2012

# In Defense of the GSES

Steven A. Ramirez
*Loyola University Chicago, School of Law*, sramir3@luc.edu

# IN DEFENSE OF THE GSES

*Steven A. Ramirez*[*]



## I. INTRODUCTION

On September 6, 2008, Treasury Secretary Hank Paulson, amidst much controversy, placed Fannie Mae and Freddie Mac in government conservatorship.[1] This decision triggered a massive run on the global financial system that reverberates even today.[2] These two government sponsored enterprises (GSEs) held half of all mortgages in the United States.[3] Now, four years later, they remain in government hands with no clear exit. Some form of reform for the GSEs looms.[4]

Yet, before reforming the secondary mortgage market it is important to identify problems and goals. In identifying problems let me suggest two guidelines that transcend partisan politics: first, axiomatically, if there is a flaw in law and regulation, always blame the most powerful elements of society and not the disempowered; second, follow the money—usually the big monetary winners bear full responsibility for policy fiascos, especially if they enjoy easy access to those with political power. In terms of policy goals, as Adam Smith recognized centuries ago, laws that favor the disempowered

---

[*] Director, Business and Corporate Governance Law Center, Loyola University Chicago School of Law, Sramir3@luc.edu.

[1] *See* Stephen Labaton & Edmund L. Andrews, *In Rescue to Stabilize Lending, U.S. Takes Over Mortgage Finance Titans*, N.Y. TIMES, Sept. 8, 2008, at A1; Press Release, Fed. Hous. Fin. Agency (FHFA), Statement of FHFA Dir. James B. Lockhart 5 (Sept. 7, 2008), *available at* http://www.fhfa.gov/webfiles/23/FHFAStatement9708final.pdf.

[2] *See* ANATOLE KALETSKY, CAPITALISM 4.0: THE BIRTH OF A NEW ECONOMY IN THE AFTERMATH OF CRISIS 141–48 (2010).

[3] Charles Duhigg, *U.S. Likely to Keep the Reins on 2 Fallen Mortgage Giants*, N.Y. TIMES, Mar. 3, 2009, at A1.

[4] *See* Vicki Needham, *Housing Regulator Releases Plan to Wind Down Fannie, Freddie*, THE HILL (Feb. 21, 2012), http://thehill.com/blogs/on-the-money/1091-housing/211849-housing-regulator-releases-plan-to-wind-down-fannie-freddie.

must support sound policy, and laws that favor the "masters" must tend toward corruption.[5]

Following these axioms, the problems arise from the corruption and rigging of the secondary mortgage market by those that held the greatest amount of power and pocketed the greatest profits. Thus, the fundamentally racist effort to lay exclusive blame on "minority borrowers," or those who hold the lowest degree of power and suffered the greatest degree of loss, must fail as utter nonsense.[6] These modern-day Bull Connors will suffer the adverse verdict of history.

On the other hand, government efforts to expand home ownership seem destined to fall into disrepute in a high inequality environment because the very wealthy need no help to own homes. Further, untethering financial elites from regulation seems destined to lead to rigged and manipulated housing markets, especially if government picks up the tab in the end.

Applying these basic guidelines to recent problems in the secondary mortgage market provides insight into sound policy going forward. This article will first identify the causes of the mortgage market woes. Then, this article seeks to identify sustainable and economically sound policy goals.

## II. WHAT WENT WRONG?

There is no question that secondary market mortgage reform is very important. There is no question the United States must do something. Today, Fannie and Freddie executives enjoy private sector pay while their businesses enjoy the backing of a government agency.[7] The fundamental questions are: (1) what is wrong with housing in the United States today?; (2) what is wrong with the mortgage market?; and (3) what is wrong with the securitization process?

---

[5] STEVEN A. RAMIREZ, LAWLESS CAPITALISM: THE SUBPRIME CRISIS AND THE CASE FOR AN ECONOMIC RULE OF LAW (forthcoming Dec. 2012) (citing ADAM SMITH, WEALTH OF NATIONS 151 (Prometheus Books 1991) (1776)).

[6] *See* andré douglas pond cummings, *Racial Coding and the Financial Market Crisis*, 2011 UTAH L. REV. 141, 147–51, 207 (2011) ("The dirty little myth has transmogrified slightly and now attaches full market crisis fault to minority borrowers, the Community Reinvestment Act, and the federal government," including the GSEs).

[7] *See* Derek Kravitz, *Fannie, Freddie Executive Pay Limited, Bonuses Cut*, USA TODAY, Mar. 9, 2012, *available at* http://www.usatoday.com/money/companies/management/story/2012-03-09/fannie-mae-freddie-mac-exec-pay/53439310/1. The taxpayers fund huge private-sector compensation while guaranteeing the liabilities of the businesses—amounting to $170 billion in bailout funds paid to date. *Id.* In fact, GSE executives make far more than the President. Bruce Krasting, *Another Sweet Deal For The Heads Of Fannie And Freddie*, BUSINESS INSIDER (Mar. 12, 2012), http://articles.businessinsider.com/2012-03-12/news/31146828_1_compensation-fannie-and-freddie-retention-bonuses#ixzz1pa3I9ri9. *See generally* Lucian A. Bebchuk & Jesse M. Fried, *Executive Compensation at Fannie Mae: A Case Study of Perverse Incentives, Nonperformance Pay, and Camouflage*, 30 J. CORP. L. 807 (2005) (examining the flaws in executive compensation at Fannie Mae).

The mortgage market saw a tremendous spike in race-based predatory lending during the subprime boom.[8] For example, in the second half of 2006, at least half of all collateralized debt obligations (CDOs) issued were issued pursuant to something known as the "Magnetar Trade."[9] The Magnetar Trade denotes a hedge fund strategy whereby the hedge fund sponsors a CDO fund through an agreement to purchase the riskiest tranch—known as the equity tranch.[10] At the same time, the hedge fund has input into the selection of the CDO's collateral.[11] Further, the hedge fund holds an undisclosed short position on all other tranches of the CDO, and so it profits when the CDO fails.[12] The hedge fund never effectively discloses these short positions and their input into the selection of collateral to investors in the CDO.[13] This produced a strange, never seen before, reality: the sponsor of collateralized debt obligation funds (pools of mortgages) had a perverse incentive to see the funds fail while simultaneously helping to select mortgages to place in the funds.[14]

What could be more predatory than the sabotage of mortgages, to go looking for mortgages that were the most risky mortgages available, those most likely to default? The SEC charged three financial giants with fraud.[15] Goldman Sachs paid a record fine of $550 million arising from its involvement in the so-called Magnetar Trade.[16] But, this strategy pervaded Wall Street during the height of the subprime frenzy.[17]

Unfortunately, the Magnetar Trade is only the tip of the iceberg in terms of the pervasiveness of predatory lending. The state of Illinois spearheaded a multistate predatory lending action against Countrywide leading to an $8.7 billion dollar settlement (affecting over 400,000 homeowners nationwide).[18] The U.S. Department of Justice recently settled

---

8 cummings, *supra* note 6, at 177–81 (stating that "predatory lending ran amok in the run-up to the financial market crisis," especially in minority communities).

9 *See* FINANCIAL CRISIS INQUIRY COMMISSION, THE FINANCIAL CRISIS INQUIRY REPORT 190–95 (Jan. 2011) [hereinafter FCIC REPORT]; Jesse Eisinger & Jake Bernstein, *The Magnetar Trade: How One Hedge Fund Helped Keep the Bubble Going*, PROPUBLICA (Apr. 9, 2010), http://www.propublica.org/article/the-magnetar-trade-how-one-hedge-fund-helped-keep-the-housing-bubble-going.

10 *Id.* at 192.

11 *Id.*

12 *See id.*

13 *Id.*

14 Eisinger & Bernstein, *supra* note 9.

15 Edward Wyatt, *Citigroup to Pay Millions to End Fraud Complaint*, N.Y. TIMES, Oct. 20, 2011, at A1.

16 Steven A. Ramirez, *The Real Subprime and Predatory Fraud (Fannie and Freddie Acquitted Again and Again II)*, CORP. JUST. BLOG (Nov. 6, 2011, 6:41 PM), http://corporatejusticeblog.blogspot.com/2011/11/real-subprime-and-predatory-fraud.html. Citigroup and JP Morgan Chase settled charges for $285 million and $153.6 million, respectively. *Id.*

17 *Id.*

18 *Id.* (citing Press Release, Ill. Attorney Gen., Illinois Attorney General Madigan Leads $8.7 Billion Groundbreaking Settlement of Lawsuit Against Mortgage Giant

the largest fair lending lawsuit in the nation's history involving 200,000 victims of lending discrimination nationwide.[19] Similarly, the Federal Reserve fined Wells Fargo for predatory lending and steering involving 10,000 home mortgages.[20] According to a study cited by the Wall Street Journal, 61% of all subprime loans in 2006 went to prime borrowers.[21] The Los Angeles Times reported that 32 former Ameriquest employees "across the country say they witnessed or participated in improper practices, mostly in 2003 and 2004. This behavior was said to have included deceiving borrowers about the terms of their loans, forging documents, falsifying appraisals and fabricating borrowers' income to qualify them for loans they couldn't afford."[22] Thus, massive predatory lending formed a core cause of the subprime debacle.

The primary victims of this predatory lending were communities of color—that is, the most disempowered elements of our society. An early study showed that high income African-Americans were more likely to be steered into subprime loans than even low income white borrowers.[23] And, "the bursting of the housing market bubble in 2006 . . . took a far greater toll on the wealth of minorities than whites. From 2005 to 2009, inflation-adjusted median wealth fell by 66% among Hispanic households and 53% among black households, compared with just 16% among white households."[24]

We never saw this kind of predatory lending before in America. What changed?

The nation suffered its highest economic inequality in its history. According to economists, the more wealth that is concentrated in fewer hands, the easier it is for elites to engage in collective action and to rig the

---

Countrywide (Oct. 6, 2008), *available at* http://www.illinoisattorneygeneral.gov/pressroom/2008_10/20081006.html; *Helping Illinois Homeowners*, LISA MADIGAN ATTORNEY GENERAL, http://www.illinoisattorneygeneral.gov/pressroom/2008_10/20081006.html (last visited Mar. 30. 2012)).

19 Press Release, Dep't of Justice, Justice Department Reaches $335 Million Settlement to Resolve Allegations of Lending Discrimination by Countrywide Financial Corporation (Dec. 21, 2011), *available at* http://www.justice.gov/opa/pr/2011/December/11-ag-1694.html.

20 Ramirez, *supra* note 16.

21 Rick Brooks & Ruth Simon, *Subprime Debacle Traps Even Very Credit-Worthy*, WALL ST. J. (Dec. 3, 2007), http://online.wsj.com/article/SB119662974358911035.html.

22 Mike Hudson & E. Scott Reckard, *Workers Say Lender Ran 'Boiler Rooms'*, L.A. TIMES, Feb. 4, 2005, *available at* http://www.latimes.com/business/la-fi-ameriquest4feb0405,1,5202756.story.

23 AMAAD RIVERA, BRENDA COTTO-ESCALERA, ANISHA DESAI, JEANNETTE HUEZO & DEDRICK MUHAMMAD, FORECLOSED: STATE OF THE DREAM 2008 14–15 (2008), *available at* http://www.faireconomy.org/files/StateOfDream_01_16_08_Web.pdf.

24 RAKESH KOCHHAR, RICHARD FRY, & PAUL TAYLOR, WEALTH GAPS RISE TO RECORD HIGHS BETWEEN WHITES, BLACKS, HISPANICS 1 (July 26, 2011), *available at* http://www.pewsocialtrends.org/files/2011/07/SDT-Wealth-Report_7-26-11_FINAL.pdf.

legal and regulatory system.[25] Thus, high inequality leads to compromised legal and regulatory systems.[26] There is a wealth of economic literature about the pernicious effects of inequality on a robust middle class.[27]

Simon Johnson and James Kwak focus on the concentrated economic power of the financial sector as the crux of the problem driving the financial crisis.[28] Emmanuel Saez shows a massive spike in individual income inequality culminating in 2007, on the eve of the crisis. The top .01% at that time (15,617 families with annual income above $7,890,000), controlled 6% of national income; this was six times what the top .01% controlled in the 1970s.[29] During this same period, the power of the CEO over public firms also soared—a trend that I have termed "CEO primacy" in public corporations.[30] In my forthcoming book, *Lawless Capitalism: The Subprime Crisis and the Case for an Economic Rule of Law*, I term these trends "a triple whammy" of economic concentration that drove all aspects of the financial crisis.[31]

This radical concentration of economic power coincided with allowing banks to get so large and so interconnected in such a non-transparent way that the failure of one bank would take down the whole financial sector.[32] The largest banks used economic extortion to get politicians to bail them out with massive government support—including $180 billion to keep the GSEs afloat and further protect the so-called too-

---

25 *See* MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS 127 (2nd ed. 1971) ("Since relatively small groups will frequently be able voluntarily to organize and act in support of their common interests, and since large groups normally will not be able to do so, the outcome of the political struggle among the various groups in society will not be symmetrical. . . . [S]mall 'special interest' groups, the 'vested interests,' have disproportionate power.").

26 *See* Edward Glaeser, Jose Scheinkman & Andrei Shleifer, *The Injustice of Inequality*, 50 J. MONETARY ECON. 199 (2003) ("[I]f political and regulatory institutions can be moved by wealth or influence, they will favor the established, not the efficient.").

27 *See, e.g.*, William Easterly, *Inequality Does Cause Underdevelopment: Insights from a New Instrument*, 84 J. DEV. ECON. 755 (2007); *see infra* notes 28–31 and accompanying text (citing economic literature).

28 SIMON JOHNSON & JAMES KWAK, 13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN 59 (2010) ("Something changed during the last quarter century . . . the financial sector just got bigger and bigger.").

29 Emmanuel Saez, Striking it Richer: The Evolution of Top Incomes in the United States (Updated With 2009 and 2010 Estimates) fig. 3 (March 2, 2012) (unpublished article), *available at* http://elsa.berkeley.edu/~saez/saez-UStopincomes-2010.pdf.

30 Steven A. Ramirez, *The Special Interest Race to CEO Primacy and the End of Corporate Governance Law*, 32 DEL. J. CORP. L. 345, 346 (2007).

31 RAMIREZ, *supra* note 5.

32 *See* FCIC REPORT, *supra* note 9, at xvi–xvii ("Panic fanned by a lack of transparency of the balance sheets of major financial institutions, coupled with a tangle of interconnections among institutions perceived to be 'too big to fail,' caused the credit markets to seize up."). *See generally* GARY H. STERN & RON J. FELDMAN, TOO BIG TO FAIL: THE HAZARDS OF BANK BAILOUTS (2004) (discussing the idea of "too big to fail").

big-to-fail banks.[33] The implicit government guarantee caused banks and financial institutions to take more risks in the mortgage market than ever before.[34]

Derivatives deregulation also led to uncontrolled risk. As noted above, collateralized debt obligation funds derive their value from underlying collateral such as pools of mortgages.[35] And, like those CDOs involved in the Magnetar Trade, derivatives can hide risks.[36] Undisclosed risks can trigger sudden shifts in risk perception that feed panics, as investors flee newly realized risks at once.[37]

Consider the failure of Lehman Brothers. On the eve of its failure, Lehman Brothers had 900,000 derivatives contracts, and owed $40 of debt for each dollar of equity—meaning that only a 2.5% decline in asset values would render it insolvent.[38] They also held massive investments in real estate.[39] It is difficult for anyone, even a sophisticated investor, to make an intelligent investment choice on a firm that has 900,000 derivatives contracts. It is impossible to measure such risks. When risk perceptions shifted, Lehman suffered an electronic run that ultimately forced the highly leveraged firm into bankruptcy.[40] Investors lost confidence in Lehman and

---

33 *See* Julie Andersen Hill, *Shifting Losses: The Impact of Fannie's and Freddie's Conservatorships on Commercial Banks*, 35 HAMLINE L. REV. (forthcoming 2012) ("[T]he FHFA's conflicting mandates encourage the Enterprises to shift losses to smaller banks while absorbing losses that could be passed on to large banks, potentially exacerbating the problem of banks that are too big to fail.").

34 *See* OFFICE OF FED. HOUS. ENTER. OVERSIGHT, SYSTEMIC RISK: FANNIE MAE, FREDDIE MAC AND THE ROLE OF OFHEO 42 (2003) (explaining how the perception that the government would guarantee GSE debt caused less stringent credit limits); John C. Dugan, Comptroller of the Currency, Office of the Comptroller of the Currency, Remarks before the Exchequer Club 6 (July 21, 2010), *available at* http://www.occ.gov/news-issuances/speeches/2010/pub-speech-2010-84a.pdf ("[T]he recent financial crisis was caused by a number of factors . . . [including,] at the heart of it all, the worst mortgage underwriting in our nation's history.").

35 *See supra* text accompanying notes 9–14 (explaining the "Magnetar Trade").

36 FCIC REPORT, *supra* note 9, at xx.

37 *See id.* ("Within the financial system, the dangers of this debt were magnified because transparency was not required or desired. Massive, short-term borrowing, combined with obligations unseen by others in the market, heightened the chances the system could rapidly unravel.").

38 FCIC REPORT, *supra* note 9, at xix, 65; Carol J. Loomis, *Derivatives: The Risk that Still Won't Go Away*, CNN MONEY, http://money.cnn.com/2009/06/22/news/economy/derivatives_regulation_risks.fortune/index.htm (last updated June 24, 2009) (regarding Lehman's failure, "blame can be laid first on out-of-control leverage and bad investments in commercial real estate"). With only one dollar of equity supporting $41 in assets, a decline of 2.44% in asset values wipes out all equity.

39 FCIC REPORT, *supra* note 9, at xx ("By the end of 2007, Lehman had amassed $111 billion in commercial and residential real estate holdings and securities, which was almost twice what it held just two years before, and more than four times its total equity.").

40 *See id.* at 324–343 (providing a detailed explanation of the events that led to Lehman's downfall).

ultimately the entire financial sector.[41] Given these risks, and its thin capital base relative to debt, Lehman's failure seemed inevitable.[42]

The Private Securities Litigation Reform Act of 1995 ("PSLRA")[43] made it harder to sue for securities fraud.[44] The securitization of mortgages is a security.[45] When someone lies in connection with the purchase or sale of a securitized mortgage pool, a claim arises under the federal securities laws.[46] Unbelievably, the PSLRA actually exempts "forward looking" securities fraud from civil liability.[47] Further, it requires a higher level of proof of scienter (before discovery) than ever before.[48] So, fraudulent mortgage securitizations could proceed with less risk of liability under the federal securities laws than ever before.

Then there is the problem of massive accumulation of dollar currency reserves by developing nations. These nations accumulate dollar reserves to suppress the value of their currency relative to the dollar.[49] So, for example, China buys dollar assets with Yuan, which constricts the supply of dollar assets and places more Yuan supply into the global financial system. This helps nations export to the United States and renders U.S. labor relatively less competitive. It also lowers interest rates on U.S. debt instruments, including mortgage backed securities.[50] The price of U.S. debt was cheap, which resulted in an overabundance. This contributed towards excessive debt in our society.[51] It also helps transnational corporations by lowering the cost of manufacturing in developing nations and making products relatively cheaper for consumers in developed nations.[52]

---

41 *Id.* at xx, xxi, and 65.

42 *Id.* at 325 ("[S]ome institutional investors believed it was a matter not of *whether* Lehman would fail, but *when.*").

43 Private Securities Litigation Reform Act of 1995, Pub L. No. 104-66, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).

44 Steven A. Ramirez, *Arbitration and Reform in Private Securities Litigation: Dealing with the Meritorious As Well As the Frivolous*, 40 WM. & MARY L. REV. 1055, 1072 (1999).

45 *See* Zachary J. Gubler, *The Financial Innovation Process: Theory and Application*, 36 DEL. J. CORP. L. 65–66 (noting that one type of financial instrument that is responsible for the secondary mortgage market collapse, the Collateralized Debt Obligation, is a security).

46 *See generally* Christopher J. Miller, Note, *"Don't Blame Me, Blame the Financial Crisis": A Survey of Dismissal Rulings in 10B-5 Suits for Subprime Securities Losses*, 80 FORDHAM L. REV. 273 (2011) (discussing cases involving securities fraud in the context of mortgage-related securities created during the financial crisis).

47 Ramirez, *supra* note 44, at 1076.

48 *Id.* at 1074.

49 FCIC REPORT, *supra* note 9, at 419–20.

50 *See id.*; Steven A. Ramirez, *Taking Economic Human Rights Seriously After the Debt Crisis*, 42 LOY. U. CHI. L.J. 713 (2011).

51 FCIC REPORT, *supra* note 9, at 419–20 (dissenting statement of Keith Hennessy, Douglas Holtz-Eakin, and Bill Thomas).

52 *See* Steven A. Ramirez, *American Corporate Governance and Globalization*, 18 LA RAZA L.J. 47, 53–54 (2007).

All of these problems from financial deregulation to the structure of globalization to the PSLRA benefited CEOs, especially CEOs in the financial sector. Indeed, their compensation soared even as investors lost mightily.[53] In terms of the nation's mortgage market, elites rigged the entire system towards failure by using their power to free themselves from a wide array of regulatory constraints.

With all these extraneous problems (and many more) which negatively impacted the secondary mortgage market, one may wonder whether the GSEs contributed at all to the crisis.[54] Both the Bush and Clinton Administration imposed affordable housing mandates upon the GSEs.[55] Thus, it strains credulity to claim that the GSEs played zero role in a real estate market bubble (and bust) driven by subprime mortgages to lower income borrowers. On the other hand, the FCIC dissent correctly argued that there was a global real estate bubble, and the GSEs operated only in the United States.[56] Further, the GSE portfolios greatly outperformed private label mortgage backed securities issuers.[57] The FCIC commissioners reached broad agreement that the GSEs did not solely cause the financial crisis although they were one of many contributing factors.[58] That seems reasonable.

This counsels caution. Due to the fact that the crisis is rooted in a variety of causes, many of which are extraneous to the secondary mortgage market, reform of that market should proceed carefully. If the secondary

---

[53] *See* Lucian A. Bebchuk, Alma Cohen & Holger Spamann, *The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008*, 27 YALE J. ON REG. 257, 272–73 (2010) (analyzing the net financial payoff for Bear Stearns and Lehman executive teams during 2000-2008 and concluding that "performance-based" compensation more than made up for paper losses from exposing the firms to high risk investments); Steven A. Ramirez, *Lesson from the Subprime Debacle: Stress Testing CEO Autonomy*, 54 ST. LOUIS U. L.J. 1, 6 (2009) (discussing the distorted consequences of risk-taking conduct by CEOs that leads to high financial payoffs in executive compensation "while offloading staggering risks" of losses onto the corporation and the global economy); Sanjai Bhagat & Brian Bolton, Investment Bankers' Culture of Ownership 4–5, 18–20 (Aug. 2010) (unpublished manuscript), *available at* http://ssrn.com/abstract=1664520 (reviewing executive compensation of the CEOs at the 14 largest firms involved in the 2008 financial crisis and concluding that compensation arrangements created perverse incentives for excessive risk-taking that resulted in positive payoffs for the CEOs, while the shareholders suffered large losses).

[54] *See* cummings, *supra* note 6, at 151–203 (comprehensively analyzing the causes of the financial crisis).

[55] FCIC REPORT, *supra* note 9, at xxvii.

[56] FCIC REPORT, *supra* note 9, at 415–16 (dissent of Keith Hennessey, Douglas Holtz-Eakin, and Bill Thomas).

[57] FCIC REPORT, *supra* note 9, at xxvi.

[58] *Compare* FCIC REPORT, *supra* note 9, at xxvi ("We conclude that these two entities contributed to the crisis, but were not a primary cause."), *with* FCIC REPORT, *supra* note 9, at 437 (containing the dissenting views of FCIC commissioners, which conclude that "Fannie Mae and Freddie Mac did not by themselves cause the crisis, but they contributed significantly in a number of ways"). One of the ten commissioners assigns much more blame to the GSEs. *See* FCIC REPORT, *supra* note 9, at 441–538 (dissent of Peter J. Wallison).

mortgage market is a victim of a shotgun blast to the torso, then brain surgery is ill-advised.

## III. WHAT POLICY GOALS CAN SUCCEED ECONOMICALLY?

Not long ago, the housing market in the United States functioned well. After New Deal Reforms (which included the formation of Fannie Mae), home ownership soared.[59] New methods of home finance became the norm—including the thirty-year mortgage.[60] This meant jobs in the housing industry that frequently served as a catalyst for exiting recessions, as low interest rates from economic slack would naturally spur housing.[61] It also meant anchoring the middle class more firmly in the American economy in a way that only home ownership can accomplish.[62] Indeed, home ownership became the spine of the middle class economic fortunes after the New Deal.[63]

Fannie Mae was formed during the Great Depression.[64] Thereafter, from the 1930s until 2003 or 2004 when the bubble really got quite excessive, housing in America was a bright spot.[65] It was a success. It fomented a robust middle class and there are many stories of families who moved from lower class status to middle class status and beyond largely on the back of housing.[66] We used wealth in the form of housing to fund retirements, we used wealth in the form of housing appreciation to send kids to college, and, historically, there is a tight correlation between housing market appreciation and GDP.[67]

---

59 *See* Andrea J. Boyack, *Laudable Goals and Unintended Consequences: The Role and Control of Fannie Mae and Freddie Mac*, 60 AM. U. L. REV. 1489, 1495–1500 (2011).

60 *See id.* at 1545 n.254.

61 *See* Lynne L. Dallas, *Short-Termism, the Financial Crisis, and Corporate Governance*, 37 J. CORP. L. 265, 281–84 (2012).

62 *See* Boyack, *supra* note 59, at 1499.

63 Steven A. Ramirez, *The Law and Macroeconomics of the New Deal at 70*, 62 MD. L. REV. 515, 559–61 (2003).

64 National Housing Act, Pub. L. No. 73-479, § 1, 48 Stat. 1246, 1246 (1934) (codified at 12 U.S.C. § 1716 (2006)).

65 Boyack, *supra* note 59, at 1492 ("For decades, the U.S. mortgage finance system was the envy of the world—the only industrialized nation to have a significant segment of housing costs covered by private capital through a securitization investment system." (footnote omitted)).

66 *See* Kai Wright, *The Assault on the Black Middle Class*, AM. PROSPECT (June 26, 2009), http://prospect.org/article/assault-black-middle-class ("Homeownership has been a crucial building block of middle-class wealth ever since Jefferson promoted land-tenure laws that favored freeholders and Lincoln signed the Homestead Act. Today, housing represents nearly two-thirds of all middle-class wealth.").

67 *See* Adam Hersh, *Economic Recovery is Still Threatened*, MARKETWATCH (Jan. 27, 2012), http://articles.marketwatch.com/2012-01-27/commentary/ 30764560_1_ quarter-of-economic-expansion-fourth-quarter-growth-gdp. One commentator explains:

Further, one cannot build houses in China to sell in America. Jobs in the housing sector cannot be outsourced. This means that a robust housing industry can operate to stabilize employment in a globalized economy. Typically, housing has led the economy out of recessions.[68] Today many commentators argue that there will be no robust recovery without a recovery in housing.[69] Government sponsored loans account for up to seventy-five percent of today's mortgage market.[70]

Therefore, government policies that support and stabilize home ownership contribute to a robust middle class and should be pursued in a sustainable manner, particularly during an economic downturn.[71] Trying to expand home ownership when an economy is shredding jobs will not work. Unfortunately, the Bush Administration's efforts to pursue broader home ownership in the face of contracting employment failed miserably.[72] The futility of this effort is manifest in the employment ratio, the broadest measure of employment:[73]

---

> [I]n typical recessions residential investment tends to lead the recovery, up 23% on average at this point in the business cycle, [but] at present it is languishing more than 45% below its pre-recession level. . . . [R]esolving weakness and uncertainty in the real estate market are central to boosting both household consumption and residential investment.

*Id.*

[68] Chris Isidore, *Desperate for a Housing Rebound*, CNNMONEY (June 2, 2011), http://money.cnn.com/2011/06/02/news/economy/housing_economy/index.htm ("Housing typically helps lead the way in an economic recovery not only through a surge of construction and the hiring that goes with it, but through demand for goods and services that go into forming a new household.").

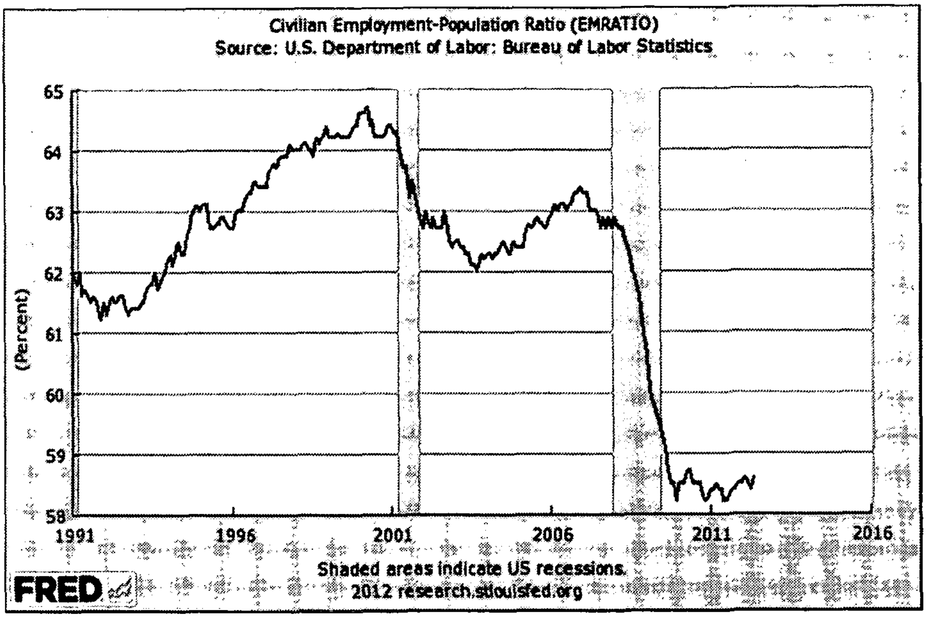
[69] Robert Reich, *Housing is the Rotting Core of the US Recovery*, FIN. TIMES (Feb. 27, 2012), http://www.ft.com/intl/cms/s/0/d10dd468-6136-11e1-a738-00144feabdc0.html#axzz1nguOtyFP ("[T]he negative wealth effect of home values, combined with declining wages, makes it highly unlikely the US will enjoy a robust recovery any time soon.").

[70] *See* Boyack, *supra* note 59, at 1526 n.159.

[71] Lawrence H. Summers, *To Fix the Economy, Fix the Housing Market*, REUTERS (Oct. 24, 2011), http://blogs.reuters.com/lawrencesummers/2011/10/24/to-fix-the-economy-fix-the-housing-market/.

[72] *See Bush Aims to Boost Minority Home Ownership*, CNN (June 17, 2002), http://articles.cnn.com/2002-06-17/politics/bush.minority.homes_1_home-ownership-home-buyers-american-dream-down-payment-fund?_s=PM:ALLPOLITICS.

[73] *Civilian Employment-Population Ratio*, FED. RES. BANK ST. LOUIS, http://research.stlouisfed.org/fred2/series/EMRATIO (last updated May 1, 2012).




The lesson is that expanding home ownership makes sense unless an economy fails to produce job growth and earnings growth to sustain more mortgage debt.[74]

Still, do we need the GSEs in their current form? The private governance structure serves no discernible policy goal. The GSEs used millions to influence lawmakers and escape appropriate regulation.[75] The FCIC termed the GSEs the "kings of leverage."[76] No private actor should benefit from a government guarantee except in narrow circumstances and for limited purposes under government supervision.[77] The GSEs even aroused the SEC which presently claims that the GSE executives committed securities fraud.[78] Finally, the GSEs invested in subprime loans in a reckless manner (and at an inopportune time).[79] In short, the GSEs were corrupt and reckless.

Nevertheless, a government agency that exists to assure that loans are well-documented and well-underwritten may benefit the secondary market and will certainly benefit the U.S. economy, just as the GSEs did in

---

74 I argued in 2006 that the current structure of globalization would create a crisis in buying power and too much debt. *See* Steven A. Ramirez, *Endogenous Growth Theory, Status Quo Efficiency, and Globalization*, 17 BERKELEY LA RAZA L.J. 1, 4 (2006).

75 FCIC REPORT, *supra* note 9, at xxvi.

76 *Id.* at xx.

77 *See id.* at xxvi–xxvii.

78 *See* Nick Timiraos & Chad Bray, *SEC Brings Crisis-Era Suits*, WALL ST. J. (Dec. 17, 2011), http://online.wsj.com/article/SB10001424052970203733304577102310955780788.html.

79 Boyack, *supra* note 59, at 1516–18.

the past.[80] Such a function facilitates the flow of capital into the nation's housing market by allowing banks to recycle their scarce capital into new loans.[81] Creating mortgage backed securities consisting of geographically diverse mortgages reduces risks to local and regional banks.[82] Such securities also provide a safe haven for investors seeking low-risk but higher returns than sovereign debt.[83] Guaranteeing such safe debt instruments need not cost the government and taxpayers in a well-regulated mortgage market where the government guarantee backs only the highest quality mortgages.[84] This function secures lower cost capital for home mortgages for the middle class.[85]

Indeed, this function of facilitating a safe and sound secondary mortgage market is so important that no private actor should add to the costs of such a program or benefit from the government guarantee. Thus, the cost of private compensation and other executive benefits should be eliminated in favor of government sector salaries, benefits, and job security. This would eliminate the core problem arising from the GSEs and create an appropriate blend of private and government functions.

Further, a model for this type of government guarantee program already exists—the Federal Deposit Insurance Corporation (FDIC). The FDIC is a self-funded, independent agency.[86] The FDIC administers bank deposit insurance, backed by the full faith and credit of the United States.[87] It charges insurance premiums for the risks it assumes and enjoys broad regulatory power to control the risks it assumes.[88] Moreover, banks that fail to comply with safe and sound lending practices lose deposit insurance.[89] The proper and detailed institutional design of a federal mortgage guarantee corporation is beyond the scope of these remarks. Yet, a compelling case can be made for the need for such an agency.[90]

---

80 *See id.* at 1539–54.

81 See id. at 1540 (stating that "reductions in GSE market activity would markedly increase uncertainty in the finance capital available for single family and multifamily residential mortgages").

82 Mark L. Korell, *The Workings of Private Mortgage Bankers and Securitization Conduits*, *in* A PRIMER ON SECURITIZATION 91, 96 (Leon T. Kendall & Michael J. Fishman eds., 1996).

83 *See id.* at 1551.

84 *See id.* at 1557–58.

85 *See id.* at 1543–47 (explaining how, without the GSEs, the cost of mortgage capital will increase significantly).

86 *See History of the FDIC*, FDIC, http://www.fdic.gov/about/history/index.html (last updated Jan. 20, 2012).

87 *See Symbol of Confidence*, FDIC, http://www.fdic.gov/consumers/banking/confidence/symbol.html (last updated July 20, 2010).

88 *FDIC Enforcement Decisions and Orders*, FDIC, https://www5.fdic.gov/EDO/index.html (last updated Jan. 2, 2012).

89 *Id.*

90 *See* Jacob Werrett, Note, *Achieving Meaningful Mortgage Reform*, 42 CONN. L. REV. 319, 349–64 (2009).

The residential real estate market still stagnates under declining values.[91] The government cannot withdraw its support from that sector without courting another brush with economic disaster. There are many proposals for reform; but no proposal that seeks to revert to a pre-Depression privatized mortgage market should be taken seriously. The United States is the only industrialized nation to offer thirty-year mortgages, as a result of the GSEs.[92] Eliminating this mortgage product would cause a long and deep disruption of the nation's housing market.[93]

Given the historic success of the United States in fostering home ownership, reformers should be reluctant to radically experiment with untested or, worse, failed approaches. The destruction of sound legal and regulatory infrastructure after decades of economic stability drove this crisis. Reverting to yesteryear's laissez-faire ideology will lead to yesteryear's serial economic disasters. Today, the urgent need is to stabilize the real estate market, even if some gains in home ownership must be forfeited due to economic stagnation.

## IV. CONCLUSION

The GSEs played an important role in U.S. economic prosperity since their creation as part of the New Deal in the 1930s. The recent setbacks of the GSEs should not detract from the success they achieved in capitalizing middle class home ownership. The GSEs require restructuring, not abolition. That restructuring should focus on supporting a robust middle class and avoid any further benefits to the very wealthy and powerful.

---

91 Shobhana Chandra, *Home Prices in 20 U.S. Cities Decline 4%*, BLOOMBERG (Feb. 28, 2012), http://www.bloomberg.com/news/2012-02-28/home-prices-in-20-u-s-cities-decline-4-.html.

92 Boyack, *supra* note 59, at 1493.

93 *Id.* at 1537–54.