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Sacred Cows and Workhorses: The Sale of Accounts and Chattel Paper under the U.C.C. and the Effects of Violating a Fundamental Drafting Principle

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REGULATION AND REFORM OF THE MORTGAGE MARKET AND THE NATURE OF MORTGAGE LOANS: LESSONS FROM FANNIE MAE AND FREDDIE MAC

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I. INTRODUCTION

These are not happy times for many of the participants in the mortgage finance market. As the other articles in this symposium describe,[1] a substantial number of borrowers, mortgage loan originators, financial institutions, other lenders, investment bankers, government-sponsored enterprises (Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac)), and investors have faced and continue to face financial hardship, insolvency, and bankruptcy. The current mortgage market crisis has generated criticism from various parts of the mortgage finance

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1. Kristen David Adams, *Homeownership: American Dream or Illusion of Empowerment?*, 60 S.C. L. REV. 573 (2009); Raymond H. Brescia, *Part of the Disease or Part of the Cure: The Financial Crisis and the Community Reinvestment Act*, 60 S.C. L. REV. 617 (2009); John Patrick Hunt, *One Cheer for Credit Rating Agencies: How the Mark-to-Market Accounting Debate Highlights the Case for Rating-Dependent Capital Regulation*, 60 S.C. L. REV. 749 (2009); Gerald Korngold, *Legal and Policy Choices in the Aftermath of the Subprime and Mortgage Financing Crisis*, 60 S.C. L. REV. 727 (2009); Brian M. McCall, *Learning from Our History: Evaluating the Modern Housing Finance Market in Light of Ancient Principles of Justice*, 60 S.C. L. REV. 707 (2009); Steven L. Schwarcz, *Understanding the Subprime Financial Crisis*, 60 S.C. L. REV. 549 (2009); Samuel C. Waters, *A View from the Trenches: The Legal Practitioner and Loss Mitigation*, 60 S.C. L. REV. 807 (2009); Alan M. White, *Borrowing While Black: Applying Fair Lending Laws to Risk-Based Mortgage Pricing*, 60 S.C. L. REV. 677 (2009).

market and many demands for reform.[2] Some reforms are necessary and can be useful. There is a danger, however, that other reforms will harm the mortgage finance market in ways that will ultimately harm future homebuyers.

Any useful reforms in the mortgage finance market will require a sound analysis of the many different contributing causes of the current crisis. Is the current crisis the result simply of greedy mortgage loan originators, investment bankers, and rating agencies? Defrauded, gullible, or crooked borrowers? Gullible or lazy investors? Lax regulation? Excessive promotion of affordable housing? Or is the current crisis the result of a sustained period of too-low interest rates that created a real estate bubble that enticed all participants in the mortgage finance market—borrowers, originators, investment bankers, investors, and Fannie Mae and Freddie Mac—to follow the siren call of quick profits and quick accumulation of wealth? The various proposals for reform will most likely reflect both the proposers' views of the causes of the current crisis and their degree of faith in the efficacy of free markets or market regulation. But such proposals also must take into account another significant underlying factor.

A significant fundamental factor underlying the current, as well as past, mortgage finance market crises is the failure of policymakers to understand and take into account the nature and characteristics of the mortgage loan as an item of property and, to a lesser extent, the nature of mortgage loan transactions. It is a truism—often honored in the breach—that any regulatory regime should reflect the nature of the property and transactions being regulated.[3] When regulatory regimes, like the current provisions of Article 9 of the Uniform Commercial Code governing true security interests in tangible personal property, reflect the nature of the property and transactions being regulated,[4]

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2. *See, e.g.*, Schwarcz, *supra* note 1, *passim* (arguing that a "market liquidity provider" could prevent future financial crises by stabilizing a panicked market).

3. *See, e.g.*, Thomas E. Plank, *Assignment of Receivables Under Article 9: Structural Incoherence and Wasteful Filing*, 68 OHIO ST. L.J. 231, 270–71 (2007) (concluding that distinct property items require different regulatory regimes).

4. In the case of receivables—rights to payment—Article 9 of the Uniform Commercial Code has been less successful in part because of the failure to appreciate the nature of these intangible personal property items. *See, e.g.*, *id.* at 232, 238, 249 (citations omitted) (criticizing Article 9's use of a "lien" paradigm that rightly assumes that the "debtor" retains title to the personal property, subject to a security interest, and can therefore create more than one security interest in the personal property that it owns for regulating the sale of receivables; criticizing Article 9's use of terms of security such as "debtor," "secured party," "collateral," "security interest," and "security agreement" to include the seller, the buyer, the receivables sold, the ownership interest, and the sale agreement; and also criticizing Article 9's filing requirement for the assignment of receivables); Thomas E. Plank, *Sacred Cows and Workhorses: The Sale of Accounts and Chattel Paper Under the U.C.C. and the Effects of Violating a Fundamental Drafting Principle*, 26 CONN. L. REV. 397, 452–61 (1994) (criticizing the use of misleading

they are successful. The 150 years of previously unsatisfactory attempts to create an efficient regulatory regime for security interests in tangible personal property—many based on the model of security interests in real property—illustrate the costs of the failure to recognize and take into account the nature of personal property.[5]

A significant characteristic of the single family mortgage loan—predominantly, a level payment amortizing loan with a thirty-year maturity[6]—is the fact that, in the hands of the owner of the loan, the loan is a long-term asset.[7] Accordingly, any owner of mortgage loans must be able to finance this long-term asset through long-term debt financing or other long-term liabilities.[8] The mortgage loan also has other characteristics—the monthly payment of principal in small but continuously increasing amounts and the unpredictable prepayment before maturity—that present additional challenges for any owner of mortgage loans that seeks to match its long-term liabilities with long-term assets that may prepay.

Sound financing of any viable enterprise requires that the enterprise match its assets and its liabilities, and the history of the mortgage finance market in the United States has demonstrated the unhappy results for enterprises that attempt to finance long-term assets with short-term liabilities.[9] Specifically, a significant factor contributing to the mortgage market crisis of the Depression of the 1930s was the predominant use of short-term mortgage loans, which typically required no amortization or only partial amortization and a balloon payment due in three to six years, to finance housing—a long-term asset.[10] Beginning in the early 1930s, Congress responded to this problem by enacting legislation that encouraged the development of long-term amortizing mortgage loans.[11]

Unfortunately, the regulatory regime that created long-term mortgage loans simply moved the problem up one level because it provided for the financing of these long-term mortgage loans through very short-term financing—the use of

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defined terms to incorporate the sale of accounts and chattel paper under the pre-2001 revisions of Article 9 and describing the many drafting errors in Article 9 resulting from such use).

5. *See generally* 1 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY §§ 1.1–6.8.2, at 5–195 (1965) (discussing the history and development of independent security devices).

6. *See infra* text accompanying note 29.

7. *See, e.g.*, Thomas E. Plank, *The Security of Securitization and the Future of Security*, 25 CARDOZO L. REV. 1655, 1660 (2004) (discussing the use of loan proceeds to "originate more receivables").

8. *See id.*

9. For a discussion of the risks that loan originators must assume, see *id.* at 1661–62.

10. *See* WILLIS R. BRYANT, MORTGAGE LENDING: FUNDAMENTALS AND PRACTICES 17–19 (2nd ed. 1962).

11. *See id.* at 19–20.

deposits of savings and loan associations.[12] This regulatory regime finally exploded in the savings and loan associations crisis of the 1970s and 1980s when the entire savings and loan industry became insolvent.[13]

Congress, the regulatory authorities, and the market responded to this crisis and this faulty regulatory regime by creating the public securitization of mortgage loans by Fannie Mae and Freddie Mac and by creating the private securitization of mortgage loans by mortgage originators and investment bankers.[14] Unfortunately, the regulatory structure of Fannie Mae and Freddie Mac encouraged them to engage in the risky business of buying higher yielding mortgage loans and mortgage-backed securities and financing those purchases through shorter-term, lower-rate debt that carried the implicit guarantee of the United States government.[15] In addition, investment bankers and lenders also held significant amounts of mortgage-backed securities that they financed with shorter-term debt.[16]

The collapse of the riskier mortgage-backed securities and of the real estate values underlying many mortgage loans and mortgage-backed securities caused a severe decline in the market value of the mortgage loans and the mortgage-backed securities held by Fannie Mae, Freddie Mac, financial institutions, investment banks, and others.[17] This decline led to the conservatorship of Fannie Mae[18] and Freddie Mac,[19] the extinguishment of Bear, Stearns & Co.,[20] acquisition of the banking operations of Washington Mutual Bank by JPMorgan

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12. *See* Kenneth E. Scott, *Never Again: The S&L Bailout Bill*, 45 BUS. LAW. 1883, 1885 (1990).

13. *See infra* text accompanying notes 70–79.

14. *See infra* text accompanying notes 80–87.

15. *See infra* text accompanying notes 104–09.

16. *See* GLOBAL JOINT INITIATIVE TO RESTORE CONFIDENCE IN THE SECURITIZATION MKTS., RESTORING CONFIDENCE IN THE SECURITIZATION MARKETS 5 (2008), *available at* http://www.sifma.org/capital_markets/docs/Survey-Restoring-confidence-securitization-markets.pdf.

17. *See, e.g.*, Henry M. Paulson Jr., Sec'y, U.S. Dept. of Treasury, Remarks on the Role of the GSEs in Supporting the Housing Recovery Before the Economic Club of Washington (Jan. 7, 2009), *available at* http://www.ustreas.gov/press/releases/hp1345.htm (discussing how investors lost confidence in mortgage-backed securities as real estate values began to fall in 2007, resulting in a drop in stock prices).

18. *In re* Conservatorship of Fed. Nat'l Mortgage Ass'n. (Fed. Hous. Fin. Agency Sept. 18, 2008) (notice regarding determination and appointment of Federal Housing Finance Agency as conservator for Fannie Mae), *available at* http://www.ofheo.gov/media/fnm/legalfilings/NoticeregardingconservatorFNMA.pdf.

19. *In re* Conservatorship of Fed. Home Loan Mortgage Corp. (Fed. Hous. Fin. Agency Sept. 18, 2008) (notice regarding determination and appointment of Federal Housing Finance Agency as conservator for Freddie Mac), *available at* http://www.ofheo.gov/media/fre/legalfilings/NoticeregardingconservatorFHLMC.pdf.

20. *See* Robin Sidel, et al., *The Week That Shook Wall Street: Inside the Demise of Bear Stearns*, WALL ST. J., Mar. 18, 2008, at A1.

Chase Bank,[21] the bankruptcy of Lehman Brothers Holdings, Inc.,[22] the absorption of Wachovia Corporation into Wells Fargo,[23] the absorption of Merrill Lynch & Co. into Bank of America Corp.,[24] and the demise of many mortgage-loan originators.[25]

Consequently, future regulation of the mortgage market must reflect the nature of the mortgage loan. In particular, if the federal government continues to play a significant role in assisting the financing of the mortgage market, as is most likely, any federal program must take into account the necessity for providing for the long-term financing of mortgage loans. A program in which the federal government simply purchased mortgage loans and held them to maturity would most likely satisfy this criteria. This model would not, in my view, be desirable. A better model is the current guarantee programs of Fannie Mae and Freddie Mac, but without the current ability of Fannie Mae and Freddie Mac to purchase loans and mortgage-backed securities and to finance them with short-term debt.

Other reform proposals that help make the mortgage finance market more efficient should be enacted. For example, regulations that enable borrowers to understand the terms and risks associated with their mortgage loans are desirable, and elimination of the application of the holder in due course doctrine to consumer borrowers—but not commercial entities—is probably desirable.[26]

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21. Press Release, Fed. Deposit Ins. Corp., JPMorgan Chase Acquires Banking Operations of Washington Mutual (Sept. 25, 2008), *available at* http://www.fdic.gov/news/news/press/2008/pr08085.html.

22. *In re* Lehman Brothers Holding Inc., No. 08-13555 (JMP), 2008 WL 4902202 (Bankr. S.D.N.Y. Nov. 6, 2008).

23. Wells Fargo & Co. (Fed. Reserve Bd. Oct. 12, 2008), *available at* http://www.federalreserve.gov/newsevents/press/orders/orders20081012a1.pdf.

24. Bank of America Corp., 2008 WL 5158247, at *1 (Fed Reserve Bd. Nov. 26, 2008), *available at* http://www.federalreserve.gov/newsevents/press/orders/orders20081012a1.pdf.

25. *See, e.g.*, Robert B. Avery et al., *The 2007 HMDA Data*, FED. RES. BULL. (Fed. Reserve Bd., Wash., D.C.), Dec. 23, 2008, at A107–10 (noting that 169 lending institutions that reported data under the Home Mortgage Disclosure Act in 2006 ceased lending operations because of bankruptcy or otherwise); Ben Rooney, *Three Regional Banks Fail*, CNNMONEY, Jan. 30, 2009, http://money.cnn.com/2009/01/30/news/economy/failed_banks/index.htm (noting the failure of six banks in January 2009).

26. *See, e.g.*, Celeste M. Hammond, *Predatory Lending—A Legal Definition and Update*, 34 REAL EST. L.J. 176, 200 (2005) (discussing the immunity that a holder in due course has from the claims and defenses that a mortgagor would have against an originator). Consumer borrowers will generally not be aware of the ramifications of signing a negotiable instrument, which is the standard document that evidences a single-family mortgage loan. On the other hand, elimination of holder in due course status would likely increase the interest rates on mortgage loans. *See, e.g.*, Kurt Eggert, *Held up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 510 (2002) ("A traditional law and economics analysis contends that abolishing the holder in due course doctrine would increase interest rates and fees to borrowers because it would make collection from borrowers less certain and more

On the other hand, other types of "reform"—such as banning prepayment penalties, imposing limits on interest rates, imposing other limitations on mortgage loans, increasing the delay in foreclosing mortgage loans, banning or limiting the types of mortgage loans that borrowers can enter into, imposing onerous duties on mortgage originators, and imposing liability on purchasers of mortgage loans for the acts of originators beyond the amount of the mortgage loan—do not address the fundamental problem of the long-term nature of mortgage loans but may make mortgage loans more expensive and less available to families of limited or moderate income or resources.

II. CHARACTERISTICS OF THE MORTGAGE LOAN

The owner of a mortgage loan, like the owner of any payment obligation, has the benefits and burdens of ownership.[27] The specific benefits and burdens derive from the nature of the mortgage loan, and the specific characteristics of a mortgage loan affect the value of the loan.[28] Although the long-term amortizing mortgage loan provided a method for financing residential real estate—a long-term asset—it also introduced its own set of problems. For the last twenty-five years, the typical residential mortgage loan has been a thirty-year fixed-rate loan requiring a level monthly payment of principal and interest.[29] The payment amount is determined mathematically to ensure that the principal is fully paid

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expensive."). Nevertheless, purchasers of mortgage loans are probably better able to police shoddy work by originators than consumer borrowers. *See id.* at 607–08. In this regard, although I disagree with most of what Professor Kurt Eggert says about securitization, I believe he makes a good case for the elimination of the holder in due course doctrine. *See id.* at 607–14. Commercial borrowers and assignors of mortgage loans, however, should still be subject to the limitations on liability that the holder in due course doctrine gives to good faith purchasers of mortgage notes. *See id.* 611–12.

27. *See* Thomas E. Plank, *The True Sale of Loans and the Role of Recourse*, 14 GEO. MASON U. L. REV. 287, 294–302 (1991).

28. *See, e.g.*, *id.* at 296–98 (describing how benefits and burdens reflect a property's characteristics, which in turn affect an ownership party's right to the future increase in the market value of the loan).

29. Adjustable-rate conventional mortgage loans annually averaged (on a unweighted basis) 26% of all loans originated from 1982 through 2005. *See* FED. HOUS. FIN. BD., TABLE 9: TERMS ON CONVENTIONAL SINGLE-FAMILY MORTGAGES, ANNUAL NATIONAL AVERAGES, ALL HOMES, *available at* http://www.fhfb.gov/ (follow "Reporting" hyperlink; then follow "Monthly Interest Rate Survey" hyperlink; then follow "Historical Summary Tables" hyperlink; then follow "Table 9" hyperlink) (last visited Mar. 6, 2009). In only three years did the percentage of adjustable-rate mortgages exceed 50%: in 1984, 1985, and 1988, when mortgage interest rates averaged approximately 12%, 11%, and 9%, respectively. *See id.* From 1997 through 2004, at least 75% of all fixed-rate loans were thirty-year loans. *Id.* at TABLE 28, *available at* http://www.fhfb.gov/ (follow "Reporting" hyperlink; then follow "Monthly Interest Rate Survey" hyperlink; then follow "Historical Summary Tables" hyperlink; then follow "Table 28" hyperlink (table is incorrectly denoted as Table 20)) (last visited Mar. 6, 2009).

by the maturity date.[30] Accordingly, each monthly payment includes a principal payment, in an amount that initially is small but that grows gradually, and an interest payment, in an amount that initially is large but that declines gradually.[31] For example, a thirty-year mortgage loan in the amount of $100,000 bearing interest at the rate of 6% per annum will have a monthly payment of $599.55, with a final payment of $600.08 in month 360 to fully amortize the mortgage. Table 1 illustrates how the principal and interest components change over time.

TABLE 1: MONTHLY AMORTIZATION
(as of the beginning of each month and the last month of each year)

Month	Year	Outstanding Balance	Monthly Interest Payment	Monthly Principal Payment
1	0	$100,000.00	$500.00	$99.55
2	0	$99,900.45	$499.50	$100.05
3	0	$99,800.40	$499.00	$100.55
4	0	$99,699.85	$498.50	$101.05
5	0	$99,598.80	$497.99	$101.56
6	0	$99,497.25	$497.49	$102.06
7	0	$99,395.18	$496.98	$102.57
8	0	$99,292.61	$496.46	$103.09
9	0	$99,189.52	$495.95	$103.60
10	0	$99,085.92	$495.43	$104.12
11	0	$98,981.80	$494.91	$104.64
12	0	$98,877.16	$494.39	$105.16
60	5	$93,188.00	$465.94	$133.61
120	10	$83,866.03	$419.33	$180.22
180	15	$71,292.09	$356.46	$243.09
240	20	$54,331.72	$271.66	$327.89
300	25	$31,454.73	$157.27	$442.28
360	30	$597.09	$2.99	$597.09

30. *See* Thomas E. Plank, *Toward a More Efficient Bankruptcy Law: Mortgage Financing Under the 2005 Bankruptcy Amendments*, 31 S. ILL. U. L.J. 641, 642 (2007).

31. *See id.* at 642–43.

As Table 1 shows, the owner of a mortgage loan receives an amount of principal each month for the life of the loan. Accordingly, the owner of the mortgage loan should be an institution that has the ability to reinvest this principal each month.[32] In addition, this receipt of monthly principal directly contrasts with the typical United States Treasury note or bond, and most corporate and state and local government bonds, which provide for periodic payment of interest but only one principal payment at maturity.[33]

Another significant feature of a mortgage loan is that it is prepayable by the borrower: either voluntarily if the borrower sells the house or refinances the mortgage loan or involuntarily if the borrower defaults. Accordingly, unlike a United States Treasury note or bond and many corporate and state and local government bonds, the ultimate payment of principal on any mortgage loan is unpredictable.[34] This lack of predictability imposes risks on the owner of the loans and is therefore a cost that the lender must recoup through the interest rate on the loan, through prepayment penalties, or through make-whole premiums.

Investors in a pool of mortgage loans attempt to predict when they will receive principal by estimating the speed at which the mortgage loans in the pool will prepay.[35] These speeds, however, change as market conditions change.[36] Table 2 illustrates how different prepayment rates affect the final payment date for a pool of $100,000,000 of mortgage loans using a common formula for prepayments, known as the PSA formula. PSA variously refers to "prepayment speed assumptions,"[37] or the "Public Securities Association," which later became the Bond Market Association before merging into the Securities Industry and Financial Markets Association (SIFMA).[38]

This formula more closely models the rate of prepayments for newly originated mortgage loans than a constant prepayment rate formula, which is also used by investors in the mortgage finance market. The constant prepayment rate assumes prepayment each month, beginning at origination, at one-twelfth of

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32. *See id.* at 643 ("[A]ny holder of a mortgage loan must be equipped to handle these dribbles of principal.").

33. *Id.*

34. *See id.* at 644 (discussing the impact that prepayment has on the value of mortgage loan pools).

35. *See id.*

36. *See id.* (discussing how changing market value and interest rates affect prepayment rates).

37. *See* BOND MKT. ASS'N, AN INVESTOR'S GUIDE TO COLLATERALIZED MORTGAGE OBLIGATIONS 26 (2008), www.freddiemac.com/mbs/docs/investors_guide_CMOs.pdf.

38. *See* Linda Lowell & Michael Corsi, *Mortgage Pass-Through Securities*, *in* THE HANDBOOK OF MORTGAGE-BACKED SECURITIES 45, 56 (Frank J. Fabozzi ed., 6th ed. 2006); SIFMA Welcome to the Securities Industry and Financial Markets Association, http://www.sifma.org (last visited Mar. 16, 2009).

an assumed annual rate.[39] The PSA assumes prepayment in the first month at one-twelfth of 0.2%, in the second month at one-twelfth of 0.4%, with the percentage increasing each month in increments of 0.2% until the thirtieth month, and then remaining at 6% per annum.[40] Prepayment rates are then expressed as a multiple of the PSA. Hence, 100 PSA assumes, beginning with the thirtieth month, an annual prepayment rate of 6%; 200 PSA assumes an annual rate of twice this rate, or 12% beginning at the thirtieth month; and 400 PSA assumes an annual rate of four times this rate, or 24% beginning at the thirtieth month.

TABLE 2: EFFECT OF PREPAYMENTS—$100,000,000 MORTGAGE POOL (Multiple OF PSA)

	Prepayment Rate:				
	0 PSA	**100 PSA**	**200 PSA**	**300 PSA**	**400 PSA**
Final Maturity (months)	360.0	179.0	134.0	112.0	97.0
Final Maturity (years)	30.0	14.9	11.2	9.3	8.1

The prepayment of 200 PSA represents a reasonably good estimate of the prepayment rate in the market in a stable environment. Note that, at a 200 PSA annual prepayment rate, the expected maturity is 11.2 years. Mortgage loans have traditionally been priced by reference to the ten-year United States Treasury bond.[41]

Another burden of ownership of a mortgage loan is the risk of loss from default by the borrower. Because real estate secures a mortgage loan, the owner of the mortgage loan should recover a substantial portion, if not all, of the amounts due the owner. The amount of the loss depends on several factors. First, the owner is not likely to recover much more than the value of the

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39. *See* BOND MKT. ASS'N, *supra* note 37, at 22 ("[Constant Prepayment rate is] [t]he percentage of outstanding mortgage loan principal that prepays in one year, based on the annualization of the Single Monthly Mortality (SMM), which reflects the outstanding mortgage loan principal that prepays in one month."); *see also* Lowell & Corsi, *supra* note 38, at 54 ("A constant prepayment assumption is not realistic. . . . [A]ssuming constant prepayments is comparable to assuming that interest rates will remain at current levels.").

40. *See* BOND MKT. ASS'N, *supra* note 37, at 26–27; Lowell & Corsi, *supra* note 38, at 56–58.

41. Kenneth J. Thygerson, *Capitalizing on the Mortgage Market*, 3 ANN. REV. BANKING L. 179, 182 (1984).

underlying residential property subject to the mortgage. Second, the owner is entitled to interest that accrues but that is not paid as well as the principal balance of the loan. Accordingly, the longer it takes to foreclose the mortgage, the greater the owner's loss from the accrual of unpaid interest. Not surprisingly, the more equity behind the mortgage loan—the lower the loan-to-value ratio—the lower the potential loss. Not only does the equity provide a cushion for declines in the market value and foreclosure value of the real estate, but a greater equity also provides a greater incentive to the homeowner to attempt to protect the investment and therefore not to default. In any event, the expected risk of loss from borrower default is built into the interest rate.[42] Any legal developments that increase the costs of foreclosure, including the time to complete a foreclosure, will increase the interest rates that future borrowers must pay for future mortgage loans.[43]

Table 3 presents hypothetical losses on a pool of $100,000,000 of mortgage loans that are (1) "conforming" loans that are eligible for purchase by Fannie Mae and Freddie Mac,[44] (2) "jumbo loans" that would meet the underwriting criteria of Fannie Mae and Freddie Mac but whose principal balance exceeds the limits for purchase by Fannie Mae and Freddie Mac,[45] (3) "alt-A" loans for borrowers that are generally creditworthy but that do not meet the underwriting criteria of Fannie Mae and Freddie Mac for any number of reasons,[46] and (4) "subprime" mortgage loans for borrowers who are considered less

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42. *See* 144 CONG. REC. E88 (daily ed. Feb. 4, 1998) (statement of Rep. Gekas) ("Lenders redistribute bankruptcy debt by charging you and me higher interest rates . . . .").

43. *See, e.g.*, Brian M. Heaton, Note, *Hoosier Inhospitality: Examining Excessive Foreclosure Rates in Indiana*, 39 IND. L. REV. 87, 106 (2005) ("[A]lthough judicial foreclosure is intended to protect borrowers, lenders could be passing the higher costs of court proceedings to homeowners in the form of higher interest rates and larger fees. These additional costs make it more difficult for borrowers to increase equity in their homes, which makes them more susceptible to default." (citing Karen M. Pence, *Foreclosing on Opportunity: State Laws and Mortgage Credit*, 88 REV. ECON. & STAT. 177 (2006)).

44. *See, e.g.*, David Reiss, *Subprime Standardization: How Rating Agencies Allow Predatory Lending to Flourish in the Secondary Mortgage Market*, 33 FLA. ST. U. L. REV. 985, 1010 (2006) (stating that conforming loans are loans which Fannie Mae and Freddie Mac may buy because these loans meet the statutorily imposed restrictions on the types of loans these entities may purchase).

45. *See, e.g.*, *id.* at 1010 n.164 ("Those loans that comply with Fannie Mae and Freddie Mac requirements except for the restrictions on loan amount are typically referred to as 'jumbo' mortgages." (citing Wayne S. Passmore et al., *GSEs, Mortgages Rates, and the Long-Run Effects of Mortgage Securitization*, 25 J. REAL EST. FIN. & ECON. 215, 218 (2002)).

46. *See, e.g.*, KENNETH TEMKIN ET AL., U.S. DEP'T OF HOUS. & URBAN DEV., SUBPRIME MARKETS, THE ROLE OF GSES, AND RISK-BASED PRICING 4 (2002), *available at* http://www.huduser.org/Publications/pdf/subprime.pdf ("[Alt-A] borrowers have FICO scores similar to those in the prime market . . . .").

creditworthy.[47] The loss percentages set forth below are intended to be illustrative, but they are within the range of actual losses experienced or expected in the future.[48]

TABLE 3: MARKET VALUE CHANGES
Effect of Default

	Percent of Present Value of $100,000,000 Based on Loan Type:			
	Conforming	**Jumbo Loans**	**Alt-A**	**Subprime**
Loss rate	<1.0%	<1.5%	<10.0%	<25.0%
Loss (in millions)	<1	<1.5	<10	<25

Although a concern, the risk of loss from borrower default for most mortgage loans need not be the most significant risk for the owner of mortgage loans. One of the most significant risks of ownership of mortgage loans—but also a great opportunity for gain—results from the change in the market value of the mortgage loan because of post-origination changes in interest rates for comparable mortgage loans.[49] This risk results primarily from the long-term nature of the fixed-rate mortgage loan, but it is exacerbated by the risk of prepayment.[50]

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47. *See, e.g., id.* ("Subprime lenders offer mortgages to people who represent a higher level of risk than borrowers who meet standard prime underwriting guidelines.").

48. *See, e.g.*, Francis Parisi & Thomas G. Gillis, *Standard & Poor's Revises U.S. Subprime, Prime, and Alternative-A RMBS Loss Assumptions*, STANDARD & POOR'S RATINGSDIRECT, July 29, 2008, at 2, *available at* http://www2.standardandpoors.com/spf/pdf/media/subprime_prime_alt-a_072908.pdf (providing loss assumptions for prime jumbo loans of 0.32% for 2005 loans, 0.81% for 2006 loans, and 1.17% for first-half 2007 loans; providing loan assumptions for subprime loans of 23% for 2006 loans and 27% for first-half 2007 loans; and further providing loan assumptions for adjustable alt-A loans up to 12.2% for 2006 loans and 15% for first-half 2007 loans). Standard & Poor's also modified its loss projections for fixed rate alt-A 2006 and 2007 loans to 10.5% and 12.25%, respectively. Jeremy Schneider et al., *Criteria Assumptions: Default and Loss Assumptions for U.S. Fixed Alt-A RMBS Transactions*, STANDARD & POOR'S RATINGSDIRECT, Sept. 25, 2008, *available at* http://www2.standardandpoors.com/portal/site/sp/en/eu/page.article/3,2,2,0,1204839908968.html. Projections for alt-A loans originated before 2006 were lower than 10%. Scott Davey et al., *Standard & Poor's Revised Default and Loss Curves for U.S. Alt-A RMBS Transactions*, STANDARD & POOR'S RATINGSDIRECT, Dec. 19, 2007, at 7–8, *available at* http://www2.standardandpoors.com/spf/pdf/media/Dec 19 Alt-A methodology.pdf.

49. *See* Plank, *supra* note 30, at 644 ("[M]ortgage loans bear a significant risk of gain or loss because of changes in market interest rates.").

50. *See supra* text accompanying notes 27–34.

To understand this risk, Table 4 presents hypothetical values for a pool of $100,000,000 of mortgage loans under different interest rate assumptions. It assumes the origination of $100,000,000 of mortgage loans bearing interest at a then market rate of 6% per annum. It then shows how a change of two percentage points in market mortgage loan rates for comparable loans two years after the origination of the pool affects the market value of the pool.[51]

Table 4 shows that if market interest rates go up two years after origination, the present value of the outstanding pool goes down. The change would be very dramatic if the pool did not prepay, as shown in the 0 PSA prepayment column. The next column, under the 200 PSA prepayment rate, shows what the effect would be if the pool prepaid at the rate that was assumed when the mortgage pool was originated—the "pricing speed."

TABLE 4: MARKET VALUE CHANGES
EFFECT OF CHANGES IN INTEREST RATES
(two years later)

	Percent of Present Value of $100,000,000 Based on Prepayment Rate:			
Market rate	**0 PSA**	**200 PSA**	**100 PSA**	**400 PSA**
6%	100.0%	100.0%	100.0%	100.0%
8%	82.0%	91.9%	89.3%	
4%	125.3%	109.3%		106.3%
Change			-10.7%	6.3%

Relying on the pricing speed described above to determine the effect of prepayment, however, is not realistic. When market mortgage rates go up, the

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51. For example, between January 1973 and December 1974, effective interest rates increased from 7.68% to 9.54%. FED. HOUS. FIN. BD., TABLE 17: TERMS ON CONVENTIONAL SINGLE-FAMILY MORTGAGES, MONTHLY NATIONAL AVERAGES, ALL HOMES, *available at* http://www.fhfb.gov/ (follow "Reporting" hyperlink; then follow "Monthly Interest Rate Survey" hyperlink; then follow "Historical Summary Tables" hyperlink; then follow "Table 17" hyperlink) (last visited Mar. 8, 2009). From January 1978 to January 1982, effective interest rates increased each January from 9.15%, to 10.28%, to 12.02%, then to 13.57%, and finally to 15.69%, respectively. *Id.* Thereafter, over the next five years, interest rates declined to 9.53% in January 1987. *Id.* In the next two and a half years, interest rates ranged from a low of 9.11% in March and April 1987 to a high of 10.56% in June 1989. *Id.* Rates then declined to a low of 6.76% in October 1993, went back up to 8.23% in March 1995, declined to 6.90% by January 1999, went back up to 8.16% in June 2000, and thereafter dropped to 6.93% in September 2001. *Id.*; *see also infra* text accompanying notes 75–79.

prepayment speeds for outstanding mortgage loans that bear a lower rate decline. As illustrated by the 100 PSA prepayment column, the decline in the prepayment speed increases the decline in the present value of the pool, a decline of 10.7%—or a decline from $100,000,000 to $89,300,000. Further, as shown in Table 2, the maturity of the mortgage loan pool lengthens from 11.2 years to 14.9 years. On the other hand, if interest rates decline, the present value of the cash flow from the existing mortgage loans increases, but the decrease in interest rates gives borrowers a strong incentive to refinance their mortgage loans at lower rates, and therefore prepayment speeds increase greatly. The increase in prepayment speeds reduces the increase in value of the mortgage loans, and therefore the increase is slightly more than 6%.[52] To the extent that a drop in interest rates creates faster prepayments, the increase in the value of the remaining loans will be less,[53] and a drop in interest rates of two percentage points is likely to increase the prepayment speed to more than 400 PSA.

Hence, the owner of mortgage loans loses more in value from an increase in market mortgage rates than the owner would gain from a decrease in mortgage rates. Further, unlike the borrower who may refinance and prepay when market rates for mortgage loans decline, the owner of the loan does not have the option of requiring the borrower to prepay the mortgage loan when market rates go up.[54] In effect, the borrower has a "call option"—which has value—but the owner of the mortgage loan does not have a comparable "put option."[55] The potential for loss without a concomitant potential for a similar gain imposes a cost—the cost of the borrower's call option—on the owner of the mortgage loan.[56] The owner of the loan must recoup this cost in the interest rate that it charges or, as is common for commercial loans and corporate debt that is prepayable, in the form of prepayment penalties, redemption premiums, and make-whole premiums.[57] Finally, for conforming mortgage loans and jumbo loans, the expected loss from borrower default as shown in Table 3 (in the range of less than $1.5 million) is substantially smaller than the loss from changes in market value shown in Table 4.

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52. *See supra* tbl.4.

53. *See* Plank, *supra* note 30, at 644.

54. *See* Alan L. Feld & Stephen G. Marks, *Legal Differences Without Economic Distinctions: Points, Penalties, and the Market for Mortgages*, 77 B.U. L. REV. 405, 406 (1997) ("Interest rate motivated prepayments exacerbate interest rate risk, because such prepayments put the lender on the wrong side of any shift in the interest rates.").

55. A call option is the right of the holder to purchase a property item from the owner for a "fixed price even if the market rises," and a put option is the right of the owner of a property item to sell that property item to another party—and thereby require that person to become the owner—"at a fixed price even if the market declines." BLACK'S LAW DICTIONARY 1127–28 (8th ed. 2004).

56. *See* Plank, *supra* note 30, at 644.

57. *See* Camisha Simmons, *Lender Drafting Mishaps' Effect on Prepayment Premiums and Other Damages*, AM. BANKR. INST. J., July/Aug. 2008, at 26, 26.

Prepayments create an additional risk. To the extent that an owner of loans has issued debt to finance the purchase of mortgage loans that have a specified rate, and the owner was relying on the interest payments to service the debt, a drop in mortgage rates, an increase in prepayments, and a reinvestment of those prepayments in lower yield assets will reduce the available assets to repay then outstanding debt issued in a higher interest rate market.[58] In 2006, the Office of Federal Housing Enterprise Oversight criticized Fannie Mae for shortcomings in managing, accounting for, and disclosing this type of risk.[59]

One way for owners of mortgage loans to ameliorate the effect of changes in market interest rates is to shift the risk to borrowers through an adjustable-rate mortgage. Table 5 shows how a change in market mortgage rates would affect the borrower.

TABLE 5: MARKET VALUE CHANGES EFFECT ON ADJUSTABLE RATE MORTGAGES

Loan Rate	Monthly Payment	Change	First Month's Interest Payment	Change	First Month's Principal Payment	Change
6%	$599.55		$500.00		$99.55	
8%	$733.76	$134.21	$666.67	$166.67	$67.09	($32.46)
4%	$477.42	($122.13)	$333.33	($166.67)	$144.09	$44.54

This table illustrates some interesting features of a mortgage loan. Preliminarily, as a matter of mathematics, the higher the interest rate on an amortizing loan, the lower the initial principal payments and the slower the reduction of the principal balance by amortization. For example, at the end of ten years, the principal balance of a 6% loan will amortize to $83,685.81, but the principal balance of an 8% loan will amortize to $87,725.54—a balance that is larger by $4,039.73. From the borrower's perspective, however, the more significant risk is the increase in the monthly payment. Compounding this risk is the fact that the slower repayment of the mortgage loan results not only in higher interest payments currently, but also in higher interest rates calculated on a more slowly reducing (and therefore larger) principal balance. Nevertheless, if the borrower can afford to make this increased payment, the owner of the

58. *See* OFFICE OF FED. HOUS. ENTER. OVERSIGHT, REPORT OF THE SPECIAL EXAMINATION OF FANNIE MAE 46, 50, 155 (2006), *available at* http://www.ofheo.gov/media/pdf/fnmspecialexam.pdf.

59. *See id.* at 46–47, 50, 220, 251.

mortgage loan has successfully shifted a significant portion of the market value risk to the borrower.[60]

This risk shifting raises two issues. The first issue is whether the borrower is an appropriate risk taker. In my view, so long as the borrower truly understands the risk, the borrower should have the option of assuming that risk. Even though I, as a reasonably well-informed consumer of mortgage loans, would never take out an adjustable-rate mortgage loan, I would be loathe to deny that choice to someone else. Having a borrower achieve this level of understanding may, however, be problematic.

The second issue is whether the borrower can in fact absorb this risk. Because an increase in the mortgage rate could cause the borrower to default,[61] the owner of the mortgage loan still retains some risk of loss from changes in market interest rates. On the other hand, if the mortgage rate declines, the borrower, and not the owner of the mortgage loan, receives the benefit.[62] To solve for the risk of default from payment shock, the originator must underwrite the mortgage loan under an assumption of a higher than expected interest rate.[63]

Finally, although this discussion has focused on the effect of changes in mortgage market interest rates on the value of mortgage loans, the value of mortgage loans can change dramatically for other reasons, including regulatory changes such as moratoria on foreclosures or a change in the Bankruptcy Code that would permit modification of single-family residential mortgage loans. Further, as the current market illustrates, the market value of mortgage loans can change when buyers and investors lose faith in mortgage loans because of the decline in the real estate value underlying the mortgage loans.[64]

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60. This shifting is not necessarily complete. For example, there may be a lag time for the change in the mortgage rate to catch up with current market mortgage interest rates. Further, adjustable interest rate mortgage loans may adjust on the basis of different indices that do not necessarily correlate with other floating-rate indices. Also, for the sake of simplicity, this discussion also ignores the different variations of adjustable-rate mortgage loans, such as the use of teaser rates followed by higher rates, or variations in the same loan on time of adjustment.

61. Randall S. Kroszner, Governor, Bd. of Governors of the Fed. Reserve Sys., Remarks at the Consumer Bankers Association 2007 Fair Lending Conference: The Challenges Facing Subprime Mortgage Borrowers (Nov. 5, 2007), *available at* http://www.federalreserve.gov/newsevents/speech/kroszner20071105a.htm.

62. *See, e.g.*, Michael Bykhovsky, *Overview of Recent Prepayment Behavior and Advances in Its Modeling and Valuation*, *in* THE HANDBOOK OF MORTGAGE-BACKED SECURITIES, *supra* note 38, at 535, 546–47 (discussing how many financially astute borrowers choose ARM loans in hopes of refinancing at a lower fixed rate when mortgage rates decline).

63. *See* Anand K. Bhattacharya et al., *An Overview of Mortgages and the Mortgage Market*, *in* THE HANDBOOK OF MORTGAGE-BACKED SECURITIES, *supra* note 38, at 3, 5.

64. *See, e.g.*, Tom Petruno, *When Faith Is Frayed*, L.A. TIMES, July 12, 2008, at A1 (discussing the correlation between the declining housing market and the falling value of mortgage-backed securities in May 2008).

III. THE LONG-TERM MORTGAGE LOAN AND THE MARKET

The development of the long-term amortizing mortgage loan responded to the problems created by using short-term mortgage loans to finance long-term real estate.[65] Unfortunately, financial institutions financed many of these amortizing mortgage loans with short-term deposits. This system worked reasonably well when interest rates were stable,[66] and I have heard it called the "3-6-3" system: the savings association borrowed money from its depositors at 3%, the savings association lent money to homeowners at 6%, and the owners and officers were on the golf course by 3 p.m. The system, however, was vulnerable to increases in interest rates or other market conditions that would cause depositors—who were providing very short-term financing—to withdraw their deposits.[67] The film, *It's a Wonderful Life*, in which Jimmy Stewart played George Bailey, the operator of the Bailey Brother's Building & Loan, illustrates the risk.[68] When depositors feared for their deposits, they sought withdrawals of cash that the savings institution did not have, and George's primary defense was to explain that the depositors' money was not in a safe in the back of the building but was tied up in their neighbors' homes.[69]

This system came under stress in the 1960s because of inflation and higher market interest rates.[70] Reliance on short-term loans to finance long-term financial assets is problematic for two reasons. First, by their nature, interest rates on short-term financing change quickly. In the 1970s and 1980s, savings associations had to pay higher rates to depositors to keep their deposits, in many cases higher than the interest that their existing portfolio of mortgage loans was paying.[71] Short-term rates increased dramatically during this time. For example, from April 1971 to April 1973, the prime interest rate charged by banks to their most creditworthy customers ranged between 4.75% and 6.61%. The rate increased in May 1973, and remained between 7.01% and 12.00% from May 1973 to January 1976.[72] The rate decreased in February 1976 to 6.75%, and

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65. *See supra* text accompany notes 6–13.

66. *See, e.g.*, Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Remarks at the Federal Reserve Bank of Kansas City's Economic Symposium: Housing, Housing Finance, and Monetary Policy (Aug. 31, 2007), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20070831a.htm (discussing the success that lenders had in financing long-term loans with short-term deposits before the savings and loan associations crises).

67. *See* Scott, *supra* note 12, at 1885–86; Bernanke, *supra* note 66.

68. IT'S A WONDERFUL LIFE (RKO Radio Pictures 1946).

69. *Id.*

70. *See* Scott, *supra* note 12, at 1887; Bernanke, *supra* note 66.

71. Scott, *supra* note 12, at 1885, 1887; Bernanke, *supra* note 66.

72. *See* BD. OF GOVERNORS OF THE FED. RESERVE SYS., AVERAGE MAJORITY PRIME RATE CHARGED BY BANKS ON SHORT-TERM LOANS TO BUSINESS, QUOTED ON AN INVESTMENT BASIS,

remained under 10% until November 1978, when the interest rate hit 10.94% and stayed above 10% until May 1985, going above 20% in several months in 1980 and 1981.[73] Savings institutions holding 7% loans originated in the earlier 1970s were not earning enough to pay depositors a competitive short-term rate in the late 1970s and early 1980s.[74]

Second, the increase in market interest rates caused the present value of their assets to decline, as illustrated by Table 4 above. For example, the average rate on thirty-year fixed-rate conventional mortgage loans from April 1971 to March 1973 fluctuated between 7.29% and 7.70%.[75] Thereafter, through October 1978, mortgage rates increased from 7.54% to 9.86% until they reached 10.11% in November 1978, 11.09% in July 1979, 12.83% in November 1979, and 16.33% in April 1980.[76] The rates went down slightly after that for a few months, then reached 18.16% in September 1981, and stayed above 12.03% until November 1985.[77] These rising interest rates for mortgage loans caused a dramatic decrease in the value of the portfolios of savings institutions holding 7% and 8% loans originated in the earlier 1970s. As a result, by the late 1970s and early 1980s, many savings institutions became insolvent.[78] Indeed, because the savings and loan industry concentrated on financing long-term mortgage loans with short-term deposits, the entire industry was insolvent in 1981.[79]

Since the 1930s, the federal government has played a significant role in financing single-family mortgage loans.[80] In 1968, the federal government expanded that role when it created two new entities out of the then-existing

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available at http://www.federalreserve.gov/releases/h15/data/Monthly/H15_PRIME_NA.txt (last visited Mar. 9, 2009).

73. *See id.*

74. Scott, *supra* note 12, at 1885, 1887; Bernanke, *supra* note 66.

75. *See* BD. OF GOVERNORS OF THE FED. RESERVE SYS., CONTRACT RATE ON 30-YEAR, FIXED-RATE CONVENTIONAL HOME MORTGAGE COMMITMENTS, *available at* http://www.federalreserve.gov/releases/h15/data/Monthly/H15_MORTG_NA.txt (last visited Mar. 9, 2009).

76. *See id.*

77. *See id.*

78. Scott, *supra* note 12, at 1885, 1887; Bernanke, *supra* note 66.

79. *See* Scott, *supra* note 12, at 1885, 1887; *see also* Cottage Sav. Ass'n v. Comm'r, 499 U.S. 554, 556–58 (1991) (involving a transaction to exchange similar packages of mortgage participation interests pursuant to the regulation of the Federal Home Loan Bank Board). Cottage Savings Association exchanged a package of single family mortgage participation interests, with a face value of approximately $6.9 million, for a package of similar mortgage participation interests held by four other savings associations. *Id.* at 557–58. Both packages had a market value of $4.5 million, generating a $2.4 million loss for Cottage Savings for federal income tax purposes. *Id.* The Court upheld the deductibility of the loss. *Id.* at 568.

80. *See* BRYANT, *supra* note 10, at 9–13; Peter M. Carrozzo, *Marketing the American Mortgage: The Emergency Home Finance Act of 1970, Standardization and the Secondary Market Revolution*, 39 REAL PROP. PROB. & TR. J. 765, 766–68 (2005).

Federal National Mortgage Association, or Fannie Mae—the Government National Mortgage Association, or Ginnie Mae, and the new Fannie Mae.[81] Ginnie Mae, as a federal governmental agency, continued many of the functions of the former Fannie Mae. Ginnie Mae also could guarantee (backed by the full faith and credit of the United States Government) mortgage pass-through certificates, backed by mortgage loans insured by the Federal Housing Administration (FHA) or guaranteed by the Veterans Administration (VA).[82] Fannie Mae became a federally chartered corporation authorized to purchase FHA-insured and VA-guaranteed mortgage loans and issue pass-through certificates backed by those mortgage loans.[83]

In 1970, Congress created the Federal Home Loan Mortgage Corporation, or Freddie Mac, to assist in creating a secondary market for mortgage loans through the purchasing of conventional mortgage loans—loans that were not FHA-insured or VA-guaranteed—and issuing and guaranteeing mortgage pass-through certificates that could be sold in the capital markets.[84] Congress also broadened Fannie Mae's authority to permit Fannie Mae to purchase conventional loans that met statutorily prescribed standards, including a limit on the original principal balance, and to issue mortgage pass-through certificates backed by these conventional loans.[85] By purchasing mortgage loans and issuing guaranteed mortgage-backed securities to investors, Fannie Mae and Freddie Mac, also known as government sponsored enterprises (GSEs), provided a long-term source of financing for originators of mortgage loans.[86] Finally, beginning in the 1980s, the private securitization of mortgage loans provided an additional source of long-term financing.[87]

These characteristics explain the dramatic shift, beginning in the 1970s, of the predominant holders of mortgage loans from savings institutions to Fannie

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81. *See* Housing and Urban Development Act of 1968, Title VIII, Pub. L. No. 90-448, § 801, 82 Stat. 476, 536 (codified as amended at 12 U.S.C § 1717(a) (2006)).

82. *See id.* (codified as amended at 12 U.S.C §§ 1717(a)(2)(A), (b)(1), 1721, 1723(a) (2006)); U.S. DEP'T OF THE TREASURY, GOVERNMENT SPONSORSHIP OF THE FEDERAL NATIONAL MORTGAGE ASSOCIATION AND THE FEDERAL HOME LOAN MORTGAGE CORPORATION 17–18 (1996).

83. *See* § 801, 82 Stat. at 536 (codified as amended at §§ 1717(a)(2)(B), 1719, 1723(b)); U.S. DEP'T OF THE TREASURY, *supra* note 82, at 18.

84. Federal Home Loan Mortgage Corporation Act of 1970, Title III, Pub. L. No. 91-351, §§ 301–310, 84 Stat. 451, 451–58 (codified as amended at 12 U.S.C. §§ 1451–1459 (2006)); *see generally* Carrozzo, *supra* note 80, at 768–97 (discussing the creation of a secondary market for conventional mortgages).

85. Emergency Home Finance Act of 1970, Pub. L. No. 91-351, § 201, 84 Stat. 45, 450–51 (codified as amended at 12 U.S.C. § 1717 (2006)).

86. *See* Joseph C. Shenker & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1369, 1384–85 (1991).

87. *See id.* at 1380–92.

Mae, Freddie Mac, and the issuers of private mortgage-backed securities. From 1958 to 1979, savings institutions held more than 50% of all single-family mortgage loans.[88] Thereafter, the share held by savings institutions declined significantly, and as of the end of 2006, savings institutions held only 7.8% of all first-lien single-family mortgage loans.[89]

In contrast, by the end of 2006, the GSEs, either directly or through trusts, held 44.4% of all first-lien single-family mortgage loans,[90] and issuers of private mortgage-backed securities held 22.7% of all first-lien single-family mortgage loans.[91] From the end of 2006 through September 2008, the principal

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88. *See* BD. OF GOVERNORS OF THE FED. RESERVE SYS., FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES: ANNUAL FLOWS AND OUTSTANDINGS 1975–1984, at 86 tbl.L.218, ll.5 & 12 (2008) [hereinafter FRB OUTSTANDINGS 1975-1984], *available at* http://www.federalreserve.gov/releases/z1/Current/annuals/a1975-1984.pdf; BD. OF GOVERNORS OF THE FED. RESERVE SYS., FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES: ANNUAL FLOWS AND OUTSTANDINGS 1965–1974, at 86 tbl.L.218, ll.5 & 12 (2008) [hereinafter FRB OUTSTANDINGS 1965–1974], *available at* http://www.federalreserve.gov/releases/z1/Current/annuals/a1965-1974.pdf; BD. OF GOVERNORS OF THE FED. RESERVE SYS., FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES: ANNUAL FLOWS AND OUTSTANDINGS 1955–1964, at 86 tbl.L.218, ll.5 & 12 (2008), [hereinafter FRB OUTSTANDINGS 1955–1964], *available at* http://www.federalreserve.gov/releases/z1/Current/annuals/a1955-1964.pdf. From 1945 through 1957, savings institutions held the largest amount of mortgage loans, more than 35% from 1945 through 1951, and more than 40% from 1951 through 1957. FRB OUTSTANDINGS 1955–1964, *supra*, at 86 tbl.L.218, ll.5 & 12; BD. OF GOVERNORS OF THE FED. RESERVE SYS., FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES: ANNUAL FLOWS AND OUTSTANDINGS 1945–1954, at 86 tbl.L.218, ll.5 & 12 (2008).

89. *See* BD. OF GOVERNORS OF THE FED. RESERVE SYS., FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES: ANNUAL FLOWS AND OUTSTANDINGS 2005–2007, at 86 tbl.L.218, ll.5, 12, 22 & 24 (2008) [hereinafter FRB OUTSTANDINGS 2005–2007], *available at* http://www.federalreserve.gov/releases/z1/Current/annuals/a2005-2007.pdf (using the following formula, remove the home equity junior liens, a substantial portion of which are not long-term amortizing mortgage loans: (line 12 minus line 24) divided by (line 5 minus line 22)); *see also* BD. OF GOVERNORS OF THE FED. RESERVE SYS., FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES: ANNUAL FLOWS AND OUTSTANDINGS 1995–2004, at 86 tbl.L.218, ll.5, 12, 22 & 24 (2008) [hereinafter FRB OUTSTANDINGS 1995–2004], *available at* http://www.federalreserve.gov/releases/z1/Current/annuals/a1995-2004.pdf; BD. OF GOVERNORS OF THE FED. RESERVE SYS., FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES: ANNUAL FLOWS AND OUTSTANDINGS 1985-1994, at 86 tbl.L.218, ll.5, 12, 22 & 24 (2008) [hereinafter FRB OUTSTANDINGS 1985–1994], *available at* http://www.federalreserve.gov/releases/z1/Current/annuals/a1985-1994.pdf; FRB OUTSTANDINGS 1975–1984, *supra* note 88, at 86 tbl.L.218, ll.5, 12, 22 &24 (collectively evidencing the significant decline in the percentage of first-lien single family mortgage loans held by savings institutions).

90. *See* FRB OUTSTANDINGS 2005-2007, *supra* note 89, at ll.5, 17, 18 & 22 (using the following formula, remove the home equity junior liens, a substantial portion of which are not long-term amortizing mortgage loans: (line 17 plus line 18) divided by (line 5 minus line 22)).

91. *See id.* at ll.5, 19, 22 & 26 (using the following formula, remove the home equity junior liens, a substantial portion of which are not long-term amortizing mortgage loans: (line 19 minus line 26) divided by (line 5 minus line 22)). The figures for the GSEs include mortgage loans held or guaranteed by Ginnie Mae, the Federal Home Loan Board, and the Farmers Home Administration. *See* FRB OUTSTANDINGS 2005–2007, *supra* note 89, at 80 tbl.210 n1. However,

amount and percentage of first-lien single-family mortgage loans backing private securitizations declined to 18.7% because of a lack of confidence in mortgage-backed securities,[92] and the loans held by GSEs, either directly or through trusts, grew to 51.6%.[93] Nevertheless, the mortgage market will need a rebound in the private securitization of mortgage loans if there is to exist significant long-term financing of mortgage loans outside of the federal government or the GSEs. Interestingly, since 1955, commercial banks have held between 13% and 17% of first-lien single-family mortgage loans.[94]

Fannie Mae and Freddie Mac purchase mortgage loans, transfer them to trusts that issue pass-through certificates that entitle the certificate holders to the interest on and principal of the mortgage loans, and guarantee the timely receipt of principal and interest on these certificates.[95] In addition, these GSEs purchase mortgage loans and mortgage-backed securities for their own portfolios and finance these purchases by issuing unsecured debt.[96] Frequently, the aggregate

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the holdings of Fannie Mae and Freddie Mac dwarf the holdings of these latter entities. *See infra* notes 104–08 and accompanying text.

92. *See id.* at ll.5, 17, 18 & 22 (using the following formula, remove the home equity junior liens, a substantial portion of which are not long-term amortizing mortgage loans: (line 17 plus line 18) divided by (line 5 minus line 22)).

93. *See* BD. OF GOVERNORS OF THE FED. RESERVE SYS., FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES: ANNUAL FLOWS AND OUTSTANDINGS THIRD QUARTER 2008, at 94, tbl.L.218, ll.5, 19, 22 & 26 (2008) [hereinafter FRB OUTSTANDINGS THIRD QUARTER], *available at* http://federalreserve.gov/releases/z1/current/z1.pdf (using the following formula, remove the home equity junior liens, a substantial portion of which are not long-term amortizing mortgage loans: (line 19 minus line 26) divided by (line 5 minus line 22)).

94. *See id.* at ll.5, 11, 22 & 23 (using the following formula, remove the home equity junior liens, a substantial portion of which are not long-term amortizing mortgage loans: (line 11 minus line 23) divided by (line 5 minus line 22)); FRB OUTSTANDINGS 2005–2007, *supra* note 89, at ll.5, 11, 22 & 23 (same); FRB OUTSTANDINGS 1995–2004, *supra* note 89, at ll.5, 11, 22 & 23 (same); FRB OUTSTANDINGS 1985–1994, *supra* note 89, at ll.5, 11, 22 & 23 (same; however, no information was collected on second-lien loans until 1990); FRB OUTSTANDINGS 1975–1984, *supra* note 88, at ll.5, 11 (no information collected on second-lien loans, which were less prevalent then); FRB OUTSTANDINGS 1965–1974, *supra* note 88, at ll.5, 11 (same); FRB OUTSTANDINGS 1955–1964, *supra* note 88, at ll.5, 11 (same).

95. *See* FED. NAT'L MORTGAGE ASS'N, ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE FISCAL YEAR ENDED DECEMBER 31, 2007 (FORM 10-K), at 5 (2008) [hereinafter FANNIE MAE, FORM 10-K], *available at* http://www.fanniemae.com/ (follow "Investor Relations" hyperlink; then follow "SEC Filings" hyperlink; then follow "Annual Filings" hyperlink; then follow "PDF" hyperlink for 10-K, 02/27/08).

96. *See* FED. HOME LOAN MORTGAGE CORP., QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2008 (FORM 10-Q), at 1 (2008) [hereinafter FREDDIE MAC, FORM 10-Q], *available at* http://www.freddiemac.com/ (follow "Investor Relations" hyperlink; then follow "SEC Filings" hyperlink; then follow "Quarterly Filings" hyperlink; then follow "PDF" hyperlink for 10-Q, 08/06/2008).

amounts of the guaranteed mortgage-backed securities and this unsecured debt are lumped together. For example, the statement of the Director of the Federal Housing Finance Agency (FHFA) on September 7, 2008, announcing the appointment of the FHFA as the conservator of both Fannie Mae and Freddie Mac stated that "the Enterprises have $5.4 trillion of guaranteed mortgage-backed securities (MBS) and debt outstanding, which is equal to the publicly held debt of the United States."[97]

The difference between the two types of obligations may not be significant either from the perspective of investors that hold highly rated mortgage-backed securities guaranteed by a GSE or direct debt issued by a GSE and that need timely payment of the principal and interest on their investments, or from the perspective of the reputation of the GSEs. There are, however, significant differences between the two that dramatically affect the operations of the GSEs. In the case of the guaranteed mortgage-backed securities, the GSEs retain only the risk of loss.[98] Accordingly, for every $100 billion of mortgage-backed securities guaranteed by the GSEs, the GSEs' liability is a tiny percentage of that amount—probably less than 1%, or $1 billion.[99] The GSEs cover this risk by collecting a guarantee fee in the range of an annual rate of 0.25% of the principal balance of the mortgages underlying the securities, and this fee has generally been sufficient to cover the expected losses.[100]

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97. James B. Lockhart, Dir., Fed. Hous. Fin. Agency, Statement of FHFA Dir. James B. Lockhart (Sept. 7, 2008), *available at* http://www.ofheo.gov/media/statements/FHFAStatement9708.pdf.

98. *See, e.g.*, Richard Scott Carnell, *Handling the Failure of a Government-Sponsored Enterprise*, 80 WASH. L. REV. 565, 575 (2005) (citing CONG. BUDGET OFFICE, ASSESSING THE PUBLIC COSTS AND BENEFITS OF FANNIE MAE AND FREDDIE MAC 5 (1996), *available at* http://www.cbo.gov/ftpdocs/0xx/doc13/Fanfred.pdf) ("The guarantee entails modest credit risk to the GSEs arising from the possibility that homebuyers will default on their loans and that the value of the property will not cover the balance due on the loans.").

99. *See* FREDDIE MAC, FORM 10-Q, *supra* note 96, at 29 tbl.12 (showing that Freddie Mac's credit loss ratio for the three months ending June 30, 2008, was 0.181% (18.1 basis points) and for the six months ending June 30, 2008, was 0.151% (15.1 basis points), both less than 1%); FANNIE MAE, FORM 10-K, *supra* note 95, at 46 (showing that Fannie Mae's credit loss ratio between 2003 and 2007 ranged from 0.01% (1.0 basis points) to 0.053% (5.3 basis points), or less than 1% (100.0 basis points)).

100. *See* FREDDIE MAC, FORM 10-Q, *supra* note 96, at 29 tbl.12 (showing that "[s]ingle-family credit losses, in basis points (annualized)" of 18.1 basis points (or 0.181 %) for the three months ending June 30, 2008, and of 15.1 basis points (or 0.151 %) for the six months ending June 30, 2008); FANNIE MAE, FORM 10-K, *supra* note 95, at 46 & 47 nn.16, 17 (showing Fannie Mae's average effective guaranty fee rate between 2003 to 2007 ranged from 0.218% (21.8 basis points) to 0.237% (23.7 basis points); *see also* FREDDIE MAC, GLOSSARY OF FINANCE AND ECONOMIC TERMS, http://www.freddiemac.com/finance/smm/g_m.htm (last visited Mar. 11, 2009) ("[A guarantee fee is] compensation charged for undertaking responsibility for another's debt. . . . Secondary-mortgage-market companies charge guarantee fees—typically about one-quarter of a percentage point of the loan amount—for bearing the default risk on loans pooled into securities.").

On the other hand, the GSEs retain full liability for the debt that they issue. GSEs use the proceeds of this debt, among other purposes, to acquire and hold mortgage loans and mortgage-backed securities[101] for which the GSEs retain full market value risk—not just default or credit risk.[102] Therefore, although the amount of the GSEs' debt is substantially lower than the amount of their guaranteed mortgage-backed securities,[103] the GSEs' liability on such debt is greater than their liability on the guarantees.

For example, as of the end of 2007, Fannie Mae had assets totaling approximately $883 billion (including approximately $728 billion of mortgages and mortgage-related securities held in its portfolio), had short- and long-term debt of approximately $796 billion, and had guaranteed mortgage-backed securities held by third parties in the amount of over $2.1 trillion.[104] Fannie Mae's debt equaled about 38% of the principal balance of the guaranteed mortgage-backed securities, but Fannie Mae's liability on its guarantee would not exceed 1–2%[105]—substantially less than its liability on its debt. This was a significant improvement from the end of 2003 when Fannie Mae had assets totaling approximately $1 trillion (including about $909 billion of mortgages and mortgage-related securities held in its portfolio), had short- and long-term debt of $961 billion, had guaranteed mortgage-backed securities held by third parties in the amount of around $1.3 trillion, and had a ratio of debt to guaranteed mortgage-backed securities of about 74%.[106]

Similarly, as of June 30, 2008, Freddie Mac had interest-earning assets consisting of mortgage loans and mortgage-related securities totaling approximately $734 billion (not limited to single-family mortgage loans), had short- and long-term debt of about $776 billion, and had guaranteed mortgage-backed securities held by third parties in the amount of approximately $1.8 trillion.[107] Its debt equaled about 43% of the principal balance of the guaranteed

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101. *See* FREDDIE MAC, FORM 10-Q, *supra* note 96 ("We also purchase mortgage loans and mortgage-related securities for our retained portfolio. We finance our purchases for our retained portfolio and manage associated interest-rate and other market risks primarily by issuing a variety of debt instruments and entering into derivative contracts in the capital markets.").

102. *See, e.g.*, Carnell, *supra* note 98, at 575–76 (explaining that the GSEs' portfolio investments represent their greatest risk because they assume the risk that a rise in interest rates will run down market values of mortgage-backed securities and that a drop in interest rates will entice borrowers to prepay).

103. *See* FANNIE MAE, FORM 10-K, *supra* note 95, at 46.

104. *Id.* at 46 & 47 nn.9, 11 (reflecting both the larger single-family mortgage loans and the much smaller multi-family mortgage loans as well as mortgage-related securities).

105. *See supra* note 99 and accompanying text (explaining that Fannie Mae had a credit loss ratio of less than 1%).

106. *See* FANNIE MAE, FORM 10-K, *supra* note 95, at 46 & 47 nn.9, 11.

107. *See* FREDDIE MAC, FORM 10-Q, *supra* note 96, at 17 tbl.3, 94 tbl.2.1.

mortgage-backed securities, but Freddie Mac's liability on its guarantee would not exceed 1–2%[108]—substantially less than its liability on its debt.

Current federal law acknowledges the significant difference between (1) the GSEs' guaranteed mortgage-backed securities and the loans underlying those securities and (2) the GSEs' direct debt and the mortgage loan and mortgage-backed securities that the GSEs held in their portfolios. The Housing and Economic Recovery Act of 2008,[109] effective July 30, 2008, created the FHFA to replace the Office of Federal Housing Enterprise Oversight (OFHEO),[110] authorized the Director of the FHFA to appoint the FHFA as conservator of the GSEs,[111] and provides detailed provisions for the rehabilitation of the GSEs.[112] The Act expressly provides that any mortgages or mortgage pools held by Fannie Mae or Freddie Mac in trust for the benefit of other persons are not available to satisfy claims of creditors of Fannie Mae or Freddie Mac, but will continue to be held for the benefit of those third parties.[113] Accordingly, if either Fannie Mae or Freddie Mac were to default on their guarantees of their pass-through certificates, the holders would nevertheless have the rights set forth in the documents governing those certificates. The holders would continue to receive payments as set forth in the applicable trust agreements to the extent of the assets in the related trusts.[114] If Fannie Mae's or Freddie Mac's obligations under their guarantees exceeded the available assets of the trusts, the holders would have an unsecured claim for damages against the defaulting GSE, which would "be estimated in accordance with the regulations of the Director."[115] Other provisions of the Act also recognize these differences in the two types of obligations.[116]

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108. *See supra* note 99 and accompanying text (explaining that Freddie Mac had a credit loss ratio of less than 1%).

109. Housing and Economic Recovery Act of 2008, Pub. L. No. 110–289, 122 Stat. 2654 (amending scattered sections of 5, 12, and 15 U.S.C.).

110. *Id.* § 1101, 122 Stat. at 2661–63 (amending 12 U.S.C. §§ 4511–4512) (replacing the OFHEO with the FHFA and replacing the Director of the OFHEO with the Director of the FHFA).

111. *Id.* § 1145, 122 Stat. at 2734 (amending 12 U.S.C. § 4617(a)(1)).

112. *See id.*, 122 Stat. at 2734–38 (amending 12 U.S.C. § 4617(a)(2), (b)(2)(D), (G)-(H)) (authorizing the Director to appoint the FHFA as conservator of a GSE to rehabilitate it, among other reasons, and authorizing the Agency as conservator to take appropriate actions to restore a GSE to a sound condition, such as disposing of a GSE's assets or paying a GSE's valid obligations).

113. *Id.* § 1145, 122 Stat. at 2746 (amending 12 U.S.C. § 4617(b)(19)(B)(i)) ("Any mortgage, pool of mortgages, or interest in a pool of mortgages held in trust, custodial, or agency capacity by a regulated entity for the benefit of any person other than the regulated entity shall not be available to satisfy the claims of creditors generally . . . .").

114. *Id.*, 122 Stat. at 2746–47 (amending 12 U.S.C. § 4617(b)(19)(B)(ii)).

115. *Id.*, 122 Stat. at 2747 (amending 12 U.S.C. § 4617(b)(19)(B)(iii)).

116. For example, the Act mandates that the Director of the FHFA determine criteria governing GSEs' portfolio holdings to secure the soundness of these holdings and establish risk-

In the case of the direct debt securities of each GSE, however, the payment of the entire debt depends on the value of the assets—including the mortgage loans and the mortgage-backed securities—that the GSE holds in its portfolio.[117] If the GSE was to become insolvent, the debt holders will receive payment of only a portion of their debt obligations.[118]

The continued deterioration of the mortgage market in 2008 created the necessary political will to provide for a more robust regulation of the GSEs, which had been suggested for years.[119] The deterioration of the mortgage market also exposed the financial weakness of the GSEs' strategy to issue debt to finance and hold significant portfolios of long-term mortgage loans and mortgage-backed securities.[120] Finally, because of concerns about the ability of the GSEs to pay their direct debt or their guarantee on their guaranteed mortgage-backed securities, the Director of the FHFA put the GSEs into conservatorship on September 7, 2008.[121] To restore confidence in the GSEs, the United States Treasury Department provided credit support to each GSE in the form of (1) a Government Sponsored Enterprise Credit Facility, by which the Treasury Department will make short-term loans to each GSE to provide "liquidity if needed until December 31, 2009," secured by guaranteed mortgage-backed securities issued by the GSEs;[122] and (2) a Treasury Senior Preferred Stock Purchase Agreement with the Treasury Department to ensure that each GSE maintains a positive net worth.[123]

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based capital levels to ensure that GSEs have sufficient capital to support the liabilities that the portfolio holdings impose. *See id.* §§ 1109–1110, 122 Stat. at 2674–76 (amending 12 U.S.C. §§ 1426, 4611, 4624). In contrast, concerning guarantee fees, the Act only mandates a study of such fees and a breakdown of risk assessment, but does not mandate any establishment of criteria over guarantee procedures or require a minimum capital level to make support guarantee liability. *See id.* § 1601, 2008 122 Stat. at 2824–25 (amending 12 U.S.C. § 4514a).

117. *Id.*, 122 Stat. at 2742–43 (amending 12 U.S.C. § 4617(b)(9)(A)).

118. *See id.*

119. *See, e.g.*, Federal Enterprise Regulatory Reform Act of 2003, S. 1508, 108th Cong. (2003) (proposing reform of Fannie Mae and Freddie Mac).

120. *See supra* text accompanying notes 98–103.

121. *See supra* text accompanying notes 18–19.

122. Office of Pub. Affairs, U.S. Dep't of Treasury, Fact Sheet: Government Sponsored Enterprise Credit Facility (Sept. 7, 2008), http://www.treasury.gov/press/releases/reports/gsecf_factsheet_090708.pdf.

123. Press Release, Henry M. Paulson Jr., Sec'y, U.S. Dept. of Treasury, Statement by Secretary Henry M. Paulson, Jr. on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers (Sept. 7, 2008), *available at* http://www.treas.gov/press/releases/hp1129.htm; *see also* Amended and Restated Senior Preferred Stock Purchase Agreement, U.S. Dep't of Treasury-Fed. Home Loan Mortgage Corp., Sept. 26, 2008 [hereinafter Freddie Mac Preferred Stock Agreement], *available at* http://ustreas.gov/press/releases/reports/seniorpreferredstockpurchaseagreementfrea.pdf; Amended and Restated Senior Preferred Stock Purchase Agreement, U.S. Dep't of Treasury-Fed. Nat'l

The Senior Preferred Stock Purchase Agreement gives the Treasury Department an "upfront $1 billion issuance of senior preferred stock with a 10% coupon from each GSE, quarterly dividend payments, warrants representing an ownership stake of 79.9% in each GSE going forward, and a quarterly fee starting in 2010."[124] The Treasury Department is obligated to contribute cash capital, up to $100 billion to each GSE, "[i]f the Federal Housing Finance Agency determines that a GSE's liabilities have exceeded its assets under generally accepted accounting principles,"[125] in exchange for senior preferred stock "senior to all other preferred stock, common stock or other capital stock to be issued by the GSE."[126] Each agreement includes several covenants by each GSE, including covenants (i) that it will not "[i]ncrease its debt to more than 110% of its debt as of June 30, 2008," and (ii) that "[e]ach GSE's retained mortgage and mortgage backed securities portfolio shall not exceed $850 billion as of December 31, 2009, and shall decline by 10% per year until it reaches $250 billion."[127]

These developments illustrate both the strengths and weaknesses of the GSEs. The guarantee of mortgage pass-through certificates by an agency with the implicit backing of the United States Government enabled originators of mortgage loans to find a long-term source of financing for these long-term assets.[128] Investors could purchase highly liquid mortgage-backed securities backed by mortgage loans that had the payment characteristics that matched their needs and that bore no credit risk.[129] Presumably, these investors could account for the risk of changes in the market value of these mortgage-backed securities.

The weaknesses of the GSEs, however, also stem directly from the nature of mortgage loans and the decision of the GSEs to hold significant portfolios of longer-term mortgage loans and mortgage-backed securities financed through direct debt issuance. Unlike the savings and loan associations crisis of the 1970s

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Mortgage Ass'n, Sept. 26, 2008 [hereinafter Fannie Mae Preferred Stock Agreement], *available at* http://www.ustreas.gov/ press/releases/reports/seniorpreferredstockpurchaseagreementfnm1.pdf; Office of Pub. Affairs, U.S. Dep't of Treasury, Fact Sheet: Treasury Senior Preferred Stock Purchase Agreement (Sept. 7, 2008), http://ustreas.gov/press/releases/reports/pspa_factsheet_090708hp1128.pdf [hereinafter Stock Purchase Agreement Fact Sheet].

124. Stock Purchase Agreement Fact Sheet, *supra* note 123.

125. *Id.*

126. *Id.* at 2.

127. *Id.*; *see also* Freddie Mac Preferred Stock Agreement, *supra* note 123, at 9 (describing indebtedness and mortgage assets covenants); Fannie Mae Preferred Stock Agreement, *supra* note 123, at 9 (same).

128. *See, e.g.*, Freddie Mac, Our Role in the Secondary Market, http://www.freddiemac.com/corporate/company_profile/our_role_secmkt/index.html (last visited Mar. 11, 2009) (explaining how Freddie Mac provides financing to lenders).

129. *See id.*

and 1980s, which was caused by a decline in the value of mortgage loans held by savings institutions as the result of the increase in market interest rates,[130] the financial disaster that befell the GSEs from this strategy resulted from a decline in the value of their mortgage loans from other causes.[131] Nevertheless, many commentators warned that the GSEs' strategy created substantial systemic risk.[132] Although the risk materialized from the collapse in the market value of mortgage loans,[133] the assumption of market value risk through the GSEs' direct holdings and direct debt issuance jeopardized their ability to provide a source of long-term financing through their guarantee programs.

The other important source of long-term financing for mortgage loans had been the private securitization of mortgage loans.[134] Instead of relying on an implicit federal government guarantee, the private securitization of mortgage loans relies on the legal isolation of a pool of mortgage loans from the operating risks and, therefore, the bankruptcy risks of an originator.[135] By being isolated from the bankruptcy risks of an operating company that is the originator or owner of the loans, private mortgage-backed securities avoid the costs that the Bankruptcy Code imposes on secured creditors of debtors in bankruptcy.[136] A significant feature of the Bankruptcy Code is that all debts of the debtor in bankruptcy become accelerated, a form of involuntarily prepayment that imposes costs on creditors.[137] By avoiding the risk of bankruptcy of the originator, mortgage-backed securities do not face the risk of prepayment that the holders of debt—including secured debt—of an operating company face.[138] In the past year, however, private securitization has suffered from the loss of confidence in the creditworthiness of the underlying mortgage loans.[139] Private securitization will not return to its former level until the real estate bubble of the last few years is fully deflated, and investors regain confidence in the real estate values underlying mortgage loans, in the integrity of the mortgage loan origination process, and in the integrity of the private mortgage-backed securities.

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130. *See supra* text accompanying notes 67–79.

131. *See supra* text accompanying notes 17–25.

132. *See, e.g.*, Bhattacharya et al., *supra* note 63, at 33 ("The portfolio growth of the [GSEs] has . . . become a fairly thorny political issue, kindling worries that the size of the agency portfolios creates risks for the stability of the financial markets.").

133. *See supra* text accompanying note 92.

134. *See* Shenker & Colletta, *supra* note 86, at 1380–92.

135. *See* Thomas E. Plank, *Sense and Sensibility in Securitization: A Prudent Legal Structure and a Fanciful Critique*, 30 CARDOZO L. REV. 617, 622 (2008).

136. *See* Plank, *supra* note 7, at 1660–71; Plank, *supra* note 135, at 621–23.

137. *See, e.g.*, 11 U.S.C. § 502(b) (2006) ("[T]he court, after notice and a hearing, shall determine the amount of such claim . . . and shall allow such claim in such amount . . . .").

138. *See supra* text accompanying notes 27–34.

139. *See supra* text accompanying note 92.

IV. CONCLUSION

Former Secretary of the Treasury Henry M. Paulson noted in a speech at the Economic Club of Washington on January 7, 2009, that many investors "fled mortgages" (which would include the mortgage-backed securities issued in private securitizations) that bore any kind of credit risk.[140] Nevertheless, as he observed, the ability of the GSEs to continue to issue guaranteed mortgage-backed securities enabled the conforming loan market to function relatively well.[141] These developments demonstrate that the guarantee model of the GSEs could continue to provide an important method for supporting the long-term financing of mortgage loans. The specific form that the GSEs should take presents difficult questions, as former Secretary Paulson noted in his speech.[142] Should the GSEs simply become federal agencies carrying the guarantee of the federal government? Should the GSEs be completely privatized? Should they continue to be quasi-governmental enterprises carrying the implicit backing of the federal government?

In any event, whatever the shape of the reform of the GSEs and other reforms of the regulatory regime for the mortgage finance market, the reforms must take into account the fact that a mortgage loan is a long-term asset and that owners of mortgage loans either must have matching long-term liabilities or must finance their holdings with long-term financing. GSEs that provide a guarantee against default, and therefore eliminate a portion of the risk of holding long-term assets, can play an important stabilizing function in the mortgage finance market.

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140. Paulson, *supra* note 17.
141. *See id.*
142. *See id.*