals of FHA's mortgage insurance program. The stated operational goals of the MMIF are (1) "to minimize the default risk to the [MMIF] and to homeowners" and 2) "to meet the housing needs of the borrowers that the single family insurance program . . . is designed to serve."[106] In addition, it is widely recognized that FHA's mortgage insurance program has "traditionally play[ed] a countercyclical role in the mortgage [insurance] market," which essentially means that it does not act like a private mortgage insurer.[107] It is difficult for reforms to strike a balance between these goals and roles of the MMIF simply because they are somewhat at odds. By reaching borrowers who are traditionally underserved in the mortgage financing market, FHA necessarily exposes itself to more risk because this borrower population often represents a greater risk to the lender. If FHA's insurance program is reformed to reduce risk by imposing more costs on borrowers, it is likely that the goal of reaching this population will be undermined. Furthermore, because FHA plays a role distinct from that of private mortgage insurers, reforms that make FHA behave more like a private insurer will undercut this fundamental role of FHA. The upshot of these tensions is that lawmakers and HUD must be mindful of these goals when examining how to cure the solvency issues that FHA currently faces.

A. Current Reforms in Place

When Congress passed HERA in 2008, it expanded FHA's fiduciary responsibilities with respect to the MMIF. If MMIF is "not meeting [its] operational goals" or "there is a substantial probability that the [MMIF] will [fail to meet] its established target subsidy rate," FHA may make

105. *Id.*

106. 12 U.S.C. § 1708(a)(7) (2011).

107. Jones, *supra* note 5, at summary.

(1) "programmatic adjustments . . . as necessary to reduce the risk to the [MMIF]," or (2) "make appropriate premium adjustments."[108] Below is a summary of the most significant programmatic adjustments made by FHA and an analysis of their effects. An overview of the premium adjustment policies follows with an analysis of their effects and implications.

1. Programmatic Adjustments

FHA has taken a plethora of measures in attempts to bolster the solvency of the MMIF over the past several years. These fall into six primary categories: (a) down payment adjustments, (b) net worth requirements for FHA-approved lenders, (c) Home Equity Conversion Mortgage (HECM) consolidation, (d) loss mitigation home retention options, (e) Homeowners Armed with Knowledge (HAWK) initiative, and (f) non-mitigation alternatives. Each is discussed below.

a. Down Payment Adjustments

A final rule issued by HUD on September 3, 2010, makes changes to FHA-insured loan eligibility and down payment requirements based on credit score.[109] Part of the impetus for this change was FHA's concerns about "risk layering." "[W]hen a loan exhibits multiple risk factors," such as a low borrower credit score and a high LTV, it is more likely that the borrower will default.[110] These credit score requirements, coupled with the LTV requirements discussed below in the mortgage insurance premium adjustments section, aim to reduce these risks.

A summary of the changes is shown in the table below.[111]

Credit Score	Previous Required Down Payment	Current Required Down Payment
< 500	10%	Not eligible for FHA insurance
500–579	3.5%	10%
≥ 580	3.5%	3.5%

Essentially, FHA disqualified certain borrowers—those with credit scores below 500—from eligibility for FHA insurance and significantly increased the down payment requirements for borrowers with credit scores between 500 and 579. In its Federal Register notice, the agency pointed out that although "FHA serves very few borrowers with credit scores below

108. 12 U.S.C. § 1708(a)(6).

109. Federal Housing Administration Risk Management Initiatives: New Loan-to-Value and Credit Score Requirements, 75 Fed. Reg. 54,020 (Sept. 3, 2010); *see also* Mortgagee Letter 10-29, *supra* note 42.

110. Jones, *supra* note 5, at 23.

111. *Id.* (citing FHA Mortgagee Letter 10-29).

500[,] . . . the performance of th[o]se borrowers is very poor"—leading to high rates of default and insurance claims, which are a burden on the MMIF.[112] The agency decided to require a higher down payment (10 percent) for borrowers with credit scores between 500 and 579 because data showed that borrowers with credit scores in this range have "significantly worse default and claim experience than do [those with] loans at or above [a credit score of] 580."[113] The agency believes that requiring this higher down payment will go far in ensuring that those with lower credit scores are actually capable of repaying their mortgages.[114]

During the comment period, several commenters expressed concerns that these reforms did not go far enough to protect the financial health of the MMIF and suggested even "more stringent credit score . . . requirements" with accompanying higher down payment requirements.[115] The agency declined to impose more stringent requirements based on its data showing that such was not necessary and due to concerns that "[t]oo high of a minimum score would undermine [FHA's goal] of expanding affordable homeownership opportunit[ies]."[116] At the other end of the spectrum, other commenters expressed concerns that the new credit score requirements are too stringent and will reduce homeownership opportunities for those traditionally underserved and also restrict the availability of mortgage financing in a way that harms the broader economy.[117] The agency again cited to data and the need to "balance the twin goals of [ensuring] the financial stability of the MMIF" while ensuring access to affordable homeownership opportunities.[118] It also pointed out that HUD's threshold for FHA-insured mortgages (500) is still well below the cutoff score (620) used by many private lenders.[119]

Another important consideration with respect to the new credit score requirements is the magnitude of effect they will have. As the agency points out, "very few" of the loans it insured had borrower credit scores of less than 500.[120] "Since 2009, well [below] 10% of FHA-insured loans . . . have been made to borrowers with credit scores below 600," which likely means that the number of loans made to those with scores below 500 is even lower.[121] Although eliminating these very risky loans from FHA's

112. Federal Housing Administration Risk Management Initiatives: New Loan-to-Value and Credit Score Requirements, 75 Fed. Reg. 54,020–54,022 (proposed Sept. 3, 2010).

113. *Id.*

114. *Id.*

115. *Id.*

116. *Id.*

117. *Id.*

118. *Id.*

119. *Id.*

120. *Id.*

121. Jones, *supra* note 5, at 24.

portfolio is beneficial, it is not clear that this will have more than superficial effects if the number of loans it affects is truly very low. At the very least, however, it ensures that FHA is not exposing itself to needless risk.

In addition to the credit score limitations imposed by the agency, HERA "prohibit[s] FHA from insuring loans that [involve] seller-funded down payment assistance."[122] This closed a loophole where borrowers were able to access otherwise-prohibited seller down payment assistance by having the funds come from a nonprofit down payment assistance program to which the seller later made a contribution.[123] This statutory prohibition eliminated a large source of risk: data showed that seller-funded down payment assistance loans had claim rates up to three times higher than other FHA-insured loans.[124] According to the actuarial report released in late 2012, FHA posited that the economic value of the fund actually would have been positive at the end of FY2012 had these loans not been insured.[125] These types of loans "are expected to cost the [MMIF] over $15 billion" ultimately.[126]

b. Net Worth Requirements for FHA-Approved Lenders

In light of concerns about FHA-approved lenders having sufficient liquidity to withstand losses and fluctuations in the market, the agency published a rule that imposes net worth requirements on FHA-approved lenders.[127] This rule requires FHA-approved non-small business lenders and mortgagees "to have a minimum net worth of $1 million, [at least] 20 percent [of which] must be liquid assets."[128] The rule imposes an additional requirement that as of May 2013, all FHA-approved lenders also have "an additional net worth of one percent of the total volume in excess of $25 million of FHA single-family insured mortgages originated, underwritten, purchased, or serviced during the prior fiscal year."[129] The agency, in its rule making, pointed out that "the net worth requirements [for] FHA-approved mortgagees had not been increased since 1993," and thus an increase was overdue for several reasons, including inflation.[130]

122. *Id*. at 26.

123. *Id*.

124. *Id*.

125. Annual Report, *supra* note 9, at 25.

126. *Id*.

127. Jones, *supra* note 5, at 27; *see also* 24 C.F.R. § 202.5(n).

128. Federal Housing Administration: Strengthening Risk Management Through Responsible FHA-Approved Lenders, 77 Fed. Reg. 51,465 (proposed Aug. 24, 2012).

129. 24 C.F.R. § 202.5(n)(3)(i) (2013).

130. Federal Housing Administration: Continuation of FHA Reform: Strengthening Risk Management Through Responsible FHA-Approved Lenders, 75 Fed. Reg. 20,718, 20,719 (proposed Apr. 20, 2010).

Some commenters expressed concerns that the additional burdens these requirements place on lenders would either undermine the economic recovery by putting increased strain on lenders or that the costs of these requirements would ultimately be passed on to borrowers.[131] The agency responded to these concerns by pointing out that FHA must be fiscally accountable, and one way to ensure this is to take steps to protect its insurance funds by requiring that mortgagees are in a sounder financial position.[132]

On the whole, it is likely that these new requirements will increase the probability that FHA-approved lenders have sufficient liquidity to withstand market fluctuations, which should serve to help protect FHA's own portfolio.

c. HECM Consolidation

The agency also made changes to its HECM program. The HECM program is FHA's reverse mortgage program, which allows homeowners age sixty-two and older to draw on the equity in their home as a means of obtaining cash.[133]

Initially, FHA provided a single form of its reverse mortgage option, but in 2010 it announced an alternative called the HECM Saver.[134] HECM Saver differed from the standard reverse mortgage offered by "lowering upfront closing costs[] for homeowners who want[ed] to borrow a smaller amount than what would be" allowed under the standard option.[135] In early 2013, the agency announced that it would make HECM Saver "the only pricing option . . . [for] borrowers . . . seek[ing] a fixed . . . rate [HECM]."[136] This change was a result of the significant financial stress that the Fixed Rate Standard HECM placed on the MMIF. The implementation of the HECM Saver program as the only option reduces risk to the MMIF because the principal amount of money available to borrowers will be reduced, thus reducing potential payouts by FHA.[137] This change represents another attempt to eliminate or reduce a source

131. *Id.* at 20,722.

132. *Id.*

133. *FHA Reverse Mortgages (HECMs) for Seniors*, HUD.GOV, http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/sfh/hecm/hecmabou (last visited Dec. 13, 2013).

134. Press Release, U.S. Dep't of Housing & Urb. Dev., HUD Announces New Reverse Mortgage Option, Sept. 22, 2010, http://portal.hud.gov/hudportal/HUD?src=/press/press_releases_media_advisories/2010/HUDNo.10-205.

135. *Id.*

136. Press Release, U.S. Dep't of Housing & Urb. Dev., FHA Takes Additional Steps to Bolster Capital Reserves, Jan. 30, 2013, http://portal.hud.gov/hudportal/HUD?src=/press/press_releases_media_advisories/2013/HUDNo.13-010.

137. HUD Announces New Reverse Mortgage Option, *supra* note 134.

of risk going forward that placed a significant amount of financial stress on the MMIF in the past.

d. Loss Mitigation Home Retention Options

Agency reforms also focused on providing more options for borrowers. FHA's "loss mitigation home retention options" were revised in 2012 in "an effort to reduce the number of full claims against [MMIF] by assisting a greater number of qualified, distressed mortgagors in retaining their homes."[138] These reforms "[s]treamlin[ed] FHA's loss mitigation home retention option priority order by replacing [the old] structure with a 3-tier incentive structure [that consists] of special forbearances, loan modifications, and FHA-HAMP."[139] This moved HAMP up in the loss mitigation waterfall so servicers could more quickly offer more significant payment relief to struggling FHA-insured borrowers, hopefully leading to an increase in borrowers being able to retain their homes.[140] This, in turn, would reduce the number of claims filed with FHA and relieve stress on the MMIF.

e. Homeowners Armed with Knowledge (HAWK) Initiative

Another reform measure aimed at borrowers is the HAWK initiative, which seeks to increase the use of housing counseling.[141] Counseling has the potential to reduce losses to the MMIF by decreasing the likelihood that borrowers will ultimately default on their mortgages. Borrowers who receive counseling through HUD-approved agencies via the National Foreclosure Mitigation Program "were 89 percent more likely to receive a modification cure," and thus avoid default, than noncounseled borrowers.[142] Additionally, counseled borrowers that did receive a modification cure were "67 percent more likely to remain current on their mortgage nine months after [the modification]."[143] As a result of these positive outcomes, FHA's HAWK initiative seeks to make housing counseling part of FHA origination and servicing.[144]

This initiative in particular satisfies the competing goals that FHA must balance. By providing counseling to homeowners, it increases the likelihood that lenders will give borrowers more favorable treatment in

138. *See* U.S. Dep't of Hous. & Urban Dev., FHA Mortgagee Letter 12-22, Revisions to FHA's Loss Mitigation Home Retention Options (Nov. 16, 2012).

139. *Id.*

140. *Id.*

141. *Proposed FHA Solvency Act of 2013: Hearing Before the S. Comm. on Banking*, 113th Cong. 2 (2013) (written testimony of Carol Galante, FHA Commissioner), http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=3246380e-7ba8-4cd4-92e2-7d0a3daa9d36.

142. *Id.*

143. *Id.*

144. *Id.*

considering loan modifications rather than proceeding directly to foreclosure. It also satisfies the goal of facilitating homeownership in a responsible way by ensuring that borrowers understand the nature and extent of their obligations from the outset and during the life of a mortgage.

f. Non-Mitigation Alternatives: Adjustments in Sale Policies

The most direct way to minimize losses to the MMIF is to make every effort to ensure that foreclosures are avoided, thus eliminating the need for insurance claims. However, sometimes default is unavoidable, and foreclosure becomes necessary. To this end, the agency has explored several programs aimed at minimizing losses to the MMIF when "home retention is simply not an option,"[145] including a streamlined pre-foreclosure sale policy, sales that avoid placement of properties in REO, and the Distressed Asset Stabilization Program.

The streamlined pre-foreclosure sale policy allows borrowers to obtain a short sale, or pre-foreclosure sale, to avoid the costly foreclosure process.[146] Although FHA may still experience losses as a result of short sales, Commissioner Galante has asserted that these losses are "substantially lower than from the traditional FHA Real Estate Owned (REO) process," where losses to FHA are often very substantial. This also has the added benefit of sparing homeowners from the difficult foreclosure process.

FHA has explored other REO alternatives as well in an effort to reduce the costs associated with the REO disposition process.[147] These costs include "carrying costs associated with preserving, managing, and marketing REO propert[ies]."[148] One alternative is a pilot program under which lenders who have completed the foreclosure process on FHA-insured loans may sell directly to third-party purchasers without ever conveying the property to FHA.[149]

FHA's other primary REO-alternative program is its Distressed Asset Stabilization Program (DASP), whereby FHA sells severely delinquent FHA-insured mortgage loans to bidders in "areas of [the] country hard-hit by foreclosures."[150] "Once [a] loan is purchased, foreclosure [on the mortgage] is delayed for a minimum of six . . . months, during which time the new servicer can work with the borrower to find an affordable solution to avoid foreclosure."[151] Because "these loans are [sold and] pur-

145. *Id.*
146. *Id.* at 3.
147. *Id.*
148. *Id.*
149. *Id.*
150. Press Release, U.S. Dep't of Housing & Urb. Dev., HUD Announces New Note Sales Under Expanded Distressed Asset Stabilization Program, May 3, 2013 (quoting Carol Galante, FHA Commissioner), http://portal.hud.gov/hudportal/HUD?src=/press/press_releases_media_advisories/2013/HUDNo.13-066.
151. *Id.*

chased at [the] market rate, which is generally below the outstanding principal balance [remaining on the loan], . . . the investor [has] . . . incentive . . . to help the borrower avoid foreclosure."[152] Bidders in the past have included nonprofit and community-based organizations.[153]

These adjustments in sales policies allow FHA to deal more effectively with delinquent loans that are a result of the books of business from prior years. Although many FHA reforms are forward-looking to avoid and diminish the risks that led to the MMIF's current solvency problems, these changes in sales polices have the distinct advantage of dealing more cost effectively with struggling loans that are a product of prior policies.

2. Mortgage Insurance Premium Adjustments

In August 2010, Congress passed legislation that increased the maximum AMIP that FHA can charge to borrowers.[154] These changes are currently codified in the National Housing Act[155] and are summarized in the chart below. As the chart makes clear, these increases are significant changes in maximum annual premiums.

Original Principal Obligation as Percentage of Appraised Value of Property	Previous Maximum AMIP	Current Maximum AMIP
< 90%	0.5%	1.5% (for first 11 years of mortgage term)
≥ 90%	0.5%	1.5% (for first 30 years of mortgage term)
≥ 95%	0.55%	1.55% (for first 30 years of mortgage term)

The Secretary's authority (delegated to the FHA Commissioner) to adjust these premiums is couched in permissive language in the statute: it provides a ceiling up to which the Commissioner may increase the premium rates. FHA has availed itself of this authority by increasing premium rates by regulation. These changes are summarized in the chart on page 70. These changes, described by Commissioner Galante as "difficult choice[s]," have yielded an additional $10 billion in economic value for the MMIF.[156]

152. *Id.*
153. *Id.*
154. Pub. L. No. 111-229(1)(a) (2010).
155. *See* 12 U.S.C.A. §§ 1709(c)(2)(B)(i)–(ii) (2011).
156. *Federal Housing Administration's Fiscal Year 2014 Budget Request: Hearing Before the S. Subcomm. on Transp., Hous., & Urban Dev., and Related Agencies*, 113th Cong. 5 (2013) (written testimony of Carol Galante, FHA Commissioner).

Base Loan Amount	LTV	Statutory AMIP Maximum*	Current AMIP (by regulation)†
≤ $625,500	≤ 95%	1.5%	1.20%
≤ $625,500	> 95%	1.55%	1.25%
> $625,500	≤ 95%	1.5%	1.45%
> $625,500	> 95%	1.55%	1.50%

* 12 U.S.C.A. §§ 1709(c)(2)(B)(i)–(ii) (2011).
† Table derived from table found at FHA Mortgagee Letter 12-4, *supra* note 49.

In addition to the premium increases, FHA reversed a long-standing policy that canceled required MIPs "on loans for which the outstanding principal balance reache[d] less than 78% of the original principal balance."[157] That long-standing policy, although obviously beneficial to homeowners, created risk for FHA and also meant missing out on revenue.[158] This means that a borrower in an FHA-insured loan may pay AMIPs for the life of the loan. The UMIP is currently statutorily capped at 3 percent,[159] and FHA currently charges 1.75 percent of the base loan amount.[160] The current 1.75 percent UMIP charge was increased from 1 percent in April 2012.[161] The benefits of these increases are increased revenue for FHA and a better alignment of the pricing of FHA-insured mortgages with their attendant risk. On the other hand, increases in the insurance premiums also carry risks and potential negative consequences.

First, as Commissioner Galante pointed out, changes to premiums must balance improving the "[financial] outlook of the Fund [MMIF] with its countercyclical role of providing liquidity and access to credit in the midst of the recent crisis and ongoing recovery."[162] Commissioner Galante's observations are more prescient when one thinks about the long-term impacts of these premium increases. The premium increases are only beneficial to FHA insofar as they actually generate additional revenue. If the increase in premiums leads to a reduced overall volume of FHA-insured mortgages because fewer borrowers can afford the premiums (both because of increased actual cost and duration of premium payments), this may counteract the benefits of increasing the premiums while simultaneously undermining one of the key policy goals of the FHA mortgage insurance program.[163] Effectively, these premium in-

157. *Id.*
158. *Id.*
159. 12 U.S.C.A. § 1709(c)(2)(A).
160. FHA Mortgagee Letter 12-4, *supra* note 49.
161. *Id.*
162. Galante Written Testimony, *supra* note 156.
163. Jones, *supra* note 5, at 22.

creases may price some individuals out of the market for FHA insurance; because these individuals are not likely to qualify as readily for private mortgage insurance, the increases may have the ultimate effect of shutting first-time and low- to middle-income homebuyers out of the market. Furthermore, the longer duration of the AMIPs will make an FHA-insured loan a less attractive option for many borrowers because they would continue to pay premiums for much longer. This additional cost may also effectively price out some borrowers.

Additionally, if FHA raises the UMIP again, this may also have impacts on whether borrowers can afford FHA-insured loans. UMIPs are generally financed into the mortgage, so any increase in the UMIP will necessarily "reduc[e] [the] borrower's initial equity in the home."[164] Ironically, this may have the effect of increasing the riskiness of the loan.[165] Although an increased UMIP on an individual basis may not lead to default on the loan, the aggregate result of increases in the UMIP may slightly increase the riskiness of FHA's portfolio.

Finally, the increases in insurance premiums make private mortgage insurance more competitive with FHA insurance for some borrowers because the difference between private and FHA insurance rates decreases. Depending on one's perspective, making FHA look and act more like a private mortgage insurer can be a positive or a negative. Commissioner Galante recently pointed out that during the economic downturn, FHA began playing an major role in the mortgage insurance market.[166] In 2010, FHA's share of the single-family mortgage market peaked at 21.1 percent, although that share fell to 13.9 percent by FY2012.[167] She noted that "[a]s the market continues to recover and private capital returns at more normal levels, FHA's role will naturally recede."[168] Although FHA has pronounced commitment to this decreased role, it also remains true that FHA, especially in recent times of constricted credit, has bolstered the housing market and prevented a larger crisis. FHA must juggle its own needs for fiscal solvency mandated by its enabling acts, its countercyclical role in the mortgage market, and its public welfare-oriented goal of providing access to mortgage financing to those otherwise traditionally underserved.

B. Proposed Congressional Reforms

Although FHA has taken aggressive steps toward fulfilling its fiduciary responsibility with respect to the MMIF, there have been calls for more comprehensive reform. To this end, both the Senate and House have put forth legislative proposals to reform FHA. The Senate and House

164. *Id.*
165. *Id.*
166. Galante Written Testimony, *supra* note 156, at 5.
167. *Id.* at 2.
168. *Id.*

proposals differ significantly in scope and in underlying presumptions about the appropriate nature and role of government mortgage insurance programs in the broader mortgage financing market.

1. S. 1376: FHA Solvency Act of 2013

The FHA Solvency Act of 2013, introduced in the Senate on July 25, 2013, "[a]mends the National Housing Act with respect to mortgage insurance."[169] The bill seeks to reform several aspects of FHA's mortgage insurance program; these reforms are discussed section-by-section below.

a. Mortgage Insurance Premiums

Section 2 of the act would amend the National Housing Act[170] so that the agency is required to charge a minimum AMIP of least fifty-five basis points (0.55 percent) and increase UMIP and AMIP caps by fifty basis points (0.50 percent).[171]

Provision	**Old Language**	**New Language**
12 U.S.C. § 1709(c)(2)(B)	Secretary **may** establish and collect annual premium payments in an amount not exceeding **1.5%** of the remaining insured principal balance	Secretary **shall** establish and collect annual premium payments in an amount **not less than 0.55%** of the remaining insured principal balance . . . **and not exceeding 2.0% of such remaining insured principal balance**

This differs from the National Housing Act as it stands now because it sets both a floor and a ceiling on insurance premiums. It would also allow, but not require, FHA to increase premium rates by another half-percentage point. Furthermore, this section would impose additional requirements on the agency. It would require the agency to annually review the amount of AMIPs and UMIPs collected, as well as the expected losses to the MMIF.[172] Upon completion of this review, the agency would be required to adjust the AMIP and UMIP for mortgages insured after the date of the review so that "the premiums collected over the life of such mortgages will exceed the expected losses of such mortgages to the Fund plus amounts sufficient to ensure the capital reserve ratio remains at the level required."[173]

169. FHA Solvency Act of 2013, S. 1376, 113th Cong., at summary (2013).
170. 12 U.S.C. § 1709(c)(2)(B) (2011).
171. S. 1376, § 2(a)(1).
172. *Id.* § 2(a)(2).
173. *Id.*

These provisions impose some discipline on the agency both in terms of its permissible range of premiums and in its requirements to adjust the premiums when certain statutory criteria are met. By mandating annual review and premium adjustments when losses are predicted to exceed premiums, S. 1376 leaves less discretion in the hands of the agency. It also has the effect of making the agency react more conservatively to risk.

b. Indemnification by FHA Mortgagees

Section 3 of S. 1376 adds a new subsection to the National Housing Act that requires indemnification by the mortgagee under certain circumstances.[174] This section would expand the agency's "authority to seek indemnification from mortgagees approved to originate loans under the lender insurance program or the direct endorsement program."[175] The agency could seek indemnification where the mortgage (1) "contain[ed] a . . . defect such that the mortgage should not have been approved or endorsed for insurance"; and (2) the "loan becomes delinquent within 36 months of . . . approval or endorsement," or the agency "pays a claim within 36 months."[176] Additionally, "[i]f fraud or misrepresentation was involved in connection with the origination," the agency must require indemnification by the mortgagee."[177] Any indemnification funds received are to be deposited in the MMIF.[178]

This amendment to the National Housing Act represents a significant and needed indemnification authority for FHA. "Currently, the [agency] [may] only . . . seek indemnification from mortgagees under the lender insurance program."[179] By allowing FHA to seek indemnification from direct endorsement lenders, which account for 70 percent of all FHA-approved lenders, this amendment greatly expands the ability of FHA to recover losses that are a result of irresponsible lender practices.

c. Review of Mortgagee Performance

Section 4 of S. 1376 would amend § 1735f-11 of the National Housing Act to expand the criteria the agency can use to compare the performance of mortgagees. Under the current version of the Act, the agency's ability to compare mortgagees is limited in terms of geographic scope (only comparing mortgagees in an area) and factors (comparing rate of early defaults and claims for insured loans).[180] Under the proposed language in

174. *Id.* § 3(a).
175. Senate Banking Comm., FHA Solvency Act of 2013 Section-by-Section 1, http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=76ccb8b5-2cf3-4a3f-b40b-47f0b90aa957.
176. S. 1376, § 3(a).
177. *Id.*
178. *Id.*
179. Senate Banking Comm., *supra* note 175, at 1.
180. 12 U.S.C. § 1735f-11 (2001).

S. 1376, the agency may make comparisons between mortgagees based on underwriting quality, geographic area served, or "any commonly used factors . . . necessary for comparing mortgage default risk."[181] "[I]f [the agency] determines that the mortgage loans originated or underwritten by the mortgagee present an unacceptable risk to the insurance funds," it "may terminate the approval of a mortgagee to originate or underwrite single family mortgages" on a national basis.[182]

This provision has the benefit of giving FHA broader discretion to identify and mitigate risks to the MMIF. The agency may consider factors other than those listed in the Act that it determines will increase risk to the MMIF, thereby allowing it to react with changes to the mortgage financing market with more flexibility. The provision will free the agency from the constraints inherent in the current law and also allow it to evaluate risk in a more comprehensive manner.

d. Improving Underwriting Standards

Section 6 seeks to improve underwriting standards for mortgages eligible for FHA insurance.[183] The underwriting criteria under this section are more closely aligned with the Consumer Financial Protection Bureau's criteria for qualified mortgages, where a qualified mortgage refers to one that is eligible for FHA insurance.[184] The new standards would require the agency to revise the underwriting standards to include criteria whose evaluation "has historically resulted in comparatively low rates of delinquency and default during adverse economic conditions."[185] The agency is permitted to revise the criteria as necessary by mortgagee letter or rule. The criteria must include evaluations of a borrower's income and employment status, monthly mortgage payments, any other loans or debt obligations of the borrower, the monthly debt-to-income ratio of the borrower, and his or her credit history.[186] In essence, by mandating evaluation of these criteria, loans insured by FHA will have undergone a more rigorous underwriting process. The purpose of this is clear: it seeks to reduce risk by limiting FHA-insured loans to higher-credit-quality borrowers.

Despite this laudable goal, there are potential flaws with this section. First, there is no language in the proposed amendment that demands consideration of the particular borrower population that FHA traditionally serves: first-time homebuyers and those in lower-income brackets. Perhaps including comparatively low rates of delinquency and default during adverse economic conditions is a way of affording the agency some discretion in evaluating these factors, but it also provides little guidance

181. S. 1376, § 4.
182. *Id.*
183. *Id.* § 6.
184. Senate Banking Comm., *supra* note 175, at 1.
185. S. 1376, § 6(a).
186. *Id.* § 6(b).

in what precisely the agency is supposed to be comparing delinquency and default rates against. It is also not clear how much risk is too much risk. Arguably, FHA could establish underwriting standards that would alleviate almost all risk for the MMIF, but this would certainly undermine FHA's goal of providing a means of obtaining mortgage financing for underserved homebuyers.

This begs the larger question of how much discretion the agency will be afforded under this statutory language if the bill is enacted. Because the section enumerates so many specific factors, it begins to look more like Congress is dictating for whom FHA can insure mortgages. At the very least, this section imposes a consideration of several factors at a minimum and curtails the agency's discretion in what factors it considers most important. Because setting underwriting standards has traditionally been a power executed by the agency, this section raises some concerns about whether the agency's expertise and particular knowledge in this area is afforded appropriate respect.

e. Ensuring Adequate Capital Levels in the MMIF

Section 7 of S. 1376 would amend § 1711(f) of the National Housing Act to increase the capital reserve ratio to 3 percent.[187] The MMIF would be required to achieve this ratio within ten years of the enactment of S. 1376.[188] It would also impose "escalating reporting requirements and program evaluations that [would immediately] take effect . . . if the capital [reserve] ratio falls below required levels."[189] These requirements would depend on the degree to which the MMIF was undercapitalized. S. 1376 provides definitions for degrees of undercapitalization. The MMIF would be considered "undercapitalized" if "the capital reserve ratio is less than 100 percent" but greater than or equal to "50 percent of the ratio required by statute."[190] The MMIF would be "significantly undercapitalized" if "the capital reserve ratio is less than 50 percent of the required ratio but not less than zero of the ratio required by statute."[191] Finally, the MMIF would be "critically undercapitalized" if "the capital reserve ratio is negative."[192]

Depending on the degree of undercapitalization, S. 1376 requires increasingly demanding reporting requirements by the agency to Congress.[193] For example, if the fund is undercapitalized, the agency must provide annual updates to Congress regarding the financial status of the MMIF; if it is critically undercapitalized, the agency must provide quarterly

187. *Id.* § 7.
188. *Id.*
189. Senate Banking Comm., *supra* note 175, at 1.
190. *Id.* at 2.
191. *Id.*
192. *Id.*
193. *Id.*

reports to Congress.[194] Additionally, in some circumstances, premium surcharges may be mandated to provide funds to address the MMIF's solvency issues. Imposing premium surcharges would become necessary if (1) according to the annual required actuarial report, "the MMI Fund is critically undercapitalized 2 years after enactment of [S. 1376]"; (2) "the MMI Fund has not achieved a 2 percent capital reserve ratio" by FY2016; (3) after the MMIF has achieved the 3 percent ratio mandated under S. 1376, the ratio decreases in value "from one report to the next . . . without a concurrent drop in market share"; and (4) the capital reserve ratio of 3 percent is not achieved within ten years of enactment of S. 1376.[195]

Commissioner Galante, in her written testimony to the Senate, expressed concerns about these "mandatory premium increases during times when the capital reserve ratio falls below [certain] levels," emphasizing that "premiums are only one factor to consider in rebuilding [the capital reserve] account."[196] She pointed out that the language in S. 1376 "does not account for the impact increased premiums themselves will have on access to credit, endorsement values, and ultimately the health of the Fund—potentially undermining the goal of increasing the capital reserve."[197] Commissioner Galante's comments hone in on the delicate balance that must be struck with regard to imposing even more premiums on borrowers. S. 1376 would impose premiums on newly insured mortgages in addition to those already required under the National Housing Act[198] if the MMIF is designated as undercapitalized. These additional premium surcharges would be in "10 basis points of the remaining insured principal balance" on any newly insured mortgage.[199]

The proposed bill seems to assume that premium surcharges are the most effective means of bolstering capital reserves in the MMIF. Throughout her testimony before the Senate committee, Commissioner Galante identified other ways of bolstering capital reserves, including many of the steps FHA has already taken that are discussed elsewhere in this essay: making underwriting changes, changing the terms of insurance products, and making changes to programs such as the HECM program. Imposing premium surcharges may have a negative impact on access to credit because they place a higher burden on borrowers.[200] This, in turn, may harm the long-term financial health of the MMIF.

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194. S. 1376, § 7.

195. Senate Banking Comm., *supra* note 175, at 2.

196. Galante Written Testimony, *supra* note 156, at 5.

197. *Id.*

198. The language in the FHA Solvency Act of 2013 states that "in addition to the premiums collected under . . . section 203(c) [12 U.S.C. § 1709(c)], . . . the Secretary shall establish and collect annual premium payments for any newly insured mortgage. . . ." S. 1376, § 7.

199. *Id.*

200. Galante Written Testimony, *supra* note 156, at 4–5.

Furthermore, some of the requirements in the proposed bill, such as the imposition of premium surcharges when the capital reserve ratio decreases after achieving the required 3 percent, ignore the fundamental purpose of the capital reserve ratio, which is to protect the MMIF during adverse economic conditions. Automatically imposing penalties seems like an overcorrection, the consequences of which may ultimately undermine the overall financial health of the MMIF.

f. Conclusions Regarding S. 1376

S. 1376 represents a congressional attempt to ensure reduced risk for FHA's mortgage insurance program. Although many of the changes are positive and afford FHA some flexibility and additional authority to hold irresponsible mortgagees accountable and take other actions, the proposed bill also limits FHA's authority in meaningful ways. Read as a whole, it imposes discipline on FHA through an increase in statutory requirements related to the capitalization of the MMIF. As discussed above, these constraints take away some of the ability of FHA to react to risk using the economic tools it deems most appropriate by demanding that FHA at least impose premium surcharges in certain conditions. This undermines the expertise of FHA and decreases its ability to respond to economic changes in more nuanced ways. In addition, the enumeration of specific criteria that FHA must impose when drafting underwriting criteria suggests that Congress seeks an increased role in determining what kind of borrowers should be eligible for FHA-insured mortgages. Although this is certainly a congressional prerogative, Congress should be mindful of the degree to which these criteria might effectively preclude some potential borrowers from eligibility. These changes could undermine the mortgage insurance program by lowering demand and thus decreasing income from premiums.

2. H.R. 2767: Protecting American Taxpayers and Homeowners Act of 2013 (PATH Act)

The other major legislative proposal is the PATH Act, which was introduced in the House of Representatives on July 24, 2013.[201] The bill itself is comprehensive and also addresses the conservatorship of the government-sponsored enterprises. The most relevant portions for our purposes are contained in Title II, which is cited as the FHA Reform and Modernization Act of 2013.[202]

a. Restructuring FHA as a Government Corporation

If enacted, this bill would require a significant overhaul of FHA and change its fundamental nature. It would establish FHA as a wholly

201. Protecting American Taxpayers and Homeowners Act of 2013, H.R. 2767, 113th Cong. (2013).

202. *Id.*

owned government corporation.[203] This would have the effect of completely detaching FHA from HUD and establishing it as an independently owned corporation. The detachment process must be completed within five years after the enactment of this proposed bill.[204] Authority is transferred from the Secretary of HUD (who currently delegates his authority to the FHA Commissioner) to FHA at the conclusion of the transition period.[205] The powers of FHA are vested in a board of directors of FHA, composed of nine presidential appointees.[206] The board is required to include the Secretary of HUD, the Secretary of Agriculture, at least five individuals with expertise in mortgage finance, and at least two individuals with "expertise in affordable housing serving low- and moderate-income populations."[207]

The board's powers encompass the general management of FHA, including (1) "obtain[ing] guidance from participants in the mortgage markets served by the FHA"; (2) "assess[ing] the housing and mortgage insurance needs of consumers"; (3) "obtain[ing] information concerning housing finance markets . . . to better assess how the FHA can complement the roles of public and private participants"; and (4) "assist[ing] the Secretar[ies] of [HUD] and . . . Agriculture in coordinating the roles of [f]ederal housing, banking, and credit agencies generally, and . . . in the delivery of housing credit enhancement to families, communities, and hard-to-serve markets."[208]

b. Changes to MMIF Capital Reserve Requirements and Performance Mandates

Like S. 1376, H.R. 2767 also seeks to amend the capital reserve ratio. H.R. 2767 sets an even higher capital reserve ratio at 4 percent.[209] The capital ratio is determined quarterly rather than annually.[210] The bill also contains capital classifications that carry with them potential limitations on FHA or its ability to issue new loans. Capitalization designations are divided into three categories: adequately capitalized, undercapitalized, and significantly undercapitalized.[211]

If the capital ratio is greater than 4 percent, the fund is considered adequately capitalized.[212] The fund is considered undercapitalized if the capital ratio is less than 4 percent but greater than 0 percent. Within the

203. *Id.* §§ 211(a)–(b).
204. *Id.* § 281(a)(2)(B).
205. *Id.* § 284.
206. *Id.* §§ 214(a)–(b).
207. *Id.* § 214(b).
208. *Id.* § 214(f), (g).
209. *Id.* § 256(b).
210. *Id.* § 257(a)(4).
211. *Id.* § 257.
212. *Id.* § 257(a)(1).

undercapitalized designation, the consequences for FHA vary depending on the specific capital ratio. If the capital ratio is at least 2 percent but less than 4 percent, FHA is prohibited from "enter[ing] into any new commitment to insure any mortgage on a 1- to 4-family residential property that involves a principal obligation . . . exceeding 90 percent of the appraised value of the property."[213] If the capital ratio is between 0 and 2 percent, FHA is prohibited from "enter[ing] into any new commitment to insure any mortgage . . . that involves a principal obligation . . . exceeding 80 percent of the appraised value of the property."[214]

The MMIF is considered significantly undercapitalized if the capital ratio is less than 0 percent. In these circumstances, the director of FHA has broad authority to take corrective actions.[215] The director may "cease and desist from any conduct or activity" that contributes to the MMIF being significantly undercapitalized.[216] Specifically, the director may require FHA to "take corrective or remedial action, including—(A) restricting the growth of, or contracting, any category of assets or liabilities; (B) reducing, modifying, or terminating any activity that the [d]irector determines creates excessive risk to the FHA; [and] (C) terminating agreements or contracts."[217]

Additionally, if the MMIF is determined to be undercapitalized or significantly undercapitalized, FHA is required to submit a capital restoration plan to the director of FHA and carry out that plan.[218] The capital restoration plan must "set forth a feasible plan for . . . raising or restoring the capital" of the MMIF by describing the specific actions FHA will take and include "a schedule for completing the actions set forth in the plan."[219] It also requires FHA to "specify the types and levels of activities" (existing and future) that FHA will engage in during the duration of the plan.[220] The director has discretion to approve or disapprove of a capital restoration plan; in the event of disapproval, the director conveys the reasons for disapproval to FHA, which then resubmits a revised plan to the director.[221]

c. Premiums

The proposed bill changes the premiums structure in several significant ways. The most glaring difference between this bill and current legislation is that H.R. 2767 sets levels for minimum premiums but does not

213. *Id*. § 257(a)(2)(B)(i).
214. *Id*. § 257(a)(2)(B)(ii).
215. *Id*. § 257(a)(3)(B).
216. *Id*. § 258(b)(1).
217. *Id*. § 258(b)(2).
218. *Id*. § 257(c).
219. *Id*. § 258(d).
220. *Id*.
221. *Id*. § 257(c).

contain a statutory ceiling.[222] Under the proposed bill, the statutory AMIP minimum is 0.55 percent of the remaining insured principal balance for one- to four-family residential properties insured by FHA.[223] The AMIP is collected for the entire term of the mortgage.[224]

The lack of a statutory ceiling makes sense in the context of a new provision that provides for risk-based premiums.[225] Under this provision, FHA may establish a mortgage premium structure, either in the form of UMIPs, AMIPs, or both, where "the rate of premiums . . . var[ies] according to the credit risk associated with the mortgage."[226] Additionally, if an AMIP is used, the rate "may vary during the mortgage term, [although] the basis for determining the variable rate" must be determined at the outset.[227]

d. Changes to Amount of Mortgage Insurance Coverage

If this bill is enacted, it also imposes limits on the amounts of mortgage insurance coverage as a function of the principal obligation on the mortgage. It does so through a graduated approach to reducing the amount of allowable mortgage insurance coverage that FHA may provide on one- to four-family residential properties.[228] The timeline[229] is diagrammed below.

Years After PATH Enactment	**Maximum Percentage of Principal Obligation FHA May Insure**
1 year	90%
2 years	80%
3 years	70%
4 years	60%
5 years	50%

This gradual reduction in the amount FHA is permitted to insure is tied to new risk-sharing provisions.[230] Within two years of enactment, FHA is required to develop and implement a model for entering into risk-sharing agreements with respect to FHA-insured mortgages.[231] Under these agree-

222. *Id.* § 235(b).
223. *Id.*
224. *Id.*
225. *Id.* § 235(d).
226. *Id.*
227. *Id.*
228. *See generally id.* § 234.
229. *Id.* § 234(a).
230. *See generally id.* § 233.
231. *Id.* § 233(a).

ments, FHA insures a portion of the amount of a mortgage, and people or entities determined under the guidelines insure the remainder or at least a portion of the amount of the eligible mortgage.[232] In establishing the guidelines for determining what people or entities are qualified to engage in risk sharing, FHA is instructed to look first to guidelines established by Fannie Mae and Freddie Mac to see if they are sufficient for its purposes.[233] FHA is given some discretion in whether to use existing guidelines or create its own, but the guidelines must ensure that people or entities participating in risk sharing have "sufficient capital, credit worthiness, and liquidity, and are otherwise capable of fulfilling their obligations to the FHA."[234]

The bill also sets statutory floors on the amount of new business that must be insured pursuant to a risk-sharing agreement.[235] By the end of two years after enactment, FHA must ensure that in each fiscal year at least 10 percent of its new business is insured pursuant to a risk-sharing agreement.[236]

e. Other Relevant Structural Changes

In addition to the major changes outlined above, H.R. 2767 contains numerous other significant changes to FHA and its MMIF program. Under H.R. 2767, FHA's single-family and multifamily business would be limited to insuring low- to moderate-income families and first-time homebuyers.[237] This is a significant change because although FHA has a broad and historical purpose of providing access to mortgage financing for these groups, none of FHA's programs is currently means tested.

The bill also seeks to eliminate risks in other ways. High-risk borrowers are blocked out of the program under certain circumstances, including default on an FHA mortgage in the past seven years.[238] Many borrowers also may be effectively excluded from the program because of the higher down payment requirements for FHA-insured mortgages. The new down payment requirement under this bill is 5 percent.[239] The bill also imposes increased responsibility on mortgagees. If a mortgagor is in default "for 60 or more consecutive days during the [two-year] period beginning upon origination of the mortgage," the lender is required to repurchase the mortgage.[240] This removes the incentive for mortgagees from making

232. *Id.*
233. *Id.* § 233(b)(2).
234. *Id.* § 233(b)(3)(A).
235. *Id.* § 233(c)(1).
236. *Id.*
237. *Id.* § 232(a)(3).
238. *See generally id.* § 261.
239. *Id.* § 232(a)(2) (noting that for certain first-time homebuyers who have been provided with a credit enhancement, the down payment shall be "3.5 percent of the cost of acquisition of the property").
240. *See generally id.* § 264.

loans to particularly risky borrowers because they will not be able to avail themselves of FHA insurance. Additionally, the bill requires indemnification by mortgagees in situations where "the mortgagee knew, or should have known . . . , of a serious and material violation of the requirements established by the FHA . . . such that the mortgage . . . should not have been approved and endorsed for insurance," and FHA has paid an insurance claim.[241]

Finally, the bill repeals certain FHA programs, most significantly the HECM program, which has placed considerable strain on FHA in past years.[242]

f. Analysis of H.R. 2767

H.R. 2767 represents much more sweeping change than S. 1376. At its core, H.R. 2767 represents a strong effort on the part of the Republican representatives who proposed it to reduce risk to FHA, decrease its role in the mortgage insurance market, and make it behave more like a private mortgage insurer.

The macrolevel structural changes would certainly change the face of the agency by removing it from the direct control of the Secretary of HUD and allowing the FHA Commissioner to have a more clearly defined role as something akin to a national "[h]ousing [c]zar."[243] Although the Secretary currently broadly delegates most of his authority under the National Housing Act to the FHA Commissioner, this would give the FHA Commissioner a more clearly defined role.

The risk-mitigation provisions in H.R. 2767 are extensive and more demanding than those imposed by S. 1376. The risk-based premium setting as written is permissive: FHA is not required to impose a system of risk-based premiums. If utilized, risk-based premium pricing has the potential to make FHA behave much more like a private mortgage insurer and potentially price out certain borrowers. This is especially interesting in light of the stated public purpose requirement in the statute, which limits the availability of FHA mortgage insurance to first-time homebuyers and low- and middle-income borrowers. This means-tested approach harkens to an attempt to bring FHA back to its "original purpose" and to not allow FHA insurance to be used as a mortgage financing tool for those purchasing expensive homes.[244] However, this public purpose seems to be in tension with other provisions in H.R. 2767, including the limitations in insurance coverage. Presumably, private mortgage insurers would step in to cover the amount that FHA could not insure in most circumstances, but premiums charged by private mortgage insurers might

241. *See generally id*. § 265.
242. *See generally id*. § 292.
243. Brian Montgomery, *A New Path for FHA?*, VOICE OF HOUSING, (July 23, 2013), http://voiceofhousing.com/government/2013/07/a-new-path-for-fha/.
244. *Id*.

prove too expensive for some homebuyers. Similarly, the down payment requirement runs a high risk of pricing out certain borrowers while not necessarily having much impact on the financial robustness of the MMIF. A 1.5 percent increase in the down payment requirement might prove prohibitive for some borrowers while adding at most a few thousand dollars to FHA's books.[245] When debating this bill, members of Congress should be mindful of the relative differences for borrowers and the solvency of the FHA fund and consider whether measures like increases in down payment will actually decrease risk for FHA or simply price out some borrowers.

Taken as a whole, this bill envisions a reduced role for FHA in the mortgage insurance market. Although FHA has never sought to play an outsize role in the mortgage insurance market, its important role as a countercyclical force during times of restricted credit and economic crisis was demonstrated during the recent financial crisis. Stripping FHA of too much of its essential character risks undermining this role and leaving certain borrowers out of the homeownership market entirely.

V. Conclusion

As evident from the discussion above, FHA is at an important transition point in its history. The recent financial and housing crisis and its inevitable effects on the fiscal health of FHA have led to wide-ranging discussions in the halls of agencies and on Capitol Hill about the best ways to strengthen FHA. Although many of the reforms that FHA has taken so far have been successful and seem poised to eliminate some unnecessary risks, it is important that both the agency and Congress be mindful of the proper pace of change. In light of the recent crisis, it is both tempting and possible to overcorrect. However, overcorrection is particularly dangerous for a program like FHA, which must balance the countervailing goals of avoiding risk and providing a means of financing for borrowers who are objectively risky.

H.R. 2767 in many ways seems like an overcorrection. It places significantly higher demands on FHA in terms of a capital reserve ratio and premium requirements. In addition, its provisions, taken together, practically mandate a decreased role for FHA in the mortgage insurance market. Although FHA is not intended to function in the market in the same way as private insurers, the unique role that FHA plays suggests that lawmakers should seriously consider the potential consequences of a mandated drawdown of FHA's role. Additionally, H.R. 2767 seems to ignore the fact that many of the reasons FHA faces solvency issues today have already been addressed through regulations promulgated by the agency. Many of the programs that so negatively affected past books of business

245. *Id.*

no longer exist or exist in significantly modified form. Nonetheless, the long-term changes from these policy shifts will take time to be realized.

S. 1376, on the other hand, takes a more cautious approach. It puts in place additional safeguards that do not so dramatically change the face of the agency and also allows the FHA Commissioner to retain much of her authority while giving her additional tools to make necessary programmatic changes. This approach seems more prudent in a time when markets are particularly sensitive to the role of government programs that facilitate entry into those markets, such as FHA's mortgage insurance program. At a time when the economy generally and the housing market specifically are vulnerable and still recovering, S. 1376's approach appears to be the congressional solution that provides for necessary changes without upsetting the status quo too significantly.

Determining the "Sweet Spot" for the Federal Government in Residential Mortgage Finance

Alyssa Baskam

Abstract

Despite significant missteps by the government structured entities (GSEs), Fannie Mae, Freddie Mac, and Ginnie Mae, that contributed in great part to the federal housing crisis, the federal government remains a significant entity without which the housing market could not properly function. This paper aims to identify the necessary and essential role of the federal government and then proposes modifications to the current structure to fit within this role. To properly fulfill its role within residential mortgage finance, the federal government must create new, more stringent standards by: (1) returning existing GSEs to their original function of providing housing access and residential mortgages to low- and moderate-income home buyers, as well as other key target populations; (2) reemphasizing and requiring a conforming loan product; and (3) increasing the security of loans by both improving the treatment of lien priority and reworking the federal government guarantee through higher guarantee fees and higher risk sharing with private market entities.

This paper will first address the formation, evolution, and collapse of the GSEs as independent market actors. Discussion will include how the GSEs were created, for what purpose they were created, how they moved beyond this purpose to become risk-taking private actors, and how this shift led ultimately to market failure and the placement of the GSEs into a conservatorship. It will then address the "sweet spot," or the ideal mortgage market, including discussion of the optimal mortgage product, secondary mortgage market, and insurance. Finally, this paper proposes what the necessary actions and who the actors are, as well as enumerating which restructuring proposals will provide optimal reformation of the federal government's role in residential mortgage finance.

I. Introduction

The shapers of the American mortgage finance system hoped to achieve the security of government ownership, the integrity of local banking, and the

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ingenuity of Wall Street. Instead they got the ingenuity of government, the security of local banking and the integrity of Wall Street.[1]

Fannie Mae, Ginnie Mae, and Freddie Mac are government structured entities (GSEs) in the securitization business. As such, these GSEs buy mortgages from originators, form pools of these mortgages, and issue mortgage-backed securities (MBS) based on these pools to investors. The GSEs were originally intended as tools to improve the liquidity in the secondary mortgage market, but they have evolved into profit-taking firms that engage in risky investments backed by an implicit government guarantee. For almost forty years, Fannie Mae and Freddie Mac dominated the U.S. mortgage market, but in 2008, as a result of the crash of the U.S. mortgage and housing markets, they survived only because of a government bailout that resulted in both GSEs being placed into a conservatorship.[2] Following the market crash and the subsequent conservatorship of the GSEs, public opinion has called for either the restructuring or destruction of the GSEs and various proposals have been put forward with either goal in mind.

In order to properly fulfill its role within residential mortgage finance, the federal government must create new, more stringent standards by: (1) returning existing GSEs to their original function of providing housing access and residential mortgages to low and moderate income as well as other key target populations; (2) reemphasizing and requiring a conforming loan product; and (3) increasing the security of loans by both improving the treatment of lien priority and reworking the federal government guarantee through higher guarantee fees and higher risk sharing with private market entities.

II. The Beginning, Evolution, and Collapse of the GSEs as Independent Market Actors

A. The Beginning: Fannie Mae, Ginnie Mae, and Freddie Mac

1. The New Deal Response to Market Failures in the Housing Finance Market

The Depression's failures in the housing finance market led to a dramatic New Deal response that included the formation of new government institutions intended to act as market participants.[3] Three of the new government institutions included the Federal Housing Authority (FHA), the Federal National Mortgage Association (FNMA or Fannie Mae), and the

1. David Frum, NAT'L POST, July 11, 2008 (columnist and former speechwriter for President George W. Bush).

2. Dwight M. Jaffee, *Reforming the U.S. Mortgage Market Through Private Market Incentives* 1 (2011), http://faculty.haas.berkeley.edu/jaffee/Papers/JaffeeMortgageReform.pdf.

3. Adam Levitin & Susan M. Wachter, *The Public Option in Housing Finance,* 46 U.C. DAVIS L. REV. 1111, 1130 (2013).

Veterans Administration (VA).[4] Along with several other institutions, including the Federal Home Loan Banks (FHLBs) and the Federal Deposit Insurance Corporation (FDIC), they worked to improve the economy by helping to provide adequate housing.[5] Efforts included providing the market liquidity necessary for additional lending to be possible.[6] It is important to note, however, that each effort was an independent reaction to a specific market problem and these efforts did not use command-and-control regulation, i.e., regulation that specifically delineates which actions are appropriate and which are not.[7] Instead of prohibiting certain practices, the government used these institutions to fill services that the private housing finance market had failed to provide.[8]

2. The Role of the GSEs

"As government-sponsored enterprises . . . , Fannie Mae and Freddie Mac have special privileges and obligations."[9] "[T]he GSEs buy mortgages from lenders and either hold the mortgages as investments or pool the mortgages into mortgage-backed securities, which are sold to institutional investors."[10] "[T]he GSE[s'] charters prohibit them from originating mortgages, and the FHA and VA programs only insure mortgages that are originated to their specifications by private market firms."[11] Mortgage banks largely developed as a result of the introduction of FHA/VA insurance/guarantee programs.[12] FHA/VA insurance/guarantee programs are a form of federal assistance created to allow lower income households to qualify for housing loans that they otherwise would not qualify for. FHA/VA insured loans require a financing premium that is paid to the FHA in exchange for the FHA/VA's backing.[13] Mortgage banks originated or financed such loans with the intent of selling them into the secondary market to Fannie Mae or other institutional entities. Mortgage banks then maintained the servicing on those originated loans after selling them into the secondary market.[14] Fannie Mae and other institutions "guarantee that investors in these securities receive timely payment of principal and interest even [if the borrower] becomes delinquent."[15]

4. *Id.*
5. *Id.*
6. *Id.*
7. *Id.*
8. *Id.*
9. N. ERIC WEISS, CONG. RESEARCH SERV., GSES AND THE GOVERNMENT'S ROLE IN HOUSING FINANCE: ISSUES FOR THE 113TH CONGRESS 1 (2013).
10. *Id.*
11. Jaffee, *supra* note 2, at 1.
12. *See* Levitin & Wachter, *supra* note 3, at 1156.
13. *Id.*
14. *Id.*
15. WEISS, *supra* note 9, at 16.

3. The Origin of Fannie Mae, Freddie Mac, and Ginnie Mae

Fannie Mae was created "in 1938 to purchase FHA-insured mortgages."[16] Over the next twenty years, Fannie Mae's role expanded to include buying not only FHA-insured mortgages, but also FHA insurance as well. Congress gave Fannie Mae government agency status along with other additional advantages over private financial firms such as exemption from state and local income taxes. Fannie Mae continued to enjoy the advantages of being associated with the government even after it was converted into a private company in 1968.[17]

By 1968, Fannie Mae's market share had increased dramatically, so the government split Fannie Mae into the privatized Fannie Mae described above and a second entity, the Government National Mortgage Association (GNMA or Ginnie Mae).[18] Ginnie Mae was created within the U.S. Department of Housing and Urban Development (HUD) in 1968 to securitize FHA-insured and VA-guaranteed mortgages.[19] While FHA insured the mortgages, Ginnie Mae "guaranteed the timely payment of principal and interest on the bonds [that were] backed by [those] FHA-insured or VA-guaranteed mortgages."[20] Because the FHA and the VA, as well as the Rural Housing Services (RHS), set their own underwriting standards, Ginnie Mae's role was restricted to securitization of mortgages and did not bolster the timeliness of FHA or VA activity.

At this juncture, HUD continued to regulate certain activities of Fannie Mae, including its issuance of securities. HUD additionally had the authority to require Fannie Mae to focus its mortgage purchases on the "national goal of providing adequate housing for low and moderate income families, but with reasonable economic return to the corporation."[21]

In 1970, Congress passed the Emergency Home Finance Act, which President Nixon signed into law on July 24, 1970.[22] It created the Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac) to buy non-FHA/VA mortgage loans (conventional mortgages) from the savings and

16. Viral V. Acharya, Matthew Richardson, Stijn Van Nieuwerburgh & Lawrence J. White, Guaranteed to Fail: Fannie Mae, Freddie Mac and the Debacle of Mortgage Finance 14 (2011).

17. *Id.* at 14–15.

18. *See* Levitin & Wachter, *supra* note 3, at 1158.

19. *Id.*

20. *Id.* at 1159.

21. Housing and Urban Development Act of 1968, Title VIII, Pub. L. No. 90-448, § 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).

22. 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, 796 (2005).

loan (S&Ls) industry and securitize them. Congress gave ownership of Freddie Mac to the Federal Home Loan Banking System.[23] The Act also authorized Fannie Mae to purchase conventional mortgages.[24] Freddie Mac began to purchase conventional mortgages in 1971, and Fannie Mae followed suit in 1972.[25]

B. The Evolution

1. The Secondary Market

In the early 1970s, FHA and both Fannie Mae and Freddie Mac began "to lower their down payment requirements . . . to help support the housing market."[26] In 1981, as a result of rising interest rates in the mid and late 1970s, Fannie Mae began to securitize mortgages. This resulted in a strong secondary market for non-FHA/VA mortgages and consequently "loosened regulatory control over housing finance."[27] The "GSEs were subject to some command-and-control regulation," including requirements "to maintain capital levels of 2.5% for on-balance sheet [obligations] [as well as] .45% for off-balance sheet obligations." Additionally, loan purchases were subject to conforming loan limits and loan to value (LTV) limitations where there was no corresponding mortgage insurance.[28] Beyond that, however, the GSEs had a great deal of independence for underwriting practices.[29] For instance, the GSEs were able to provide structuring services that allowed investors to allocate their investments into different "tranches."[30] This allowed investors to allocate risk in a more flexible manner.[31]

2. The GSEs' New Market Strength

In 1982, Congress passed the Alternative Mortgage Transactions Parity Act, which preempted state laws prohibiting adjustable-rate mortgages, and prohibited traditional "due-on-encumbrance" clauses.[32] Due-on-encumbrance clauses were meant to prevent parties from issuing second mortgages without the first mortgagee's consent.[33] The removal of the

23. *See* Levitin & Wachter, *supra* note 3, at 1159.

24. *See* Carrozzo, *supra* note 22, at 800.

25. Levitin & Wachter, *supra* note 3, at 1159 (citing Edwin L. Dale, Jr., *Fanny May to Buy Regular Mortgages*, N.Y. TIMES, Dec. 2, 1970, at 73); Carrozzo, *supra* note 22, at 800.

26. *See* Levitin & Wachter, *supra* note 3, at 1160.

27. *Id.* at 1161–62.

28. *Id.* at 1162.

29. *Id.*

30. Ingrid Gould Ellen, John Napier Tye & Mark A. Willis, *The Secondary Market for Housing Finance in the United States: A Brief Overview*, *in* THE AMERICAN MORTGAGE SYSTEM, 7, 9 (Susan W. Wachter & Marvin Smith eds., 2011).

31. *Id.*

32. *See* Levitin & Wachter, *supra* note 3, at 1164.

33. *Id.*

prohibition against adjustable-rate mortgages, combined with the removal of the due-on-encumbrance clause, opened the door for a broader mortgage market. Concurrently, the S&L industry collapsed in the 1980s,[34] leaving room for the privatized Fannie Mae and Freddie Mac to dominate the market.[35]

Fannie and Freddie were poised to inherit a large market share for two reasons. First, although the U.S. government had not explicitly guaranteed GSE obligations, investors frequently assumed that an implicit government guarantee existed.[36] This implicit guarantee gave Fannie Mae and Freddie Mac a competitive edge against private investors with no government perks. Second, at this point, the GSEs had maintained their own underwriting standards.[37] These standards helped the GSEs to exert a large amount of influence over the private market's mortgage terms, and this influence resulted in the conforming loan product.

3. The Conforming Loan Product

"The GSEs [historically] set the contract design and underwriting standards for the loans they acquired,"[38] which became known as the "conforming loan product." The GSEs would not buy loans unless they fit within these standards. As what came to be known as the "American mortgage," the conforming loan product consisted of a 20 percent down payment, self-amortizing, thirty-year fixed-rate mortgage. This mortgage included no prepayment penalties and became an affordable standard within the United States.[39] Additionally, the GSEs were limited by statute to purchasing only those loans that had less than 80 percent LTV ratios.

The conforming loan product also received the benefit of FHA insurance. FHA "provid[es] insurance for mortgage loans backed by the 'full faith and credit of the United States.'"[40] This insurance is paid for within the purchaser's monthly mortgage payments and "is designed to protect the lender from the losses incurred if the borrower defaults on the mortgage."[41] FHA insurance typically was available only for loans that met certain characteristics: (1) maximum interest rate of 5 percent; (2) fixed-rate and fully amortized; (3) held by institutional lenders instead of individuals; and (4) a low down payment requirement with long terms.[42] Additionally,

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34. *Id.* at 1162.
35. *Id.*
36. *See* Ellen et al., *supra* note 30, at 9.
37. *See* Levitin & Wachter, *supra* note 3, at 1166.
38. Mercatus Ctr., *House of Cards: Reforming America's Housing Finance System* 19 (Mar. 2012).
39. *See* Ellen et al., *supra* note 30, at 9.
40. Oonagh McDonald, Fannie Mae and Freddie Mac: Turning the American Dream into a Nightmare 25 (2012).
41. *Id.*
42. *Id.*

borrowers had to pay closing costs, prepaid fees for insurance and interest, escrow fees, and property taxes.[43] Finally, FHA insurance was not available for loans that surpassed the conforming limits; more expensive loans could not receive the benefit of the Ginnie Mae guarantee.

4. The Private-Label Securitization Market

The private-label securitization (PLS) market began in 1977.[44] Private-label securities are mortgages securitized by private, rather than federal, institutions. Unlike in the GSE-dominated secondary market, "investors incurred both interest rate risk *and* credit risk on the [mortgage-backed securities that] they purchased."[45] Interest rate risk is the vulnerability tied to the mortgage based on movements in prevailing interest rates whereas credit risk is that mortgage's vulnerabilities related to default. In the GSE's secondary market, investors accepted only the interest rate risk.[46] The PLS market grew in the mid-1990s following the implosion of the S&L industry and began securitizing riskier loans, including subprime loans.[47] These loans were typically ineligible for purchase by Fannie Mae or Freddie Mac because they were above the GSEs' conforming loan limit.[48] In 1994, as a result of the increase in subprime lending, the Home Ownership and Equity Protection Act of 1994 attempted to reregulate the mortgage industry.[49] However, between 1996 and 2007, federal banking regulators pushed back against these federal reregulation attempts and campaigned for further deregulation; by 2004, hardly any mortgage regulation remained.[50] Additionally, the PLS securities were typically issued by investment banks (non-banks), and many of the underlying mortgages were originated by non-bank companies.[51] As a result, there was little regulatory presence in the PLS market, and PLS originators were able to make offers to borrowers without heavily scrutinizing their ability to pay.[52] This was desirable for PLS originators because they could pursue the origination of riskier mortgages.

5. The Relaxation of GSE Guidelines

As a result of the growing strength of the PLS market and its subprime loans, the GSEs began to see their market share decrease. When this decrease in market share threatened their continued growth and profit, the

43. *Id.*
44. *See* Levitin & Wachter, *supra* note 3, at 1167.
45. *Id.* (emphasis in original).
46. *Id.*
47. *Id.*
48. *See* Ellen et al., *supra* note 30, at 10.
49. *See* Levitin & Wachter, *supra* note 3, at 1168.
50. *Id.* at 1169–70.
51. *See* Ellen et al., *supra* note 30, at 10.
52. *Id.*

GSEs responded by loosening their underwriting guidelines and expanding their portfolios.[53] Beginning around 2005, Fannie Mae and Freddie Mac increased their exposure to nontraditional mortgages.[54] Nontraditional mortgages carry a heightened risk level stemming from different mortgage standards regarding loan principal and interest.[55] "While the written standard was the same for MBS and portfolio operations, they did not contain the same mix of products (i.e., only their portfolios were vulnerable to PLS subprime risk)."[56] The expansion of the GSEs' portfolios to include downgraded, riskier PLS mortgages left the GSEs without sufficient capital to secure all of their holdings, leaving them in turn unable to carry on their mortgage-based security business.[57]

The FHA also relaxed its requirements. In 1999, the National Housing Act was amended to allow the FHA to reduce its requisite down payments to approximately 3 percent of the appraisal price of the property.[58] The guidelines were further relaxed so that borrowers did not have to pay more than 3 percent of the total out-of-pocket funds, including the down payment, closing costs, prepaid fees for insurance and interest, escrow fees, and property taxes.[59] The FHA also began to focus only on the borrower's one-to two-year credit history and additionally allowed gifts to be used to cover the down payment.[60] Gifts came from nonprofit consumer advocacy groups, among others.

In addition to the relaxation of standards in response to private competition, the government's increased focus on emphasizing fair practices in lending challenged the GSEs' regulations.[61] The Federal Reserve Bank of Boston developed a comprehensive program meant to advise lenders how to ensure that their borrowers were treated fairly, which suggested that lack of credit history not be treated as a negative factor.[62] Following

53. *Id.* at 11.

54. Robert Van Order, *Some Thoughts on What to Do with Fannie Mae and Freddie Mac*, *in* The American Mortgage System, 339, 349 (Susan W. Wachter & Marvin Smith eds., 2011).

55. FDIC Law, Regulations, Related Acts, "Interagency Guidance on Nontraditional Mortgage Product Risks," http://www.fdic.gov/regulations/laws/rules/5000-5150.html (accessed June 10, 2014).

56. *Id.*

57. Adam J. Levitin & Susan M. Wachter, *Information Failure and the U.S. Mortgage Crisis*, *in* The American Mortgage System, 243, 264 (Susan W. Wachter & Marvin Smith eds., 2011).

58. *See* McDonald, *supra* note 40, at 27.

59. *Id.*

60. *Id.*

61. *See id*. at 4.

62. *Id.*; *see also* Alicia Munnell, Lynn E. Browne, James McEneaney & Geoffrey M. B. Tootell, *Mortgage Lending in Boston: Interpreting HMDA Data*, Federal Reserve Bank of Boston Working Paper No. 92-7 (Oct. 1992), http://www.bostonfed.org/economic/wp/wp1992/wp92_7.pdf (accessed June 11, 2014).

these suggestions, Fannie Mae and Freddie Mac accepted overtime, part-time work, second jobs, and seasonal work as valid income sources.[63] Such recommendations contributed to the weakening of underwriting standards.

An additional factor that increased the weakening of underwriting was federal pressure for depository institutions to meet the credit needs of a wider variety of families. The Community Reinvestment Act (CRA) of 1977, which applies to all federally insured banks, encouraged depository institutions to meet the credit needs of low- and moderate-income neighborhoods. "Fannie Mae and Freddie Mac had to meet HUD's annual percent-of-business goals . . . for three categories: [(1)] low and moderate income; [(2)] underserved; and [(3)] special affordable."[64] In 1995, more stringent requirements were enacted that influenced the ratings that depository institutions would receive. These requirements, however, allowed banks to include lending by mortgage companies or subsidiaries in their performance evaluations.[65] Banks began to focus on activities that counted toward their rating, and this increase in CRA-related activity may have been a factor in the subprime mortgage crisis.[66]

C. The Collapse

By 2008, the U.S. mortgage and housing markets crashed.[67] The stock market in the United States fell to between a third and half of its value, and international trade declined by 12 percent.[68] As a result, many credit institutions, including Lehman Brothers, AIG, Merrill Lynch, Washington Mutual, Wachovia, and Citigroup, began to fail.[69] Fannie Mae and Freddie Mac survived only because of two factors. First, both GSEs received a substantial government bailout; and second, they were both placed into a conservatorship overseen by the Federal Housing Finance Agency (FHFA).[70]

1. The Subprime Mortgage Crisis

> Ultimately, the expansion of PLS and nontraditional mortgages was its own undoing. These products drove the housing bubble but ultimately priced out too many potential homeowners, making home price increases unsustainable.[71]

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63. McDonald, *supra* note 40, at 5.
64. *Id.* at 6.
65. *Id.* at 8.
66. *Id.*
67. *See* Acharya et al., *supra* note 16, at 48.
68. *Id.* at 48–49.
69. *Id.* at 49.
70. *See* Levitin & Wachter, *supra* note 3, at 1171.
71. Levitin & Wachter, *supra* note 57, at 244.

"Fannie Mae and Freddie Mac are where they are because they were run as the largest hedge fund on the planet."[72] With the increase in PLS and nontraditional mortgages, a housing bubble grew unchecked. The housing bubble included housing price increases that priced many potential homeowners out of the market, as well as prohibited current homeowners from refinancing.[73] Teaser rates from many adjustable-rate mortgage loans increased, causing dramatic increases in monthly mortgage payments for large percentages of new homeowners.[74] In May 2007, Ben Bernanke, then chairman of the Federal Reserve, "referred [in particular] to the sharp increase in foreclosure rates in [these] subprime mortgages with adjustable interest rates."[75] At the time, these subprime mortgage products "accounted for two-thirds of the first-lien loans or 9% of all first-lien loans outstanding."[76] "[I]n the first quarter of 2007, [t]here was a sharp increase in debt servicing and property liability tax for many borrowers."[77] This led to a dramatic increase in mortgage delinquency and foreclosure rates, especially in those subprime mortgages.[78] Those foreclosures in turn increased the amount of housing reentering the market, lowering housing prices further.[79] "For the 2007 financial year . . . , Fannie Mae recorded losses of $2.05[] [billion] . . . [,] [and] Freddie Mac reported a $3.1[] [billion] loss."[80] The rising interest rates on outstanding loans coupled with the decline in housing prices caused the 2008 subprime mortgage crisis. Escalating the effects of rising interest rates and declining housing prices was the movement by subprime mortgage companies away from the subprime mortgage business.[81] In 2006, shares of mortgage companies had fallen by 58 percent from the previous year.[82] By 2007, more than 100 mortgage companies either had shut down their subprime mortgage units, suspended company operations, or closed entirely.[83]

In 2008, following the 2007 collapse of its two hedge funds, Bear Stearns saw its customers and counterparties losing faith in its strength; by March 13 its liquidity was plummeting.[84] In the end, the New York Federal Reserve Bank took over the management of Bear Stearns'

72. *See* ACHARYA ET AL., *supra* note 16, at 5.
73. *See* Levitin & Wachter, *supra* note 57, at 245.
74. *Id.*
75. *See* MCDONALD, *supra* note 40, at 265.
76. *Id.*
77. *Id.* at 283.
78. *Id.*
79. *Id.*
80. *Id.* at 291.
81. *Id.* at 284.
82. *Id.*
83. *Id.*
84. *Id.* at 292.

mortgage-related securities, other assets, and hedge funds, which JP Morgan helped subordinate, and JP Morgan announced a deal to buy Bear Stearns.[85] "By 2008, the combined GSE market share [had risen] to 72.6% of all mortgage originations," an increase in market share of 18 percent from 2007.[86] However, "[t]he net income losses for the [Fannie and Freddie] were $108.8 [billion] by the end of th[at] [same] year."[87]

In April 2008, the Office of Federal Housing Enterprise Oversight (OFHEO) released its annual report to Congress, which stated unequivocally that it had "significant supervisory concerns" regarding the GSEs.[88] Freddie Mac's risks included deterioration as a result of its previous two years of buying and guaranteeing high-risk loans. Fannie Mae's risks centered on interest rate risks that existed as a result of failing to hedge its portfolio investments.[89] By July, the GSEs' stocks were falling dramatically, especially because of concerns that they were undercapitalized.[90] In response, Congress enacted the Housing Economic Recovery Act (HERA) on July 30.[91] It included proposals for "explicit government backing" of the GSEs and abolished OFHEO.[92] It also "created a single housing regulator, the Federal Housing Finance Agency" (FHFA).[93] Despite the enactment of HERA and the subsequent Hope for Homeowners Act, the GSEs continued to report record losses and their shares continued to drop in value.[94]

2. Conservatorship

On September 7, 2008, the director of the FHFA announced that Fannie Mae and Freddie Mac would be placed into a conservatorship run by the FHFA.[95] Conservatorship was one of the options provided by HERA.[96] Then Treasury Secretary Henry Paulson announced his support for the measure, stating that "[c]onservatorship was the only form in which I would commit taxpayer money to the GSEs."[97] Federal Reserve Bank

85. *Id.*
86. *Id.* at 293.
87. *Id.*
88. *Id.* at 295.
89. *Id.*
90. *Id.* at 296–97.
91. Pub. L. No. 110-289, 122 Stat. 2654 (2008) (to be codified at scattered sections of 12, 15, 26, 37, 38, and 42 U.S.C.).
92. McDonald, *supra* note 40, at 298–99.
93. *Id.* at 299.
94. *Id.* at 302.
95. Neil Irwin & Zachary Goldfard, *U.S. Seizes Control of Mortgage Giants*, Wash. Post, Sept. 8, 2007, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2008/09/07/AR2008090700259.html.
96. *See* McDonald, *supra* note 40, at 303.
97. U.S. Dep't of Treasury, Press Release, Statement by Secretary Henry M. Paulson, Jr. on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers, Sept. 7, 2007.

Chairman Bernanke also supported the measure.[98] "[T]he FHFA took control of the GSEs, and as such, the powers of the Board of Directors, officers and shareholders."[99] As a result, "both Chief Executives were removed from office," and FHFA was given "the power to cancel certain contracts." This was done in order to, first, preserve the assets currently held by the GSEs and, second, return the GSEs to sound financial condition so that the conservatorship could be concluded.[100]

One of the FHFA's first moves as conservator was to temporarily increase the GSEs' portfolio limits to $850 billion with the goal of decreasing the portfolios by at least 10 percent annually.[101] Although the FHFA's senior preferred stock agreement did not enumerate the process by which the GSEs were to reduce their portfolio assets 10 percent annually, this would require the sale of any mortgage-backed securities held by the GSEs over the allotted percentage by December 31 of each subsequent year.[102] In August 2010, the Congressional Budget Office (CBO) "project[ed] that an additional $65 billion [could] be required to keep them afloat until 2019 . . . [and] estimated that the total taxpayer losses might ultimately reach the neighborhood of an astounding $350 billion."[103] "Between November 2008 and the end of March 2011, the government made net payments to the GSEs of $130 [billion]," and "[a]dditional cash payments are expected for several years to come."[104] The CBO reported that "[t]he cost of . . . supporting Fannie Mae and Freddie Mac . . . ha[s] led to . . . a wide range of proposals" for what the federal role should be in the residential housing market in the future. However, Fannie Mae and Freddie Mac were completely excluded from the Dodd-Frank Wall Street Reform and Protection Act in 2010.[105]

Even though Fannie Mae and Freddie Mac began posting record profits in 2013, these profits came at the cost of $187.5 billion in taxpayer aid since they were placed under conservatorship in 2008.[106] The conservatorship was

98. Federal Reserve System, Press Release, Statement by Federal Reserve Board Chairman Ben S. Bernanke, Sept. 7, 2007.

99. *Id.*

100. *See* McDonald, *supra* note 40, at 303.

101. U.S. Department of the Treasury, Federal National Mortgage Association, Federal National Mortgage Association, Amended and Restated Senior Preferred Stock Purchase Agreement, Sept. 26, 2008, http://www.fhfa.gov/Conservatorship/Documents/Senior-Preferred-Stock-Agree/2008-9-26_SPSPA_FannieMae_RestatedAgreement_N508.pdf (accessed June 11, 2014).

102. *Id.*

103. *See* Acharya et al., *supra* note 16, at 4.

104. *See* McDonald, *supra* note 40, at 318.

105. *Id.* at 319.

106. Cheyenne Hopkins, *House Committee Approves Hansarling's Housing-Finance Bill*, Bloomberg, July 24, 2013, http://www.bloomberg.com/news/2013-07-24/house-committee-approves-hensarling-s-housing-finance-overhaul.html.

never meant to be a permanent solution, and so the question remains: what is the "sweet spot" for the federal government in residential mortgage finance?

III. The "Sweet Spot" or the Ideal Mortgage Market

While some have proposed removing the federal government from the mortgage market entirely, most proposals accept that some federal oversight is necessary. In order to determine what the "sweet spot" for the federal government would be, this part focuses on three elements: (1) the mortgage product, (2) the secondary mortgage market, and (3) mortgage insurance.

A. The Mortgage Product

The ideal mortgage market may provide a variety of products in order to serve as many households as possible, but the focus should be on the ideal mortgage product. The ideal mortgage product includes three factors: (1) fixed rates, (2) the absence of a prepayment penalty, and (3) a standard loan product.

1. Fixed-Rate Mortgages

As described in Part II, the fixed-rate mortgage is a staple of the American housing industry and as such is often called the American mortgage. A fixed-rate mortgage (FRM) is "a mortgage with payments that remain the same throughout the life of the loan because the interest rate and other terms are fixed and do not change."[107] "[I]f interest rates increase during the term of a[n] [FRM], the lender is worse off (the lender is earning less than the current opportunity costs), while the borrower is better off (the borrower is paying less than the current opportunity costs). For a FRM, the extent of the interest rate risk increases with the term of the loan."[108] The FRM benefits the borrower because its terms are clear; unlike an adjustable-rate mortgage (ARM), the terms that the borrower agrees to at the outset remain constant. The lender and any investors take more risk because a shift in the interest rates over thirty years can change the value of the investment in that mortgage, but this makes sense—the investor seeks more reward and should therefore receive more risk.

2. No Prepayment Penalties

Although originally prohibited by regulation, prepayment penalties were common in many subprime mortgages.[109] A prepayment penalty

107. U.S. Department of Housing and Urban Development Glossary of Terms, *available at* http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/sfh/buying/glossary.

108. Lawrence J. White, *The Way Forward: Residential Mortgage Finance in a Post-GSE World* 3 (Mercatus Ctr., Working Paper No. 11-10, 2011).

109. Daniel Indiviglio, *Should We Ban Prepayment Penalties*, ATLANTIC, June 17, 2009, http://www.theatlantic.com/business/archive/2009/06/should-we-ban-prepayment-penalties/19560/.

is "a provision in some loans that charge a fee to a borrower who pays off a loan before it is due."[110] As described in Part II, subprime lenders used teaser rates to encourage borrowers to take out mortgages.[111] The prepayment penalty was a significant part of this transaction because inevitably subprime lenders raised the interest rates on the adjustable rate subprime mortgages. Because of the prepayment penalty, borrowers were unable to renegotiate their loans without paying a sizeable fee.[112] Prepayment penalties shift risk from the investor back to the borrower, removing risk for the (likely) more sophisticated party and placing it onto the (likely) less sophisticated party. The threat of a prepayment penalty can dissuade a borrower from immediately paying off a loan despite high interest rates, which down the road cost the borrower more money and may lead to eventual default. The ideal mortgage market does not utilize tools such as the prepayment penalty because in the ideal market, consumers would not enter into a mortgage without understanding the terms of the mortgage product, including the applicable interest rate. Instead they would be educated to reduce the chance of future default or foreclosure.

3. Standard Loan Product

Historically, the GSEs did not buy loans unless they fit within set standards, which resulted in the concept of the conforming loan product. This product, in addition to the thirty-year fixed-rate mortgage, required a 20 percent down payment and was self-amortizing.[113] Both elements are necessary for the ideal mortgage product. First, while a 20 percent down payment is not an absolute necessity, a significant down payment is an important indicator of the borrower's ability to afford the loan over the long term. The size of the down payment can be reduced where there is supplementary mortgage insurance. However, in the absence of supplementary mortgage insurance, the down payment reduces the possible risk on any given mortgage. This is important for ensuring the stability of both the ideal mortgage product and the ideal mortgage market as a whole. Second, self-amortization occurs when "monthly payments are large enough to pay the interest and reduce the principal on [a] mortgage."[114] By requiring self-amortization, the ideal mortgage product would prevent the occurrence of negative amortization, which "occurs when the monthly payments do not cover all of the interest cost[s]." Negative amortization leaves borrowers in an increasingly worse situation, potentially leading to default and foreclosure.[115]

110. *See* Glossary, *supra* note 107.

111. *See* Levitin & Wachter, *supra* note 3, at 1166.

112. See Indiviglio, *supra* note 109, for a more detailed analysis of prepayment penalties in subprime mortgages.

113. *See* Ellen et al., *supra* note 30, at 13.

114. *See* Glossary, *supra* note 107.

115. *Id.*

Additionally, the standard fixed-rate product should have a due-on-encumbrance clause. A due-on-encumbrance clause is necessary to ensure that senior liens maintain their value. Due-on-encumbrance clauses exist where a senior lienor holds an undivided interest and does not want to continue to hold this interest if other interests vest in that property. By using a due-on-encumbrance clause, the senior lienor has complete control over whether other interests can vest because they can chose to accelerate the lien that they originated as a penalty if the property holder encumbers (takes another lien) on the property without permission. Additionally, the senior lienor has control with regards to an existing junior lienor because where there is a due-on-encumbrance clause, a junior lienor cannot further leverage the subject of an existing mortgage without first gaining the permission of the senior lienor.[116] This is necessary in the ideal mortgage market because it increases transparency and prevents the false impression of value in any mortgage product.

Finally, the ideal mortgage product would include a conforming loan limit above which the GSEs would not securitize. Proposals have encouraged reducing the current conforming loan limit by at least 10 percent a year for the next three to five years.[117] Noncomforming mortgages that fall outside of the strict underwriting guidelines would be left to private firms.

B. The Secondary Mortgage Market

An efficient and stable secondary mortgage market is an essential part of the ideal mortgage market because its purpose "is to ensure a deep and broad market for mortgage-backed securities."[118] One way that the secondary mortgage market helps provide for a broad mortgage market is by encouraging higher debt liquidity, which "helps ensure a reliable and consistent source of capital," reduces regional rate variation, improves regional availability for the same mortgage products, and "results in better pricing of securities [which] ultimately [creates] lower mortgage rates for borrowers."[119] In addition to ensuring the existence of a reliable and consistent source of capital, the secondary mortgage market is necessary to protect consumers and provide credit to underserved markets.[120]

116. *Id.*

117. *See* White, *supra* note 108, at 9.

118. Ingrid Gould Ellen & Mark A. Willis, *Improving U.S. Housing Finance Through Reform of Fannie Mae and Freddie Mac: A Framework for Evaluating Alternatives*, *in* THE AMERICAN MORTGAGE SYSTEM, 305, 306 (Susan W. Wachter & Marvin Smith eds., 2011).

119. *Id.*

120. *Id.* at 306–07.

1. Consumer Protection

The secondary mortgage market can be a tool for the protection of consumers where it ensures the "availability of safe products that are well-priced and clearly understood by borrowers."[121] The secondary mortgage market can do this by developing standards for the mortgages sold within its markets. This effort includes creating a standard loan document as well as a system or platform for regulating mortgages. Regulation must include the quality of the industry's servicing of mortgage loans and the rating of its securities.[122] Toward this end, the government should implement requirements regarding the treatment of senior liens as well as the general regulation of reporting standards for key industry actors. Additionally, originators and securitizers should be required to retain a certain percentage of the security's risk when it is sold.[123]

In addition to improving the policing of mortgage loans, the ideal mortgage market should require better capital rules. Capital rules provide for the accounting of existing capital and for cushions and incentives to control risk.[124] Fannie Mae and Freddie Mac's capital rules prior to the crisis required "tests that simulated company performance under stressful conditions and required that enough capital be held to survive them and a minimum capital requirement that applied even if they passed the stress tests."[125] Unfortunately, stress tests and minimum requirements work only if the institutions implementing them properly record information. If accurate information is not properly recorded, stress tests cannot accurately predict how GSEs will perform in downward economic environments. Further, inaccurate information skews the minimum requirements such that they cannot properly protect the institutions, and they will not be able to assure that the GSEs have enough capital to weather fiscal upheaval. In order to ensure sufficient liquidity, the market needs to set up incentives so that all institutions engaged in the mortgage market, including lenders and investors, minimize distortions to resource allocation.[126] By combining improved communication channels and reporting mechanisms, stress tests, and minimum capital requirements,

121. *Id.*

122. *Id.* at 313.

123. Dep't of the Treasury, U.S. Dep't of Hous. & Urban Dev., Reforming America's Housing Finance Market: A Report to Congress 20 (2011), *available at* http://www.treasury.gov/initiatives/documents/reforming%20america's%20housing%20finance%20market.pdf.

124. *See* Van Order, *supra* note 54, at 351.

125. *Id. Returning Private Capital to Mortgage Markets: A Fundamental for Housing Finance Reform: Hearing Before the S. Comm. on Banking, Hous., & Urban Affairs, Subcomm. on Securities, Insurance & Investments* 9 (May 14, 2013) (testimony of Robert Van Order), http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=534eeb05-8174-48e3-952c-a59106baa3f5.

126. Van Order, *supra* note 54, at 354.

the ideal mortgage market would achieve a level of transparency not previously seen.

2. Underserved Markets

The secondary mortgage market can be significant for underserved markets by helping to secure appropriate products and resources for both single-family and multifamily mortgages where they would otherwise be unavailable.[127] Government support is necessary when the private market actors in the secondary mortgage market fail to serve the needs of portions of the market such as rural areas, lower-income households, small rental properties, and manufactured housing properties.[128] "The government should continue to provide direct loan or loan guarantee/ insurance for certain underserved borrowers and communities through the FHA, VA, and USDA."[129] One way this can be done is by increasing affordable rental options for low-income households,[130] notably "by expanding FHA's capacity to support" lending to the multifamily market, which includes properties such as apartment complexes.[131] This could benefit underserved low-income households because these households often reside in multifamily market properties. If the FHA increased its support for such properties, low income families might be able to live in higher quality multifamily market properties instead of finding government support only available for free-standing houses, where the financially responsibility is greater.[132]

Another way the government can continue to provide support is by implementing a risk sharing program with private lenders.[133] Potential risk sharing programs are described in more detail below, but generally these programs provide a government guarantee for loss beyond a certain point. This government guarantee could encourage private actors to engage in underserved markets. Another important resource is housing counseling: instead of enabling a first-time homeowner to finance a

127. *See* Ellen & Willis, *supra* note 118, at 307.

128. Chris Estes, NHC Recommendations to the Senate Committee on Banking on Mortgage Finance Reform, 113th Cong. (2013), *available at* http://www.nhc.org/media/files/NHC_Senate_Banking_mortgage_finance.pdf.

129. White House Fact Sheet, *available at* http://www.whitehouse.gov/the-press-office/2013/08/05/fact-sheet-better-bargain-middle-class-housing.

130. Reforming America's Housing Finance Market, *supra* note 123.

131. Estes, *supra* note 128, at 4 ("The Fannie Mae and Freddie Mac multifamily businesses are proven and profitable, and they remained so even during the crisis. Both businesses have delinquency rates consistently under 1 percent, compared to 12.15 percent delinquency for commercial mortgage backed securities in 2010 and 9.65 percent in 2012.").

132. FHFA, The 2014 Strategic Plan for the Conservatorship of Fannie Mae and Freddie Mac 11 (May 13, 2014), http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2014StrategicPlan05132014Final.pdf (accessed June 12, 2014).

133. *Id.*

house with no guidance, education must be at the center of the ideal mortgage market.[134]

C. Mortgage Insurance

Guarantees that encourage investment in the housing market by protecting investors against losses are essential for the ideal mortgage market. Guarantees should include both insurance like those provided by the FHA and guarantees like those provided by the VA. They should additionally include a mix of both public and private action. Ultimately, the goal is to create a mortgage market that simultaneously provides liquidity and stability so that taxpayer risk is minimized.[135]

1. Explicit Guarantee

Guarantees are certainly a challenge because the introduction of a guarantee invites the problem of moral hazard. Moral hazard exists where a party feels emboldened to take risks without suffering the consequences of its actions. In terms of a mortgage market, moral hazard comes into play when investors believe that they will not be responsible for the costs of their risky investments. Consequently, the guarantee must be limited in a way that encourages investment without courting risk. One way this may be done is through guaranteeing only mortgages that meet certain stringent requirements with regards to principal and interest.[136] Additionally, this guarantee should be explicit. Government guarantees within housing finance systems are either explicit or implicit, but explicit guarantees are preferable because they can be more "well-structured and priced" than implicit guarantees.[137] The transformation of the government guarantee from implicit to explicit will have an immediate impact on the federal balance sheet liabilities. However, this increase in publicly disclosed liability will be ameliorated by the possible resulting benefit: the publication of guarantees on the federal balance sheets would enable the government to require insured parties to pay guarantee fees, which would help reduce the impact of insurance on the federal budget.[138] It would also create a limit on government liability. Where the government guarantee is implicit, investors expect unlimited government support in crisis, but where the guarantee is explicit, investors are on notice of what support they can expect to receive. Such understanding can only benefit the ideal mortgage market.

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134. *See* Estes, *supra* note 128.

135. *See* Ellen & Willis, *supra* note 118, at 308.

136. *Id.* at 309.

137. *Housing Finance Reform: Should There Be a Government Guarantee?: Hearing Before the S. Comm. on Banking, Hous., & Urban Affairs* 1 (Sept. 13, 2011) (testimony of Adam J. Levitin), http://www.creditslips.org/files/levitin-senate-banking-testimony-9_13_11.pdf.

138. *See* Ellen & Willis, *supra* note 118, at 312.

2. Direct Market Securitization

An ideal insurance provision would include not only a very limited guarantee, but it would also require first-loss coverage to minimize the chances that the above-mentioned guarantee would be called into play.[139] "First-loss" is the position that absorbs the initial losses that occur due to default. This restructuring of liability should come in the form of requiring private actors to take the first loss up to a greater percentage of the loan amount.[140] This restructuring is essential because the 2008 recession arguably could have avoided if the GSEs had required a first-loss buffer of 10 percent.[141] By requiring private actors to take the first loss, the moral hazard associated with a government guarantee would be reduced, and private actors would more diligently pursue a stable product that in turn would help maintain the ideal stabilized mortgage market.

IV. The Necessary Steps for Optimal Residential Mortgage Finance Reform

A. Choosing the Proper Restructuring Proposal

Having dealt with defining the parameters of the ideal mortgage market, we must now determine what steps are necessary in order for mortgage finance reform to become a trajectory toward that ideal market. Proponents have raised four potential restructuring options: (1) return Fannie Mae and Freddie Mac to their stockholders with little to no change in their congressional charters; (2) eliminate Fannie and Freddie's GSE status and convert them into private corporations; (3) eliminate Fannie and Freddie's GSE status and convert them into one or more new government agencies; or (4) make supplementary changes to the existing structures of the GSEs in order to support the secondary mortgage market. The viability of these proposals is discussed below.

1. Proposals that would return the GSEs to their shareholders are not viable.

Proposals to return the GSEs to their shareholders are not viable because shareholder management has historically failed to produce stable regulation of the GSEs. In a Congressional Research Service (CRS) report, N. Eric Weiss, a specialist in financial economics, examined the options for the GSEs along with the future government role in residential mortgage markets.[142] One of the options he examines is returning control to GSE

139. *Id.* at 311.

140. *Id.* at 308.

141. Michael Ide, *Fannie Mae, Freddie Mac: Johnson-Crapo First Loss Provision Analysis*, ValueWalk (Mar. 24, 2014), http://www.valuewalk.com/2014/03/fannie-mae-freddie-mac-johnson-crapo-first-loss-provision.

142. Weiss, *supra* note 9.

shareholders.[143] In this scenario, according to Weiss, the GSEs would continue to be shareholder-owned companies with special charters and special obligations to the housing market.[144] The GSEs would have to decide whether to retire the senior preferred stock held by the federal government as the result of the 2008 crisis and conservatorship; implicit in this option is the assumption that the GSEs would return to profitability. The option of returning GSE control to their shareholders is supported by arguments that the GSEs have returned to profitability under the conservatorship and have improved efficiency and consumer choice in the market.[145] However, while many proposals support converting the GSEs into private entities, there seem to be no actual proposals from Congress or in the academic literature that advocate returning the GSEs to existing shareholders. This seems to suggest that there are no readily conceivable strategies for ensuring a positive outcome, especially given the immense failure the GSEs experienced in 2008 while under shareholder control.

Conversely, several arguments—focusing primarily on historical failures in shareholder management—have been made in opposition to returning the GSEs to shareholder control. First, the GSEs' history demonstrates substantial "previous financial and management problems," occurring as early as 1982.[146] Second, more recent history, including the government bailout and conservatorship, has demonstrated that shareholder management is inherently flawed.[147] This inherent flaw exists because the very nature of the GSEs suggests that governmental protection will always underlie the shareholder management's decisions. The 2008 crisis exposed this flaw by demonstrating that the GSEs were "too big to fail."[148] As a result, if the GSEs are returned to their shareholders, investors and shareholders will continue to engage in riskier behavior than they would if they felt responsible for financial failure.[149] There might be more cause to support shareholder management if the 2008 collapse was the first time that the GSEs faced serious problems as a result of mismanagement, but, as Weiss points out, Fannie Mae and Freddie Mac in the early 2000s signed consent agreements with OFHEO and the SEC; paid fines of $400 million and $125 million, respectively; and replaced their management as the result of significant financial and management problems.[150] Furthermore, attracting new common shareholders may be

143. *Id.* at 8.
144. *Id.*
145. *Id.* at 8–9.
146. *Id.* at 10 ("[T]he government intervened after Congress passed the Miscellaneous Revenue Act of 1982, which provided some tax benefits for Fannie Mae.").
147. *Id.*
148. *Id.* at 10, 13.
149. *Id.* at 10.
150. *Id.*

difficult given the treatment of past common shareholders during the government bailout and conservatorship.[151] Finally, nothing suggests that standardization of the mortgage finance system cannot be done without the GSEs. As a result, the likely risks present in any shareholder ownership scenario suggest that returning ownership of the GSEs to its existing shareholders is not viable.

2. Proposals that would convert the GSEs into private entities are not viable.

Proposals that support converting the GSEs into private entities are not viable for similar reasons to those that support returning the GSEs to their shareholders. First, the history of the GSEs demonstrates that the increase in private market actors combined with the decrease in government regulations heightens the potential for economic instability in the market.[152] Second, even where it is made explicitly clear that no government guarantee exists to protect against risky investments, moral hazard can become a serious problem where there are few dominant actors in the market. Such was the case in the 2008 financial crisis, where the government bailed out Fannie Mae and Freddie Mac, as well as numerous PLS mortgages, even in the absence of a government guarantee.[153] This bailout created, or continued, the impression that the housing market in general is "too big to fail."[154]

While proposals for the privatization of the housing market are not viable, several are worth discussing, including H.R. 2767, Protecting American Taxpayers and Homeowners Act of 2013 (PATH Act); and proposals by Peter Wallinson, Arnold King, Michael Lea, and Anthony B. Sanders of the Mercatus Center at George Mason University.

Starting with the one of the more publicized proposals, the PATH Act details a proposed wind-down of Fannie Mae and Freddie Mac that would limit their authority as well as require risk sharing of at least 10 percent of the annual business of each GSE by private market participants.[155] The PATH Act considers acceptable "risk sharing transactions" to include "increased mortgage insurance requirements, credit-linked notes and securities, senior and subordinated security structures, and such other structures and transactions."[156] Title III, the National Mortgage Market Utility Act, would require the FHFA director to issue a charter for a National Mortgage Market Utility within two years of enactment of the PATH Act.[157] This Utility would be operated as a not-for-profit entity and

151. *Id.*
152. *See* Van Order, *supra* note 54, at 349.
153. *See* WEISS, *supra* note 9, at 1.
154. *Id.* at 13.
155. H.R. 2767, 113th Cong. § 103–105 (2013).
156. *Id.*
157. *Id.*

the operator would be determined through an application process, whereby the recipient demonstrates competence and experience.[158] The Utility would develop standards for residential mortgages but would not be "guaranteed, in whole or in part, by the United States [g]overnment."[159]

Another proposal, "A New Housing Finance System for the United States," suggests that the GSEs be wound down by reducing their conforming loan limit by 20 percent of the previous year's cap so that private securitization assumes the role of providing a secondary market.[160] Peter Wallinson, the proposal's author, suggests that as the GSEs incrementally withdraw from the markets, "private securitization will assume the role of providing a secondary market."[161] He foresees the final conclusion of the GSEs occurring through the auctioning off of Fannie Mae and Freddie Mac's intellectual property, systems, securitization platforms, goodwill, customer relationships, and organizational capital.[162]

In "The Future of Fannie Mae and Freddie Mac,"[163] Michael Lea and Anthony B. Sanders propose three approaches to unwinding the GSEs and reinserting the private mortgage market into a dominance role: "(1) covered bonds, (2) rebirth of the private-label MBS market, and (3) greater lender holding of whole mortgage loans."[164] Lea and Sanders predict two possible outcomes: "the mortgage markets will shrink because they are unable to attract new capital," or else "banks and other entities will expand to fill the gap left by" Fannie and Freddie. They find the latter outcome to be the most likely.[165]

While the proponents of each suggested privatization policy provide measured analysis and detailed processes, they are overwhelmed by the

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158. *Id.*

159. *Id.*

160. Peter J. Wallison, *A New Housing Finance System for the United States* 12 (Mercatus Center, Working Paper No. 11-08, 2011). Peter J. Wallison, Arthur F. Burns Fellow in Financial Policy Studies of the American Enterprise Institute, has served as general counsel of the U.S. Treasury Department, where he had a "significant role in the development of the Reagan administration's proposals for the deregulation of the financial services industry," http://www.aei.org/scholar/peter-j-wallison/.

161. *Id.*

162. *Id.*

163. Michael Lea & Anthony B. Sanders, *The Future of Fannie Mae and Freddie Mac* 4 (Mercatus Center, Working Paper No. 11-06, 2011). Dr. Michael Lea is a lecturer of finance, the former director of the Corky McMillin Center for Real Estate at San Diego State University, and the author of more than seventy-five articles and book chapters on housing and mortgage finance. Anthony B. Sanders is Distinguished Professor of Finance in the School of Management at George Mason University with expertise in investments, fixed-income, mortgages, housing economics, and real estate finance.

164. *Id.*

165. *Id.* at 7.

unavoidable fact that "fully private housing finance systems simply do not exist in the developed world."[166] Arnold Kling provides a more measured discussion of privatization proposals with his "devil you know" strategy and its comparison to his "Jimmy Stewart banker" strategy, which calls for the government to leave the mortgage guarantee business entirely.[167] Under this approach, the GSEs would be gradually phased out over five years, and local banks would be expected to revert to originating and holding mortgages.[168] King suggests, however, that phasing out the GSEs entirely is inferior to his "devil you know" strategy, which would reform the existing GSEs by incorporating both public and private actors, returning the GSEs to shareholder-owned status, and empowering the Treasury to oversee the GSEs' functions.[169] Additionally, instead of privatizing the GSEs completely, he calls for the continuation of key GSE risk management tools, including risk-based pricing, loss reserving, and capital policies.[170] Even if the government followed one of the above privatization proposals and the market became fully privatized, as long as a few dominant actors maintain a majority of the market share, investors will perceive the housing market as protected. As a result, privatization of the housing market will not prevent risky investments, nor will it prevent future government expenditures.

3. The best proposals include those that would convert the GSEs into one or more new government agencies, make supplementary changes to the existing structure of the GSEs, or both.

The most viable reform proposals are those that would convert the GSEs into new entities or make supplementary changes to the existing GSEs. An approach that incorporates both public and private actors would be superior to complete removal of the government's role, which would unnecessarily discard the resources that exist as a result of the government's experience with the GSEs.[171] These include the thirty-year fixed-rate mortgage, risk management, and interest rate tools, as well as the GSEs' stress-tested regulatory model.[172] An entirely new model might seem ideal, but its failures and holes cannot be recognized until tested by the market. Conversely, the GSEs' present regulatory model has already demonstrated its failings and problem areas, giving regulators

166. Levitin Testimony, *supra* note 137.

167. Arnold Kling, *Two Approaches to GSE Reform* 2 (Mercatus Center, Working Paper No. 11-07, 2011). Arnold Kling is a Mercatus Center–affiliated senior scholar at George Mason University and a member of the Financial Markets Working Group.

168. *Id.* at 8–9.

169. *Id.* at 2, 5.

170. *Id.*

171. *Id.*

172. *Id.*

a clear picture of what changes are needed. The past failures of the GSEs occurred as the result of political priorities that did not align with the regulation procedures in place. By ensuring that the GSEs' priorities coincide with rather than conflict with their regulations, institutional failure should not be an issue moving forward.[173] Thus, the most viable reform proposals are those that would utilize the resources that the GSEs have accrued to convert the GSEs into new entities or make supplementary changes to the existing GSEs, including better accountability measures and controls.

B. Implementing Reform

1. Generally

Restructuring efforts would need to encompass not only Fannie Mae and Freddie Mac, but also Ginnie Mae and FHA. Fannie Mae and Freddie Mac as they currently exist should be wound down. "FHA should [be] return[ed] to its pre-crisis role as a targeted provider of mortgage credit access for low- and moderate-income Americans and first-time homebuyers," and Ginnie Mae could be expanded to help support FHA's role as a targeted provider.[174] By re-implementing a lower conforming loan limit for FHA insurance, more expensive home mortgages would return to being funded by the private market, and the GSEs would be able to refocus on the populations they were designed to serve.[175] Additional changes would include creating programs for downpayment assistance and counseling for low- and moderate-income homebuyers, which would be paid for initially by the Treasury or the FHFA but ultimately by GSE profits.[176]

2. Changes in Securitization

Several aspects of securitization need to be changed. First, the federal guarantee needs to be overhauled by implementing an explicit guarantee rather than allowing government oversight to imply a guarantee for investments. By issuing an explicit guarantee, the federal government would incorporate a new level of accountability because the guarantee would be reflected on the budget sheet.[177] Government guarantees help promote stability by preventing banking panics and credit bubbles.[178] Additionally, an explicit guarantee would be a service that a government entity can price, whereas the implicit guarantee could not be calculated, especially if the government ends up guaranteeing losses.[179] Additionally,

173. *Id.* at 5.
174. Reforming America's Housing Finance Market, *supra* note 123.
175. *Id.*
176. *Id.* at 23.
177. *See* Acharya et al., *supra* note 16, at 7.
178. David Min, *How Government Guarantees Promote Housing Finance Stability*, 50 Harv. J. On Legis. 437, 444 (2013).
179. *See* Ellen et al., *supra* note 30, at 312.

the government could require investors to pay guarantee fees in exchange for the service. This explicit guarantee could be a limited guarantee that increases during credit downturns or that guarantees a certain ratio of the mortgage together with a private insurance partner.[180] In 2013, the FHFA required each GSE to transfer a portion of its credit risk to private actors, but the GSEs still retained the catastrophic risk for all mortgages funded.[181] In exchange for this risk position, a guarantee fee was charged. Thus, the use of an explicit guarantee and guarantee fees has already served to increase the private market's role in the market while simultaneously helping to wind down Fannie Mae and Freddie Mac's role.[182]

Second, securitization should be regulated through a single government-sponsored securitization platform rather than through multiple competing platforms.[183] Securitization platforms make up the infrastructure for the secondary market. Federal and private actors have competing securitization platforms where different credit standards are required for conforming mortgages.[184] The FHFA issued a white paper on February 21, 2012, detailing its strategic plan for the conservatorship of the GSEs; the first item was to maintain a government-sponsored platform.[185] The FHFA's 2014 update on this government-sponsored platform, the Common Securitization Platform, lays out five features that the platform will exhibit: (1) data validation, (2) issuance support, (3) disclosure, (4) master servicing operations, and (5) bond administration.[186] The FHFA's ultimate goal is for each of these modules to be used by all GSEs servicing mortgages and for the platform to "be adaptable for use by [all private] market participants in the future."[187] In order for the FHFA to successfully integrate such a platform, however, the agency must develop parameters for a single common security—something Fannie Mae and Freddie Mac have previously been unable to do.[188]

Both the Senate and the House have proposed government-sponsored platforms. The PATH Act proposes a "securitization infrastructure platform" that would be operated by a chartered utility,[189] as well as a

180. *See* White, *supra* note 108, at 9–10.

181. *See* The 2014 Strategic Plan for the Conservatorship of Fannie Mae and Freddie Mac, *supra* note 132, at 12.

182. Reforming America's Housing Finance Market, *supra* note 123, at 12–13.

183. Fed. Housing Finance Agency, A Progress Report on the Common Securitization Infrastructure (2013), *available at* http://www.fhfa.gov/PolicyProgramsResearch/Policy/Documents/WhitePaperProgressReport43013.pdf.

184. *See* The 2014 Strategic Plan for the Conservatorship of Fannie Mae and Freddie Mac, *supra* note 132.

185. *Id.*

186. *Id.* at 17.

187. *Id.*

188. *Id.*

189. H.R. 2767, 113th Cong. § 311–313 (2013).

repository for registration and use of "mortgage-related documents."[190] "Mortgage-related documents" would include all documents associated with a qualified mortgage security, including standard form mortgage agreements, disclosures, pooling and servicing agreements, representations and warranties, indemnification and remedies, and servicing reporting documents.[191] While the repository is likely too ambitious and opens the door to security breaches, a securitization platform is necessary. The Senate proposal, S. 1217, the Housing Finance Reform and Taxpayer Protection Act of 2013, calls for a "corporation" that would oversee the approval of private mortgage insurers, servicers, and issuers, as well as for an updated list detailing those approved.[192] Currently, the GSEs approve the mortgage product based on its conformation to a set of promulgated standards, but the Senate proposal would go further by creating an additional hurdle for all actors interested in becoming secondary market participants.[193] Further, the proposal would establish a mutual securitization company under the FMIC to develop, securitize, sell, and otherwise meet the issuing needs of the market, including credit unions, community and mid-sized banks, and non-depository mortgage originators.[194] This would not remove private firms, but they would be subject to the oversight of the corporation.[195] Finally, the Senate proposal would create a uniform mortgage "database for the collection, public use, and dissemination of uniform loan level information on eligible mortgages."[196] The Senate's database proposal has similar terms to the FHFA's framework, which the FHFA plans to put into place "with appropriate timing." Such a securitization platform would help to greatly streamline the mortgage finance process, as well encourage the cooperation of public and private actors in the secondary mortgage market.

Third, securitization needs to be improved with regards to the treatment of lien priority, which is of utmost importance. Both of the securitization platforms under the House and Senate proposals would ensure an improvement in the treatment of lien priority. Additionally, requiring a due-on-encumbrance clause as suggested in Part II would improve the treatment of lien priority because it would bar junior lienors from accepting a mortgage without the senior lienor's approval.[197]

Fourth, securitization needs to include a greater amount of risk sharing with private market actors. The Senate proposal would require banks to hold capital of 10 percent of the principal of the underlying securities to

190. H.R. 2767, 113th Cong. § 312 (2013).
191. H.R. 2767, 113th Cong. § 322 (2013).
192. S. 1217, 113th Cong., Title II (2013).
193. S. 1217, 113th Cong. § 215 (2013).
194. S. 1217, 113th Cong. § 215 (2013).
195. S. 1217, 113th Cong. Title II, Subtitle B (2013).
196. S. 1217, 113th Cong. § 224 (2013).
197. *See* Glossary, *supra* note 107.

cover any first loss on the loans.[198] Additionally, Title II of the Senate proposal would require each "mortgage-backed security issued through FMIC [to] have a private investor bearing the first risk of loss and holding at least 10 cents in equity capital for each dollar of risk."[199] Increasing the amount of risk-taking held by the private market would reduce the implicit government guarantee because private actors would be on notice that they bear the first risk of loss. As a result, there would be a greater degree of stability because all actors would have skin in the game and act accordingly.[200] Putting private market capital ahead of the explicit guarantees provided by the GSEs would encourage greater private market participation and responsibility.[201]

Finally, securitization should incorporate catastrophic reinsurance to better stabilize the housing finance market in the long run. Catastrophic reinsurance is a form of reinsurance that indemnifies the acquirer for losses over a certain amount that arise from a single catastrophic event or series of events.[202] Typically, catastrophic reinsurance is implemented to protect against loss caused by natural disaster, but the government has previously utilized catastrophic reinsurance in the Terrorism Risk Insurance Act of 2002.[203] The Act established the Terrorism Risk Insurance Program (TRIA) under which the federal government is empowered to cover losses, once private insurers pay out a set minimum, that occur as a result of acts of terrorism.[204] Here, the government could expand the notion of catastrophic reinsurance to cover dramatic economic downturns; comparable to TRIA, it would not engage until and unless losses exceeded a certain limit.[205] This would make the government guarantee even more explicit and would earmark a role for the federal government in times of economic upheaval.

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198. S. 1217, 113th Cong. (2013).

199. S. 1217, 113th Cong., Title II (2013). James Hamilton, *Senators Warner and Corker Explain Their Mortgage Securitization Bill at Policy Forum*, JIM HAMILTON'S WORLD OF SECURITIES REGULATION (Sept. 22, 2013, 6:02 PM), http://jimhamilton blog.blogspot.com/2013_08_01_archive.html.

200. REFORMING AMERICA'S HOUSING FINANCE MARKET, *supra* note 123, at 12 (Increasing the private market role bearing credit risk will encourage private markets to become the primary source of mortgage credit and bear the burden for losses).

201. *Id.* at 13.

202. Risk and Insurance Management Glossary, http://www.irmi.com/on line/insurance-glossary/terms/c/catastrophe-reinsurance.aspx (accessed June 8, 2014).

203. *See* WEISS, *supra* note 9.

204. Property Casualty Insurers Association of America, *Study on Natural Catastrophes and Insurance,* Comments in Response to the Federal Insurance Office April 24, 2013, request, https://www.pciaa.net/web/sitehome.nsf/lcpublic/379/ $file/PCI_Comments_FIO_Nat_Cat_062413.pdf (accessed June 17, 2014).

205. *See* WEISS, *supra* note 9.

3. Collapse of Fannie Mae and Freddie Mac's Stock Holdings

Fannie Mae's and Freddie Mac's existing stock holdings and portfolio investments should be eliminated. As a result of the conservatorship, their stock ownership has already largely been wound down. In 2008, "[e]ach GSE gave [the] Treasury $1[] [billion] in senior preferred stock and warrants to acquire . . . 80% [of its common stock]."[206] The Treasury also agreed to buy senior preferred stock from the GSEs if their liabilities exceeded their assets.[207] By so doing, "the Treasury effectively destroyed" the value of GSE stocks held by common and preferred shareholders and consequently protected all debt holders instead.[208] Additionally, foreign central banks, including the Bank of China Ltd, which at the time had the largest holdings in the GSEs of China's four largest commercial banks, had already begun to reduce their GSE holdings.[209]

Despite the overall reduction in GSE stock ownership that resulted from Treasury and foreign actions, work remains to wind down the GSE's common shares. Fannie Mae's and Freddie Mac's delisted common shares were up about 500 percent as of July 2013; investors such as Perry Capital and Fairholme Fund bought the GSEs' old preferred stock.[210] However, the GSEs and the government reached an agreement in 2012 that any increase in their net worth would be used as dividends on taxpayer money invested in the GSEs.[211] Hedge fund managers have been lobbying Congress to pay attention to the interests of the junior preferred holders.[212] One proposed solution would be for the profits generated by the GSEs to be used as capital for Fannie and Freddie and for preferred shares to be converted into common stock with all senior and junior shares receiving greater allotments.[213] Such an arrangement however seems unlikely in the face of the taxpayer expenditures that helped save Fannie and Freddie.[214] Since the emergence of the PATH Act and the Senate Proposal, the GSEs' penny shares have begun to decrease once again.[215]

206. McDonald, *supra* note 40, at 304.

207. *Id.*

208. *Id.* at 306.

209. *Id.* at 305.

210. Jonathan R. Laing, *Fannie, Freddie: On Borrowed Time*, Barrons, June 29, 2013, http://online.barrons.com/article/SB50001424052748704755304578621870811760716.html#articleTabs_article%3D3.

211. *Id.* Both Perry Capital and Fairholme Fund have filed lawsuits seeking to overturn this agreement, contending that the agreement is an overreach of government power that takes potential returns to junior-preferred and common stock holders.

212. *Id.*

213. *Id.* at 1–2.

214. *Id.* at 4.

215. Nathan Vardi, *The Fannie and Freddie Penny Stock Boom Gets Crushed*, Forbes, June 26, 2013, http://www.forbes.com/sites/nathanvardi/2013/06/26/the-fannie-and-freddie-penny-stock-boom-gets-crushed/.

Collapsing Fannie and Freddie's stock ownership would require coordination with the Treasury, which owns senior preferred stock. This could be retired voluntarily, or as the GSEs have already agreed, profits could be used to pay back the inflow of taxpayer dollars over the past six years.[216] Likely, the conclusion of the GSEs' current stock ownership will include some combination of the two approaches.

In addition to the GSEs' stock ownership, the GSEs' portfolio investments must be wound down. Several proposals have suggested methods for doing so, but all include an incremental annual reduction.[217] The White House's proposal would reduce "Fannie Mae and Freddie Mac's investment portfolios by at least 15% per year[] [in order] to reduce Fannie Mae and Freddie Mac's holdings of risky mortgages and related securities to a manageable balance by 2018."[218] The PATH Act also calls for a *minimum* reduction of 15 percent annually.[219] In order to most effectively wind down the GSEs' holdings, one of the most immediately necessary steps is the enactment of a prohibition preventing the GSEs from making any more purchases.[220]

4. Replacement of the GSEs

Once the stock holdings of Fannie Mae and Freddie Mac are wound down, the federal government must deliberately wind down both institutions and find a new actor to take their place.[221] Because privatization not viable, the question becomes how to restructure the government's involvement so that it maximizes the chance of creating the ideal mortgage market. One potential way is to expand Ginnie Mae and the FHA to incorporate the remnants of Fannie Mae and Freddie Mac by adding a new "pool" within their functions. By creating a new pool, the "bad bank" aspects of Fannie and Freddie would not intermingle with the functioning aspects of FHA and Ginnie Mae.[222]

Another option for replacing Fannie Mae and Freddie Mac is to create an entirely new entity for non-FHA loans. S. 1217, discussed under Part IV.B.2, would replace Fannie Mae, Freddie Mac, and the Federal Housing Finance Agency (FHFA) with a modernized, streamlined Federal

216. Steven M. Dadioff & David Zaring, *Hedge Fund's Suit on Fannie and Freddie May Spell Trouble for U.S.*, N.Y. TIMES DEALBOOK, July 29, 2013, http://dealbook.nytimes.com/2013/07/29/hedge-funds-suit-on-fannie-and-freddie-may-spell-trouble-for-u-s/?_r=0.

217. *See* H.R. 2767, 113th Cong. (2013); S. 1217, 113th Cong. (2013); White House Fact Sheet, *available at* http://www.whitehouse.gov/the-press-office/2013/08/05/fact-sheet-better-bargain-middle-class-housing.

218. White House Fact Sheet, *supra* note 217.

219. H.R. 2767, 113th Cong. (2013).

220. *See* Ellen et al., *supra* note 30, at 327.

221. REFORMING AMERICA'S HOUSING FINANCE MARKET, *supra* note 123, at 12.

222. *See* Ellen & Willis, *supra* note 118, at 327.

Mortgage Insurance Corporation (FMIC), modeled partially after the FDIC.[223] GSE functions and utilities would be transferred to the FMIC. Additionally, the GSE's failed housing goals would be refocused to ensure the availability of "sufficiently decent housing."[224]

While lawmakers have considered the above-mentioned ideas for replacing Fannie Mae and Freddie Mac, the best option for the future of the GSEs would be to combine privatized actors with explicit government guarantees. This would combine a privatized system of housing finance with FHA, U.S. Department of Agriculture, and VA assistance for low- and moderate-income borrowers with the option for catastrophic reinsurance that includes a "mechanism [for the government guarantee] to scale up during times of crisis."[225] Basically, the government guarantee would only take a portion of the risk up front, but the catastrophic reinsurance would enable the government to step in if the private capital minimum requirements became insufficient to cover widespread losses resulting from economic upheaval.[226] FHA, USDA, and VA assistance for low- and moderate-income borrowers would provide a lower-cost access to mortgage credit than many of the proposals discussed above while at the same time the catastrophic reinsurance option would place the private market in the position of first loss.[227] By allowing the government guarantee to scale up during times of crisis, this option would help to soften contraction of the economy and keep the market more generally stable.[228] While this option provides operational challenges by requiring varying amounts of government involvement, the inclusion of FHA, USDA, and VA aid for low and moderate income borrowers rather than a very specific narrow subset of people creates less of a distance for the government role to travel in times of crisis.[229] This is doubly so because of the inclusion of catastrophic reinsurance, which would have already given the government a set crisis threshold beyond which it would intervene.

V. Conclusion

Privatization of the housing finance system may be ideologically appealing, but "fully private housing finance systems do not [work and do not] exist in the developed world."[230] The federal government must play a role in the housing finance market. With the proper balance between private and public market actors, the U.S. housing market can rebound and flourish. This balance requires a mortgage product with a

223. S. 1217, 113th Cong. (2013).
224. *Id.*
225. Reforming America's Housing Finance Market, *supra* note 123, at 28.
226. *Id.*
227. *Id.*
228. *Id.*
229. *Id.*
230. Levitin Testimony, *supra* note 137.

fixed-rate and no prepayment penalties; a secondary mortgage market that seeks to protect its consumers and serve the underserved; and mortgage insurance that makes both an explicit government guarantee and incorporates private market actors. By collapsing the existing Fannie Mae and Freddie Mae stock and enlarging the powers of FHA and Ginnie Mae to protect and serve low- to moderate-income homebuyers, the federal government can find its "sweet spot" in residential housing finance.

Resident Health and HUD's Choice Neighborhoods Initiative

Jonathan J. Sheffield, Jr.

In 2010, the Department of Housing and Urban Development (HUD) launched the Choice Neighborhoods Initiative (CNI), which provides funds for public housing authorities and other local organizations to redevelop distressed public and federally assisted housing in some of the nation's poorest neighborhoods.[1] CNI was in part designed to overcome the shortcomings of HUD's earlier HOPE VI[2] public housing redevelopment program.[3] CNI

1. *Choice Neighborhoods*, HUD.GOV, http://portal.hud.gov/hudportal/HUD?src=/program_offices/public_indian_housing/programs/ph/cn (last visited Mar. 11, 2014) [hereinafter HUD, *Choice Neighborhoods*].

2. HOPE VI was a public housing transformation program that was designed to "[c]hange the physical shape of public housing"; "[e]stablish . . . incentives for resident self-sufficiency and comprehensive services that empower residents"; reduce "concentrations of poverty by placing public housing in [low-]poverty [(opportunity)] neighborhoods"; "promote mixed-income communities"; "[f]org[e] partnerships with other agencies, local governments, nonprofit organizations, and private businesses to leverage support and resources" for public housing redevelopment projects. HOPE VI was created by the Departments of Veterans Affairs and Housing and Urban Development, and Independent Agencies Appropriations Act, 1993 (Pub.L. 102-389), approved on October 6, 1992. About HOPE VI, HUD.GOV, http://portal.hud.gov/hudportal/HUD?src=/program_offices/public_indian_housing/programs/ph/hope6/about (last visited Mar. 14, 2014). Funding was discontinued in 2010. *Id.*

3. *See* Philip Tegeler et al., *Affirmatively Furthering Fair Housing in HUD Housing Programs: A First Term Report Card*, J. AFFORDABLE HOUSING & COMMUNITY DEV. L., 27, 44 (2013) (noting HOPE VI's failure to provide one-for-one replacement of public housing units, guarantee families the right to return to their original community, and offer families the opportunity to move from HOPE VI redevelopment project areas to new, low-poverty, integrated neighborhoods). Former HUD Secretary Shaun Donovan described CNI as an effort to "expand on the legacy of HOPE VI by expanding the range of activities eligible for funding and capitalize on the full range of stakeholders we know are needed and want to be involved—from local governments and non-profits to private firms and public housing agencies." Shaun Donovan, Secretary, U.S. Dep't of Hous. & Urban Dev., Prepared Remarks at the Brookings Institution Metropolitan Policy Program's Discussion: From De-

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focuses to a large extent on improving access to education and employment for residents of distressed neighborhoods.[4]

While access to jobs and education is integral to neighborhood revitalization efforts,[5] the health of residents determines whether they are well enough to attend school or go to work.[6] Residents in low-income, low-opportunity, high-poverty, and high-crime neighborhoods[7] are more likely to be in poor health.[8] Diabetes and hypertension are widespread among a significant number of working-age residents of distressed public housing

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spair to Hope: Two HUD Secretaries on Urban Revitalization and Opportunity (July 14, 2009), *available at* http://www.hud.gov/news/speeches/2009-07-14.cfm [hereinafter Donovan Remarks]. Some commentators have described CNI as essentially a program that (1) uses HOPE VI funds on additional initiatives, such as early childhood education programs; and (2) employs additional criteria that "take into account '"green development and energy efficiency strategies.'" Georgette Chapman Phillips, *An Urban Slice of Apple Pie: Rethinking Homeownership in U.S. Cities*, 24 Notre Dame J.L. Ethics & Pub. Pol'y 187, 216 (2010).

4. *See* Donovan Remarks, *supra* note 3 (announcing one of CNI's goals is improvements to neighborhood assets and amenities, which include good schools and commercial activity). This multidiscipline attack strategy comes in part as response to the failure of prior antipoverty programs that tried to address problems facing high-poverty communities, *e.g.*, education, unemployment, and crime, in isolation. Daina Staisiunas, *Mixed-Income Housing: A Collaborative Strategy to Spark Urban Economic Development*, 17 Pub. Interest L. Rep. 263, 265 (2012) (citing Ronald Brownstein, *Fallen Leaves: The Latest Effort to Revive Chicago's Woodlawn Neighborhood Will Test Obama's Urban Strategy*, Nat'l J., Oct. 14, 2011, http://www.nationaljournal.com/columns/political-connections/in-obama-s-old-backyard-urban-renewal-goes-holistic-20111013). *But see* HUD's Fiscal Year (FY) 2013 NOFA for the Choice Neighborhoods Initiative—Implementation Grants (2013), http://portal.hud.gov/hudportal/documents/huddoc?id=fy13cnimplemnofafinal.pdf [hereinafter 2013 CNI NOFA] ("solutions . . . using place-based strategies to address . . . poor quality housing, inadequate schools, poor health, high crime and lack of capital").

5. *See, e.g.*, Staisiunas, *supra* note 4, at 265 ("Money is typically what separates a 'good' neighborhood from a 'bad' one. Thus, economic opportunity is a vital prong of revitalization efforts. Under the mixed-income model, [as used in HUD's CNI], not only will the community benefit from crime reduction, youth enrichment programs and job training, but these improvements will also make the community more attractive for commercial retail investors. Local retailers, in turn, can reinvest their profits into the surrounding community by providing employment opportunities and increasing local tax revenue.").

6. *See infra* notes 25–30 and accompanying text.

7. Often referred to as distressed neighborhoods. *See* 2013 CNI NOFA, *supra* note 4, at 1 (CNI uses strategies to address challenges of distressed neighborhoods, which include poor quality housing, inadequate schools, poor health, high crime, and lack of capital).

8. *See* Part I (discussing resident health in distressed neighborhoods).

and neighborhoods.[9] Asthma, which is more prevalent in distressed neighborhoods than in high-opportunity neighborhoods, is the leading cause of absence of children from school.[10]

To some degree, CNI considers resident health and the health impact of proposed projects. HUD claimed in its 2013 notice of funding availability (NOFA) that CNI supports locally driven solutions for poor health,[11] but this claim is largely without substance.[12] In actuality, resident health impact is a minor concern in CNI planning and implementation grant proposals and projects, primarily because HUD places so little emphasis on health in its rating factors and program requirements.[13] Under CNI currently, resident health is effectively secondary to increasing access to education and employment opportunities.[14] Because the health of residents impacts their ability to go to school or work, HUD should reconfigure CNI so that improving health is one of program's central goals in addition to improving access to employment and education opportunities. HUD can ensure that CNI and other housing revitalization programs make the maximum possible contribution to the health of individuals in distressed

9. *See id.* (discussing Popkin's findings that adults in public housing study were debilitated by their unaddressed health needs).

10. *Asthma Facts and Figures*, Asthma and Allergy Foundation of America, http://www.aafa.org/display.cfm?id=8&sub=42#_ftnref12 ("Among children ages 5 to 17, asthma is the leading cause of school absences from a chronic illness. It accounts for an annual loss of more than 14 million school days per year (approximately 8 days for each student with asthma) and more hospitalizations than any other childhood disease. It is estimated that children with asthma spend nearly 8 million days per year restricted to bed."). Notably, asthma causes problems for adults, and it is likely adults in distressed housing and neighborhoods also suffer asthma at higher rates than other segments of the population. *See id.* ("For adults, asthma is the fourth leading cause of work absenteeism and "presenteeism," resulting in nearly 15 million missed or lost ("less productive") workdays each year (this accounts for nearly $3 billion of the "indirect costs" shown above).").

11. 2013 CNI NOFA, *supra* note 4, at 1.

12. *See* Parts III.A & B (discussing HUD's CNI requirements related to resident health).

13. *See, e.g.*, 2013 CNI NOFA, *supra* note 4, at 67 (awarding one point under the CNI grant application rating process for projects located in Federally Qualified Health Center service areas, but eleven points to projects that offer educational opportunities through early learning, schools, and other resources); *id.* at 14 (defining public or assisted housing as distressed if it is predominated by unemployed residents or residents with very low-income; high rates of crime; or lacking transportation, supportive services, economic opportunity, schools, civic and religious institutions, and public services resulting in social distress). Notably HUD does not define public or assisted housing as distressed if most of its residents suffer from serious health problems caused by the housing or neighborhood. *See id.* (defining distressed housing without reference to resident health as a measure for whether housing is distressed).

14. *Id.*

neighborhoods by developing housing policies that are aimed at improving those aspects of housing and neighborhoods that impact health.

The following article provides an examination—through the lens of resident health—of CNI and its first round of 2011 implementation grants. This article discusses the extent to which CNI is designed to improve resident health outcomes. It also discusses how 2011 CNI implementation grantees have responded to resident health needs and critiques those efforts. Ultimately, this article suggests how HUD could change CNI in order to improve resident health and thereby improve the efficacy of the program's efforts to increase resident access to jobs and education.

Part I of this article discusses findings from two studies suggesting that neighborhood effects on resident health outcomes may warrant direct attention from HUD in its CNI program and from CNI grantees. Part II explains the existing parts of the program that are relevant to shaping CNI implementation grantees' vision for improvements to neighborhoods and supportive services that affect resident health. Part II also reviews the efforts of 2011 CNI implementation grantees (the first round of grants), focusing particularly on how their plans provide health strategies or interventions in response to resident needs assessments. Part III critiques, based on distressed neighborhood resident health outcomes, the CNI program and plans of the 2011 implementation grantees. Part IV proposes changes that HUD should make to CNI to improve resident health outcomes in distressed neighborhoods and thereby to improve CNI's efficacy.

I. Resident Health in Distressed Neighborhoods

Distressed neighborhoods and poor housing conditions are associated with a variety of negative health outcomes.[15] These negative health outcomes prevent many residents of distressed neighborhoods from obtaining employment and becoming self-sufficient.[16] Part I examines two reports that clearly illustrate the extent to which distressed neighborhoods impact the health of their residents: a 2010 report by Susan Popkin of the Urban Institute about resident health outcomes in the HOPE VI program[17] and a 2013 report from the National Center for Healthy Housing that considers what kinds of neighborhood characteristics cause poor resident health outcomes.[18]

15. *See infra* notes 17–34 and accompanying text (discussing studies by Susan Popkin and the National Center for Healthy Housing, which found negative health outcomes such as diabetes, hypertension and depression are more prevalent among residents of public housing and distressed neighborhoods).

16. *See infra* notes 17–28 and accompanying text (relating Popkin's findings that HOPE VI resident health outcomes were debilitating).

17. Susan J. Popkin, *A Glass Half Empty? New Evidence from the HOPE VI Panel Study*, 20:1 Housing Pol'y Debate 43–63 (2010).

18. *See* Jeffrey Lubell et al., Nat'l Ctr. for Healthy Hous., *Housing and Health: New Opportunities for Dialogue and Action* 7–9 (Apr. 20, 2013), http://www.nchh.

Health outcomes of individuals living in distressed neighborhoods were tracked over the course of HUD's HOPE VI program through a panel study conducted by Dr. Popkin.[19] HUD designed HOPE VI "to address the social and economic needs of residents [living in distressed public housing] and the health of the surrounding neighborhood."[20] Poor health was a major issue for respondents to the HOPE VI panel study.[21] "In 2005, . . . 41 percent [of respondents] identified their health condition as either 'fair' or 'poor.'"[22] Furthermore, "respondents were much more likely to describe their health as fair or poor than [were] other adults overall."[23] Respondents were also twice as likely than other groups to be obese and suffering from serious medical conditions, including arthritis, asthma, depression, diabetes, hypertension, and stroke, at rates twice or more than other groups.[24]

Not only did HOPE VI panel respondents report higher rates of disease, but their illnesses prevented them from working and achieving self-sufficiency.[25] "[O]ne in four respondents reported [having] such difficultly with physical mobility that [he] could not walk three city blocks, climb 10 steps without resting, or stand for two hours."[26] "[H]ealth problems [were] by far the biggest barrier to employment: . . . among working-age respondents, nearly a third . . . reported poor health, and most of them . . . were unemployed."[27] "The strongest predictor of not working was having severe challenges with physical

org/Portals/0/Contents/Health%20&%20Housing%20New%20Opportunities_r3%20final.pdf.

19. Popkin, *supra* note 17.

20. *Id.*; *see also* Susan J. Popkin, *Race and Public Housing Transformation in the United States*, *in* NEIGHBOURHOOD RENEWAL AN HOUSING MARKETS: COMMUNITY ENGAGEMENT IN THE US AND UK 138, 148 (2008), http://www.eslarp.uiuc.edu/courses/FAA391_Spring11/Popkin.pdf.

21. Popkin, *supra* note 17; *see also* Carlos A. Manjarrez, Susan J. Popkin & Elizabeth Guernsey, *Poor Health: Adding Insult to Injury for HOPE VI Families*, METRO. HOUS. & CMTYS. CTR. 2 (June 2007), http://www.urban.org/UploadedPDF/311489_HOPEVI_Health.pdf.

22. Popkin, *supra* note 17; *see also* David J. Price & Susan J. Popkin, *The Health Crisis for CHA Families*, PROGRAM ON NEIGHBORHOODS AND YOUTH DEV. 1 (2010).

23. Popkin, *supra* note 17.

24. *Id.*

25. *Id.*

26. *Id.*; *see also* Price & Popkin, *supra* note 22, at 1.

27. Popkin, *supra* note 17; *see also The Choice Neighborhoods Initiative: A New Community Development Model: Hearing Before the Subcomm. on Hous., Transp., & Cmty. Dev. of the S. Comm. on Banking, Hous., & Urban Affairs* (Mar. 27, 2012) (testimony of Susan J. Popkin, Urban Institute), http://www.urban.org/uploadedpdf/901491-the-choice-neighborhoods-initiative.pdf.

mobility."[28] "Depression also substantially reduced the probability of being employed."[29] Poor physical health is also a significant barrier to self-sufficiency.[30]

Additionally, the National Center for Healthy Housing has provided a detailed analysis of how residents' health may be impacted by characteristics of their neighborhood.[31] "Physical neighborhood attributes affect health by facilitating (or impairing)" access to walkable/bike-able paths, public transportation, open park spaces for recreation and physical activity, and fresh fruits and vegetables.[32] "[R]esidents who live in close proximity to parks and recreational spaces are much more likely to engage in regular physical activity, reducing their risk of" obesity, diabetes, heart disease, cancer, and stroke.[33] Additionally, "mixed-use and transit-oriented development increases opportunities for walking and bicycling . . . and overall physical activity. In particular, clustering housing, educational facilities, office buildings, restaurants, . . . parks, . . . retail establishments, . . . and grocery stores within neighborhoods results in increased pedestrian activity and reduced obesity."[34] "Lack of access to healthy food is also [associated with] health problems, including obesity, diabetes, . . . cardiovascular disease," and increased rates of mortality.[35]

Studies of the health impact of neighborhood attributes suggest that housing policies aimed at transforming distressed neighborhoods into "Choice Neighborhoods" should aim to improve not only access to employment and education, but also access to better health through amenities and resources that produce positive health outcomes. "Unfortunately, the health of America's public housing residents has received very little attention from [housing] policymakers over the years."[36] Perhaps this has changed as the result of HUD's implementation of

28. Popkin, *supra* note 17; *see also Hearing on S. 829 Before the Subcomm. on Hous., Transp., & Cmty. Dev. of the S. Comm. on Banking, Hous., & Urban Affairs* (June 20, 2007) (testimony of Susan J. Popkin, Urban Inst.); *Hearing on HOPE VI Reauthorization Before the Subcomm. on Hous. & Cmty. Opportunity of the H. Comm. on Fin. Servs.* (June 21, 2007) (testimony of Susan J. Popkin, Urban Inst.), http://www.urban.org/UploadedPDF/901088_HOPE_VI.pdf.

29. Popkin Testimony, *supra* note 27.

30. Laura Harris & Deborah Kaye, *How Are HOPE VI Families Faring? Health, Brief #5 of Metropolitan Housing and Communities: A Roof Over Their Heads* (2004), http://www.urban.org/publications/311073.html.

31. *See* Lubell et al., *supra* note 18, at 7–9.

32. *Id.* at 2.

33. *Id.* at 8.

34. *Id.*

35. *Id.*; *see also* Mari Gallagher, *Examining the Impact of Food Deserts on Public Health in Chicago*, at 6 (2013), http://www.marigallagher.com/site_media/dynamic/project_files/Chicago_Food_Desert_Report.pdf.

36. *See* Manjarrez et al., *supra* note 21, at 5.

CNI[37] and the government's initiative to focus on health in all federal programs.[38] Part II will examine the CNI program and the efforts of the 2011 CNI implementation grantees, focusing on each grantee's plans to address the health needs of residents in distressed neighborhoods.

II. HUD's CNI and CNI's Five 2011 Implementation Grantees

To be eligible for Choice Neighborhoods Initiative (CNI) funding, neighborhoods must have the following characteristics: high poverty, high crime rates, high residential vacancy rates, and low-performing schools.[39] CNI "[g]rantees must combine housing redevelopment and a comprehensive mix of physical [and] social service . . . improvements within CNI target neighborhoods—with an emphasis on creating high-quality educational opportunities from early childhood through college."[40] Ultimately, HUD intends for CNI to "spur additional public and private investment [in distressed neighborhoods to transform struggling neighborhoods into sustainable mixed-income, mixed-use communities."[41] Thus, HUD intends for CNI to benefit residents in some of the nation's highest-poverty neighborhoods by redeveloping parts of those neighborhoods. Rather than move such residents to existing opportunity neighborhoods,[42] HUD intends to create opportunity neighborhoods out of distressed neighborhoods.[43]

CNI provides "[i]mplementation grants [that] directly fund [transformation plans[44] for] housing development, neighborhood improvements

37. *See* 2013 CNI NOFA, *supra* note 4, at 3 (stating projects funded in 2013 are aimed at addressing poor health, among other things).

38. *See* R.W. Bostic et al., *Health in All Policies: The Role of the US Department of Housing and Urban Development and Present and Future Challenges*, 31:9 HEALTH AFF. 2130–37 (2012).

39. HUD, *Choice Neighborhoods*, *supra* note 1.

40. MARTHA GALVEZ, POVERTY & RACE RESEARCH ACTION COUNCIL, AN EARLY ASSESSMENT OF OFF-SITE REPLACEMENT HOUSING, RELOCATION PLANNING AND HOUSING MOBILITY COUNSELING IN HUD'S CHOICE NEIGHBORHOODS INITIATIVE 2 (Mar. 2013), http://www.prrac.org/pdf/choiceneighborhoods-affh.pdf.

41. *Id*.

42. Neighborhoods are often designated Opportunity Neighborhoods by policymakers if the neighborhood has certain education, commercial, transportation, recreation, structural, and social assets. *See* BUILDING NEIGHBORHOODS OF OPPORTUNITY, WHITE HOUSE REPORT 3 (2012), *available at* http://www.whitehouse.gov/sites/default/files/uploads/nri_report.pdf.

43. Tegeler et al., *supra* note 3, at 47 (noting "100 percent of the units [in CNI redevelopment projects] would be placed right back into some of our nation's most high-poverty, segregated neighborhoods."). In fact, none of the 2011 implementation sites planned to construct replacement units outside the target CNI neighborhoods. *Id.*

44. HUD requires CNI grant applicants to submit a transformation plan, which is "a comprehensive neighborhood revitalization strategy." HUD, *Choice Neighborhoods*, *supra* note 1. If the applicant's project is funded under CNI, the grantee must

and [supportive] services, based on . . . proposals submitted by [local entities]."[45] To be eligible for funding, transformation plans must seek to improve: (1) "developmental assets that allow residents to attain the skills needed to be successful in all aspects of daily life (e.g., educational institutions . . . and health resources)"; (2) "commercial assets . . . associated with production, employment, transactions, and sales . . . "; (3) "recreational assets that create value in a neighborhood beyond work and education (e.g., parks, open space, . . . [and] athletics . . .)"; (4) "Physical assets that are associated with the built environment and physical infrastructure (e.g., housing, commercial buildings, . . . roads[,] [sidewalks and bike paths])"; and (5) "social assets that establish well-functioning social interactions (e.g., public safety and community engagement)."[46]

Grantees must develop transformation plans using rating factors provided under and required by the HUD CNI Planning Grant application.[47] HUD uses the rating factors in awarding points that are used to decide which projects to fund.[48] Applications earn points by speaking directly on how the proposed project, if funded, would address CNI's target goals.[49]

In 2011, the first round of CNI implementation grants were received by Boston, Chicago, New Orleans, San Francisco, and Seattle.[50] Details of each city's proposal are discussed below.

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use the transformation plan in order to achieve CNI's "core goals," which are focused on housing, people, and neighborhood. *Id.* The transformation plan is the grantee's "guiding document" during the implementation of the grant. *Id.* Grantees must use the transformation plan in carrying out revitalizing efforts in the neighborhood's public housing or federally assisted housing units. *Id.* Grantees must also use the transformation plan to redevelop the surrounding neighborhood. *Id.* HUD notes "applicants will need to work with public and private agencies," for-profit and non-profit businesses, and community-members in order to successfully implement the transformation plan. *Id.* Grantees must "gather and leverage resources needed to support the financial sustainability of the plan." *Id.* Moreover, grantees' "efforts should build community support for and involvement in the development of the [community's transformation] [p]lan." *Id.*

45. GALVEZ, *supra* note 40, at 3; *see also* Dep't of Hous. & Urban Dev., HUD's Fiscal Year (FY) 2011 NOFA for the Choice Neighborhoods Initiative–Planning Grants, (Apr. 18, 2013) [hereinafter 2011 CNI NOFA], http://portal.hud.gov/hudportal/documents/huddoc?id=cn_planning_nofa.pdf.

46. 2011 CNI NOFA, *supra* note 45, at 11.

47. *Id.*

48. *Id.*

49. *Id.*

50. *Id.*

A. Boston

The City of Boston received a $20.5 million CNI implementation grant to transform the Quincy Corridor.[51] The plan calls for $12.3 million toward the redevelopment of 129 distressed units spread across eleven buildings in the Woodledge/Morrant Bay housing development.[52] Each of the 129 units will be either rehabilitated or demolished and replaced on a one-to-one basis (a requirement of all CNI redevelopment projects) and all units will continue to have project-based Section 8 subsidies.[53] About "$3.075 million will be used for community improvements such as community facilities, parks, gardens, economic development, job creation and asset building. The remaining $3.075 million will be used for supportive services for residents of Quincy Heights and the surrounding Quincy Street Corridor."[54]

The transformation plan for the Quincy Corridor, "a ½ square mile [neighborhood] centered on Quincy Street," was based on a resident needs assessment.[55] Approximately 8,900 people live in the Quincy Corridor, "about 38% of whom have incomes below the poverty line or make less than 30% of the area median income."[56] Before applying for the CNI grant, the City of Boston completed a resident needs assessment, part of which inquired about health issues.[57] The assessment found that fifteen of the 126 respondents said they had significant health care problems.[58] The plan also indicated that the Quincy Corridor is home to a large senior population.[59] The remaining health data used in the CN implementation grant planning was based on city-wide statistics related to health.[60] "Compared with the highest income neighborhoods, residents of Boston's lowest-income neighborhoods . . . experience a 30% higher death rate from all causes, and are two and a half times as likely to die from diabetes."[61]

In response to the resident needs assessment, the Boston transformation plan does not incorporate a goal specifically related to resident health but rather focuses on education, economic opportunity, reduction of blight, and housing structures.[62] However, the plan does include some

51. *Choice Neighborhoods*, City of Boston.gov, http://www.cityofboston.gov/dnd/pdr/choice_neighborhoods.asp (last visited Mar. 12, 2014).
52. *Id.*
53. *Id.*
54. *Id.*
55. City of Boston Dep't of Neighborhood Dev. & Dorchester Bay Econ. Dev. Corp., Round 2 Implementation Grant Application, at Narrative Exh. 2 (2011).
56. *Id.*
57. *Id.*
58. *Id.*
59. *Id.*
60. *Id.*
61. *Id.* at 12.
62. *Id.*

measures to address the poor health of some residents.[63] The Boston Public Health Commission provides school, home, and community-based services, addressing not only on clinical care and health outcomes but also on social conditions that affect health and well-being.[64] The Commission's efforts target providing health care to adolescents and reducing violence.[65] Four of the Commission's health centers are located in the community surrounding the Quincy Corridor, but none are located in the CN; the nearest health center is more than a mile away from most residents of the Qunicy corridor.[66] The plan also includes a program for seniors called Rock & Roll, which includes meals, transportation, exercise, and other creative activities for seniors three times a week.[67] The plan does not specifically aim to improve residents' access to nutritious food; a Super Stop and Shop at a nearby mall is the only fresh food retail establishment within one mile of the Quincy Corridor.[68] The plan does include the construction or rehabilitation of parks and community gardens.[69]

B. Chicago

The City of Chicago and a private developer, the Preservation of Affordable Housing (POAH), were awarded a $30.5 million implementation grant to redevelop Grove Parc, a distressed HUD-subsidized development in the Woodlawn neighborhood.[70] POAH is currently underway with transforming Grove Parc into a "healthier mixed-use community" with 420 homes, new commercial spaces, a community resource center, and a youth recreation facility.[71] The Woodlawn "Vision for Neighborhood" section of the transformation plan "sets . . . goals in a number of areas, including economic development, public safety and education and workforce development."[72]

Chicago's Woodlawn neighborhood is an engaged and historic community situated near the thriving Hyde Park neighborhood.[73] Despite its proximity to such a prosperous neighborhood, the Woodlawn community

63. *Id.*
64. *Id.*
65. *Id.*
66. *Id.*
67. *Id.*
68. *Id.* at 50.
69. *Id.*
70. Preservation of Affordable Housing (POAH), *Woodlawn Choice Neighborhood Initiative*, http://poah.org/woodlawnchoice/index.htm (last visited Mar. 12, 2014).
71. POAH, *Vision for Housing*, at B.1, http://poah.org/portfolio/illinois/GROVE%20PARC%20WOODLAWN/Vision%20for%20Housing.pdf (last visited June 3, 2014).
72. Staisiunas, *supra* note 4, at 267; *see also* POAH, *Vision for Neighborhood*, http://poah.org/portfolio/illinois/GROVE%20PARC%20WOODLAWN/Vision%20for%Neighborhood.pdf, (last visited Mar. 12, 2014).
73. *Id.*

has a high prevalence of gang violence, among other social issues.[74] "Between 2007 and 2009, the neighborhood suffered more than 19 Part I [murder and non-negligent manslaughter, forcible rape, robbery, and aggravated assault] violent crimes per thousand residents, nearly twice that of the City of Chicago as a whole."[75] "The result is [critical] gaps in retail services that force Woodlawn residents to do 70% of their shopping outside the community."[76]

The City of Chicago and POAH assessed resident health needs and in turn directly addressed negative health outcomes in its "Vision for People" section of the transformation plan.[77] About 74 percent of respondents self-reported "being in good health, although they also identified blood pressure, diabetes and weight as issues they would like to address. More than 27% . . . said that they did not have any health insurance."[78] About 30 percent of the respondents requested nutrition and exercise programs and primary health education.[79] POAH incorporated into the plan a supportive services strategy that responded directly to the resident needs assessment.[80] This includes a "Healthy Family" program that "will focus on adult fitness and nutrition, chronic condition management" and other determinants of health.[81] "Other key components of the health strategy include a mobile medical care unit, health education, [and] community health service projects."[82] Furthermore, "[r]esidents will be encouraged to participate in the fitness programs offered by the City Parks and Recreation Department and the nearby Harris Park," which provides sports and recreation programs.[83]

"POAH is partnering with the University of Chicago's Urban Health Initiative (UHI), . . . a network of community health centers and local hospitals working together to [get residents insured and] connect [them] to primary health care services" in order "[t]o address the high rate of the

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74. *Id.*; *see also* Fran Spielman, *Federal Grant Gives Troubled Woodlawn a 'Second Chance'*, CHI. SUN-TIMES, Aug. 31, 2011, http://www.suntimes.com/7389679-418/federal-grant-gives-troubled-woodlawn-a-second-chance.html (reporting foreclosed homes, vacant lots, failing schools, and a comment from U.S. Rep. Bobby Rush (D-IL) that Woodlawn deals with "bad retail [stores], [and] constant . . . bombardedment in the news about how bad they are").

75. POAH, *Vision for Neighborhood*, *supra* note 72, at D.1.

76. *Id.*

77. POAH, *Woodlawn Choice Neighborhood Initiative*, *supra* note 70.

78. POAH, *Vision for People*, at C.1, http://poah.org/portfolio/illinois/GROVE%20PARC%20WOODLAWN/Vision%20for%20People.pdf (last visited Mar. 14, 2014).

79. *Id.*

80. *Id.* at C.2.

81. *Id.*

82. *Id.*

83. *Id.*

uninsured and the health needs of residents."[84] "Through these relationships, residents will be encouraged to establish a medical home other than the emergency room and will ultimately identify and address untreated physical and psychological distress."[85]

Finally, under the Woodlawn transformation plan, residents will have "excellent access to neighborhood amenities" that promote good health. "Within a mile of the geographic center of the targeted Grove Parc development, residents [will have] access to . . . three Fresh Food Retail outlets, . . . eight Services outlets, and fourteen Civic and Community Facilities."[86]

C. New Orleans

The Housing Authority of New Orleans (HANO) and the City of New Orleans received a $30.5 million CNI implementation grant to redevelop Iberville and assist in the revitalization of the surrounding Treme neighborhood.[87] In April 2011, Urban Strategies, a nonprofit organization, and its partners conducted a detailed survey of all members of households in the Iberville community.[88] The survey found that only 56 percent of residents self-reported being in good or excellent health; only 63 percent "had health insurance, most through Medicaid. Many residents ha[d] serious health issues:" 22 percent had asthma, 11 percent diabetes, and 43 percent high blood pressure.[89] "Focusing on the health of their children, . . . 40% reported their children have asthma, and although . . . 73% indicated their children eat 5 servings of fruits and vegetables a day, . . . 42% reported that their children eat sweets/candy daily, and . . . 38% said there are times when there is insufficient food in the house."[90]

The Iberville/Treme transformation plan calls for a supportive services strategy "designed to meet the needs identified in the [s]urvey . . . and builds upon existing neighborhood assets."[91] One of the plan's goals focuses on the health of children and families.[92] Specifically this includes priority services for children, youth, and adults provided by Urban Strategies.[93] Urban Strategies will implement "With Every Heartbeat is Life," a program through which residents will be "train[ed] . . . to educate their

84. *Id.*
85. *Id.*
86. POAH, *Vision for Neighborhood*, *supra* note 72, at D.3.
87. Housing Auth. of New Orleans (HANO), Round II Application for Iberville/ Tremé, Choice Neighboods Initiative: A Transformation in New Orleans, *Vision for People*, at C.1, https://www.hano.org/communities/iberville/Round2.pdf (last visited Mar. 12, 2014).
88. *Id.*
89. *Id.*
90. *Id.*
91. *Id.* at C.2.
92. *Id.* at D.1.
93. *Id.* at E.1.

neighbors on how to live healthy lifestyles and . . . raise awareness of the risk factors" for heart disease.[94] The plan also aims to: (1) increase access for adults to the Tulane Health Center, a federally qualified health center nationally recognized for its community-based mental and physical health services; (2) increase access for children and youth to the Louisiana State University Tiger Care Pediatric Clinic, another federally qualified health center, which specializes in the mental and physical health needs of children and youth; (3) implement a new obesity screening program; and (4) increase access to the New Orleans Food for Families Program, which provides nutritional food to at risk populations such as pregnant women, seniors, and parents with children under the age of six.[95]

The plan expands access to neighborhood amenities that are also expected to produce positive health outcomes.[96] "In HANO's needs assessment, residents prioritized access to basic amenities such as a supermarket with fresh foods, . . . [a] drugstore, and healthcare."[97] As a result, the transformation plan intends to "[i]ncrease fresh food access in Iberville/Tremé by 25%."[98] "There are 4 existing and 2 planned fresh food retail establishments within 1 mile of the geographic center of Iberville, including 1 existing and 2 planned supermarkets, and 3 other markets with fresh produce."[99] As part of the plan, the implementation team will "secure a grocery store and farmers' market . . . , and work with the owner of the Circle Foods Store to re-open a neighborhood market [closed] since Katrina."[100]

A series of longitudinal studies, used to illustrate change over time, will measure the effects of the Iberville/Treme transformation plan on residents.[101] "To truly account for change among existing residents, [the plan includes] data collection following specific individuals rather than just summary demographic data at a larger scale."[102] The plan's implementation team, with data collection partners, "will establish a protocol for monthly data collection and information sharing."[103] The following is an example of the data collection method employed: "A Neighborhood Goal is to increase access to supermarkets and encourage healthier eating habits. . . . The effectiveness of this goal will be analyzed using a) annual expenditure data within supermarkets as reported by NAICS code within each census tract, and b) ongoing collaboration with community groups

94. *Id.* at C.2.
95. *Id.*
96. *Id.* at D.1.
97. *Id.*
98. *Id.*
99. *Id.* at D.3.
100. *Id.* at D.1.
101. *Id.* at E.3.
102. *Id.*
103. *Id.*

and citywide participants of [a local initiative called] the Fresh Food Initiative."[104]

D. San Francisco

The San Francisco Housing Authority (SFHA), together with McCormack Baron Salazar Development, Inc., a for-profit developer of economically integrated neighborhoods, received a $30.5 million CNI implementation grant to redevelop 257 public housing units and in the Eastern Bayview neighborhood.[105] In total, the transformation plan includes the creation of 1,126 mixed income units among mixed use buildings.[106] "[T]he southeastern San Francisco community known as Eastern Bayview, . . . includes the targeted Alice Griffith site, a severely distressed public housing development and its surrounding neighborhood. Constructed in 1962, Alice Griffith is a family development of two-story townhouse style buildings scattered throughout a 22-acre site."[107]

The information available about the SFHA transformation plan does not disclose whether a resident needs assessment was conducted prior to submission of the implementation grant application, but the transformation plan includes several goals pertinent to resident health.[108] "Positive outcomes for Alice Griffith residents will be achieved through . . . improved access to health care [provided by an] expansion to the [n]eighborhood's Southeast Health Center and development of a senior center and aging campus."[109] The plan calls for neighborhood investments necessary for long-term community success.[110] This includes creating better access to nutritious food by bringing in private businesses.[111] "Expected outcomes [of the neighborhood improvement efforts] include . . . improved resident health through healthier food options; and support for greening [initiatives], such as [increased] recreational [facilities] along the shoreline."[112] These outcomes will be tracked through surveys and other data collection endeavors not specified in the SFHA implementation grant supporting documents.[113]

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104. *Id.*

105. HUD, Choice Neighborhoods Project Summaries FY 2011, San Francisco, http://portal.hud.gov/hudportal/documents/huddoc?id=CNFY2010-2011.pdf.

106. *Id.*

107. *Id.; see also Choice Neighborhoods: McCormack Baron Salazar*, Partner.HUD.gov (Feb. 26, 2014), http://partner.hud.gov/content/choice-neighborhoods-6?detail=50.

108. *Choice Neighborhoods: McCormack Baron Salazar*, *supra* note 107.

109. *Id.*

110. *Id.* ("retail attraction through SF Shines Facade Improvement Program (an initiative to provide streetscape enhancement and recommendations for business attraction and retention)").

111. *Id.*

112. HUD, Choice Neighborhoods Project Summaries FY 2011, *supra* note 105.

113. *Id.*

E. Seattle

The Seattle Housing Authority (SHA) received a $10.27 million implementation grant to redevelop the Yesler Terrace public housing community.[114] In 2012, HUD awarded an additional $19.73 million toward the project.[115] Yesler Terrace is the second oldest publicly subsidized community in the United States; redevelopment is necessary because of maintenance, health, and safety issues presented by the seventy-year old SHA buildings.[116] "Many of [Yesler Terrace's] 1,200 residents are families with children, seniors, people with disabilities and immigrants who speak a variety of different languages."[117] The Yesler neighborhood

> suffers from high poverty rates, [high] crime rates, and poor schools relative to [other neighborhoods in] the City of Seattle. . . . The overall Yesler neighborhood plan includes the replacement of 561 public housing units at Yesler Terrace in conjunction with up to 6,000 units of mixed-income housing as well as retail, educational facilities, health clinics, urban agriculture, parks, new transportation infrastructure, and other community amenities in the neighborhood.[118]

Although SHA did not provide any information concerning a resident needs assessment, the transformation plan addresses health in several ways.[119] With respect to the redeveloped building itself, the plan incorporates urban design and architectural techniques that promote walking.[120] Additionally, SHA's health care partner, NeighborCare Health, is incorporated into the CNI transformation plan.[121] NeighborCare is a community health center that provides "primary medical, dental and behavioral health care services . . . to low-income and uninsured individuals, seniors on fixed incomes, immigrants, and the homeless."[122] Under the plan,

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114. Press Release, Seattle Housing Authority, $10.27 Million HUD Choice Neighborhood Grant Awarded for Yesler Terrace Renewal, Aug. 31, 2011, http://www.seattlehousing.org/news/releases/2011/10-million-dollar-grant-for-yesler/index.html.

115. Press Release, Seattle Housing Authority, *$19.73 Million HUD Grant Awarded to Seattle Housing for Yesler Terrace Redevelopment*, Dec. 13, 2012, http://www.seattlehousing.org/news/releases/2012/choice-neighborhoods-grant/.

116. Yesler Terrace Redevelopment Fact Sheet (2013), http://seattlehousing.net/wp-content/uploads/2013/12/FAQ_Yesler_December_2013.pdf.

117. Yesler Terrace Redevelopment Fact Sheet (2011), http://www.seattlehousing.org/redevelopment/pdf/Fact_Sheet_Yesler_July_2011.pdf.

118. Housing Authority of the City of Seattle, Partner.HUD.gov, http://partner.hud.gov/content/choice-neighborhoods-6?detail=51 (last visited Feb. 24, 2014).

119. Seattle Housing Authority, Yesler Neighborhood: Choice Neighborhoods (2014), http://seattlehousing.org/redevelopment/yesler-terrace/ChoiceNeighborhoods/index.html.

120. *Id.*

121. *Id.*

122. *Id.*

NeighborCare will provide "two health educators to connect residents with medical services and help [them] understand how to navigate the medical system."[123] The plan also provides subsidies to small businesses to create better access to nutritious food in the neighborhood.[124] Additionally, the nearby Horiuchi Park "is being enhanced with help from the City of Seattle to include community garden space."[125] The neighborhood will feature 15.9 acres of parks and semi-private open spaces for leisure, gardening, and play.[126] Finally, the plan includes efforts to create safe, convenient, and enjoyable walking and bike routes.[127]

III. Resident Health-Focused Analysis of 2011 CNI Implementation Grantee Transformation Plans and CNI Generally

Analyzing the promise that HUD's CNI holds for distressed neighborhoods requires a careful look at both CNI and the 2011 implementation grants through the lens of resident health.[128] The above studies by Susan Popkin and the National Center on Healthy Housing provide information about the impact of neighborhood characteristics and housing conditions on resident health.[129] After careful analysis, it is clear that CNI and the 2011 implementation grants could do more to consider resident health in the transformation planning process. Indeed, CNI should include greater emphasis on health because the health of residents is determinative of their educational and employment outcomes, both of which are central objectives of CNI.[130]

This section will first consider HUD's CNI requirements for applicants and grantees and next examine the effect of CNI's requirements on 2011 implementation grantees.

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123. Press Release, *supra* note 115.

124. Yesler Neighborhood: Choice Neighborhoods, *supra* note 119.

125. *Id.*

126. Yesler Terrace Redevelopment Fact Sheet (2011), *supra* note 117.

127. *Id.*

128. *See* Parts I and II (discussing the importance of resident health and the aims of the CNI program generally).

129. The following assessment is based on information from HUD's 2011 Notice of Funding Availability (NOFA), supporting documents prepared by HUD, and information about individual grantee plans gathered from CNI proposals and other documents available on grantees' websites. As such, the analysis is limited to the information made available by HUD and the 2011 CNI implementation grantees. *See* 2011 CNI NOFA, *supra* note 45.

130. *See id.* at 9 (("support positive outcomes for families who live in the target development(s) and the surrounding neighborhood, particularly outcomes related to residents' health, safety, employment, mobility, and education"). *See also* 2013 CNI NOFA, *supra* note 4, at 1.

A. HUD Does Not Require CNI Grant Applicants to Consider the Health Needs of Residents in Their Transformation Plans

Under the 2011 rating scheme used by CNI, an application goal seeking increased access to healthy food can earn only a few points;[131] if applicants choose not to address this sub-factor at all, the rating factor points could easily be made up elsewhere.[132] Thus, the rating scheme relegates access to healthy food and other factors related to health to a de minimus position in comparison to the other categories. However, although not a specific goal of the CNI program, both the New Orleans and San Francisco plans addressed access to healthy food.[133] Thus, the choice about whether to implement resident health interventions under CNI is left primarily to the grantees.

As mentioned above, under HUD's current rating scheme for awarding implementation grants, developers may select CNI rating factors other than those most pertinent to resident health.[134] This may undermine the effectiveness of CNI because resident health outcomes to some extent determine resident education and work outcomes.[135] Organizations and cities applying for CNI funding may not appreciate the nexus of housing policy and health illustrated by Popkin and the National Center for Healthy Housing. As a result, local organizations applying for implementation grants may elect not to take optional, yet important, affirmative steps to address resident health needs in their transformation plans.

While each distressed neighborhood presents its own challenges and needs, several specific resident health needs, if they are present, warrant

131. 2011 CNI NOFA, *supra* note 45.

132. *See, e.g.,* 2013 CNI NOFA, *supra* note 4, at 67 (announcing how applicants may earn 31 points (out of 216) for developing strategies that benefit people; of those strategies, health-related efforts (resident needs assessment and access to a federally qualified health center) account for only 11 possible points). CNI provides 3 possible points to applicants for conducting a resident health needs assessment. In terms of health-related, it asks for information related to the number and percentage of children and adults who: have a place where they regularly go when they are sick, other than an emergency room; report good physical health; report stress or psychological distress; have health insurance. *Id.* As discussed above, these measures of health are broad and HUD could easily require applicants to collect more information from residents related to specific illnesses. The responses are optional, so residents could choose not to respond if they felt uncomfortable. HUD could also require applicants to use aggregated information collected from nearby hospitals about the number of people being treated for certain illnesses from that zipcode. Public health departments may also be able to assist with this data collection and distribution.

133. *See* HUD, Choice Neighborhoods Project Summaries FY 2011, *supra* note 105.

134. *See generally* 2013 CNI NOFA, *supra* note 4.

135. *See* Popkin, *supra* note 17; Lubell et al., *supra* note 18 (discussing research from HOPE VI and other studies, which have shown poor health prevents people from obtaining employment and engaging in other parts of life).

interventions in CNI development efforts. For instance, research shows that problems posed by lack of access to nutritious foods result in negative health outcomes for residents, including diabetes, obesity, and hypertension, many of which are debilitating if not adequately treated.[136] Hence, if these unaddressed health needs are present in a community, they warrant intervention from any effort to transform a distressed neighborhood without access to healthy food.

By allowing grantees to determine which neighborhood problems to address under the rating factors, CNI applicants may ignore important health consequences of their proposals, or more likely, refrain from enacting needed health interventions in the process of transforming the neighborhood. This may undermine any efforts to help residents achieve other CNI goals such as education and employment. CNI purports to be about more than bricks and mortar; it aims to solve the interconnected challenges of poor-quality housing, inadequate schools, poor health, high crime, and lack of capital in neighborhoods with distressed public or federally assisted housing.[137] Therefore, HUD should prioritize resident health in CNI applications for implementation grants because working-age and otherwise ready-to-work residents of public housing and distressed neighborhoods are more likely to suffer from poor health.[138]

Illustrative of the above critique is the "Severe Distress of the Targeted Neighborhood" rating sub-factor from the 2011 NOFA, which could have considered the neighborhood's access to health services, healthy food, or amenities that facilitate physical activity, but failed to do so.[139] The "Severe Distress of the Targeted Neighborhood" sub-factor falls under the 'Need' rating, which awards points to applicants based on the assessed needs of the distressed development and surrounding neighborhood.[140] The sub-factor awards points based on the degree to which the neighborhood suffers from poverty, long-term vacancy rates, crime, and school performance.[141] However, social determinants of health, such as access to healthy food and spaces conducive to physical activity, may be as important as or correlate with poverty, crime, and school performance. Indeed, one 2006 study from the National Institutes of Health suggests that neighborhoods with poor-quality housing and high crime rates can cause stress, one of the precursors of depression.[142] The Popkin study discussed

136. *See* Popkin, *supra* note 17; Lubell et al., *supra* note 18.

137. *See* HUD, *Choice Neighborhoods*, *supra* note 1.

138. *See* Popkin, *supra* note 17; Lubell et al., *supra* note 18; *see also supra* Part II (reporting the Popkin and Center for Healthy Housing findings related to resident health in HOPE VI project areas and distressed neighborhoods).

139. 2011 CNI NOFA, *supra* note 45.

140. *Id.*

141. *Id.*

142. *See, e.g.*, Carolyn E. Cutrona et al., *Neighborhood Characteristics and Depression*, 15:4 Curr. Dir. Psychol. Sci. 188–92 (2008), http://www.ncbi.nlm.nih.gov/

above suggests that poor health is an obstacle to gainful employment and positive school performance as well.[143] Therefore, social determinants of health should be part of the sub-factor for Neighborhood Distress, since better health is perhaps the most important need faced by the residents of CNI neighborhoods.

Furthermore, the manner in which points are awarded under the rating factors allows for the actual needs of the community to be only a small part of the entire plan. Health needs receive only four points.[144] The "Severe Distress of the Target Neighborhood" rating sub-factor is worth twelve points out of eighty.[145] "Severe Physical Distress of Public Housing and/or Assisted Housing," which is related to inadequate building design and deficiency, is worth another twelve points.[146] The "Need for Affordable Housing" is worth one point.[147] In total, the needs of the community that warrant intervention are total twenty-five out of eighty points.[148] This may operate to the detriment of neighborhoods that are in urgent need by favoring those applications that achieve more points under the remaining rating factors. As an example, the factor "Capacity," which is worth twenty points, include a four-point sub-factor that is wholly related to leverage experience of the applicant.[149] Unfortunately, HUD has not deviated largely from its 2011 rating scheme in its 2013 NOFA, the most recently released requirements for CNI applicants as of the date of this article.[150]

B. HUD Does Require That CNI Implementation Grantees to Monitor Tenant Health Outcomes During Project Implementation, but That Is Not Enough

Each CNI grantee must develop metrics, based on objectives set forth in HUD's NOFA for that particular grant period, to measure success of the CNI investment project.[151] The 2013 CNI NOFA objectives are related to housing, people, and neighborhood.[152] Under the housing objective,

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pmc/articles/PMC2186297/?report=reader () (finding neighborhoods with poor-quality housing, few resources, and unsafe conditions impose stress, which can lead to depression).

143. *See* Part II (discussing Popkin's findings).

144. *See* 2011 CNI NOFA, *supra* note 45, at 54 (announcing 31 points available out of 216 total for the application's section related to CNI's People objective).

145. *Id.* at 40.

146. *Id.* at 38.

147. *Id.* at 41.

148. *Id.* at 36.

149. *Id.* at 37.

150. 2013 CNI NOFA, *supra* note 4, at 73–74 (changing the points available under the Severe Distress of the Targeted Neighborhood sub-factor to 13).

151. *See id.* at 3 (setting forth HUD's objectives for CNI grants made during the 2013 fiscal year).

152. *Id.* at 3–4.

CNI grantees should create housing that is energy efficient, sustainable, accessible, free from discrimination, mixed-income, well-managed, and financially viable.[153] Under the neighborhoods objective, CNI grantees should improve neighborhoods in several ways, including ensuring that health clinics and doctors' offices are not farther away from the choice neighborhood than they are for the median neighborhood in the metropolitan area.[154] Although both of these objectives include provisions related to resident health, they do not set forth criteria for measuring resident health outcomes. Nor does the people objective offer a clear requirement for how grantees must measure resident health outcomes either during the project implementation phase or after completion.

The people objective requires implementation grantees to develop a metric for measuring health outcomes, but the NOFA does not specify what factors the grantee should be measure. Under the people objective, the NOFA states that CNI residents should benefit from quality health care, specifically "[h]ealth for residents [of the choice neighborhood] over time [should be] as good as or better than that of other households with similar economic and demographic conditions."[155] This seems promising, because it requires the grantee to at least pay attention to resident health outcomes enough to compare them to residents with similar economic and demographic conditions. However, the NOFA does not indicate how grantees must show that resident health is at least as good as other households.[156] As a result, determining how to meet this objective is left to a grantee's discretion, posing a problem for ensuring that implementation grantees accurately measure resident health outcomes in meaningful ways. The lack of reliable data in turn affects HUD's ability to compare resident outcomes in one CNI neighborhood against outcomes elsewhere.

153. *Id.* at 3. The only part of this objective addressing resident health is a requirement that housing developed under CNI should have healthy indoor air quality. *Id.*

154. *Id.* at 4.

155. *Id.*

156. HUD could require implementation grantees to track resident health outcomes in a number of ways. HUD could require all grantees to monitor self-reporting of certain kinds of illnesses that are more prevalent in distressed neighborhoods, such as diabetes, hypertension, and depression. Furthermore, HUD could uniformly require resident questionnaires at regular intervals. HUD could also require implementation grantees to measure ventilation, carbon dioxide, and radon, all of which have an impact on resident health. *See* Jill Breysse et al., *Health Outcomes and Green Renovation of Affordable Housing*, 126:1 PUB. HEALTH REP. 64–75 (2011), *available at* http://www.ncbi.nlm.nih.gov/pubmed/21563714 (assessing health of low-income residents via questionnaire and measuring ventilation, carbon dioxide, and radon in residences).

C. How the 2011 Implementation Grantees Collected and Considered Resident Health Information in Their Transformation Planning Process Varies Widely

Each of the five 2011 implementation grantees addressed resident health to some extent in their transformation plans.[157] However, only three conducted resident health needs assessments, and only one conducted a detailed health needs assessment designed specifically for residents of the proposed choice neighborhood.[158]

The City of Boston CNI application used a resident needs assessment but reported only the number of residents in the distressed development with significant health problems, leaving unreported the specific types of health problems affecting residents. Moreover, the Boston transformation plan relies on city-wide statistics to predict health issues faced by residents of the actual choice neighborhood. This extrapolation methodology is relatively less informative compared to the reports of other implementation grant applicants, such as the health assessment in Chicago of residents in the target Woodlawn neighborhood.

The Chicago CNI planning process, similar to that used in Boston, also used resident self-reporting to identify health needs. However, the Woodlawn assessment gathered more specific information, specifically concerning health issues that residents would like to address; whether residents had health insurance; and what services they would like to have access to. While these questions were more informative than asking residents whether they have "serious health problems" and extrapolating using city-wide statistics (Boston), merely asking residents if they are in "good health" (Chicago) is not as informative as the survey methods employed by Urban Strategies in New Orleans.

The resident health needs assessment methods used in the New Orleans CNI planning process is superior to those of the four other 2011 implementation grantees. The New Orleans resident health needs assessment determined the prevalence of asthma, diabetes, and high blood pressure among adults in the neighborhood; it also asked about health outcomes for children in the neighborhood. Moreover, the New Orleans CNI project will use the results of the resident health needs assessment in longitudinal studies that will measure the effects of the Iberville/Treme transformation plan on residents over time.

However, some 2011 implementation grantees may not have collected any resident health data during the planning process. Information available on the San Francisco and Seattle CNI transformation plans does not disclose whether resident health needs assessments were utilized in drafting the plans. Specifically, the Seattle Housing Authority (SHA) made no reference to a resident health needs assessment in its vision

157. *See* Part II.
158. POAH, *Woodlawn Choice Neighborhood Initiative*, *supra* note 70.

for the CN implementation grant, suggesting that SHA may not have collected any resident health data. Neither does the information available about the San Francisco Housing Authority's transformation plan disclose whether it conducted a resident needs assessment prior to submitting its application.

Thus, under the current system, CNI does not collect neighborhood health data uniformly across implementation grantees, which will prevent a meaningful review of the health impact of the first round of implementation grants. If CNI grant applicants did conduct health needs assessments designed specifically for residents of the proposed choice neighborhood, such assessments could be used to show the long-term effects of CNI on resident health. This is particularly important because, as seen in the case of many HOPE VI projects that displaced residents, researchers found some redevelopment projects may actually harm resident health.

D. Some 2011 Implementation Grantees Have Conducted Resident Health Needs Assessments and Initiated Promising Health Interventions, While Others Have Not

The New Orleans and Woodlawn implementation grant efforts illustrate the available appropriate health intervention responses that CNI grantees should make in response to certain community health needs. In comparison to the other 2011 CNI implementation grantees, New Orleans provided the most robust and comprehensive health intervention response to community health needs.[159] The New Orleans implementation grant calls for: (1) health education and supportive services provided by non-profit Urban Strategies; (2) increased access to several nearby federally qualified health centers that provide a variety of services; (3) an obesity screening program; (4) increased access to a program that provides nutritional food to at risk populations; and (5) increased access to healthier food by 25 percent through supermarkets, farmers' markets, and smaller grocers that sell with fresh food.[160]

In its transformation plan, the Woodlawn CNI in Chicago, responding to an assessment of resident health needs, provided several interventions designed to address negative health outcomes.[161] Woodlawn's health interventions include a healthy family program focusing on adult fitness and nutrition, a mobile medical care unit, health education, programs designed to encourage residents to participate in nearby parks and recreation programs, and other community health service projects.[162]

159. *See* HANO, *Vision for People*, *supra* note 87 (detailing HANO's community health needs assessment and health interventions in response to that assessment).

160. *Id.*

161. POAH, *Vision for People*, *supra* note 78, at C.2.

162. *Id.*

Boston's transformation plan does not include any goals specifically related to resident health, although Boston conducted a resident needs assessment, used citywide health data, and found significant health needs.[163] In contrast, the San Francisco transformation plan includes several goals pertinent to resident health, although available information does not disclose the extent to which residents suffer from unmet health needs.[164] San Francisco will expand the neighborhood's health center; develop a senior center; encourage businesses to offer healthier food options; and support outdoor greening initiatives that will create additional athletic recreation opportunities.[165] Seattle also provided little detail about assessed resident health needs, but its plan calls for health interventions similar to those in San Francisco.[166]

E. Resident Health Needs in Distressed Neighborhoods Warrant a Variety of Health Interventions, Which CNI Should Require from CNI's Grantees

Research from the Popkin HOPE VI study and the Center for Healthy Housing suggest that all CNI planning and implementation grantees should make better health outcomes for residents a major focus of CNI efforts.[167] CNI grantees could provide a variety of interventions to address resident health needs,

> including partnering with public health clinics, [federally qualified health centers,] school-based health clinics, hospitals, and home visiting programs; [provid]ing mental health and substance abuse counseling in [on-site] supportive service programs; building recreational facilities; [creating partnerships for communities to use school recreational and athletic facilities]; and incorporating design elements into the built environment to promote active living.[168]

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163. City of Boston, CNI Grant Application, *supra* note 55, at Narrative Exh. 2, p. 12.

164. HUD, Choice Neighborhoods Project Summaries FY 2011, San Francisco, *supra* note 105.

165. *Choice Neighborhoods: McCormack Baron Salazar*, *supra* note 107.

166. *See supra* notes 105–13 and accompanying text (San Francisco's plan calls for several health interventions, including pedestrian friendly building design for the redeveloped distressed housing; incorporation of the neighborhood health center into the transformation plan; subsidizing small businesses that provide access to nutritious food; and redeveloping public park space).

167. *See* Robin Smith et al., Urban Institute, *Monitoring Success in Choice Neighborhoods*: *A Proposed Approach to Performance Management*, at 29–30 (April 2010), http://www.urban.org/UploadedPDF/412092-monitoring-success-in-choice.pdf ("We believe the research [from HOPE VI] suggests that all sites should make health a major focus of their supportive services for residents.").

168. *Id.* at 30.

As discussed in Part III.D, several of the 2011 CNI implementation grantees have already initiated some of these health interventions.

Moreover, CNI grantees should also implement necessary interventions for children's health by ensuring "children have safe places to play [and] that there are adequate recreational facilities."[169]

IV. Proposals for HUD's Choice Neighborhoods Initiative

Because the effects of neighborhood characteristics and housing conditions on health have several important implications for objectives of HUD's Choice Neighborhood Initiative, health-related issues warrant greater attention from HUD. Toward this end, HUD should require CNI grantees to design transformation plans in light of the impact that housing conditions and neighborhood effects have upon resident health. The author proposes that HUD change its CNI program in six ways to pay greater attention to health of residents in choice neighborhoods. This would improve CNI's efficacy and HUD's ability to measure the program's impact.

First, HUD should impose uniform health-outcome related data collection requirements by CNI grantees. Since its inception, CNI has been in the process of developing a metric that will be used to measure the progress of implementation grantees toward CNI's existing objectives, which do not directly include resident health.[170] However, a CNI requirement that grantees monitor health outcomes, in addition to the program's specific objectives, would provide insight into how to change the program to create better resident health outcomes. The New Orleans implementation grant, which tracked resident access to healthy food, among other data, provided an excellent example of data collection. Ideally, each implementation grantee would track such information and provide the data to HUD for public distribution.

Second, health outcomes should be monitored for residents of the entire choice neighborhood, not just for residents of the redeveloped distressed buildings. Collecting neighborhood-wide data would be informative, not only for future CNI implementation grantees, but also for designing health interventions in other distressed neighborhoods. For instance, the data collected by the City of Boston in its resident needs assessment reported only the number of residents in the distressed development with significant health problems and then relied on city-wide statistics to predict health issues faced by residents of the actual choice neighborhood. This was relatively less informative compared to the reports of other implementation grant applicants, such as Chicago in its Woodlawn application.

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169. *See id.* ("supportive services [provided under CNI grants] must focus on children's health and well-being, ensuring that services are not only provided to heads of household, but [also] to children and youth").

170. 2011 CNI NOFA, *supra* note 45.

Moreover, the Seattle Housing Authority, which is implementing its own preexisting redevelopment plans under a CNI grant, did not make any reference to a resident needs assessment in its vision for the CNI implementation grant. This may indicate that SHA did not collect any resident health data at all. Thus, under the current system, CNI does not collect neighborhood health data uniformly across implementation grantees, which will prevent the successes or failures of the first round of implementation grants from providing relevant information to HUD, state, and local policy makers.

Third, to improve community health in distressed neighborhoods, HUD should require implementation grantees to perform resident health needs assessments to develop strategies to improve the health of residents based on these assessments. HUD already requires CNI applicants to complete a physical needs assessment by an independent engineer or architect who conducts a physical inspection of the dwelling units and nondwelling space.[171] While a neighborhood is eligible for CNI because it contains distressed housing, making such an assessment imperative, CNI's other objectives relate specifically to improving conditions for people. Although CNI awards applicants three points for conducting a general resident needs assessment,[172] grantees may choose the specific needs to evaluate and are not required to consider resident health. Moreover, the methodology used by CNI applicants varies.[173]

One of CNI's three core objectives is to respond to needs of residents in distressed neighborhoods, warranting a requirement that all CNI grant applicants conduct resident health needs assessments.[174] Adequate health is fundamental to improving the other areas of life, including access to

171. HUD, FY2012 Choice Neighborhoods Planning Grants: NOFA Questions and Answers, http://portal.hud.gov/hudportal/documents/huddoc?id=nofaq_a2012.pdf ("A Physical Needs Assessment (PNA) "should be prepared by an independent registered engineer or architect that conducts a physical inspection of at least 10 percent of the dwelling units and 50 percent of the non-dwelling space.").

172. *See* 2013 CNI NOFA, *supra* note 4, at 67.

173. *See e.g.*, Sacramento Housing and Redevelopment Agency, Choice Neighborhood Initiative, *Twin Rivers Resident Needs Assessment*, at 3 Aug. 2012), http://www.shra.org/Portals/0/pdf/public_housing/Choice%20Neighborhood%20Resident%20Needs%20Assessment%20FINAL.pdf (noting the methodology of the resident needs assessment was adapted from the Iberville Household Survey, developed by Urban Strategies). Moreover, resident needs assessments may lack uniformity for a variety of reasons. For instance, the Iberville Household Survey, developed by Urban Strategies, is copyright protected. *Id.* Hence any CNI applicant who wishes to use the Iberville survey must be licensed by Urban Strategies.

174. HUD Fiscal Year 2010 NOFA for the Choice Neighborhoods Initiative—Round 1 NOFA (2010), http://www.hud.gov/offices/pih/programs/ph/cn/docs/2010-cn-nofa.pdf.

jobs and education, for residents in distressed neighborhoods.[175] Toward this end, HUD should require CNI grant applicants to conduct resident health needs assessments and to assess and respond to health needs of residents. The efforts of POAH in Chicago's Woodlawn Choice Neighborhood provides an example of how HUD could require CNI applicants to be attentive to resident health needs.

Fourth, HUD should specifically include an objective for improved resident health outcomes that is reflected in the rating factors used to make CNI funding decisions.[176] Toward this end, HUD should require CNI applicants to include efforts in their transformation plans to encourage the development of accessible neighborhood businesses that provide healthy, affordable food.

Fifth, where residents report high rates of not having health insurance, HUD should require that each implementation grant strengthen ties between agencies that provide health services and Choice Neighborhood residents. "Local partnerships highlighted by Health and Public Housing Conferences sponsored by HUD, the Joint Center for Political and Economic Studies, and the Urban Institute illustrate ways in which even limited cooperation between public housing authorities and public health agencies can improve the living environment and health of public housing residents."[177] In light of this, CNI should specifically require implementation grant applicants to provide social services designed to connect residents to health care services. The plan employed by the Woodlawn CNI provides an excellent example of this approach.

Sixth, and perhaps most important, HUD should allocate more of its discretionary funding to CNI in order to address the needs of a growing number of distressed neighborhoods across the country. In comparison to the $6.3 billion allocated to the HOPE VI program between 1992 and 2006,[178] CNI is on track to receive significantly less.[179] Between 2010 and 2013, CNI was allocated $390 million.[180] In contrast, HOPE VI

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175. *See* Part II (discussing Popkin's findings).

176. *See* HUD, *Choice Neighborhoods*, *supra* note 1 (CNI objectives related to housing, people, and neighborhood). Notably, there is an improved health objective already located under HUD's CNI objective related to people, but it is not adequately reflected in the rating factors. In its NOFA for CNI grants, HUD encourages applicants to undertake efforts to improve resident health. *See* http://www.hud.gov/offices/pih/programs/ph/cn/docs/2010-cn-nofa.pdf. However, CNI applicants receive comparatively fewer points for health-related concerns.

177. Manjarrez et al., *supra* note 21, at 6–7, and accompanying text.

178. *Id.* at 9; *see also* HUD, Public and Indian Housing Choice Neighborhoods, 2013 Summary Statement and Initiatives (Apr. 18, 2013), http://portal.hud.gov/hudportal/documents/huddoc?id=choice-neighb.pdf.

179. Manjarrez et al., *supra* note 21 and accompanying text; *see also* Public and Indian Housing Choice Neighborhoods, *supra* note 178.

180. Manjarrez et al., *supra* note 21.

funded redevelopment projects at an average close to $450 million per year.[181]

However, HUD's ability to fund CNI is limited by congressional discretion to fund and cut CNI appropriations, which have been vulnerable to deep budget cuts since the program's inception. In FY2011, less than two years after HUD unveiled CNI, Congress cut the appropriation for CNI by 50 percent, bringing it down to $100 million.[182] In FY 2012, the House Appropriations Subcommittee further dampened the Obama administration's attempt to expand CNI by eliminating its $250 million request.[183] From its start, CNI has faced considerable political opposition from Congress.

The restricted funding that CNI receives allows for only a few distressed neighborhoods to be funded across the country each year. Even if CNI achieves better education, employment, and health outcomes for residents in the targeted neighborhoods, the program will have a minimal impact on problems caused by distressed neighborhoods across the nation.

Conclusion

Many aspects of community planning and design in the CNI program are aimed at improving physical components of neighborhoods, which may in turn produce positive health outcomes. Some of the 2011 implementation grantees goals that focused on the people who live in distressed neighborhoods may result in improved resident health. However, successfully reducing the negative health outcomes associated with distressed neighborhoods to a substantial degree may require further affirmative steps on the part of HUD and implementation grantees.

An analysis of the transformation plans of the 2011 inaugural class of CNI implementation grantees demonstrates that cities and developers have very dissimilar approaches to redeveloping distressed neighborhoods. Some choose to respond to resident health needs with interventions, while others appear to have focused on other aspects of neighborhood transformation. However, if transformation plans do not prioritize resident health, HUD's CNI may not have the total transformative effect that the program is intended to achieve. As Susan Popkin found in her studies of HOPE VI, poor physical health of residents is a significant barrier to self-sufficiency and health problems may be the biggest barrier to employment for residents of Choice Neighborhoods. Thus, while creating vibrant mixed-income, mixed-use spaces and creating access to employment and education may be laudable goals, such program efforts will lack efficacy to any large degree if the poor health of residents goes virtually ignored.

181. *Id.*

182. Peter W. Salsich, Jr., *The Choice Neighborhoods Initiative Model Cities by Another Name, or Truly Transformative?*, Prob. & Prop., 34, 39 (Mar./Apr. 2012).

183. *See* Jason Jordan, *HUD Sustainability Grants Survive in Spending Compromise*, APA Pol'y News (Apr. 14, 2011).