THE RISE, FALL, AND RETURN OF THE PUBLIC OPTION IN HOUSING FINANCE

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INTRODUCTION

The U.S. housing finance system presents a conundrum for the scholar of regulation, as it simply cannot be described using the traditional regulatory vocabulary. Regulatory cosmology has long had but a limited number of elements: direct command-and-control legislation; Pigouvian taxation and subsidies; tradable Coasean quantity permits; and regulation via litigation.

None of these traditional regulatory approaches, however, is adequate to describe the regulation of housing finance in the United States. Instead, to understand U.S. housing finance regulation, it is necessary to conceive of a distinct regulatory approach, namely that of the "public option"—having the government compete in the market place for the provision of goods and services. Understanding the use of the public option in housing finance regulation—and its limitations—is critical to understanding the regulatory failures that precipitated the financial collapse in 2008, and holds lessons for a revised housing finance regulatory system.

Since the New Deal (and with roots going back to at least World War I), the fundamental approach of the US housing finance regulation has been the "public option"—having the government compete in the market against private enterprises. By having the government as a market participant with substantial market power, the government has been able to set the terms on which much of the market functions. In particular, the government has assumed a variety of secondary market or insurance roles that have allowed it to regulate the

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mortgage origination market upstream via market power in the secondary market and insurance markets.[2]

The public option approach to regulation is hardly unique to housing finance. It appears, in various forms, throughout government, whether from the most quotidian local government functions such as trash collection and policing to the provision of public pools, recreation facilities, parks, schools, universities, mass transit, and roads the provision of payment systems, pensions (Social Security), deposit insurance, medical insurance (Medicare and Medicaid), and national security and, most recently, the controversial (and ultimately abandoned) proposed "public option" for health insurance.

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

In other cases of public options, there is a segmentation of the market, with the government competing in (or as the sole competitor in) part of the market, while ceding other parts of the market to private parties. For example, in the District of Columbia, the municipality handles trash collection for 1-4 family residences, while private contractors handle larger multi-family structures and non-residential structures.

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

Relatedly, the use of a "public option" may be segmented by locality; municipal fire departments exist in some (predominantly urban)

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

communities, while others (often suburban or rural communities) have private (volunteer) fire companies. Historically, however, the fire company market was completely private, and rival fire companies would compete violently for the right to put out blazes; the development of municipal fire departments represents a displacement of private competitors. In related ambulance services, however, private companies continue to compete with the ambulances provided by municipal fire departments. Segmentation can occur as the result of monopoly-granting legislation, an unlevel playing field that favors the public option, or because of private market failures that cede the field to public participants.

Sometimes the "public option" exists in a complementary relationship to private firms, such as the employment of private police forces by universities to supplement public police resources. And sometimes the public option is the provision of a public good, such as the provision of lighthouses.

There are many other examples of public options that could be adduced, and obviously there are significant differences among these arrangements. One could rightly question whether they are in fact all manifestations of the same phenomenon or distinct phenomena. As it stands, we lack the regulatory vocabulary to have a taxonomy of public options and government-in-the-market. Despite the widespread existence of various types of "public options," they remain a virtually untheorized phenomenon.[3]

This paper does not attempt to present a general theory of public options as a form of regulation. Instead, having noted the phenomenon of the public option as a regulatory approach, this paper examines the use of public options in housing finance. It does so by tracing the arc of housing finance regulation from the Depression to the present. In so doing, it shows how public options were adopted during the Depression. Many of these public options were intended to be short-term measures, filling what were hoped to be temporary gaps in the market. Yet they endured and remained the major regulatory framework for housing finance for decades. Starting in the late 1960s, however, the public option regulatory approach began to be undermined, first by the

[3] Adam J. Levitin, *Public-Private Competition in Payments: The Role of the Federal Reserve*, Georgetown Law and Economics Research Paper, No. 1420061, June 23, 2009 (identifying public options as a distinct regulatory tool); DAVID A. MOSS, WHEN ALL ELSE FAILS: GOVERNMENT AS THE ULTIMATE RISK MANAGER (2004); JEAN-JACQUES LAFONT & JEAN TIROLE, A THEORY OF PROCUREMENT AND REGULATION 637-653 (1993) (modeling public private competition incentives).

privatization of Fannie Mae and creation of Freddie Mac, then by the relaxation of the remaining command-and-control regulations on mortgage lending, and then by the emergence of a private securitization market. The result was that when a wholly private market in housing finance emerged, there was simply no effective regulatory framework in place to address the risks attendant to the market.

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

This paper commences with a discussion of the housing finance crisis that was part of the Great Depression. It then turns to a consideration of the Hoover and Roosevelt regulatory response, which was to create government institutions in the market, rather than engaging in direct regulation or Pigouvian taxation. The paper then traces the fate of the public option approach through the privatization of the public options and the emergence of a new form of private competition. It shows that while the market developed, the regulatory framework did not; housing finance regulation continued to rely on a public option approach even as there was no longer a public option. The result was a functionally unregulated space in which housing finance's endemic information and agency problems returned in a déjà vu of the Depression-era mortgages.

I. HOUSING FINANCE CRISIS DURING THE DEPRESSION

The shape of the U.S. housing market was substantially different before the Great Depression. First and foremost, prior to the Depression, homeownership rates were substantially lower than today. From 1900 to 1930, homeownership rates hovered around 46%, and then declined slightly during the Depression. Renting, rather than owning, was pre-Depression norm, and those who owned their homes often owned them free and clear of liens. The prevalence of renting and of free and clear ownership was larger a function of the scarcity of mortgage finance.

Mortgage finance was scarcer in pre-Depression America because of the structure of U.S. financial markets. Pre-Depression mortgages were funded by primarily by depository institutions (national and state-chartered banks and state-chartered savings institutions), life insurance companies, or by individuals directly. They were not funded by capital markets, and no secondary market of scale existed.

A. Non-Geographically Diversified Funding and Lending

The funding of mortgages through depositaries, life companies and individuals meant that pre-Depression housing finance market was intensely local, yet still vulnerable to national waves in the availability of financing. Interest rates and the availability of financing varied significantly by locality and region. This was because of the local nature of the lending base. Interstate banking restrictions limited the geographic scope of banks' activities,[4] and individuals—who held a third of all mortgage debt as late as 1939—only lent locally.[5] Life companies lent on a more national scale using correspondent relationships, but they were a limited part of the market. Accordingly, there was much greater mortgage availability in capital-rich regions like the East than in capital-poor regions like the South and West.[6] Moreover, the pre-Depression the economy as a whole was much more localized, and consumer credit was more sensitive to local economic conditions. The result was that mortgage financing was highly cyclical and geographically based.

B. Flighty Funding

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

Both deposits and life insurance policies are particularly flighty forms of funding. Depositors can rapidly withdraw their funds from banks and thrifts, and life insurance policyholders can often demand the cash value of their policies. Moreover, both deposits and life insurance policies have shown themselves to be vulnerable to runs, in which one depositor's withdrawal of funds will trigger others or panics, in which the travails of one institution will spread to others. The result is the problem faced by George Bailey in *It's a Wonderful Life* when the Bailey Building and Loan Association's depositors demand their money back.

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[4] McFadden Act

[5] John H. Fahey, *Competition and Mortgage Rates*, 15 J. LAND & PUB. UTILITY ECON 150 (1939) (Fahey was Chairman of the Federal Home Loan Bank Board)

[6] Lance Davis, *The Investment Market, 1870-1914: The Evolution of a National Market*, 33 J. ECON. HIST. 355, 392 (1961) (finding empirical confirmation of regional interest rate differentials for both short-term and long-term capital); Kenneth A. Snowden, *Mortgage Rates and American Capital Market Development in the Late Nineteenth Century*, 47 J. ECON. HIST. 671, 688-89 (1987) (finding regional home and farm mortgage interest rate variation in excess of predicted risk premia); Kenneth A. Snowden, *Mortgage Lending and American Urbanization, 1880-1890*, 48 J. ECON. HIST., 273, 285 (1988).

George tries to explain to them that the money isn't in the vault—it's in their homes and can't be immediately liquefied.

The problem of flighty funding was a familiar one to US finance prior to the New Deal, but none of the solutions adopted were particularly effective. Consortiums of financial institutions attempted to arrange private cross-guarantees of each others obligations, such as that done by the New York Clearing House Association during the Panic of 1907, but these private arrangements only covered the institutions that were party to them. Thus, in 1907, the New York trust companies were not Clearing House members, and did not benefit from the cross-guarantee.

Individual states had guaranteed some types of bank obligations, such as notes, from as early as 1829, and federal deposit insurance was proposed in Congress starting in 1886. By the turn of the century, deposit insurance proposals were part of both major parties' Presidential platforms. Individual states began to adopt deposit insurance (the Democratic proposal to address the flightiness problem) starting in 1907, but its effectiveness was limited by the extent of the guarantee and the fiscal strength of states. In 1911, the federal government had authorized the U.S. Postal Service to offer passbook savings accounts, which were guaranteed by the government. Postal savings accounts ended up being used primarily by immigrant populations and had the ironic effect of exacerbating runs on private banks during the Depression because of their government guarantee and statutorily fixed 2% interest rate, which was well above market during much of the Depression.

C. Thin Secondary Markets

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

Attempts had been made prior to the Depression to establish secondary mortgage markets in the United States based on European models. By the mid-nineteenth century, deep secondary mortgage markets were well-established in both France (the state-chartered joint-stock monopoly *Crédit Foncier*) and the German states (cooperative borrowers' associations called *Landschaften* and private joint-stock banks in Prussia and Bavaria), and "[b]y 1900 the French and German market for mortgage-backed securities was larger than the corporate bond market and comparable in size to markets for government debt."[7] Although there were significant design differences in the European systems, they all operated on a basic principal—securities were issued by dedicated mortgage origination entities. Investors therefore assumed the credit risk of the origination entities. Because these entities' assets were primarily mortgages, the real credit risk assumed by the investors was that on the mortgages.

The European systems survived because they ensured that investors perceived them as free of default risk. This was done through two mechanisms. First, there were close links between the mortgage origination entities and the state. Mortgage investors thus believed there to be an implicit state guarantee of payment on the securities they held. Second, and relatedly, the state required heavy regulation of the mortgage market entities, including underwriting standards, overcollateralization of securities, capital requirements, dedicated sinking funds, auditing, and management qualifications.[8]

A series of attempts were made between the 1870s and 1920s to create secondary mortgage markets.[9] Generally these secondary market efforts focused on farm or commercial mortgages. No major attempt was made at developing a secondary market for residential real estate. All failed, resulting in ever-larger scandals. The details of these attempts and their failures need not concern us here; it is enough to note a few commonalities. First, all were purely private enterprises; there was no government involvement whatsoever. Second, they were virtually unregulated, and what regulation existed was wholly inadequate to ensuring prudent operations. Third, they all failed because of an inability to maintain underwriting standards, as the loan originators had no capital at risk in the mortgages themselves, regulation was scant, and investors in the mortgage-backed bonds lacked the ability to monitor the origination process or the collateral. In contrast, successful European

[7] Kenneth A. Snowden, *Mortgage Securitization in the United States: Twentieth Century Developments in Historical Perspective*, in ANGLO-AMERICAN FINANCIAL SYSTEMS: INSTITUTIONS AND MARKETS IN THE TWENTIETH CENTURY, MICHAEL D. BORDO & RICHARD SYLLA, EDS. 261, 270 (1995).

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

[9] The 1870s saw a 44% increase in farm acreage and a 54% increase in the number of farms in the mid-continent states near the frontier. H. Peers Brewer, *Eastern Money and Western Mortgages in the 1870s*, 50 BUS. HIST. REV. 356, 356-57 (1976); Snowden, *supra* note 7, at 274-79.

structures, "were either publicly financed or sponsored and were subject to intense regulatory scrutiny."[10]

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

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

The funding base for pre-Depression mortgages dictated the terms of the mortgages because of the risks that lenders—and their regulators—could tolerate. The typical pre-Depression mortgage was a short-term, non-amortizing loan.[11] The ratio of the loan amount to the value of the collateral property (the loan-to-value ratio or LTV) was relatively low, meaning a high down payment was required for a purchase. Less than 50% downpayments were rare,[12] although mortgages from savings and loan associations had slightly lower downpayments. (See Figure 1.) Thus, D. M. Frederiksen reported that the average mortgage loan in 1894 was for between 35 and 40 percent of the property's value.[13]

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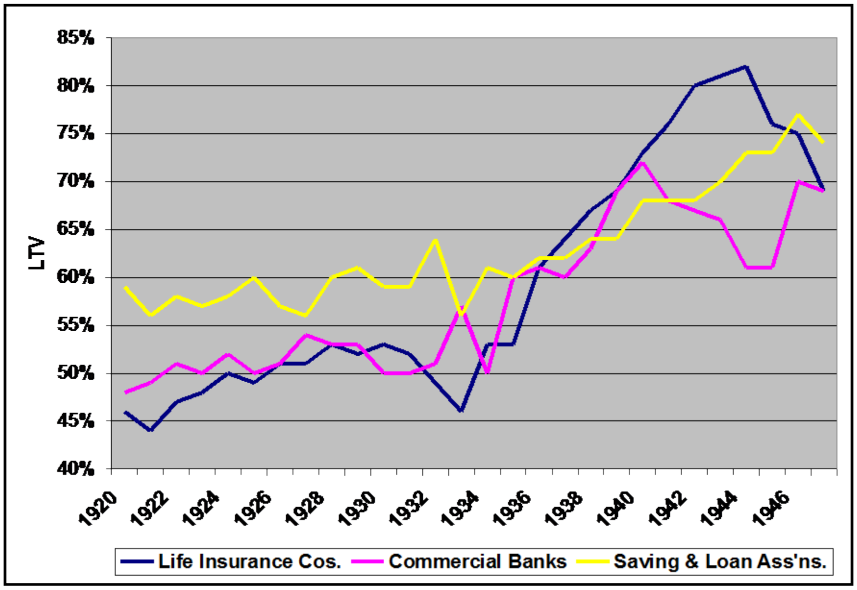
[10] Snowden, *supra* note 7, at 263.

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

[12] http://www.hud.gov/offices/hsg/fhahistory.cfm.

[13] D. M. Frederiksen, *Mortgage Banking in America*, 2 J. POL. ECON. 203, 204-205 (1894).

Figure 1. Average Mortgage Loan to Value Ratio, 1920-1947[14]



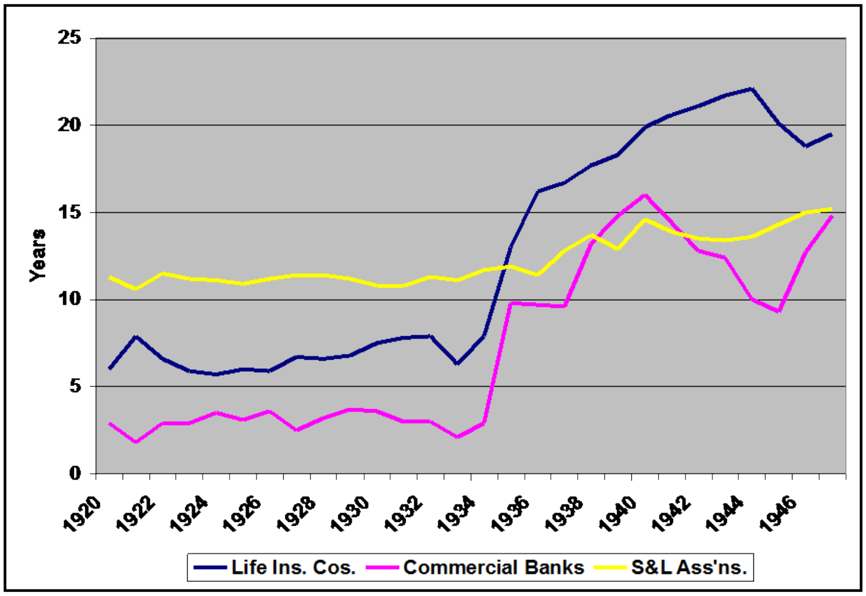
The loans were also for short terms, typically five years or less. Frederiksen reported in 1894 an average loan lifespan 4.81 years.[15] There appears to have been some variance, however, based on type of lending institution; savings and loan associations extended longer-term credit, with contract lengths averaging around 10 years. (See Figure 2).

The pre-Depression mortgage was generally short term albeit fixed-rate loan. The short term limited lenders' exposure to interest rate risk, but the fixed rate increased their interest rate risk exposure. If rates went up, the lender would find itself holding a below-market asset, while if rates fell, the borrower would refinance, but as indicated, the short term of the mortgage limited lenders' exposure, while increasing the borrowers' exposure. Given monetary instability in pre-Depression America, this was a significant risk, as inflation could quickly make a mortgage obligation unaffordable.

[14] LEO GREBLER *ET AL.*, *CAPITAL FORMATION IN RESIDENTIAL REAL ESTATE*, 503, Table O-6 (1956).

[15] Frederiksen, *supra* note 13, at 204-205.

Figure 2. Average Contract Length of Mortgages on 1-4 Family Residences, 1920-1947[16]



The pre-Depression mortgage was also typically not fully amortizing—the borrower would make only periodic interest payments during the term of the mortgage, with the most or all of the principal due in a lump sum (a "balloon" or a "bullet") at the end. Again, savings and loan associations were more likely to make amortized mortgages than other lenders, "an adaptation of the concept of a continuing savings plan."[17] Most mortgaged homeowners did not have the cash to pay off the balance, so they would simply refinance the loan, frequently from the same lender. This structure lowered the interest rate risk for the lending institution while raising it for the borrower.

The bullet loan structure made periodic mortgage payments more affordable. Yet because it was designed to be rolled over into a new loan, it always carried the risk that refinancing would not be possible. Not surprisingly, foreclosure rates were substantially higher on nonamortized or partially amortized loans.[18] (See Figure 3.)

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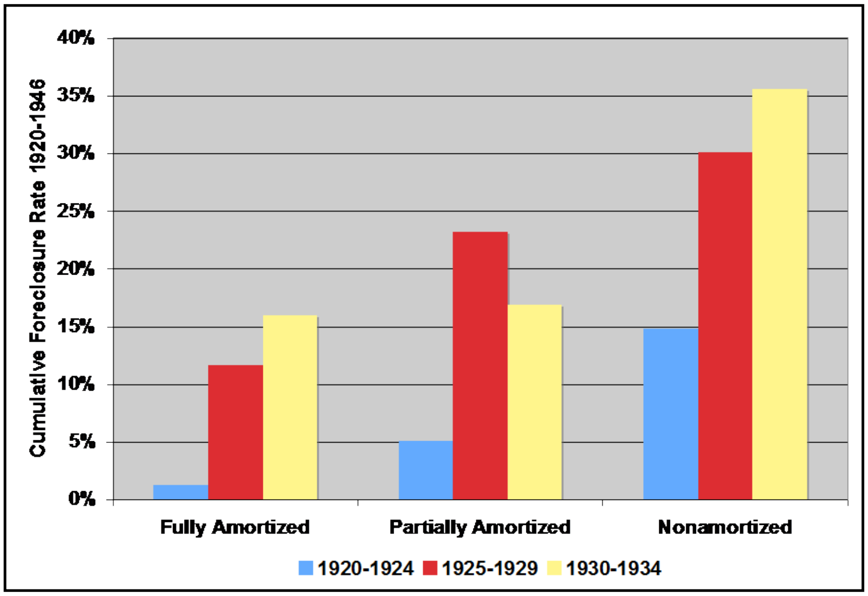
[16] GREBLER *ET AL.*, *SUPRA* note 14, 234, Table 67,

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

[18] *See* RAYMOND J. SAULNIER, *URBAN MORTGAGE LENDING BY LIFE INSURANCE COMPANIES* 83, 85 (1950) (Also noting that "Amortization provisions are of most importance on loans made sufficiently long before a period of mortgage distress to permit repayments to reduce the principal substantially.").

Figure 3. Cumulative Foreclosure Rates 1920-1946 by Amortization and Loan Origination Year[19]



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

Pre-Depression foreclosure rates were quite low; around .3% in 1929,[20] compared with an average of around 1% since 1978.[21] For 1920-1946, however, cumulative foreclosure rates were nearly double, for loans with LTV of 40% or more almost 20%[22] although they were lower

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[19] *See* SAULNIER, *SUPRA* note 18 at 140, Table B11 (1950).

[20] *See ID.* at 80.

[21] MBA National Delinquency Surveys.

[22] *See* SAULNIER, *SUPRA* note 18 at 89, Table 26 (1950) (9.5% cumulative foreclosure rate for LTV<40%, 18.6% cumulative foreclosure rate for LTV≥40%). Many borrowers also had junior mortgages on their properties, increasing the cumulative LTV ratio.

for loans with lower LTVs.[23] Because the loans did not amortize, the LTV ratio did not decrease during the life of the loan.

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

E. Lack of an Effective Market-Clearing Mechanism

A final problem in the pre-New Deal mortgage market was not patent until the Great Depression: the lack of an effective market-clearing mechanism for underwater mortgages. The Great Depression brought with it a foreclosure crisis, a decline in home construction, and a precipitous drop in mortgage finance availability due to financial institution failure and retrenchment. New housing starts dropped 90% from their peak in 1925 to 1933,[24] contributing to unemployment in home building and related industries. As unemployment soared, many homeowners found themselves strapped to make mortgage payments.

Moreover, the Depression's credit contraction left homeowners with bullet loans unable to refinance and facing unaffordable balloon payments. The predominant mortgage structure exposed homeowners to interest rate risk. Interest rate risk metastasized into credit risk. Home prices dropped as much as 50%, half of all residential mortgages were in default in 1933,[25] and at the worst of the Depression, nearly 10% of homes were in foreclosure.[26]

The fall in home prices during the Depression was a problem because the only way for the market to clear was through foreclosure. Absent foreclosure, lenders continued to carry non-performing assets on their books, making creditors unsure of the lenders' real financial position and unwilling to extend credit to them. Similarly, the lenders themselves retrenched in the face of non-performing, underwater assets.

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[23] *See* ID. at 91, Table 27 (1950) (providing data on foreclosure loss rates for life insurance companies).

[24] Weiss, *supra* note 17, at 112.

[25] Weiss, *supra* note 17, at 112.

[26] Richard Green & Susan M. Wachter, *The American Mortgage in Historical and International Context*, 19 J. ECON. PERSPECTIVES 93, 94-95 (2005).

Foreclosures cut through the fog of non-performing assets, but they were—and are—a slow clearing mechanism with many potential externalities—and states' Depression-era legislation aimed to make them even slower.

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

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

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

The New Deal regulatory response to the market failures in the housing market is notable for what it did *not* do. It did not proceed through command-and-control regulation. For example, it did not prohibit non-amortizing mortgages. Nor did it contain individual mandates for the purchase of private mortgage insurance. Similarly, it did not proceed through the Internal Revenue Code by taxing disfavored mortgage products (such as non-amortized or uninsured mortgages). Instead, the Hoover-Roosevelt response was to use government as a gap-filler in the market: where the market did not produce services and products, the government would.[27] Interstitial government.

[27] There was some precedent to this in the housing space; during World War I, the industrial boom in war production lead to a rapid influx of rural residents to urban industrial areas,

The Hoover-Roosevelt response involved the creation of four distinct public options.[28] These pieces were not part of a master plan devised beforehand. The initial two components were responses to different exigencies and interest groups, while the later two were responses to the problems created by the first two components.

A. Liquidity and Diversification: FHLB

First, in 1932, Congress created the Federal Home Loan Bank (FHLB) system, a credit reserve system modeled after the Federal Reserve, with 12 regional FHLBs mutually-owned by their member institutions and a central Federal Home Loan Bank Board to regulate the system.[29] Membership in the regional FHLBs was initially limited to safe and sound savings and loan associations, building and loan associations, savings banks, and insurance companies that were in the business of making long-term loans.[30] Thus, commercial banks—which could joint the Federal Reserve's discounting system—were excluded from the FHLB system. The Federal Reserve at this time could not make advances against mortgage collateral.[31]

The FHLBs' provided liquidity to mortgage lenders through the rediscounting of mortgages, meaning lending against mortgage collateral. FHLB rediscounting was initially restricted to lending against long-term mortgages with maturities between 5 and 15 years[32] and up to the lesser of 60% of the mortgage loan principal or 40% of the property

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where there was inadequate housing stock. U.S. Housing Corporation was created to build affordable housing stock for war production workers.

[28] This is not meant to imply that these four pieces were the entirety of federal involvement in the housing market. For example, the Emergency Relief and Construction Act of 1932 authorized the Reconstruction Finance Corporation to make loans to corporations formed to provide low income housing or urban renewal. Emergency Relief and Construction Act of 1932, 72 P.L. 302 § 201(a)(2); 72 Cong. Ch. 520; 47 Stat. 709, 711 (July 21, 1932).

[29] Federal Home Loan Bank Act, 72 P.L. 304; 72 Cong. Ch. 522; 47 Stat. 725 (July 22, 1932).

[30] Federal Home Loan Bank Act, 72 P.L. 304 §4(a); 72 Cong. Ch. 522; 47 Stat. 725, 726 (July 22, 1932).

[31] Paul Matthew Stoner, *The Mortgage Market—Today and After World War I*, 19 J. OF LAND & PUB. UTILITY ECON. 224, 227 (1943). Starting in 1974, the Federal Reserve was permitted to rediscount mortgages, like the FHLBs. The Emergency Home Purchase Assistance Act of 1974, P.L. 93-449, § 5, 88 Stat. 1368 (Oct. 18, 1974), *codified at* 12 U.S.C. § 347b(a) (second paragraph).

[32] 12 U.S.C. § 1421(a)(1)(C) (restricting FHLB membership eligibility to institutions making long-term loans, and deferring to Federal Home Loan Bank Board discretion on what is long-term); 12 C.F.R. § 925.1 (defining long term as longer than five years); Federal Home Loan Bank Act, 72 P.L. 304 §10(b); 72 Cong. Ch. 522; 47 Stat. 725, 732 (July 22, 1932) (mortgages with more than 15 years remaining to maturity ineligible as collateral for FHLB advances). The 15 year limit was gradually extended to 30 years and then abolished. 74 P.L. 76; 74 Cong. Ch. 150; 49 Stat. 293, 295 (May 28, 1935) (extending term to 20 years); 80 Cong. Ch. 431; 80 P.L. 311; 61 Stat. 714 (Aug. 1, 1947) (extending term to 25 years); 88 P.L. 560; 78 Stat. 769, 805 (Sept. 2, 1964) (extending term to 30 years); 97 P.L. 320; 96 Stat. 1469, 1507 (Oct. 15, 1982) (abolishing term limitation).

value.[33] Maximum property values were also prescribed for eligible collateral.[34] The FHLBs funded their own operations by issuing bonds, for which they were jointly and severally liable.[35] The FHLBs debt was not backed by the federal government, although an implicit guarantee might well have been assumed.[36]

The FHLB system created a secondary market for mortgages in the U.S. solved the problems of locality in mortgage lending. Whereas mortgage lenders were geographically constrained in both their lending and funding bases, the FHLB system provided a method for diversifying geographic risk in lending and tapping a national (or international) funding base.

Starting in 1933, the FHLB system also assumed regulatory oversight of the new federal savings and loan associations authorized by the Home Owners' Loan Act.[37] This new type of lending institution was to promote mutual thrifts for savings and mortgage lending. The Home Owners' Loan Act limited federal S&L lending activity: all lending had to be against real estate, and loans beyond 15% of total assets had to be secured by first liens on properties located within 50 miles of the S&L's home office and with a property value cap.[38] Federal thrifts were also restricted to making only fixed-rate loans.[39]

B. Federal Deposit Insurance: FDIC and FSLIC

Oversight authority over the federal S&Ls included resolution authority for failed institutions.[40] Resolution authority was bolstered in 1934 with the creation of the Federal Savings and Loan Insurance Corporation (FSLIC).[41] FSLIC provided deposit insurance for savings and loans, just as the Federal Deposit Insurance Corporation (FDIC),

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[33] Federal Home Loan Bank Act, 72 P.L. 304 §10(a)(1); 72 Cong. Ch. 522; 47 Stat. 725, 731 (July 22, 1932).

[34] Federal Home Loan Bank Act, 72 P.L. 304 §10(a)(1); 72 Cong. Ch. 522; 47 Stat. 725, 731 (July 22, 1932).

[35] Federal Home Loan Bank Act, 72 P.L. 304 §11(f); 72 Cong. Ch. 522; 47 Stat. 725, 734 (July 22, 1932), *codified at* 12 U.S.C. § 1431(b)-(c).

[36] Federal Home Loan Bank Act, 72 P.L. 304 §15; 72 Cong. Ch. 522; 47 Stat. 725, 736 (July 22, 1932), *codified at* 12 U.S.C. § 1435 ("All obligations of Federal Home Loan Banks shall plainly state that such obligations are not obligations of the United States and are not guaranteed by the United States.").

[37] Home Owners' Loan Act of 1933, 73 P.L. 43 § 5(c); 73 Cong. Ch. 64; 48 Stat. 128, 132 (June 13, 1933).

[38] Home Owners' Loan Act of 1933, 73 P.L. 43 § 5; 73 Cong. Ch. 64; 48 Stat. 128, 132-33 (June 13, 1933).

[39] CITE REGS ON THIS.

[40] Home Owners' Loan Act of 1933, 73 P.L. 43 § 5(d); 73 Cong. Ch. 64; 48 Stat. 128, 133 (June 13, 1933).

[41] National Housing Act, Title IV, 73 P.L. 479 § 402; 73 Cong. Ch. 847; 48 Stat. 1246, 1256 (June 27, 1934).

created in 1932, provided for commercial banks. Deposit insurance was critical because it helped depositary institutions address the duration mismatch between their assets (often long term) and liabilities (short-term deposits). Deposit insurance helped make deposits less flighty and thereby enabled depositaries to better manage maturities without keeping significant liquid assets on hand.

C. Market Clearing: HOLC

Faced with a growing mortgage default problem, Congress responded in 1933 by authorizing the FHLBB to create the Home Owners' Loan Corporation (HOLC), a U.S. government corporation,[42] authorized to refinance troubled mortgages. HOLC purchased defaulted mortgages from financial institutions in exchange for tax-exempt 4% 18-year bonds.[43] The financial institutions had to take a haircut on the refinancing, as HOLC would loan up to the lesser of 80% of LTV (but using a generous appraisal standard) or $14,000.[44] HOLC then restructured the mortgages into 15-to-20-year, fixed-rate, fully amortized obligations at 5% interest rates. This significantly reduced mortgage payments by allowing borrowers to pay off the mortgages over a long term.[45] HOLC originated and serviced all of its mortgages in-house.

HOLC received applications from 40% (!) of all residential mortgagors in its first year of operation and refinanced half of them.[46] HOLC resulted in a sudden and massive government entrance into the mortgage market, resulting in the government directly holding one in ten mortgages. Nonetheless, "[i]t was well understood that in the H.O.L.C. no permanent socialization of mortgage lending was intended and no attempt to preserve home ownership irrespective of public cost."[47] Therefore, HOLC "did not serve to divide opinion on any fundamental issues. Creditors were relieved of a crushing weight of frozen assets in a time of great stress, and debtors obtained more favorable credit terms

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[42] Home Owners' Loan Act of 1933, 73 P.L. 43 § 4(a)-(b); 73 Cong. Ch. 64; 48 Stat. 128, 129 (June 13, 1933).

[43] C. LOWELL HARRISS, *HISTORY AND POLICIES OF THE HOME OWNERS' LOAN CORPORATION* **11** (1951). Home Owners' Loan Act of 1933, 73 P.L. 43 § 4(d); 73 Cong. Ch. 64; 48 Stat. 128, 130 (June 13, 1933).

[44] Snowden, *supra* note 7, at 291; C HARRISS, *SUPRA* note 43, at PIN; Home Owners' Loan Act of 1933, 73 P.L. 43 § 4(d); 73 Cong. Ch. 64; 48 Stat. 128, 130 (June 13, 1933).

[45] HARRISS, *SUPRA* note 43, at ???. Home Owners' Loan Act of 1933, 73 P.L. 43 § 4(d); 73 Cong. Ch. 64; 48 Stat. 128, 130 (June 13, 1933). The interest rate on all HOLC loans was originally 5%, but was reduced in October 1939 to 4.5%. GREBLER *ET AL.*, *SUPRA* note 14, at 257.

[46] Snowden, *supra* note 7, at 292; HARRISS, *SUPRA* note 43

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

than had ever before prevailed in this country."[48] HOLC, then, represented a temporary public option, but the standards it set—long-term, fixed-rate, fully-amortized mortgages—became ingrained in U.S. housing finance.

Because HOLC would not refinance at 100% LTV, HOLC refinancings required consent of the existing mortgagee. At first, the federal government guaranteed only the timely payment of interest on HOLC securities, but not repayment of principal. Lenders were reluctant to accept HOLC refinancing, as they were both taking an instant haircut and assuming the credit risk of HOLC, whose assets were, by definition, a bunch of lemon loans.[49] Therefore, in order to facilitate HOLC refinancings, the federal government began to guarantee the principal on HOLC securities too,[50] and HOLC securities eventually traded at par.[51]

While HOLC resulted in a sudden and massive government entrance into the mortgage market—within a year it owned over 10% of all mortgages—"It was well understood that in the H.O.L.C. no permanent socialization of mortgage lending was intended and no attempt to preserve home ownership irrespective of public cost."[52] Therefore, HOLC "did not serve to divide opinion on any fundamental issues. Creditors were relieved of a crushing weight of frozen assets in a time of great stress, and debtors obtained more favorable credit terms than had ever before prevailed in this country."[53] HOLC represented a deliberately temporary public option to help mortgage finance markets clear other than through foreclosure.

HOLC wound down by 1951, but it had changed the facts on the ground in four major ways. First, it had forced a market clearing in the U.S. housing market. Second, it had turned a large pool of mortgages into marketable securities.[54] Third, it had set the long-term, fully amortized, fixed-rate mortgage as the federal government standard and demonstrated its feasibility.[55] The HOLC use of the long-term, fully amortized, fixed-rate mortgage, along with the creation of the FHLB

[48] *Id.*
[49] Snowden, *supra* note 7, at 291-92.
[50] Home Owners' Loan Act of 1933, 73 P.L. 43 § 4(c); 73 Cong. Ch. 64; 48 Stat. 128, 129-30 (June 13, 1933) (guaranteed as to interest); Home Owners' Loan Act of 1933, Amendments, 73 P.L. 178; 73 Cong. Ch. 168; 48 Stat. 643 (April 27, 1934) (guarantee as to principal and interest).
[51] *Id.*
[52] David M. French, *The Contest for a National System of Home-Mortgage Finance*, 35 AM. POL. SCI. REV. 53, 54 (1941).
[53] *Id.*
[54] *Id.* at 292.
[55] KENNETH T. JACKSON, *CRABGRASS FRONTIER: THE SUBURBANIZATION OF THE UNITED STATES* 196 (1985).

system, marked the government's practice of supporting "the practice of the savings and loan associations of making long-term amortized first mortgage loans with relatively small down payments and modest monthly payments."[56] As Marc A. Weiss has noted, HOLC, along with "other New Deal programs adapted the S&L model and vastly extended it to a large number and wide range of financial institutions, increasing the length of first mortgage loans from 3 to 30 years, decreasing the down payments from 50% to 10% or less, and significantly lowering interest rates."[57] And fourth, HOLC standardized many mortgage lending procedures, including standardized national appraisal methods, mortgage forms, and origination, foreclosure, and REO management processes.[58] The government's entrance into the mortgage market as direct lender via HOLC radically reshaped the U.S. mortgage market.

The HOLC created the template for a national mortgage market out of necessity, not forethought. HOLC rapidly made the federal government the largest single mortgagee in the United States. The federal government did not want to hold the HOLC-modified mortgages long-term because of the default and interest rate risk, as well as the political liability of the government having to conduct foreclosures on defaulted HOLC loans.[59] Therefore the government hoped to sell the HOLC-modified loans back into the private market.

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

D. Mortgage Insurance: FHA and VA

The vehicle through which the government assumed mortgage credit risk while leaving borrowers with interest rate risk was federal mortgage insurance from the Federal Housing Authority (FHA). The

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[56] Marc A. Weiss, *Own Your Own Home: Housing Policy and the Real Estate Industry*, paper presented to the Conference on Robert Moses and the Planned Environment, Hofstra University, June 11, 1998, at 5.

[57] *Id.*

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

[59] HOLC exercised extreme forbearance on defaults, was slow to foreclose, and rarely took or sought to collect deficiency judgment. HOLC default management was social work-inspired with the aim of rehabilitating the homeowner, rather than maximizing value for HOLC. HARRISS, *SUPRA* note 44, at ???.

FHA, a government agency created in 1934, was mandated to insure payment of principal and interest on mortgages in exchange for a small insurance premium charged to the originator and passed on to the borrower.

Because of the credit risk assumed by FHA, FHA insurance was only available for loans meeting certain characteristics. The maximum interest rate permitted on FHA-insured mortgages (exclusive of the insurance premium) was originally 5%.[60] FHA also required that mortgages be fixed rate and fully amortized.[61]

FHA was also willing to insure long-term and (for the time) high LTV mortgages. At first, FHA would insure loans with terms up to twenty years and 80% LTV, but after the 1937 recession, terms were liberalized to provide construction stimulus.[62]

FHA underwriting terms were modeled on the terms of HOLC refinanced mortgages, but were later liberalized. Eventually FHA was willing to insure up to 97% LTV and 30-year terms (and even 40 years on certain property types),[63] thereby creating a market in long-term and high LTV loans.

FHA insurance was only available for institutional lenders, not individuals.[64] The long-term impact of the FHA's exclusion of non-institutional lenders was to almost fully institutionalize the mortgage market.[65]

Because of the credit risk it assumed, FHA had to continue the work of HOLC in developing standard national appraisal and property management procedures. The methods that FHA developed acquired widespread acceptance in the mortgage industry as a whole.[66]

FHA-insured loans were designed to assist in housing affordability. They were not, however, designed to expand homeownership to the poor, but they were designed to be a *middle-class* affordability product. Low down payment requirements and long terms

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[60] GREBLER *ET AL.*, *SUPRA* note 14, at 257. FHA authority to restrict maximum interest rates of FHA-insured loans lapsed in 1983. 12 U.S.C. § 1709–1. Repealed. Pub. L. 98–181, title IV, § 404(a), Nov. 30, 1983, 97 Stat. 1208. It was later reduced to 4.5% and then 4%, and then raised back to 4.5%. GREBLER *ET AL.*, *SUPRA* note 14, at 257.

[61] 12 U.S.C. § 1709(b)(4); 24 C.F.R. § 203.17(c)(2 (amortization). 12 C.F.R. § 203.49 (permitting insurance of adjustable rate mortgages, but only as of June 6, 1984, 49 Fed. Reg. 23584.

[62] French, *supra* note 47, at 63.

[63] GREBLER *ET AL.*, *SUPRA* note 14, at 257-58

[64] *ID.* at 246.

[65] *ID.*

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

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

In order to ensure realization of the affordability benefits of FHA-insured mortgages, it was necessary to free financial institutions from legal restrictions on their lending activities. Thus, FHA-insured loans were exempt from the LTV and maturity restrictions of the National Bank Act.[67] FHA also embarked on a successful campaign to get all 48 state legislatures to amend their banking and insurance regulations to permit state-chartered institutions to originate and hold all FHA-insurable loans.[68]

Notably, the removal of state mortgage lending restrictions was done in concert with the creation of new federal restrictions and standards. Thus, the Home Owners' Loan Act's exemption of federally-chartered thrifts from state usury laws[69] must be seen in the context of the FHA-insurance interest rate cap. The FHA-insurance interest rate cap served as a federal usury law for mortgages. It directly limited rates on FHA-insured loans,[70] and it indirectly limited rates on conventional loans through competition between FHA and conventional products. HOLA preemption was not a policy statement against usury laws, but a harmonization of them to enable a new federal mortgage product that had its own functional usury limit in FHA underwriting terms.

The FHA insurance system was a response to several problems. First, it was a reaction to the government finding itself a major mortgagee as the result of the HOLC refinancings. The government hoped to be able to sell the HOLC refinanced mortgages to private

[67] GREBLER *ET AL.*, *SUPRA* note 14, at 246-47

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

[69] 12 U.S.C. § 1463(g).

[70] Fees were not covered, however. Verify—See Fahey article…

investors, but no investors would take the credit risk on the HOLC mortgages. Offering a credit guarantee of the mortgages was the only way to move them off the governments' books. Second, the government was hoping to attract more capital into the battered mortgage sector. The FHLB system and FSLIC insurance encouraged S&L mortgage lending, but to encourage commercial bank capital deployment in the mortgage sector, more was needed. Commercial banks were reluctant to become deeply committed to mortgages not least because of the illiquidity of mortgage assets.

Standardization via FHA insurance was intended to transform mortgages into more liquid assets. Notably, FHA insurance was not originally intended as a long-term intervention in the housing market—hence the original temporary duration of the Treasury guarantee of FHA debentures. Instead, FHA was intended to deal with the problem of unloading the pool of HOLC mortgages and jump-starting the housing sector. Only when it became apparent that the sector needed longer-term care did FHA evolve into an on-going guarantee program to ensure greater housing affordability going forward.

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

FHA insurance also supplied a second necessary precondition for a secondary market—the elimination of credit risk for investors. A secondary mortgage market cannot function unless credit risk is perceived as negligible or monitorable. Elimination, or at least standardization of credit risk, is itself part of standardizing the instruments to trade in a secondary market; as long as there is heterogeneous credit risk among mortgages, secondary market liquidity will be impaired. As economic historian Kenneth Snowden has observed:

> The key to successful securitization is to issue marketable assets only on the default-free cash flow implicit in the underlying mortgage pool—for uninformed investors will be unwilling to share any of the risk associate with default. Broad and thick secondary markets arise for mortgage-backed securities like there, and they trade at yields comparable to

> government bonds. Secondary markets are much thinner, on the other hand, when the entire cash flow from the underlying mortgage is securitized or when the default insurance component is only partially split off. In the extreme, mortgage-backed securities that carry default risk may not be marketable at all.[71]

Thus, in earlier secondary market experiments, credit risk on the mortgages, which investors could not easily ascertain, was perceived as being eliminated via sureties, as with the mortgage guarantee participation certificates or the single-property real estate bond houses. As early as 1943, Paul Matthew Stoner, the FHA's Assistant Director for Statistics and Research had recognized this. He argued that FHA insurance was necessary to replace the discredited private mortgage guarantee certificate system that had collapsed in scandal with the Depression.[72] For capital markets to fund mortgages, credit risk had to be neutralized (or at least perceived as such).

FHA mortgages were sufficiently standardized in their terms and credit risk to allow for an institutional market in them.[73] Thus, as economists Leo Grebler, David Blank, and Louis Winnick have noted:

> Government insurance of residential mortgage loans has created a debt instrument that can be shifted easily from one lender to another. From the lender's point of view, government insurance endows mortgage loans with greater uniformity of quality that has ever been the case before, and it reduces the necessity for detailed examination that usually accompanies the transfer of loans from one mortgagee to another. As a result, an active 'secondary market' for FHA and VA loans has developed, which in turn has widened the geographical scope of the market for mortgage loans and given it some of the characteristics of national capital markets.[74]

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

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[71] Snowden, *supra* note 7, at 266.
[72] Stoner, *supra* note 31, at 228.
[73] French, *supra* note 47, at 63.
[74] GREBLER *ET AL.*, *SUPRA* note 14, at 252-53.

E. Liquidity Again: FNMA

Investors had little appetite for buying individual mortgages in the secondary market, even if insured, because of the liquidity and interest rate risk involved as well as the transaction costs of diligencing individual mortgages. Therefore, the National Housing Act of 1934 also contained the fifth element of the housing finance overhaul. It provided for a federal charter for national mortgage associations to purchase these insured mortgages at par and thus create a secondary mortgage market.[75] The goal was to create a secondary market that would encourage mortgage originators to make new loans by allowing them to capitalize on future cash flows through a sale of the mortgages to the mortgage associations, which would fund themselves by issuing long-term fixed-rate debt with maturities similar to those of the mortgages.

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

Therefore, the Roosevelt administration proceeded to create its own secondary market entity. This was first done through the Reconstruction Finance Corporation (RFC), the so-called "fourth branch" of government during the New Deal, a government corporation that was active in many areas of the market as a financier because of the unwillingness of private institutions to lend. RFC created a subsidiary, the Reconstruction Finance Corporation Mortgage Company (RFCMC), a Maryland state corporation; the RFCMC did not utilize the federal national mortgage association charter created by the National Housing Act. The RFCMC purchased FHA-insured mortgages, but only on existing properties.[76] The reasons for this limitation in activity are not clear.

When still no applications for a federal national mortgage association charter were forthcoming by 1938, the RFC created another subsidiary under the federal charter provisions, the Federal National Mortgage Association of Washington (later the simply the Federal

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[75] National Housing Act of 1934, Title III, 73 P.L. 479 § 402; 73 Cong. Ch. 847; 48 Stat. 1246, 1252 (June 27, 1934).

[76] JAMES S. OLSON, *SAVING CAPITALISM: THE RECONSTRUCTION FINANCE CORPORATION AND THE NEW DEAL, 1933-1940*, 196 (1988). The RFCMC was intended to make loans against income producing properties, like hotels and apartment complexes, as well as to support a market in FHA-insured loans. *See* CAROL ARONVICL, *CATCHING UP WITH HOUSING* 88 (1936); OFFICE OF WAR INFORMATION, DIVISION OF PUBLIC INQUIRIES, UNITED STATES GOVERNMENT MANUAL 435-36 (1945), *at* http://ibiblio.org/hyperwar/ATO/USGM/index.html#contents.

National Mortgage Association, and now Fannie Mae).[77] Fannie's original name indicated the Roosevelt Administration's lingering hope that private capital would emerge to support other federal national mortgage associations. Fannie Mae was originally a wholly-owned subsidiary of the Reconstruction Finance Corporation, itself a U.S. government corporation. Unlike RFCMC, Fannie Mae originally purchased FHA-insured mortgages on new construction.[78]

Fannie purchased mortgages from financial institutions in exchange for its debt securities, which were backed (at this time period) by the full faith and credit of the United States government. Fannie would either keep the mortgage loans in its own portfolio, against which it issued bonds, which it used to fund its operations, or resell the loans whole to private investors. This meant that Fannie was able to pass on some of the interest rate risk on the mortgages to its bondholders, as their bonds had fixed-rate coupons. Neither the Fannie bondholders nor the lenders that sold mortgages to Fannie in exchange for its debt securities assumed any credit risk, however, because Fannie was a government corporation.

Fannie's activities before World War II were fairly limited. In 1938, it purchased $38 million of mortgages, compared with $36 million purchased by RFCMC.[79] Its pre-war activity peak was in 1939, when it purchased $88 million in mortgages.[80] Not until a decade later did Fannie surpass this level of activity.[81]

During World War II Fannie Mae largely ceased purchase operations. In 1942, RFCMC and Fannie seem to have assumed the same (limited) activities.[82] The U.S. mortgage market was moribund during the war, and did not need government support because the

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[77] *See* 12 U.S.C. § 1716, listing purposes of Fannie Mae charter as:

(1) provide stability in the secondary market for residential mortgages;

(2) respond appropriately to the private capital market;

(3) provide ongoing assistance to the secondary market for residential mortgages (including activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities)

by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing;

(4) promote access to mortgage credit throughout the Nation (including central cities, rural areas, and underserved areas) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing; and

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

[78] OLSON, *supra* note 76, at 196.

[79] OLSON, *supra* note 76, at 196.

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

[81] *Id.*

[82] OLSON, *supra* note 76, at ???.

wartime demand for mortgage finance was extremely limited, and private funds were eager for wartime outlets.[83] Fannie purchased almost no mortgages between 1943 and 1947 (none in 1944), and let its holdings dwindle to almost nothing.[84]

FNMA's pre-war accumulation of mortgages (as well as the RFCMC's) "were expected to decrease as soon as the FHA type mortgage had proved itself."[85] The RFCMC was even dissolved in 1947.[86] Lack of wartime construction created an acute post-war housing shortage, but the immediate post-war period was also flush with lots of pent-up funds that could finance construction and mortgages.[87] By 1948, however, other, more attractive investment outlets had become available, and the mortgage market was strapped for funds.[88]

Fannie Mae was virtually reborn in 1948, when Congressed amended its charter to authorize the purchase of VA-guaranteed mortgages.[89] In 1944, aiming to make housing more affordable to discharged servicemen, Congress had authorized the Veterans Administration to guarantee mortgages for veterans. The VA would originally guaranty up to 50% of the loan, and required no down payment and capped interest rates at a level equal to or below FHA-insurance eligibility caps.[90] VA mortgages were fixed rate, fully amortized loans with terms of as long as 30-years.[91] The increase in the amortization period from 15-20 to 30 years made housing even more affordable to servicemen, and the FHA soon adopted the 30-year fixed as its standard as well. Thus, by the 1950s, most mortgages were 30-year fixed with down payments of 20 percent.[92]

Fannie Mae entered the VA-guaranteed market in force, From June 30, 1948 to June 30, 1949, Fannie Mae's holdings increased 809

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

[84] Lindholm, *supra* note 80, at 56.

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

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

[87] Lindholm, *supra* note 80, at 56-57.

[88] McKinney, Jr., *supra* note 86, at 40.

[89] Lindholm, *supra* note 80, at 58. VA-guaranteed mortgages originally differed from FHA-insured mortgages in that there is no cost to the borrower for the VA-guaranty, whereas FHA administers a mutual insurance fund, in which the borrowers pay an insurance premium for the insurance on their loans. Since 1982, however, the VA has charged a guaranty fee. *See* P.L. 97-523, 96 Stat. 605, Title IV, § 406(a)(1), Sept. 8, 1982, *codified at* 38 U.S.C. § 3729.

[90] McKinney, Jr., *supra* note 86, at 40.

[91] Servicmen's Readjustment Act of 1944.

[92] Ben S. Bernanke, Housing, Housing Finance, and Monetary Policy, Speech at the Federal Reserve Bank of Kansas City's Economic Symposium, Jackson Hole, Wyoming, August 31, 2007, *at* http://www.federalreserve.gov/newsevents/speech/Bernanke20070831a.htm - fn5.

percent (!), as Fannie Mae extended purchase commitments in order to stimulate the construction market.[93]

Fannie Mae thus set the ground for three longer term structural features of the mortgage market. First, it provided liquidity for mortgage originators by creating a secondary market that linked capital market investors to mortgage lenders to mortgage borrowers. Thus by 1950 a third of FHA-insured loans and a quarter of VA-guaranteed loans had been acquired by purchase rather than origination, compared with only 11% of conventional loans.[94]

Second, the Fannie Mae secondary market reduced regional discrepancies in interest rates and financing availability.[95] Fannie was able to harness capital of investors from capital-rich regions to purchase or invest in mortgages from capital-poor regions. This helped smooth out the impact of regional economic booms and busts on the housing sector.

And fourth, Fannie continued the work of the HOLC in establishing the 20% down, self-amortizing, 30-year fixed-rate mortgage as the national standard; the subsidized cost of funds for the 30-year fixed because of Fannie's government backing helped crowd out other mortgage products; outside of the United States the long-term fixed-rate mortgage remains a rarity.

When the 30-year fixed was first introduced during the Depression, the long-term, fixed-rate, self-amortizing mortgage was an exotic product. The product was introduced at a time of tremendous market uncertainty about future incomes and the economy, and markets were reluctant to take up new, exotic product. Even with FHA insurance many lenders were reluctant to make long-term, fixed-rate loans because of the interest rate and liquidity risk. Fannie relieved the liquidity problem by offering to buy any and all FHA-mortgages at par, and by buying long-term, fixed-rate, self-amortizing mortgages and issuing bonds, Fannie Mae transformed what were then exotic mortgage products into plain vanilla, government-backed corporate bonds, something for which the market had a strong appetite.

The 30-year fixed was a product of a moment when the entire financial system was at risk, but it had advantages which helped give it staying power. The long term of the mortgage made it possible to borrow against their long-term earnings. Indeed, the advent of the 30-year fixed-rate mortgage arguably established the middle class as a class of property

93 Lindholm, *supra* note 80, at 56-57.
94 GREBLER *ET AL.*, *SUPRA* note 14, at 253.
95 *ID.* at 260.

owners—and as a class of debtors. While individuals are not able to secure credit by indenturing themselves, the long-term mortgage serves as a proxy for long-term payment commitment. The fixed rate allows families to avoid interest rate shocks against which they have little ability to hedge. Self-amortization protects against overleverage by constantly reducing the loan to value ratio. Self-amortization also serves as the perfect hedge for families who do not want to be exposed to payment shocks, the way they would be as renters.

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

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

III. THE DECLINE OF THE PUBLIC OPTION

Coming out of the New Deal, the primary mode of regulation of the U.S. housing finance system was through public options in the secondary market. There were still a variety of regulatory cobwebs on the state and federal regulation for particular types of lenders. Federal thrifts, for example, were prohibited from making adjustable rate loans, and some state prohibited all lenders from making adjustable rate loans, but by-and-large mortgage regulation was a matter of what the GSEs would buy and what FHA would insure. Even if other loan products could formally be made, there was no secondary market for them and lenders were generally unwilling to assume the risk themselves. Thus, through the domination of the secondary market by public options, the federal government was able to effectively regulate the mortgage market.

Between the late 1960s and the 2000s, however, the housing finance underwent a series of further changes that undermined the effectiveness of the public option approach.[96] Nonetheless, regulation via public options remained the mode of regulation.

A. Privatization of Public Options

First, in 1968, the Johnson administration, eager to clear room in the federal budget for Great Society spending and the Vietnam War, split up Fannie Mae into two entities. One entity was privatized as Fannie Mae. The other remained government owned and was christened Ginnie Mae. Ginnie Mae's mission was restricted to the securitization of FHA-insured and VA-guaranteed mortgages. Fannie Mae, under a revised charter, became privately capitalized, but under government regulation.

The privatization of Fannie Mae meant that its management would be subject to pressure from shareholders, who were not particularly concerned with the policy goals embodied in Fannie Mae. The privatized Fannie Mae was subject to some command-and-control regulation. It was required to maintain minimum capital levels 2.5% for on-balance sheet and .45% for off-balance sheet obligations.[97] Fannie's loan purchases were also subject to single exposure limitations (conforming loan limits) and LTV limitations absent mortgage insurance. Otherwise, however, underwriting was left up to Fannie Mae. The potential menu of loans that Fannie Mae could purchase was determined by what was possible in the loan origination market, so Fannie was in effect constrained by state and federal regulation of the primary market. The privatization of Fannie Mae had the effect of creating a secondary market for non-FHA/VA mortgages and thereby significantly loosening regulatory control over housing finance.

B. Creation of Private Public Option: FHLMC

In 1971, the federal government chartered another GSE, the Federal Home Loan Mortgage Corporation or Freddie Mac. Freddie Mac was originally a subsidiary of the FHLB system, designed to enable the securitization of mortgages originated by the S&Ls that belonged to the FHLBs, but Freddie was soon privatized.

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[96] The rebirth of the private mortgage industry in the late 1950s due to changes in Wisconsin insurance regulation also contributed to the undermining of the public option mode of regulation. Because of space constraints, we do not explore this issue in this Paper.

[97] Verify that these were original levels in 1968.

Initially Freddie Mac operated differently from Fannie Mae. Freddie engaged in securitization via pass-thru certificates issued against dedicated pools of mortgages, whereas Fannie funded the mortgages it purchased through the issuance of corporate debt. By the 1980s, however, Fannie had begun to engage in securitization and Freddie was issuing corporate debt, so the two models converged.

The critical move presented by both GSEs was the division of credit risk from interest rate risk. Investors in the GSEs' MBS assumed interest rate risk on the securitized mortgages, but not credit risk on them. Instead, they assumed the GSEs' credit risk, which was implicitly backed by the federal government. Similarly investors in GSE debt were really investing in interest rate risk plus an implied government security.

The emergence of Freddie Mac exacerbated the problems caused by privatizing the public option of Fannie Mae without ensuring the existence of another market-wide regulatory system. Freddie competed against Fannie, which put pressure on the GSEs to loosen their underwriting standards to gain market share. Into the late 1980s, however, the GSEs still had fairly small market share; most mortgages were still held in portfolio, particularly by savings and loans. It was only with the collapse of the S&L industry in the 1980s that the GSEs truly emerged as market giants.

C. The S&Ls

From the 1950s to the 1970s, the savings and loan was the institution that dominated U.S. housing finance.

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

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

In 1980, as part of the Depository Institutions Deregulation and Monetary Control Act,[98] Congress abolished all interest rate ceilings as well as limitations on points, brokers and closing fees, and other closing costs, for first-lien mortgages on residences and mobile homes.[99] Congress also extended national banks' "most favored lender" status to other depository institutions, enabling them to select between a federal and a state maximum applicable rate for their transactions,[100] which, when combined with the Supreme Court's 1978 *Marquette* decision and follow-up state parity laws for state-chartered institutions, functionally ended meaningful interest rate regulation in the United States. The *Marquette* decision, based on a plain language reading of the 1863 National Bank Act, permitted national banks export interest rate limitations (or lack thereof) from their home state to other states.[101] States responded by enacting parity laws to protect their state-chartered institutions by giving them the right to charge whatever rate a national bank could charge.[102] The result of this regulatory race was the evisceration of usury laws.

1982, Congress passed legislation that enabled the underwriting of second mortgages[103] and that preempted state laws that prohibited adjustable rate mortgages, balloon payments and negative amortization.[104] The FHLBB also rewrote its regulations for federal thrifts, allowing them to underwrite adjustable-rate mortgages. Congress also expanded the range of assets in which S&Ls could invest ("direct investment rules"), which enabled S&Ls to invest in assets with

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[98] Pub. L. No. 96-221, tit. v, 95 Stat. 164. Prior to 1980, Congress preempted state usury caps for FHA and VA loans. Cathy Lesser Mansfield, *The Road to Subprime "HEL" Was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market*, 51 S. CAR. L. Rev. 473, 484-92 (2000). Also discuss the Reagan-era removal of FHA 5% limit.

[99] 12 U.S.C. § 1735f-7a. NOTE STATE OPT-OUT POSSIBILITY.

[100] 12 U.S.C. § 1463(g) (federal savings and loan associations); § 1785(g) (federal credit unions); § 1831d(a) (state-chartered banks and savings banks). Under federal law, states still have the ability to opt out of the most favored lender preemption.

[101] Marquette National Bank of Minneapolis v. First of Omaha Service Corp., 439 U.S. 299 (1978).

[102] ELIZABETH RENUART & KATHLEEN E. KEEST, THE COST OF CREDIT: REGULATION, PREEMPTION, AND INDUSTRY ABUSES 120-21 (2005). Almost every state has enacted some form of parity provision. John J. Schroeder, *"Duel" Banking System? State Bank Parity Laws: An Examination of Regulatory Practice, Constitutional Issues, and Philosophical Questions,* 36 INDIANA L. REV. pin, 202 (2003).

[103] Limitations on due on sale clauses in 1982.

[104] Alternative Mortgage Parity Transactions Act of 1982, 12 U.S.C. § 3801 et seq. Five states—Maine, Massachusetts, New York, South Carolina, and Wisconsin—timely opted out of AMPTA preemption. RENUART & KEEST, *SUPRA* note 102, at §§ 3.10.1, 3.10.2 at n. 679.

potentially higher yields than home mortgages, thereby relieving their borrowing-return mismatch.[105]

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

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

D. Emergence of Private Secondary Market: PLS

While the GSEs dominated the secondary market until 2003-2006, a completely private, unregulated secondary mortgage market emerged starting in 1977. This was the private-label securitization (PLS) market. The PLS market began with the securitization of ultra-high quality mortgages that were too large to meet the GSEs' conforming loan limits. While the PLS market remained quite small for many years it began to take off in the mid-1990s as a result of the S&L crisis and to experiment in the securitization of loans to ever riskier borrowers, with rapid growth starting in the early 2000s, so that by 2006, almost one-half of all mortgage originations were nontraditional products and private label securitization had grown to 56% of the securitization market.

E. Reregulation and Deregulation via Preemption

The early growth, albeit limited, in subprime lending lead to a national legislative response, the Home Ownership and Equity Protection Act of 1994, which prohibited certain predatory lending practices for "high-cost" refinancing loans.[106] HOEPA regulated balloon payments, negative amortization, post-default interest rates, prepayment penalties, due-on-demand clauses, lending without regard to the borrower's ability to repay, and payments to home improvement contractors.[107] It also required special additional Truth in Lending disclosures and imposed

[105] The FHLBB disastrously widened this expansion by permitting the S&Ls to invest up to 11% of their assets in junk bonds, rather than the 1% permitted by statute, by allowing junk bonds to be counted as both "corporate loans" and non-investment grade securities.

[106] 15 U.S.C. § 1639.

[107]

assignee liability that trumps state Uniform Commercial Code Article 3 holder-in-due-course status,[108] enabling, among other things, rescission of loans made in violation of TILA requirements.[109] Finally, HOEPA directed that the Federal Reserve Board:

> shall prohibit acts or practices in connection with—
>
> > (A) mortgage loans that the Board finds to be unfair, deceptive, or designed to evade the provisions of this section; and
> >
> > (B) refinancing of mortgage loans that the Board finds to be associated with abusive lending practices, or that are otherwise not in the interest of the borrower.[110]

HOEPA's narrow scope limited its effectiveness as lenders easily avoided its application by pricing loans just under the HOEPA cost thresholds. Moreover, the Federal Reserve, under Alan Greenspan's chairmanship, engaged in a studious policy of inaction or "nonfeasance," refusing to engage in HOEPA rulemakings despite repeated requests from consumer groups and in derogation of its statutory duty. Many states, however, passed their own "mini-HOEPA" statutes.[111] Yet between 1996 and 2007, federal banking regulator pursued a single-minded campaign of deregulation via preemption, unraveling both state consumer protection laws and state attempts to enforce federal laws. This included both preemption via regulation (arguably exceeding the federal agency's statutory authority) and via litigation, culminating in the Supreme Court's 2007 ruling in *Watters v. Wachovia*, which upheld the Office of the Comptroller of the Currency's preemption of Michigan's attempt to regulate a subprime lender that was an unregulated operating subsidiary of a national bank.[112]

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[108] 15 U.S.C. § 1640(a); 12 C.F.R. §§ 226.32, 226.34. Holders of HOEPA loans are "subject to all claims and defenses . . . that could be raised against the original lender." 15 U.S.C. § 1641(d)(1).

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[110] 15 U.S.C. § 1639(l).

[111] McCoy & Renuart, http://www.jchs.harvard.edu/publications/finance/understanding_consumer_credit/papers/ucc08-5_mccoy_renuart.pdf21 states +DC. By 2007, only six states — Arizona, Delaware, Montana, North Dakota, Oregon, and South Dakota – did not regulate any of the most troublesome subprime loan terms: prepayment penalties, balloon clauses, or mandatory arbitration clauses. Raphael W. Bostic, Kathleen C. Engel, Patricia A. McCoy, Anthony Pennington-Cross and Susan M. Wachter, *State and Local Anti-Predatory Lending Laws: The Effect of Legal Enforcement Mechanisms,* 60 J. ECON. & BUS. 47, 49, 55-58 (2008).

[112] Watters v. Wachovia Bank, N.A., 550 U.S. 1 (2007). Cite to Wilmarth and McCoy/Renuart on history of preemption campaigns.

Unlike with HOLA preemption to enable FHA-insured lending, with national standards, federal preemption was not coupled with substitute federal regulation. Instead, a regulatory vacuum was substituted for disparate state regulation. Thus, at the very time the market-wide regulation system of public options was being undermined, Congress, in an effort to protect the S&L industry from the problems created by rising interest rates, dismantled significant parts of federal and state command-and-control regulation. Federal regulators then followed-up by undercutting the remaining state command-and-control regulatory systems through preemption and by refusing to vigorously implement the new (albeit limited in scope) federal command-and-control regulatory system of HOEPA. The result, by 2000 was a multi-trillion dollar national mortgage market with little remaining regulation.

E. Return of the Bullet Loans and the Debacle

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

The new bullet loans were also tied into a global financing system that amplified their performance but lessened market discipline on underwriting, as securitization separated economic ownership from underwriting, which created agency and information problems that encouraged riskier underwriting and underpricing for risk.[113] The result was disaster.

The post-New Deal U.S. mortgage market was built around regulation by public option, not command-and-control regulation. The public option was eroded through privatization and market developments, while the existing pieces of command-and-control regulation were removed by Congress and then federal regulators. The end result was that no regulator exercised complete power over the

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[113] Adam J. Levitin & Susan M. Wachter, *Explaining the Housing Bubble*, 100 GEORGETOWN L.J. (2011).

market and agency and information problems encouraged a rapid and unsustainable race to the bottom in lending standards.

IV. LOOKING FORWARD

As of 2008, the U.S. housing finance system had returned to a public option model. The private-label securitization market was dead. Fannie and Freddie were in federal conservatorship. The remaining public entities, FHA/VA, Ginnie Mae, and the FHLBs continued to function, but the mortgage market had become almost an entirely government-supported market. Public option regulation once again maps with a public option market. And once again, the public option is an inadvertent, reactionary approach adopted in response to a crisis, rather than a deliberate, methodical approach.

Going forward, however, it is not clear that public option regulation will continue to be the order of the day. The Dodd-Frank Wall Street Reform and Consumer Protection Act, the major legislative response to the financial crisis, signaled a different regulatory approach, namely that of command-and-control regulation. The Dodd-Frank Act creates a new set of command-and-control rules for both mortgage origination and mortgage securitization. For mortgage origination, the Dodd-Frank Act prohibits residential mortgage loans if the lender has verified the borrower's ability to repay.[114] Failure to do so is a defense against foreclosure.[115] The Dodd-Frank Act provides a safe-harbor for lenders to the ability to repay requirement, which does not apply to "qualified mortgages" (QMs),[116] as defined by yet-to-be-enacted Federal Reserve Board regulations. Non-QMs do not benefit from a presumption that the borrower was able to repay,[117] and are also prohibited from bearing prepayment penalties.[118]

Dodd-Frank also undertakes a reform of the securitization market by requiring that securitizers have "skin-in-the-game," meaning that they retain some risk exposure to their securitized assets.[119] Under regulations promulgated by a consortium of federal financial regulators, securitizers must retain a certain portion of credit risk on assets securitizations (or retain near identical deals) unless the securitized assets fall into certain exempt categories. The most important of those

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[114] Dodd-Frank Act, §1411, codified at 15 U.S.C. § 1693c(a).
[115] Dodd-Frank Act, §1413, codified at 15 U.S.C. § 1640
[116] Dodd-Frank Act, § 1412, *codified at* 15 U.S.C. § 1693c(b).
[117] Dodd-Frank Act, § 1412, *codified at* 15 U.S.C. § 1693c(b).
[118] Dodd-Frank Act, § 1414, *codified at* 15 U.S.C. § 1693c(c).
[119] Dodd-Frank Act, § 941, *codified at* 15 U.S.C. § 78o-11.

exemptions is for “qualified residential mortgages” (QRMs), again a term left to definition by the federal financial regulatory consortium.

The Dodd-Frank Act also creates a new Bureau of Consumer Financial Protection, which has broad powers to regulate all mortgage origination and insurance markets. If and when the CFPB does regulate, it will be either through command-and-control regulation or regulation via litigation.

The Dodd-Frank Act’s reforms aside, it remains to be seen what will happen to the public options that today *are* the mortgage market. Will Fannie and Freddie be nationalized, privatized, or recapitalized as hybrid entities? What role, if any, will government guarantees have? Will the market segment to a public option (like FHA/VA) for the poor and private for others? Or will the temporary measures taken in 2008-2010 end up lasting for decades, just like those of the New Deal.

A consideration of the options for housing finance reform is far beyond the scope of this paper, but it seems patent that the regulatory paradigm should track the market. If the market is to be privatized, command-and-control and Pigouvian taxation makes sense as the regulatory approach. If the market is to be nationalized, then the public option model makes sense. And if we end up with a combination, where public options coexist and compete with private actors, then the lesson to be learned from the collapse of 2008 is that command-and-control and Pigouvian taxation need to be combined with public option regulation. A public option is only effective at shaping competition in the market if all parties in the market have to compete on the same rules and standards. Otherwise, the result is merely market segmentation. Moreover, without basic standards applicable to all parties, the result can quickly become a race-to-the-bottom that can damage not only private parties, but also public entities.

The public option has been associated with long-standing structural changes that transformed the shape of American homeownership and mortgages. It created the long-term, fixed-rate, fully-amortized mortgage as the standard American housing finance product. In so doing, it made possible sustainable homeownership for American households and the economy.[120] But for public options to succeed as policy tools and not turn into liabilities, they need to function in a market that has standards for all.

[120] Kenneth Jackson, Crabgrass Frontier.