

MEMBER FMIC: CREDIT-RISK SHARING WITHIN AND WITHOUT AN FMIC-BASED HOUSING FINANCE SYSTEM

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Everyone agrees that the current chapter in the life of Fannie Mae and Freddie Mac should end. Less clear is what comes next.

Starting in the latter half of 2013, the Senate Banking Committee has explored legislation that would transform the economic and regulatory landscape of housing finance in the United States. S. 1217, the Senate Proposal introduced last summer by Senators Bob Corker (R-TN) and Mark Warner (D-VA), and revised this year by Banking Committee Chairman Tim Johnson (D-SD) and Ranking Member Mike Crapo (R-ID), seeks to replace Fannie Mae and Freddie Mac, and their regulator, the Federal Housing Finance Agency, with a “Federal Mortgage Insurance Corporation” (“FMIC”), an explicit government guarantor of conforming U.S. mortgages. The Senate Proposal would maintain a strong federal presence in housing finance but would require that private capital, through risk-sharing mechanisms, absorb the first 10% of losses. Although the proposal is unlikely to pass Congress in the gridlocked 2014 election season, it carries substantial bipartisan support going into the next Congress.

This Note explores the Senate Proposal, focusing closely on two crucial features of the proposed regulatory operation of the FMIC system: the credit-risk sharing mechanisms that

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the FMIC would employ and the supervision and legal duties of market participants both inside and outside the FMIC apparatus. Primarily, this Note concludes that credit-linked note deal structures provide the most efficient and prudentially safe and sound method of transferring first-loss credit risk from the FMIC to private parties. Secondly, this Note concludes that the Senate Proposal should also include features to hasten the return of the purely private-label securitization market, such as the placement of an enhanced legal duty on private-label securitization trustees. These conclusions address broad housing finance concepts and will remain germane to the debate no matter the fate of the Banking Committee's proposed legislation.

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I. INTRODUCTION

Early in the turbulent September of 2008, the newly formed Federal Housing Finance Agency (“FHFA”) invoked special authority granted by the Housing and Economic Recovery Act of 2008 (“HERA”)¹ to seize the Federal National Mortgage Association (“Fannie Mae”) and the Federal Home Loan Mortgage Corporation (“Freddie Mac”) (together, the “government-sponsored enterprises” or “GSEs”), and placed them under federal conservatorship.² For decades, the GSEs

¹ Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, § 1145(a), 122 Stat. 2654, 2734–2767 (2008) (amending 12 U.S.C. § 4617 (2007)).

² See Press Release, James B. Lockhart, Dir., Fed. Hous. Fin. Agency, Statement of FHFA Director James B. Lockhart at News Conference Announcing Conservatorship of Fannie Mae and Freddie Mac (Sept. 7,

served the critical role of guaranteeing trillions of dollars of U.S. mortgage loan interest and principal and, thereby, facilitated an era of affordable interest rates and deep, liquid secondary mortgage-backed bond markets.³ However, despite a decade's worth of initiatives by FHFA and its predecessor agency to rectify the GSEs' accounting, systems, controls, and risk management, the steep decline in home prices and "alarming" mortgage delinquency rates of 2007–2008 swiftly overwhelmed these storied enterprises and swallowed them whole.⁴

The problem lay in the GSEs' "flawed" design,⁵ colorfully illustrated in each enterprise's dual mandate to pursue both a public mission to serve the housing market and a private mission to maximize shareholder value.⁶ Whether the GSEs are chiefly to blame for sparking the financial crisis, as some hold,⁷ or were merely reluctant participants in the mortgage bond craze, as others hold,⁸ they stamped their imprimatur

2008), available at <http://perma.cc/M838-CGVN> ("[I]n order to restore the balance between safety and soundness and mission, FHFA has placed Fannie Mae and Freddie Mac into conservatorship.").

³ See FIN. CRISIS INQUIRY COMM'N, FINANCIAL CRISIS INQUIRY REPORT 38–42 (2010) [hereinafter FCIC REPORT].

⁴ See Press Release, Lockhart, *supra* note 2. For background on the OFHEO remedial actions prior to the financial crisis, see OFFICE OF FED. HOUS. ENTER. OVERSIGHT, REPORT OF THE SPECIAL EXAMINATION OF FANNIE MAE 10–12 (2006). For reflections after the financial crisis on those remedial actions by the former Director of the Office of Federal Housing Enterprise Oversight ("OFHEO"), see ARMANDO FALCON, TESTIMONY OF ARMANDO FALCON SUBMITTED TO THE FINANCIAL CRISIS INQUIRY COMMISSION 2 (2010), available at <http://perma.cc/6J5K-WMQB> ("We accomplished much despite the fact that OFHEO was structurally weak and almost designed to fail.").

⁵ See Press Release, Henry M. Paulson, Jr., Sec'y, U.S. Dep't of the Treasury, Statement by Henry M. Paulson, Jr. on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers (Sept. 7, 2008), available at <http://perma.cc/FJS6-A2CZ>.

⁶ See FCIC REPORT, *supra* note 3, at 314.

⁷ See PETER J. WALLISON, DISSENT FROM MAJORITY REPORT OF THE FINANCIAL CRISIS INQUIRY COMMISSION 2 (2011) ("I believe that the *sine qua non* of the financial crisis was U.S. government housing policy . . .").

⁸ See FCIC REPORT, *supra* note 3, at xxv–xxvi.

on trillions of dollars of mortgage-backed securities (“MBSs”), in pursuance of both halves of their mandate, resulting in devastating losses.⁹

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank Act”),¹⁰ Congress’s chief response to the crisis, did not address the problem of the GSEs—the “two elephants in the room”¹¹—leaving their fate temporarily unknown. Moreover, in an ironic twist, because the crisis stanching private capital in the mortgage markets, the GSEs have rapidly expanded their credit risk portfolios since entering conservatorship, propping up the vast majority of U.S. mortgages right at the moment that federal taxpayer support became explicit.¹²

This situation appears to be unsustainable.¹³ From a policy perspective, HERA did not contemplate a conservatorship of this length and breadth;¹⁴ direct Treasury intervention was supposed to be HERA’s “bazooka” option: seen but never used.¹⁵ Furthermore, the FHFA is currently

⁹ See *id.* at 309 (“The GSEs were highly leveraged—owning and guaranteeing \$5.3 trillion of mortgages with capital of less than 2%.”).

¹⁰ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections).

¹¹ Edward F. Greene, *Dodd-Frank: A Lesson in Decision Avoidance*, 6 CAP. MARKETS L.J. 29, 30 (2010).

¹² See MARK ZANDI & CRISTIAN DERITIS, MOODY’S ANALYTICS, EVALUATING CORKER-WARNER A1 (2013); U.S. DEP’T OF TREASURY, REFORMING AMERICA’S HOUSING FINANCE MARKET: A REPORT TO CONGRESS 12 (2011) [hereinafter TREASURY REPORT] (“In the wake of the financial crisis, private capital has not sufficiently returned to the mortgage market, leaving Fannie Mae, Freddie Mac, FHA, and [Ginnie Mae] to insure or guarantee more than nine out of every ten new mortgages.”).

¹³ See, e.g., David Min, *How Government Guarantees Promote Housing Finance Stability*, 50 HARV. J. ON LEGIS. 437, 437 (2013) (“[M]ajor reforms of the U.S. housing finance system appear inevitable.”).

¹⁴ FED. HOUS. FIN. AGENCY, A STRATEGIC PLAN FOR ENTERPRISE CONSERVATORSHIPS: THE NEXT CHAPTER IN A STORY THAT NEEDS AN ENDING 9 (2012) [hereinafter FHFA STRATEGIC PLAN].

¹⁵ *Hearing on Recent Developments in U.S. Financial Markets and the Regulatory Responses to Them Before the S. Comm. on Banking, Hous., & Urban Affairs*, 110th Cong. 19 (2008) (testimony of Henry M. Paulson, Jr., Sec’y, Dep’t of the Treasury).

struggling to reconcile its HERA conservatorship mandate to “take such action as may be . . . necessary to put the [GSEs] in a sound and solvent condition”¹⁶ with the reality that neither the Obama Administration nor a sizeable portion of Congress desires that the GSEs emerge from conservatorship alive.¹⁷ Without precedent or guidance, FHFA requires direction from the political branches of government.¹⁸

In early 2011, the Obama Administration presented to Congress three options for reform, each contemplating the unwinding and replacement of the GSEs with mechanisms containing varying degrees of government support.¹⁹ Only in mid-2013 did Congress begin that debate. On June 25, 2013, Senators Mark Warner (D-VA) and Bob Corker (R-TN), both members of the Banking Committee, introduced S. 1217, the Housing Finance Reform and Taxpayer Protection Act (the “Corker-Warner Bill” or “Corker-Warner”).²⁰ The Corker-Warner Bill contemplated the establishment of a new federal entity, the Federal Mortgage Insurance Corporation (“FMIC”), which would provide a partial, but explicit, government guarantee on conforming MBS through a Mortgage Insurance Fund (“MIF”) funded through assessments on the industry.²¹ The FMIC would also oversee

¹⁶ 12 U.S.C. § 4617(b)(2)(D)(i) (2012).

¹⁷ See Remarks at Desert Vista High School in Phoenix, Arizona, 2013 DAILY COMP. PRES. DOC. 201300550 (Aug. 6, 2013) (“[R]ight now there’s a bipartisan group of senators working to end Fannie and Freddie as we know them. And I support these kinds of reform efforts.”). Worth noting is the fact that the GSEs have unexpectedly proven to be a profitable investment for the federal government: the GSEs have now paid around \$218.7 billion in dividends to the Treasury Department against \$187.5 billion in draws. See Doug Carroll, *Fannie, Freddie to Pay \$5.6B Dividends to U.S.*, USA TODAY (Aug. 7, 2014 5:11 PM), <http://perma.cc/CZ8E-7G4Z>.

¹⁸ See FHFA STRATEGIC PLAN, *supra* note 14, at 5–6.

¹⁹ See TREASURY REPORT, *supra* note 12 at 23–30.

²⁰ Housing Finance Reform and Taxpayer Protection Act, S. 1217, 113th Cong. (2013) [hereinafter Corker-Warner Senate Bill] (as introduced, June 25, 2013).

²¹ *Id.* § 203.

the myriad participants that operate in the securitization markets.²²

In the final four months of 2013, the Senate Banking Committee held nine hearings that explored housing finance reform in general and the Corker-Warner Bill in particular.²³ In light of the hearings, Senate Banking Committee Chairman Tim Johnson (D-SD) and Ranking Member Mike Crapo (R-ID) released a version of Corker-Warner with slight

²² See *id.* §§ 211–214. Supervised actors would include private mortgage insurers, *id.* § 211, mortgage servicers, *id.* § 212, mortgage-backed securities issuers, *id.* § 213, and mortgage bond guarantors, *id.* § 214.

²³ See *Hearing on Housing Finance Reform: Fundamentals of Transferring Credit Risk in a Future Housing Finance System Before the S. Comm. on Banking, Hous., & Urban Affairs*, 113th Cong. (2013) [hereinafter *Risk Transfer Hearing*]; *Hearing on Housing Finance Reform: Developing a Plan for a Smooth Transition Before the S. Comm. on Banking, Hous., & Urban Affairs*, 113th Cong. (2013); *Hearing on Housing Finance Reform: Powers and Structure of a Strong Regulator Before the S. Comm. on Banking, Hous., & Urban Affairs*, 113th Cong. (2013) [hereinafter *Strong Regulator Hearing*]; *Hearing on Housing Finance Reform: Essential Elements to Provide Affordable Options for Housing Before the S. Comm. on Banking, Hous., & Urban Affairs*, 113th Cong. (2013); *Hearing on Housing Finance Reform: Protecting Small Lender Access to the Secondary Mortgage Market Before the S. Comm. on Banking, Hous., & Urban Affairs*, 113th Cong. (2013) [hereinafter *Protecting Small Lenders Hearing*]; *Hearing on Housing Finance Reform: Essential Elements of a Government Guarantee for Mortgage-Backed Securities Before the S. Comm. on Banking, Hous. & Urban Affairs*, 113th Cong. (2013); *Hearing on Housing Finance Reform: Essentials of a Functioning Housing Finance System for Consumers Before the S. Comm. on Banking, Hous., & Urban Affairs*, 113th Cong. (2013); *Hearing on Housing Finance Reform: Essential Elements of the Multifamily Housing Finance System Before the S. Comm. on Banking, Hous., & Urban Affairs*, 113th Cong. (2013); *Hearing on Fundamentals of a Functioning Private Label Mortgage Backed Securities Market Before the S. Comm. on Banking, Hous., & Urban Affairs*, 113th Cong. (2013) [hereinafter, *Private-Label Securitization Hearing*]; *Hearing on Essential Elements of Housing Finance Reform Before the S. Comm. on Banking, Hous., & Urban Affairs*, 113th Cong. (2013) [hereinafter, collectively, the *Senate Banking Committee Housing Finance Reform Hearings*].

revisions (the “Johnson-Crapo Bill” or “Johnson-Crapo”),²⁴ and, on May 15, 2014, the Johnson-Crapo Bill passed the Senate Banking Committee by a 13-9 vote, with a bipartisan majority.²⁵ Interestingly, however, the dissenters comprised not only minority Republican Senators but also liberal Democratic Senators such as Elizabeth Warren (D-MA), Jeff Merkley (D-OR), and Sherrod Brown (D-OH).²⁶ Perhaps because of the strength of the Democratic dissent, Senate Majority Leader Harry Reid (D-NV) has not and is not expected to bring Johnson-Crapo to the floor before midterm elections in November 2014.²⁷

Johnson-Crapo and Corker-Warner (together, the “Senate Proposal”) strongly contrast with alternative, more partisan reforms proposed in the House of Representatives, including the Protecting American Taxpayers and Homeowners Act (“PATH Act”)²⁸ and the Housing Opportunities Move the Economy Forward Act (“HOME Forward Act”).²⁹ While the Republican-supported PATH Act would abolish the GSEs

²⁴ Housing Finance Reform and Taxpayer Protection Act of 2014, S. 1217, 113th Cong. (2014) [hereinafter Johnson-Crapo Senate Bill] (as reported by S. Comm. on Banking, Hous., & Urban Affairs, May 15, 2014). In the language of the Senate, S. 1217 (the original Corker-Warner Bill) was “ordered to be reported with an amendment in the nature of a substitute favorably,” which means that the entire text of Corker-Warner was struck and replaced with Johnson-Crapo. *See also* Press Release, Senate Comm. on Banking, Hous., & Urban Affairs, Johnson, Crapo Release Housing Finance Reform Text (Mar. 16, 2014).

²⁵ *See* Press Release, Senate Comm. on Banking, Hous. & Urban Affairs, Senate Banking Committee Passes Bipartisan Housing Finance Reform Legislation (May 15, 2014), *available at* <http://perma.cc/5N9M-2AA6>.

²⁶ Jann Swanson, *Johnson-Crapo Bill Passes Banking Committee, Margins Smaller Than Hoped*, MORTGAGE NEWS DAILY (May 15, 2014), <http://perma.cc/4CWW-FJJH>.

²⁷ *See id.*

²⁸ Protecting American Taxpayers and Homeowners Act of 2013, H.R. 2767, 113th Cong. (2013).

²⁹ Housing Opportunities Move the Economy Forward Act of 2014, H.R. ___, 113th Cong. (2014) (discussion draft, Mar. 27, 2014).

and prohibit a government guaranty in housing finance,³⁰ the Democratic HOME Forward Act contemplates a greater federal presence in housing finance through a diminished private capital first-loss requirement³¹ and a stronger affordable housing mandate.³²

This Note does not delve deeply into the legal and regulatory structures of housing finance; instead, it attempts to deal holistically with the policy concerns and considerations surrounding the Senate Proposal to reform the housing finance system—the proposal with the greatest political appetite. For a number of reasons, this Note aims to explain and editorialize on the Senate Proposal rather than to defend its underlying premise: that the federal government should participate in housing finance at all. Chief among these reasons is the contention, taken at face value for purposes of this Note, that a fully private market could support but a fraction of the current demand for housing finance in the short and medium term. Importantly, this Note does not intend to reproach the prospect of a fully private market at some future time; instead, this Note rests on the presumption, sturdy but nonetheless political, that the foreseeable future requires some form of government participation in housing finance. In light of that presumption, exploration of the Senate Proposal is paramount.

Much uncertainty still surrounds the Senate Proposal. Although it provides a launching pad, left unsaid are the details on how critical proposed infrastructure would operate. This Note seeks to fill those holes. First, the Note provides a detailed descriptive and normative analysis on how the Senate Proposal could function to develop a robust and prudentially sound government-backed market. It provides a first explanation of the three credit risk-sharing mechanisms that the Proposal contemplates and concludes

³⁰ Protecting American Taxpayers and Homeowners Act of 2013, H.R. 2767, 113th Cong. §§ 103, 312(c) (2013).

³¹ See HOME Forward Act §§ 201–202.

³² See *id.* § 401.

that the “credit-linked note” structure is the soundest for taxpayers and the most efficient for borrowers and investors. Second, the Note analyzes how the statutory imposition of a fiduciary duty on private-label securitization trustees could help restore a strong private-label securitization market to complement an FMIC-backed market. Because both of these analyses are broadly applicable to the subject of housing finance, the discussions herein should remain germane regardless of whether the Senate Proposal, or a similar bill next Congress, soon becomes law.

The Note proceeds as follows. Part II explores the history of the GSEs to their present state in federal conservatorship. Part III details the Senate Proposal and the operation of the FMIC, including the credit-risk sharing mechanisms and prudential supervision structure contemplated therein. Part III also briefly describes how the PATH Act would compare to the Senate Proposal. Part IV outlines the proper goals of any credit risk-sharing mechanism and recommends the adoption of the credit-linked note structure mechanism. Part IV argues not only that the credit-linked note structure is superior to alternatives contemplated within the Senate Proposal, but also that, for many of the same reasons, the Proposal itself is superior to the PATH Act. Part V builds on the broader policy goal of privatizing mortgage credit risk and proposes an additional reform regarding securitization trustee duties that would hasten the return of a non-governmental private-label securitization market to complement an FMIC-based system. Part VI concludes.

II. HISTORY OF THE GSES AND RECENT DEVELOPMENTS

A. From the Beginning until Conservatorship

1. Before Fannie and Freddie

Prior to the Great Depression, the private sector dominated housing finance.³³ Financing options consisted of short-term renewable loans that required “high down payments (approximately half of the home’s purchase price), short maturities (ten years or less), and large balloon payments.”³⁴ These features “presented significant challenges to widespread homeownership.”³⁵ Moreover, when the Great Depression struck, overall outstanding mortgage debt default rates reached nearly 25%.³⁶

The governmental response to the housing finance problems of the Depression began in the borrower-facing primary mortgage markets. In 1932, Congress established the Federal Home Loan Bank (“FHLB”) System.³⁷ The twelve regional FHLBs operated by, first, borrowing funds in the capital markets at government low rates, then, extending loans collateralized by residential mortgages or government securities to local mortgage lenders.³⁸ These loans supplied liquidity to the commercial banks and thrifts facing maturity mismatches associated with mortgage lending and exacerbated by delinquent borrowers.

³³ FED. HOUS. FIN. AGENCY, OFFICE OF INSPECTOR GEN., A BRIEF HISTORY OF THE HOUSING GOVERNMENT-SPONSORED ENTERPRISES 1 (2009) [hereinafter FHFA OIG HISTORY OF THE HOUSING GSES], *available at* <http://perma.cc/VE2D-K3GT>.

³⁴ *Id.*

³⁵ *Id.*

³⁶ *Id.*

³⁷ Federal Home Loan Bank Act, 12 U.S.C. § 1421 (2012).

³⁸ GOV’T ACCOUNTABILITY OFFICE, FANNIE MAE AND FREDDIE MAC: ANALYSIS OF OPTIONS FOR REVISING THE HOUSING ENTERPRISES’ LONG-TERM STRUCTURES 6 (2009) [hereinafter GAO REPORT], *available at* <http://perma.cc/Z5HZ-NWHY>.

Policymakers then moved to deposit and mortgage insurance. In 1933, Congress formed the Federal Deposit Insurance Corporation (“FDIC”), which insured (and continues to insure) deposits at FDIC-member commercial banks.³⁹ In 1934, Congress established both the Federal Savings and Loan Insurance Corporation (“FSLIC”), which insured deposits at FSLIC-member thrifts,⁴⁰ and the Federal Housing Administration (“FHA”),⁴¹ which insured (and continues to insure) FHA-approved banks, thrifts, and other mortgage lenders against certain losses sustained as a result of mortgage defaults.⁴² However, while federal insurance, combined with FHLB advances, improved financial institutions’ capital adequacy and liquidity positions, no modern secondary market on which mortgage debt could be bought and sold yet existed.⁴³

But before Congress attempted to create such a secondary market, it sought to protect borrowers and recapitalize lenders hurt by the Depression. In 1933, Congress passed the Home Owners’ Loan Act, which directed the FHLBs to

³⁹ Banking Act of 1933, Pub. L. No. 73-66, § 8, 48 Stat. 162, 168 (1933) (current version at 12 U.S.C. § 1811 (2012)). *See also* FED. DEPOSIT INS. CORP., A BRIEF HISTORY OF DEPOSIT INSURANCE IN THE UNITED STATES 27 (1998), *available at* <http://perma.cc/JLP8-JGFC>.

⁴⁰ National Housing Act, Pub. L. No. 73-479, § 402, 48 Stat. 1246, 1256 (1934). In the wake of the Savings and Loan crisis of the late 1980s, the Financial Institutions Reform, Recovery and Enforcement Act of 1989 abolished the FSLIC and transferred its insurance functions to the FDIC. *See* Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, § 401, 103 Stat. 183, 354 (1989).

⁴¹ National Housing Act §1 (current version at 12 U.S.C. § 1702).

⁴² *Id.* § 2 (current version at 12 U.S.C. § 1703). The conditioning of eligibility for highly desirable FHA insurance on the satisfaction of certain standards radically altered the mortgage finance landscape. These FHA-set standards are chiefly to thank for the modern mortgage. Unlike pre-Depression loans, FHA-eligible mortgages were long-term and had high loan-to-value ratios and fixed rates. *See* Min, *supra* note 13, at 474–75.

⁴³ *See* Adam J. Levitin & Susan M. Wachter, *The Public Option in Housing Finance*, 46 U.C. DAVIS L. REV. 1111, 1123–25 (2013) (arguing that pre-GSE attempts to form secondary mortgage markets all failed because they were private, virtually unregulated, and lacked the ability to maintain high underwriting standards).

create the Home Owners' Loan Corporation ("HOLC").⁴⁴ The HOLC was designed as a temporary measure to protect borrowers by eliminating negative equity.⁴⁵ It did so by purchasing at a discount defaulted, underwater mortgages from lenders in exchange for long-term bonds, and restructuring those mortgages into long-term fixed-rate obligations.⁴⁶ However, in order to coax lenders into taking the immediate haircut that a HOLC refinancing occasioned and into assuming the long-term credit exposure to HOLC itself, Congress amended the Home Owners' Loan Act in 1934 to enable the federal government to guarantee mortgage principal in addition to the originally authorized interest guarantees.⁴⁷

The success of HOLC, combined with the federal guarantee of HOLC-refinanced loan principal, precipitated the "sudden and massive government entrance" into the mortgage market.⁴⁸ Importantly, the long-term, fixed-rate loans that resulted from HOLC refinancings were shown to be feasible by the time HOLC wound down in 1951 and became the standard mortgage product of the federal government.⁴⁹

⁴⁴ Home Owners' Loan Act of 1933, Pub. L. No. 73-43, § 4(a), 48 Stat. 128, 129 (1933), *amended by* Act of April 27, 1934, Pub. L. No. 73-178, § 1(a), 48 Stat. 643, 643 (1934).

⁴⁵ See Levitin & Wachter, *supra* note 43, at 1134–35. Negative equity occurs when the outstanding balance on a borrower's loan exceeds the value of the asset collateralizing the loan.

⁴⁶ *Id.* at 1134.

⁴⁷ Act of April 27, 1934, Pub. L. No. 73-178, § 1(a), 48 Stat. 643, 643 (1934).

⁴⁸ Levitin & Wachter, *supra* note 43, at 1134.

⁴⁹ *Id.* at 1135.

2. From the Founding of Fannie Mae to the Reorganization of Fannie Mae and Founding of Freddie Mac

The 1934 National Housing Act first contemplated a secondary market for mortgages.⁵⁰ Title III of that Act provided for a federal charter for “national mortgage associations” that would be permitted both to purchase and sell first-lien mortgages and to raise funds for these activities through debt issuances.⁵¹ The objective of the charter was to nationalize the housing market by allowing local banks and thrifts, first, to offload their mortgage loans to the capital markets-funded national mortgage associations and, next, to make new loans with the consideration received.⁵² As opposed to the FHA insurance scheme, in which lenders retained their loans on balance sheets while insuring them against default, the national mortgage association scheme sought to encourage lenders to sell their loans to secondary market participants in exchange for cash that could be used to originate more loans.⁵³ The problem lay in founding even a single national mortgage association: no one attempted a try.⁵⁴

By 1938, the Roosevelt Administration decided to charter its own national mortgage association, as a subsidiary to the New Deal Reconstruction Finance Corporation (“RFC”), called the Federal National Mortgage Association⁵⁵—later shortened colloquially to Fannie Mae.⁵⁶ Fannie operated as a government agency that could buy, hold, and sell FHA-insured mortgage loans straight from the portfolios of private lenders in exchange for tradable fixed-rate Fannie

⁵⁰ See National Housing Act, Pub. L. No. 73-479, § 301, 48 Stat. 1246, 1252 (1934).

⁵¹ *Id.* § 301(a).

⁵² Levitin & Wachter, *supra* note 43, at 1142.

⁵³ See *id.*

⁵⁴ *Id.*

⁵⁵ *Id.* at 1143. See also 12 U.S.C. § 1717 (2012).

⁵⁶ Levitin & Wachter, *supra* note 43, at 1143.

debt securities.⁵⁷ Because these Fannie bonds carried fixed rates, Fannie was able to offload some of the interest-rate risk that it assumed from its mortgage portfolio onto the loan-originating lenders, who became Fannie bondholders upon the sale of the loan to Fannie.⁵⁸ Importantly, however, because Fannie carried a government guarantee as a subsidiary of the explicitly government-backed RFC, these Fannie bondholders assumed no credit risk for Fannie's portfolio.⁵⁹

From its creation to the 1960s, however, Fannie engaged in little activity compared to the FHA and the Department of Veterans Affairs ("VA"),⁶⁰ which began guaranteeing veterans' loans in 1944.⁶¹ In fact, Fannie's importance in the post-war years stemmed from its ready provision of liquidity to FHA-approved lenders—essentially a lender put option—should those lenders require immediate cash.⁶²

Nonetheless, after Congress re-chartered Fannie Mae in 1948, allowing Fannie to purchase and sell VA-guaranteed loans in addition to FHA-guaranteed loans,⁶³ Fannie developed three structural mortgage market features with staying power. First, Fannie created a secondary market that functioned to connect capital market investors to mortgage lenders, resulting in deeper market liquidity.⁶⁴ Second, Fannie's secondary market also reduced regional mortgage credit disparities, as investors in capital-rich areas could finance lenders and borrowers in capital-poor areas.⁶⁵ Third, because access to Fannie's liquidity required

⁵⁷ FHFA OIG HISTORY OF THE HOUSING GSEs, *supra* note 33, at 2; see Levitin & Wachter, *supra* note 43, at 1144.

⁵⁸ Levitin & Wachter, *supra* note 43, at 1144.

⁵⁹ *Id.*

⁶⁰ *Id.* at 1146.

⁶¹ See Servicemen's Readjustment Act of 1944, Pub. L. No. 78-346, § 501, 58 Stat. 284, 292 (1944), *amended by* Act of July 1, 1948, Pub. L. No. 80-864, 62 Stat. 1206, 1207 (1948).

⁶² See Levitin & Wachter, *supra* note 43, at 1148–49.

⁶³ Act of July 1, 1948, Pub. L. No. 80-864, 62 Stat. 1206, 1207 (1948).

⁶⁴ Levitin & Wachter, *supra* note 43, at 1146.

⁶⁵ *Id.* at 1147.

compliance with FHA underwriting standards, Fannie encouraged the standardization of the long-term, fully amortizing, fixed-rate mortgage product.⁶⁶

Before 1968, Fannie Mae earned money by taking the spread between the mortgage payment receivables of the FHA and VA mortgages in its portfolio and the debt that it issued to fund its mortgage purchases.⁶⁷ Consequently, by 1968, Fannie's liabilities had grown to \$7.2 billion.⁶⁸ In order to distance itself from that debt, Congress and the Johnson Administration passed the Housing and Urban Development Act of 1968 ("HUD Act"), which split the old Fannie Mae into "Ginnie Mae" (formally, the Government National Mortgage Association), a government-owned corporation that continued the traditional role of guaranteeing FHA and VA-backed mortgages and mortgage bonds, and the current Fannie Mae, a for-profit, shareholder-owned company.⁶⁹ This action removed Fannie debt from the federal budget, leaving Fannie to fund its operations through the capital markets (which, by that point, it already did).⁷⁰ Although this action removed explicit federal support for Fannie obligations, implicit government backing (should Fannie run into trouble) was widely assumed.⁷¹ The HUD Act also placed the new Fannie Mae under the supervision of the Department of Housing and Urban Development ("HUD") and enabled HUD to set numeric housing goals requiring that a portion of Fannie's mortgage purchases serve, among others, low- and moderate-income families.⁷²

Shortly after, Congress passed the Emergency Home Finance Act of 1970 ("EHFA"), which altered housing finance

⁶⁶ *Id.*

⁶⁷ See FCIC REPORT, *supra* note 3, at 38.

⁶⁸ *Id.*

⁶⁹ Housing and Urban Development Act of 1968, Pub. L. No. 90-448, § 801, 82 Stat. 476, 536 (1968) (current version at 12 U.S.C. §§ 1719, 1721 (2012)); see FHFA OIG HISTORY OF THE HOUSING GSEs, *supra* note 33, at 3.

⁷⁰ FHFA OIG HISTORY OF THE HOUSING GSEs, *supra* note 33, at 3.

⁷¹ Levitin & Wachter, *supra* note 43, at 1161–62.

⁷² GAO REPORT, *supra* note 38, at 13.

in two major ways.⁷³ First, the EHFA permitted the new Fannie Mae (as opposed to the government-owned Ginnie Mae) to “deal in mortgages which are not insured or guaranteed” by the FHA or VA, but the Act also set ground rules for such loans.⁷⁴ Thus, Congress for the first time permitted Fannie to purchase and sell non-government-backed loans.

Second, the EHFA chartered another housing government-sponsored enterprise, the Federal Home Loan Mortgage Corporation, shortened to Freddie Mac.⁷⁵ The EHFA originally conceived Freddie Mac as an FHLB entity, under the supervision of the FHLB Board,⁷⁶ and intended that Freddie Mac provide a secondary market outlet for thrifts to offload interest rate risk, as the rising rate environment drove many long-term thrift assets below market.⁷⁷ However, after the savings and loan crisis battered the thrift industry in the late 1980s, Congress amended the EHFA to reorganize Freddie Mac along the lines of Fannie Mae.⁷⁸

3. Fannie and Freddie Develop the MBS System

Within two years of founding, Freddie Mac acquired \$1.7 billion in mortgages—most, but not all, FHA and VA loans.⁷⁹ Freddie’s purpose in buying mortgages, aligning with the

⁷³ Emergency Home Finance Act of 1970, Pub. L. No. 91-351, 84 Stat. 450 (1970) (codified in scattered sections). For an extremely detailed account of the Congressional debate preceding the passage of the EHFA, see 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, 768–97 (2005).

⁷⁴ Emergency Home Finance Act of 1970 § 201 (codified at 12 U.S.C. § 1717).

⁷⁵ See *id.* § 303(a) (codified at 12 U.S.C. § 1452).

⁷⁶ *Id.*

⁷⁷ See FHFA OIG HISTORY OF THE HOUSING GSEs, *supra* note 33, at 3.

⁷⁸ Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, § 731, 103 Stat. 183, 429–30 (1989).

⁷⁹ Walter M. Strine, Jr., *New Commercial Devices—Mortgage-Backed Securities*, 13 REAL PROP. PROB. & TR. J. 1011, 1023 (1978).

purpose of policymakers stretching back to the Roosevelt Administration, was to create a national mortgage market; it sought to “suppl[y] liquid funds to those parts of the country which ha[d] mortgage investment opportunity in excess of accumulated savings.”⁸⁰ This buying purpose was matched with a selling purpose that sought to “move[] capital from other parts of the country where accumulated savings exceed[ed] mortgage investment opportunity.”⁸¹ As an entity originally established to distribute interest rate risk,⁸² Freddie Mac immediately began selling to the capital markets “Participation Certificates” (“PCs”), securities representing undivided interests in specified residential mortgages owned by Freddie Mac,⁸³ thereby matching its fixed-rate assets with fixed-rate obligations.⁸⁴ As opposed to the loan-by-loan guaranties of the FHA and VA, Freddie Mac guaranteed the timely payment of principal and interest on the entire pool.⁸⁵ These PCs, despite the name, were early government-sponsored enterprise-guaranteed mortgage-backed securities (“GSE MBSs”).⁸⁶ By 1978, Freddie Mac had become the largest MBS issuer in the world.⁸⁷

The Freddie GSE MBSs differed from MBSs that Ginnie Mae was simultaneously developing. First, Ginnie MBSs carried an explicit government guaranty and comprised only FHA- and VA-insured loans.⁸⁸ Freddie GSE MBSs, on the other hand, carried no official government guaranty and

⁸⁰ *Id.* at 1024.

⁸¹ *Id.*

⁸² See FHFA OIG HISTORY OF THE HOUSING GSEs, *supra* note 33, at 3–4.

⁸³ Strine, *supra* note 79, at 1028.

⁸⁴ See FHFA OIG HISTORY OF THE HOUSING GSEs, *supra* note 33, at 3–4. For a discussion on the interest rate risk facing contemporary thrifts, see generally David H. Pyle, *The U.S. Savings and Loan Crisis* (Inst. of Bus. and Econ. Research, Finance Working Paper No. 227, 1993).

⁸⁵ Strine, *supra* note 79, at 1023–24.

⁸⁶ *Id.*

⁸⁷ *Id.* at 1025.

⁸⁸ *Id.* at 1024.

comprised conventional, “conforming loans”⁸⁹ outside the FHA and VA universe.⁹⁰ Both MBSs, however, were essentially so-called “pass-through” securitizations, meaning that the securities issued against the mortgage pool were uniform and represented a uniform claim on the underlying pool.⁹¹ In other words, the structured finance features common in later “private-label securitization”⁹² were not present.

Fannie Mae initially continued to hold the mortgage loans it purchased on balance sheet, a decision that exposed Fannie to significant interest rate risk.⁹³ Like many thrifts at that time with similar interest-rate exposure, Fannie Mae suffered financial strain in the savings and loan crisis of the late 1980s—and Fannie survived only with federal benefits, such as favorable tax treatment and regulatory forbearance, intended to keep Fannie afloat.⁹⁴ These measures not only highlighted the superiority of the Freddie MBS system but also solidified the market theory that, despite official denials, the government would support Fannie if it stumbled.⁹⁵

The savings and loan crisis also resulted in two other significant changes to the GSE landscape. First, Congress passed the Financial Institutions Recovery, Reform, and Enforcement Act of 1989 (“FIRREA”)⁹⁶ to clean the balance sheets of failed thrifts.⁹⁷ FIRREA established the Resolution

⁸⁹ “Conforming loans” refer to loans that the GSEs are eligible to guarantee or securitize. 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).

⁹⁰ Strine, *supra* note 79, at 1024.

⁹¹ *See id.* at 1014, 1029.

⁹² *See* discussion *infra* Part II.A.4.

⁹³ FHFA OIG HISTORY OF THE HOUSING GSEs, *supra* note 33, at 4.

⁹⁴ *Id.*

⁹⁵ *See* GAO REPORT, *supra* note 38, at 3.

⁹⁶ Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183 (1989).

⁹⁷ *See* Yuliya Guseva, *Evolutionary Developments in Mortgage Securitization: Financial Law Reforms, Putative Beneficiaries, and*

Trust Corporation (“RTC”), a HOLC-like government entity charged with the disposal of failed thrifts’ real estate assets.⁹⁸ RTC officials turned to securitization to offload these assets quickly.⁹⁹ The RTC was able to sell some \$6.1 billion in failed thrift assets that conformed to the GSE underwriting guidelines to the GSEs for securitization.¹⁰⁰ As investors consequently became more familiar with securitization, GSE MBS issuance steadily increased, overtaking traditional commercial banks and thrifts as a source of mortgage funding by the 1990s.¹⁰¹

Second, in response to regulatory oversight concerns,¹⁰² Congress passed the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (the “1992 Reforms”).¹⁰³ The 1992 Reforms established a prudential regulator, the Office of Federal Housing Enterprise Oversight (“OFHEO”), to monitor the safety and soundness of the GSEs through capital requirements.¹⁰⁴ OFHEO lacked, however, key authority, held by comparable prudential banking regulators, in areas such as enforcement, capital requirements, funding, and receivership.¹⁰⁵

During the Clinton and George W. Bush Administrations, HUD became more active in its setting affordable housing goals. In 1995, HUD began issuing intermittent housing goals, requiring the GSEs to purchase mortgages made to low- and moderate-income families or on properties in underserved areas.¹⁰⁶ These goals steadily grew. For

Archetypal Economic Risks, 21 *TRANSNAT’L L. & CONTEMP. PROBS.* 395, 435 (2012).

⁹⁸ *Id.*

⁹⁹ FCIC REPORT, *supra* note 3, at 69.

¹⁰⁰ *Id.* at 68.

¹⁰¹ *Id.* at 69 fig.5.1.

¹⁰² FHFA OIG HISTORY OF THE HOUSING GSEs, *supra* note 33, at 5.

¹⁰³ Housing and Community Development Act of 1992, Pub. L. No. 102-550 §§ 1301–1395, 106 Stat. 3672, 3941–4012 (1992).

¹⁰⁴ *Id.* §§ 1311, 1313.

¹⁰⁵ FCIC REPORT, *supra* note 3, at 40.

¹⁰⁶ Theresa R. DiVenti, *Fannie Mae And Freddie Mac: Past, Present, And Future*, 11 *CITYSCAPE: J. POL’Y DEV. & RES.*, no. 3, at 231, 234.

purchases of mortgages made to low- and moderate-income families, for example, HUD increased its benchmark level from 42% of all loans purchased in 2000 to 55% in 2007.¹⁰⁷

Whether it was the increase in affordable housing goals or the decline in overall market share (driven by the rise of private-label securitization¹⁰⁸) that caused the GSEs to expand their nonprime mortgage retained portfolios remains a heated debate, albeit one beyond the scope of this Note.¹⁰⁹ What is certain, however, is that following several years of housing goal expansions and market share declines from around 2003 to 2005, the GSEs began to accumulate large portfolios of subprime mortgages and MBSs that both served the housing goals and recovered lost market share.¹¹⁰

4. The GSEs in the Financial Crisis

Large house price declines starting in December 2006¹¹¹ forever changed the fate of the GSEs. By that point, the GSEs held or guaranteed \$5.3 trillion of mortgage debt—with capital of less than 2% of its outstanding exposure.¹¹² Losses began almost immediately as the GSEs' retained portfolio—which included newly acquired nonprime assets—lost value¹¹³; the GSEs reported losses of \$5.2 billion in

¹⁰⁷ U.S. DEP'T OF HOUS. & URBAN DEV., OVERVIEW OF THE GSEs' HOUSING GOAL PERFORMANCE, 2000–2007 4 tbl.1 (2008), *available at* <http://perma.cc/M5MQ-6JYN>.

¹⁰⁸ *See* discussion *infra* Part II.A.iv.

¹⁰⁹ *Compare* WALLISON, *supra* note 7, at 11–15 (arguing that enlarged government affordable housing policy forced the GSEs to purchase subprime mortgages), *with* FCIC REPORT, *supra* note 3, at 184, 323 (concluding that the GSEs' acquisition of risky mortgages was undertaken “to meet . . . expectations for growth, to regain market share, and to ensure generous compensation for employees,” with housing goals contributing only “marginally”).

¹¹⁰ *See* FCIC REPORT, *supra* note 3, at 180–81.

¹¹¹ *See* MCGRAW HILL FIN., S&P/CASE-SHILLER U.S. NATIONAL HOME PRICE INDEX (2013), *available at* <http://perma.cc/4RAP-VFLE>.

¹¹² FCIC REPORT, *supra* note 3, at 309.

¹¹³ *See id.* at 309–310.

2007.¹¹⁴ Then, the hammer dropped. Mortgage defaults in GSE MBSs both slammed the retained portfolio and required the GSEs to stand behind their guarantee books.¹¹⁵ Year-end financial statements for 2008, concededly after the GSEs were placed into conservatorship, revealed that losses that year had exceeded \$108 billion.¹¹⁶

As losses began to pile up, OFHEO officials and government policymakers struggled to balance the GSEs' increasing prudential risk against their increasing importance in providing liquidity to the flailing housing finance system.¹¹⁷ Because the private-label market had effectively shut down, the GSEs were "the only game in town."¹¹⁸ Policymakers figured that if the GSEs bought more loans, the market could stabilize—but those loans would also strain the GSEs' balance sheets.¹¹⁹

In July 2008, Congress passed the Housing and Economic Recovery Act of 2008¹²⁰ to stabilize the GSEs and the broader housing markets.¹²¹ Division A of HERA abolished OFHEO and replaced it with FHFA, an enhanced regulator with the authority, among other new authorities, to appoint itself conservator of the GSEs "for the purpose of reorganizing, rehabilitating, or winding up the affairs of a regulated entity."¹²² In a Congressional hearing debating HERA, however, Treasury Secretary Henry Paulson called proposed Treasury authority to invest directly in the GSEs (to say nothing of FHFA's weightier proposed conservatorship

¹¹⁴ FED. HOUS. FIN. AGENCY, REPORT TO CONGRESS 2012 6 fig.6 (2013) [hereinafter FHFA 2012 REPORT TO CONGRESS].

¹¹⁵ FCIC REPORT, *supra* note 3, at 312.

¹¹⁶ FHFA 2012 REPORT TO CONGRESS, *supra* note 114.

¹¹⁷ See FCIC REPORT, *supra* note 3, at 309.

¹¹⁸ See *id.* at 311.

¹¹⁹ *Id.* at 309.

¹²⁰ Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, 122 Stat. 2654 (codified in scattered sections).

¹²¹ FCIC REPORT, *supra* note 3, at 317.

¹²² 12 U.S.C. § 4617(a)(2) (2012).

authority) a “bazooka” that would not likely be used, but whose availability would increase market confidence.¹²³

That assessment changed after an August 2008 weeklong review of the GSEs’ books by the Federal Reserve and the Office of the Comptroller of the Currency.¹²⁴ The review suggested, among other concerns, that the GSEs had been substantially understating their losses and were likely almost insolvent, if not already insolvent.¹²⁵ On September 7, 2008, FHFA Director James B. Lockhart, acting in concert with Secretary Paulson, exercised the HERA conservatorship authority, appointing FHFA conservator of the multitrillion-dollar GSEs.¹²⁶

B. The Development of the Parallel Private-Label MBS System and the Problem of Credit Risk

Outside the GSEs, from the late 1970s onward, commercial banks became involved in the issuance of MBSs as well. These securities, because they carried the name of the issuing bank as opposed to the name of one of the GSEs, acquired the moniker “private-label” MBSs.¹²⁷ Bank of America issued the first private-label MBS, a simple pass-through structure, in 1977.¹²⁸ However, while the early private-label MBS deals replaced the GSE guaranty with private mortgage bond guarantors,¹²⁹ credit risk concerns

¹²³ *Hearing on Recent Developments in U.S. Financial Markets and the Regulatory Responses to Them Before the S. Comm. on Banking, Hous., & Urban Affairs*, 110th Cong. 19 (2008) (testimony of Henry M. Paulson, Jr., Sec’y, Dep’t of the Treasury).

¹²⁴ FCIC REPORT, *supra* note 3, at 317.

¹²⁵ *Id.*

¹²⁶ Press Release, Lockhart, *supra* note 2.

¹²⁷ See Joseph P. Forte, *A Capital Markets Mortgage: A Ratable Model for Main Street and Wall Street*, 31 REAL PROP. PROB. & TR. J. 489, 492 (1996). “Private-label,” the adjective this Note chooses, is also sometimes expressed as “non-agency.” The “agencies” to which “non-agency” refers are the GSEs. Thus, “private-label” and “non-agency” refer to the same concept from a different perspective.

¹²⁸ Strine, *supra* note 79, at 1031.

¹²⁹ See, e.g., *id.* at 1033.

unknown to the GSEs (due to the implicit government-backed guaranty) generally hampered private-label MBS issuance.¹³⁰

Credit risk—the risk to investors that the underlying borrowers may default¹³¹—is what distinguishes the private-label MBS market from the GSE MBS market.¹³² While GSE MBS investors assume no credit risk, owing to the GSE guaranty on the timely payment of principal and interest, private-label MBS investors (or other non-GSE third-parties, like monoline bond guarantors), must assume all the credit risk in private-label MBS deals.¹³³ Thus, while GSE MBS investors must primarily analyze their interest rate risk exposure—whether their long-term fixed-rate MBS receivables will exceed their expected liabilities—private-label MBS investors must analyze both interest rate risk exposure and credit risk exposure.

To mitigate credit risk concerns, private-label MBS issuers have developed a variety of innovative credit enhancing deal structures.¹³⁴ These credit enhancements include both internal mechanisms, such as overcollateralization, senior-subordinate class structuring, or cash reserves loss absorption, as well as external mechanisms, such as third-party credit lines, insurance, or guaranties.¹³⁵ Nonetheless, these mechanisms have carried a cost that the GSE MBSs, with implicit government support, have not had to bear. Therefore, private-label MBSs have typically comprised loans that could not otherwise have been included in GSE MBSs because the loans failed to meet the

¹³⁰ See Forte, *supra* note 127, at 491.

¹³¹ *Private-Label Securitization Hearing*, *supra* note 23, at 43 (statement of Adam J. Levitin, Professor of Law, Georgetown University Law Center).

¹³² For a discussion on how the Corker-Warner Senate Bill may introduce credit risk into the GSE MBS market, see *infra* Part III.B.

¹³³ See Forte, *supra* note 127, at 492.

¹³⁴ See *id.* at 492 n.5.

¹³⁵ *Id.*

GSE underwriting guidelines.¹³⁶ These “non-conforming loans” include so-called “jumbo” mortgages (conforming mortgages but for exceeding the GSE loan limit) as well as so-called “subprime” mortgages (mortgages that failed the GSE credit quality requirements).¹³⁷

Private-label securitization grew in earnest following the savings and loan crisis. Although the RTC was able to offload \$6.1 billion in failed thrift assets to the GSEs, the balance of the loans did not meet the GSE underwriting guidelines.¹³⁸ Seeking greater efficiency than a one-by-one sale of loans, RTC officials worked with the private sector to securitize these assets.¹³⁹ By the time the RTC wound down, it had effected the securitization of some \$25 billion of non-GSE, private-label MBSs.¹⁴⁰ As investors became more familiar with securitization—GSE or otherwise—private-label securitization as a source of mortgage funding grew alongside GSE securitization.¹⁴¹ At its peak before the financial crisis, private-label securitization accounted for over 20% of total mortgage funding in the United States.¹⁴²

After the financial crisis struck, however, private-label securitization evaporated.¹⁴³ Issuance in 2013 remained low at \$16.8 billion (compared to \$726 billion in 2005),¹⁴⁴ mostly in high credit quality jumbo loans.¹⁴⁵ The chief cause of this contraction appears to be investor concerns with “structural

¹³⁶ *Private-Label Securitization Hearing*, *supra* note 23, at 44 (statement of Adam J. Levitin, Professor of Law, Georgetown University Law Center).

¹³⁷ *See id.*

¹³⁸ FCIC REPORT, *supra* note 3, at 68.

¹³⁹ *Id.* at 69.

¹⁴⁰ *Id.*

¹⁴¹ *Id.* at 69–70.

¹⁴² *See id.* at 69 fig.5.1.

¹⁴³ *See* FHFA 2012 REPORT TO CONGRESS, *supra* note 114, at 6 fig.5.

¹⁴⁴ *See* SEC. INDUS. AND FIN. MKTS ASS'N, U.S. MORTGAGE-RELATED ISSUANCE AND OUTSTANDING tbl.1.1. (2014).

¹⁴⁵ *Private-Label Securitization Hearing*, *supra* note 23, at 35 (statement of John Gidman, President, Association of Institutional Investors).

weaknesses” in the securitization market, including trustee conflicts of interest, originator incentive misalignment, poor contract enforcement, and low disclosure.¹⁴⁶

1. GSEs in Conservatorship of FHFA

The GSEs have operated under FHFA conservatorship since September 2008.¹⁴⁷ Nonetheless, the GSEs have continued their guaranty and securitization business nearly unabated.¹⁴⁸ Moreover, because private-label MBS issuance has evaporated for all but the highest quality jumbo loans, GSE MBS issuance now commands a much higher market share, comprising nearly 77% of all mortgages originated in 2012.¹⁴⁹

In early 2012, FHFA sent Congressional leaders a strategic plan outlining the goals of conservatorship.¹⁵⁰ This document outlined initiatives that FHFA has already undertaken in conservatorship, including initiatives relating to mortgage data standardization, servicer compensation and incentive alignment, and loan-level disclosure.¹⁵¹ The document also outlined future planned initiatives relating to foreclosure prevention, portfolio loss mitigation, and securitization standardization.¹⁵² However, without clear Congressional direction, FHFA remained uncertain how conservatorship should end. FHFA wrote to Congress:

Policymakers need to address the future structure of housing finance, which would allow for a smooth transition from today’s market. Without action by Congress, FHFA must continue to look to the existing statutory provisions that guide the conservatorships. In particular, FHFA must consider what it means to “take such action as may be

¹⁴⁶ *See id.*

¹⁴⁷ FHFA 2012 REPORT TO CONGRESS, *supra* note 114, at iii.

¹⁴⁸ *See id.* at 6 fig.5.

¹⁴⁹ *See id.*

¹⁵⁰ FHFA STRATEGIC PLAN, *supra* note 14.

¹⁵¹ *Id.* at 10–11.

¹⁵² *See id.* at 11–12.

necessary to put [Fannie Mae and Freddie Mac] in a sound and solvent condition” when it is clear that the draws the companies have taken from the Treasury are so large they cannot be repaid under any foreseeable scenarios.¹⁵³

One scenario FHFA apparently did not foresee, however, has materialized: total repayment. In August 2012, Treasury and FHFA, contracting as conservator of the GSEs, amended Treasury’s Senior Preferred Shares agreement with the GSEs, the instrument through which Treasury recapitalized the firms.¹⁵⁴ The amendment requires that the GSEs sweep every dollar of profit they earn going forward into a quarterly dividend paid to Treasury alone.¹⁵⁵ That amendment, combined with a recently rising housing market, has occasioned the payment of \$213.1 billion in dividends as of the first quarter of 2014, exceeding the GSEs’ initial draws of \$187.5 billion.¹⁵⁶ Despite these strong dividend distributions, however, the Administration remains supportive of the Senate Banking Committee efforts to wind the GSEs down.¹⁵⁷

¹⁵³ *Id.* at 9.

¹⁵⁴ See Robert E. Bostrom et al., *US Treasury Modifies Stock Purchase Agreements For Fannie And Freddie*, MONDAQ (Aug. 29, 2012), <http://perma.cc/6E7E-XVUY>.

¹⁵⁵ *Third Amendment to Amended and Restated Senior Preferred Stock Purchase Agreement* (Aug. 17, 2012), <http://perma.cc/63TX-4TDS>. Equity holders junior to the Treasury have challenged the amendment, with class action litigation ongoing. *In re Fannie Mae/Freddie Mac Senior Preferred Stock Purchase Agreement Class Action Litigs.*, No. 1:13-MC-01288 (D.D.C. Nov 18, 2013).

¹⁵⁶ See Maggie McGrath, *Fannie Mae and Freddie Mac Sending Treasury \$10.2 Billion After Posting First Quarter Profits*, FORBES (May 8, 2013), <http://perma.cc/Y95D-TCNU>.

¹⁵⁷ See Press Release, Office of the Press Secretary, Statement by the Press Secretary on Housing Finance Reform (May 15, 2014), *available at* <http://perma.cc/F8TA-M94U>.

2. GSE MBS Transactions Today

Currently, the GSEs engage in the credit guaranty and securitization business that facilitates the production of GSE MBSs. As discussed above, GSE MBSs are mortgage-backed securities for which the GSEs guarantee the timely payment of principal and interest.¹⁵⁸ Thus, while the investors who hold GSE MBSs assume prepayment risk and interest-rate risk, the GSEs themselves retain the credit risk.¹⁵⁹ Because the GSEs currently sit in federal conservatorship, this credit guaranty is the fount of taxpayer exposure to the housing market.

GSE MBSs emanate from two different lines of business: the whole loan conduit line and the lender swap transaction line.¹⁶⁰ Under the whole loan conduit line, the GSEs purchase whole loans that conform to GSE underwriting guidelines from a wide array of lenders. The GSEs then compile those whole loans into pools, securitize the pools, and issue the securities as GSE MBSs to investors in the capital markets.¹⁶¹ Under the lender swap transaction line of business, lenders or other loan aggregators themselves compile loans that conform to the GSEs' underwriting guidelines. The lenders or loan aggregators then deliver the mortgage pool to the GSEs in exchange for a GSE MBS backed by the same pool. The GSEs perform this "swap" for a guaranty fee.¹⁶²

III. THE SENATE HOUSING FINANCE REFORM PROPOSAL & OTHER PROPOSALS

Senator Bob Corker introduced the Corker-Warner Senate Bill, formally S. 1217, the Housing Finance Reform

¹⁵⁸ FANNIE MAE, BASICS OF SINGLE-FAMILY FANNIE MAE MBS 1 (2013), available at <http://perma.cc/5687-LLVZ>.

¹⁵⁹ See *id.* at 2.

¹⁶⁰ See *id.* at 1. The descriptions of the GSE lines of business in this Note comport to Fannie Mae terminology.

¹⁶¹ *Id.*

¹⁶² *Id.*

and Taxpayer Protection Act, on June 25, 2013. The Bill was then referred to the Senate Banking Committee. Senators Tim Johnson and Mike Crapo, Chairman and Ranking Member of the Banking Committee, organized nine hearings in the final four months of 2013 to consider the Bill. Chairman Johnson initially promised to pass a version of the Bill through the Committee before the end of 2013.¹⁶³

Although the Committee missed that deadline, Senators Johnson and Crapo released the Johnson-Crapo Bill on March 16, 2014.¹⁶⁴ The Johnson-Crapo Bill, very similar to the Corker-Warner Bill in substance and operation, passed the Senate Banking Committee on May 15, 2014, with a bipartisan majority, by a vote of 13-9.¹⁶⁵ Interestingly, however, the dissenters comprised not only minority Republicans but also liberal Democratic Senators such as Elizabeth Warren (D-MA), Jeff Merkley (D-OR), and Sherrod Brown (D-OH).¹⁶⁶ Perhaps because of the strength of the Democratic dissent, Senate Majority Leader Harry Reid (D-NV) has not and is not expected to bring Johnson-Crapo to the floor this Congress.¹⁶⁷

Because of the similarity of Corker-Warner and Johnson-Crapo, this Note refers to the bills collectively as the "Senate Proposal." This useful moniker, however, should not be

¹⁶³ See Press Release, Tim Johnson, Chairman, Senate Comm. on Banking, Hous., and Urban Affairs, Johnson Statement on Housing Finance Reform Hearing (Sept. 19, 2013), available at <http://perma.cc/74SN-QP26> ("Ranking Member Crapo and I are undertaking this in-depth process with the goal of reaching agreement by the end of the year.").

¹⁶⁴ Press Release, Senate Comm. on Banking, Hous., and Urban Affairs, Johnson, Crapo Release Housing Finance Reform Text (March 16, 2014), available at <http://perma.cc/4KRD-RK7C>. The Bill was officially introduced in the Senate as an amendment in the nature of a substitute. See *supra* note 23 and accompanying text.

¹⁶⁵ Press Release, Senate Comm. on Banking, Hous., and Urban Affairs, Senate Banking Committee Passes Bipartisan Housing Finance Reform Legislation (May 15, 2014), available at <http://perma.cc/5N9M-2AA6>.

¹⁶⁶ See Swanson, *supra* note 26.

¹⁶⁷ See *id.*

misinterpreted: neither bill has passed the full Senate and neither bill is expected to pass the Senate (or even receive a floor vote) before the next Congress assembles. Therefore, more important than the bills' minutiae are their general policies and architecture, which will survive even if S. 1217 formally ceases to exist.

In light of the above considerations, this Note now turns to a general exploration of how the regulatory architecture within the Senate Proposal would operate, before briefly contrasting the Senate Proposal with the proposed PATH Act,¹⁶⁸ the housing finance reform bill under consideration in the House of Representatives.

A. Broad Outline of the Senate Proposal

The Johnson-Crapo Bill as reported by the Senate Banking Committee comprises eight titles along with a collection of important defined terms. Title I directs the elimination of Fannie and Freddie Mac. Title II establishes the Federal Mortgage Insurance Corporation, or FMIC. Title III outlines the FMIC's duties, oversight authority, and structure. Title III also establishes the securitization platform through which the FMIC may confer its guaranty and sets forth requirements for market operations. Title IV explains the transfer of powers, personnel, and property from the FHFA to the FMIC. Title V deals with affordable housing issues. Title VI describes the winding down of Fannie Mae and Freddie Mac and related issues. Title VII deals with certain improvements to the functioning of the multifamily housing market. Finally, Title VIII contains general provisions.

Broadly, the Proposal seeks to replace the current GSE system with an FMIC-based system that retains the significant benefits that the GSEs offer investors and borrowers—respectively, a “liquid, transparent, and

¹⁶⁸ Protecting American Taxpayers and Homeowners Act of 2013, H.R. 2767, 113th Cong. (2013).

resilient . . . mortgage credit market”¹⁶⁹ and the “broad availability of mortgage credit”¹⁷⁰—while eliminating the massive taxpayer exposures to mortgage credit risk that the GSEs occasioned.¹⁷¹ To do so, the Proposal contemplates the development of a class of mortgage-backed securities, insured by the FMIC, created through three steps:

Origination: Private originators underwrite mortgage loans to homebuyers and sell or otherwise transfer the mortgage loans to aggregators in the secondary market.

Aggregation: Aggregators pool the mortgage loans that they purchase (or those that they originate) and, after arranging a credit risk-sharing mechanism, deliver those pools of mortgage loans eligible for FMIC insurance to the FMIC “Securitization Platform.”

Securitization: The FMIC Securitization Platform converts the pools of eligible mortgages into FMIC-backed MBSs through one of two execution methods, depending on the credit risk-sharing mechanism employed:

Guarantor Execution: The Aggregator arranges for an FMIC-supervised private guarantor to guarantee the MBS, in which case the FMIC would step in only if the guarantor failed.

Capital Markets Execution: The Aggregator arranges for investors to hold a fully-funded first-loss position (through, for example, credit-linked notes) of a portion of the MBS’s value, the depletion of which would trigger the FMIC insurance.¹⁷²

¹⁶⁹ Johnson-Crapo Senate Bill, *supra* note 24, at §§ 301(a)(1), 201(b)(1). *See also* Corker-Warner Senate Bill, *supra* note 20, at § 201(a)(1)(B)(i).

¹⁷⁰ Johnson-Crapo Senate Bill, *supra* note 24, at §§ 301(a)(1), 201(b)(5). *See also* Corker-Warner Senate Bill, *supra* note 20, at § 201(a)(1)(B)(ii).

¹⁷¹ *See* Johnson-Crapo Senate Bill, *supra* note 24, at § 301(a)(2).

¹⁷² *See* STAFF OF S. COMM. ON BANKING, HOUS., & URBAN AFFAIRS, 113TH CONG., SUMMARY OF SENATE BANKING COMMITTEE LEADERS’ BIPARTISAN HOUSING FINANCE REFORM DRAFT 1, *available at* <http://perma.cc/S8UV-STXJ>.

The Proposal provides that the FMIC develop approved credit risk-sharing mechanisms that require private market holders of a covered security to assume the first-loss position “adequate to cover losses that might be incurred in a period of economic stress,”¹⁷³ or, in any event, “not less than 10 percent of the principal or face value” of such security.¹⁷⁴ For losses in excess of that private, first-loss position, however, the Proposal contemplates the provision of government-backed insurance, an apparent concession to the policy stance that broad investor appetite for mortgage debt depends on some form of government guaranty.¹⁷⁵ Thus, the FMIC-based system would resemble the current GSE lender swap transaction line of business with a diminished credit guaranty. However, for small lenders that benefit from access to the secondary markets through the GSEs’ whole loan conduit line of business, the Senate Proposal also contemplates the creation of a cooperatively owned “Small Lender Mutual,” which would aggregate the whole loans of small lenders and deliver them to the FMIC for securitization and guaranty.¹⁷⁶

Several concepts are key to the overall functioning of the bill. First, the definition of “eligible single-family mortgage loan”¹⁷⁷ sets important thresholds for the mortgages with which the FMIC would deal,¹⁷⁸ as “single-family covered securities” must be collateralized only by eligible single-

¹⁷³ Johnson-Crapo Senate Bill, *supra* note 24, at § 302(a)(1)(A). See also Corker-Warner Senate Bill, *supra* note 20, at § 201(a)(2).

¹⁷⁴ Johnson-Crapo Senate Bill, *supra* note 24, at § 302(a)(1)(B).

¹⁷⁵ See *id.* § 303. See also Corker-Warner Senate Bill, *supra* note 20, at § 201(a)(3). The PATH Act sponsors in the House of Representatives do not share this policy stance. See Protecting American Taxpayers and Homeowners Act of 2013, H.R. 2767, 113th Cong. § 312(c) (2013).

¹⁷⁶ See Johnson-Crapo Senate Bill, *supra* note 24, at § 315.

¹⁷⁷ This Note focuses on single-family housing finance, which constitutes the majority of the total U.S. MBS market. Multifamily housing finance often impairs affordable housing policies beyond the scope of this Note.

¹⁷⁸ See Johnson-Crapo Senate Bill, *supra* note 24, at § 2(29)(A). See also Corker-Warner Senate Bill, *supra* note 20, at § 2(11).

family mortgage loans in order to qualify for FMIC insurance.¹⁷⁹ The eligible single-family mortgage loan (an “eligible loan”) definition appears to be intended to replace the “conforming loan” standards found in the GSE underwriting guidelines.¹⁸⁰ Under the current system, conforming loans receive superior pricing because adherence to the underwriting guidelines allows those loans access to the GSE guaranty, thereby rendering them fungible and liquid. As discussed later, the fungibility of mortgage loans and the resulting price improvement through access to the capital markets provide creditworthy borrowers a crucial benefit that any reform proposal should rigorously attempt to maintain.¹⁸¹ Here, the Senate Proposal’s eligible loan definition sets forth a matrix of eligibility conditions that, like current conforming loan guidelines,¹⁸² require compliance with certain origination standards,¹⁸³ including standards mirroring the Consumer Financial Protection Bureau (“CFPB”) “qualified mortgage” requirements;¹⁸⁴ loan principal amount limitations;¹⁸⁵ combinations of borrower loan-to-value (“LTV”) ratios and mortgage insurance (“MI”) coverage;¹⁸⁶ down payment floors;¹⁸⁷ license insurance coverage;¹⁸⁸ and compliance with other terms and provisions

¹⁷⁹ Johnson-Crapo Senate Bill, *supra* note 24, at § 2(65). *See also* Corker-Warner Senate Bill, *supra* note 20, at § 2(9)(A).

¹⁸⁰ *See, e.g.*, FANNIE MAE, ELIGIBILITY MATRIX 1 (2013), *available at* <http://perma.cc/9RHW-WHJN>.

¹⁸¹ *See* discussion *infra* Part IV.A.2.

¹⁸² *See* FANNIE MAE, *supra* note 180.

¹⁸³ Johnson-Crapo Senate Bill, *supra* note 24, at § 2(29)(A)(i).

¹⁸⁴ *See* 15 U.S.C. § 1639c.

¹⁸⁵ Johnson-Crapo Senate Bill, *supra* note 24, at § 2(29)(A)(ii). *See also* Corker-Warner Senate Bill, *supra* note 20, at § 2(11)(B).

¹⁸⁶ *See* Johnson-Crapo Senate Bill, *supra* note 24, at § 2(29)(A)(iii). *See also* Corker-Warner Senate Bill, *supra* note 20, at § 2(11)(C).

¹⁸⁷ *See* Johnson-Crapo Senate Bill, *supra* note 24, at § 2(29)(A)(iv). *See also* Corker-Warner Senate Bill, *supra* note 20, at § 2(11)(D).

¹⁸⁸ *See* Johnson-Crapo Senate Bill, *supra* note 24, at § 2(29)(A)(v). *See also* Corker-Warner Senate Bill, *supra* note 20, at § 2(11)(E).

that the FMIC may prescribe.¹⁸⁹ The definition provision also contemplates further requirements to be determined by the FMIC in consultation with the CFPB,¹⁹⁰ presumably relating to the CFPB's "ability-to-repay" regulatory scheme.¹⁹¹

A second key concept in the Proposal is the requirement that the FMIC guaranty only trigger on a particular product after private capital has suffered losses in excess of 10% of the principal value of the covered security.¹⁹² The Johnson-Crapo legislation provides that this 10% "attachment point" for FMIC insurance is constant no matter the quality of the collateral backing the covered security.¹⁹³ Any debate on the merits of this attachment point scheme must weigh the countervailing policy goals of, first, reducing taxpayer exposure to the mortgage markets (which counsels a high attachment point) and, second, creating a deep and liquid secondary market for capital markets investors (which counsels a low attachment point).¹⁹⁴

Finally, as mentioned above, the Proposal does not altogether abandon the feature of the current scheme in which the GSEs themselves aggregate whole loans and issue securitized MBSs—the whole loan conduit line of business.¹⁹⁵ The Johnson-Crapo Bill contemplates continuing this function through the establishment of an FMIC-regulated "Small Lender Mutual" entity, owned and operated by small

¹⁸⁹ Johnson-Crapo Senate Bill, *supra* note 24, at § 2(29)(A)(vi). *See also* Corker-Warner Senate Bill, *supra* note 20, at § 2(11)(F).

¹⁹⁰ Johnson-Crapo Senate Bill, *supra* note 24, at § 2(29)(A)(vii). *See also* Corker-Warner Senate Bill, *supra* note 20, at § 2(11)(G).

¹⁹¹ *See, e.g.*, Ability to Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z), 12 C.F.R. § 1026 (2014).

¹⁹² Johnson-Crapo Senate Bill, *supra* note 24, at § 302(a)(1)(B). *See also* Corker-Warner Senate Bill, *supra* note 20, at § 202(a)(2).

¹⁹³ *See* Johnson-Crapo Senate Bill, *supra* note 24, at § 302(a)(1)(B); *Risk Transfer Hearing*, *supra* note 23, at 41 (statement of Sandeep Bordia, Head of Residential & Commercial Credit Strategy, Barclays).

¹⁹⁴ *See id.*

¹⁹⁵ *See Protecting Small Lenders Hearing*, *supra* note 23.

lender members.¹⁹⁶ The impetus behind the continuation of this function appears to stem from its importance in allowing small lenders, such as rural community banks, access to the capital markets without the necessity of establishing costly and complex securitization platforms.¹⁹⁷ Small lenders, a popular political constituency for Senators from rural states, currently participate competitively in the national mortgage markets by selling the loans they originate to the GSEs for securitization under the GSEs' whole loan conduit line of business.¹⁹⁸ Small rural lenders' access to the secondary market through a Small Lender Mutual is intended to enable small lenders to continue to offer competitive rates not possible without capital markets funding.

B. Potential Credit Risk-Sharing Mechanisms

Perhaps the most complex and consequential feature of any future FMIC-based housing finance system will be the mechanism through which the FMIC transfers mortgage credit risk to private market participants. The Johnson-Crapo Bill establishes a process whereby the FMIC may approve of a credit risk-sharing mechanism such that its use in an MBS qualifies that MBS for FMIC insurance:

In approving credit risk-sharing mechanisms . . . the [FMIC] shall—

- (A) consider proposals that include credit-linked structures or other instruments that are designed to absorb credit losses on single-family covered securities;
- (B) consider any credit risk-sharing mechanisms undertaken by the enterprises;
- (C) ensure that the first loss position is fully funded . . . ;

¹⁹⁶ Johnson-Crapo Senate Bill, *supra* note 24, at § 315. *See* Corker-Warner Senate Bill, *supra* note 20, at § 215.

¹⁹⁷ *See, e.g., Protecting Small Lenders Hearing, supra* note 23, at 1 (statement of Sen. Tim Johnson, Chairman, S. Comm. on Banking, Hous. & Urban Affairs).

¹⁹⁸ *See id.*

- (D) ensure that each type of proposed mechanism—
- (i) enables the [FMIC] to verify that the first loss position is fully funded;
 - (ii) minimizes any potential long-term cost to the taxpayer¹⁹⁹

Since early 2013, commentators and policymakers have proposed different methods of sharing mortgage credit risk with private market participants. However, little is certain about how these structures would operate. Despite the uncertainty, congressional hearings on the matter²⁰⁰ and recent GSE deals²⁰¹ offer clues on the general contours of these structures, which are discussed below.

1. Credit-Linked Note Structure

Mentioned explicitly in the Johnson-Crapo legislation, the Credit-Linked Note Structure represents a “capital markets execution” of credit risk sharing—which is to say that capital markets participants assume the privately shared credit risk. Because of its employment of financial derivative technology, this structure is perhaps the most complex risk-sharing mechanism that policymakers have contemplated. Employed (albeit with some variations) in a handful of GSE deals issued in 2013,²⁰² it would transfer credit risk to capital markets investors through the use of credit derivatives (embedded in otherwise standard debt securities) that reference certain portions of MBSs carrying the FMIC guaranty.²⁰³

¹⁹⁹ Johnson-Crapo Senate Bill, *supra* note 24, at § 302(b).

²⁰⁰ See *Senate Banking Committee Housing Finance Reform Hearings*, *supra* note 23.

²⁰¹ See *Connecticut Avenue Securities (C-deals)*, FANNIE MAE, <http://perma.cc/UE8T-9NQC> (last visited Nov. 28, 2014); *Freddie Mac Structured Agency Credit Risk (STACR®)*, FREDDIE MAC, <http://perma.cc/L4UW-A6BX> (last visited Nov. 28, 2014).

²⁰² See *Connecticut Avenue Securities (C-deals)*, *supra* note 201; *Freddie Mac Structured Agency Credit Risk (STACR®)*, *supra* note 201;.

²⁰³ *Risk Transfer Hearing*, *supra* note 23, at 23 (statement of Kevin Palmer, Vice President, Freddie Mac).

In general, credit-linked notes (“CLNs”) resemble debt securities with embedded credit default swaps that trigger upon the occurrence of a predetermined credit event.²⁰⁴ The CLN buyer pays a principal amount to the CLN seller in exchange for CLNs that refer to cash receivables in a reference pool of assets. The CLNs also specify conditions relating to the performance of the reference assets, such as a default, that constitute a “credit event.” The CLN seller obligates itself to pay the CLN buyer specified payments over the course of the deal, returning the full principal amount at termination; however, if a credit event occurs before termination, the CLN seller is relieved of part or all of its obligation to return the principal.²⁰⁵ Therefore, somewhat confusingly, the CLN seller is in fact *buying* protection against the occurrence of the credit event, whereas the CLN buyer is *selling* protection.

In the context of the Johnson-Crapo Bill, this structure appears to envision, on the surface, a system very similar to the current GSE system. The FMIC, like the GSEs in a lender swap transaction, would provide a full guaranty on the face value of real covered securities in exchange for a guaranty fee. Thus, all the benefits to borrowers and investors that accompany the current full guaranty scheme would remain unchanged.²⁰⁶

²⁰⁴ Norman Menachem Feder, *Deconstructing Over-the-Counter Derivatives*, 2002 COLUM. BUS. L. REV. 677, 715 (2002).

²⁰⁵ *See id.* Feder lays out the following illustrative example:

For example: Bank B issues a note to Party A, under which Party A lends a principal amount to Bank B at a predetermined interest rate. Bank B will pay periodic interest payments to Party A. However, if a certain Company C defaults on a certain bond that it has issued before the note’s maturity, Party A will forfeit its rights to return of some or all of the principal and any remaining interest payments. In this example, Party A is the protection seller and Bank B is the protection buyer.

Id.

²⁰⁶ *See* discussion *infra* Part IV.A.2.

As a condition to its guaranty on the real MBS, however, the FMIC would require that the first 10% of credit losses be offloaded to private parties through the issuance of CLNs referencing the mortgage loan collateral.²⁰⁷ The aggregator would have to issue such CLNs to capital markets credit investors, thereby buying from those investors protection against credit events in the referenced security. First, the principal value of the CLNs sold would match 10% of the face value of the real FMIC-backed MBS. Second, the CLNs' designated credit events would match the conditions requiring the FMIC to uphold its guaranty. Therefore, through predetermined arrangements between the FMIC and the aggregator, the FMIC could fund its guaranty through CLNs on a fully funded basis.

In testimony before the Senate Banking Committee, a representative of Fannie Mae described Fannie's October 2013 Connecticut Avenue Securities series deals ("C-Deals"), which employ a CLN-like mechanism:

The C-Deal notes are debt issuances of Fannie Mae. One of the main differences between C-deal [*sic*] series debt and Fannie Mae's standard debt is that investors in C-Deals may experience a full or partial loss of their initial principal investment, depending upon the credit performance of the mortgage loans in the related reference pool. Another difference is that the repayment of C-Deal notes is tied to the credit and prepayment performance of a reference pool of loans. . . .

²⁰⁷ See STAFF OF S. COMM. ON BANKING, HOUS., & URBAN AFFAIRS, 113TH CONG., SUMMARY OF SENATE BANKING COMMITTEE LEADERS' BIPARTISAN HOUSING FINANCE REFORM DRAFT 1, *available at* <http://perma.cc/S8UV-STXJ>. Some uncertainty surrounds whether the FMIC would itself issue the CLNs (as the GSEs have) or would require the aggregator to issue the CLNs coincident with delivery of the pool to the Securitization Platform. This Note assumes that the aggregator would be the issuer because that course better comports with descriptions of the capital markets execution contained in the Banking Committee's summary of the legislation. *See id.*

To arrive at the pool, we applied certain selection criteria to the entire population of loans acquired in Q3 2012 to create an eligible population of loans. . . . By only referencing the loans, they remain in the MBS pools, thereby avoiding any disruption to the TBA market.

If the loans in the reference pool experience credit defaults, the investors in the C-Deals may bear losses. Credit defaults occur in the C-Deal when a loan in the reference pool reaches 180 days of delinquency, a short sale, a third party sale, a deed-in-lieu, or an REO (Real Estate Owned) disposition occurs prior to 180 days of delinquency.²⁰⁸

The C-Deal structure, which nearly mirrors the structure of two transactions that Freddie Mac closed in 2013, provides a template for how a credit-linked note structure would operate in an FMIC-based housing finance system.

2. Senior-Subordinated Structure

Another type of “capital markets execution,” the Senior-Subordinated Structure for credit risk sharing, was mentioned in the Corker-Warner Bill, but went unmentioned in the Johnson-Crapo revision. This structure refers to the mechanism that provides credit enhancement in “typical securitization[s].”²⁰⁹ In it, claims to cash flows from the pooled mortgage loans are divided into “tranches” that are given priority relative to one another.²¹⁰ The cash receivables flow first to the tranches of highest priority and then waterfall down to the tranches of lower priority. Put another

²⁰⁸ *Risk Transfer Hearing*, *supra* note 23, at 28–29 (statement of Laurel Davis, Vice President for Credit Risk Transfer, Fannie Mae).

²⁰⁹ Yingjin Hila Gan & Christopher J. Mayer &, *Agency Conflicts, Asset Substitution and Securitization* 1–2 (Nat’l Bureau of Econ. Research, Working Paper No. 12359, 2006), *available at* <http://www.perma.cc/3AVU-8KA3>.

²¹⁰ *Id.* at 1.

way, losses are incurred first on the tranche of lowest priority and then climb to those tranches of higher priority.

In the context of the Senate Proposal, the simplest form of the Senior-Subordinated Structure would ostensibly operate by dividing any covered security into at least two tranches, a senior tranche comprising 90% of the face value of the security and a subordinated tranche comprising 10%. In any given deal, the FMIC would provide insurance only to the senior tranche, requiring private market participants to incur all the losses associated with the subordinated tranche. More complex forms of the Senior-Subordinated Structure would result from the sophisticated forms of tranching found in private deal structures, which, for example, often separate into different tranches interest-payment receivables and principal-payment receivables.²¹¹ Regardless of the complexity, however, the Senior-Subordinated Structure appears to contemplate that some portion of the real covered security will not receive a guaranty, a large departure from current GSE practice.

3. Regulated Bond Guarantor Structure

The Regulated Bond Guarantor Structure is the “guarantor execution” method through which the FMIC could transfer credit risk to the private market. Unlike the Credit-Linked Note Structure or the Senior-Subordinated Structure, the Regulated Bond Guarantor Structure would not offload credit risk to capital markets investors; instead, the structure contemplates transferring risk to specialized private monoline insurers.²¹²

Under this structure, the FMIC would require as a condition of its guaranty on the full value of the real MBS that the aggregator obtain another guaranty on the full

²¹¹ See AM. SECURITIZATION FORUM, ASF SECURITIZATION INSTITUTE: RESIDENTIAL MORTGAGE-BACKED SECURITIES 5 (2006) [hereinafter ASF SECURITIZATION INSTITUTE ON RMBS], available at <http://perma.cc/9UJN-QF9E>.

²¹² See Corker-Warner Senate Bill, *supra* note 20, at § 202(b)(2)(A).

value of the real MBS from a private bond guarantor.²¹³ The FMIC would both serve as the primary prudential regulator of the private bond guarantors to ensure safety and soundness as well as provide catastrophic reinsurance on the underlying MBS in the event that the guarantor fails.²¹⁴

A key distinction between the Regulated Bond Guarantor Structure and the Senior-Subordinated and Credit-Linked Note Structures is that the FMIC retains credit risk, in the former, against the solvency of the regulated bond guarantors and, in the latter, against losses in excess of the 10% attachment point on a security-by-security basis. For example, under the Regulated Bond Guarantor Structure, if a bond guarantor guarantees one security with losses reaching 13% and another security with losses reaching only 2%, that bond guarantor will incur all of those losses so long as the guarantor is solvent. This contrasts with the other structures, which envision the FMIC incurring losses on any given security in which losses exceed 10%. Thus, under the Regulated Bond Guarantor Scheme, losses may be more thoroughly spread out because the number of bond guarantors is fewer than the number of individual securities.

One latent risk of the Regulated Bond Guarantor Structure emerges in the scenario where a bond guarantor becomes insolvent after assuming only, for example, 2% of the credit losses. While the legislative directive for the FMIC to reinsure the bond guarantor would suggest that the FMIC assume all subsequent losses, that course of action would

²¹³ See STAFF OF S. COMM. ON BANKING, HOUS., & URBAN AFFAIRS, 113TH CONG., SUMMARY OF SENATE BANKING COMMITTEE LEADERS' BIPARTISAN HOUSING FINANCE REFORM DRAFT 1, available at <http://perma.cc/S8UV-STXJ>. See also *Risk Transfer Hearing*, *supra* note 23, at 39 (statement of Ted Durant, Vice President of Analytical Services, Mortgage Guaranty Insurance Corporation); *Hearing on Essential Elements of Housing Finance Reform Before the S. Comm. on Banking, Housing, & Urban Affairs*, *supra* note 23, at 41–42 (statement of Julia Gordon, Director of Housing Finance and Policy, Center for American Progress).

²¹⁴ See Johnson-Crapo Senate Bill, *supra* note 24, at § 303(c)(2)(B); Corker-Warner Senate Bill, *supra* note 20, at § 204(c).

conflict with the legislative prohibition against the FMIC assuming any losses prior to the 10% attachment point. The Johnson-Crapo drafters have attempted to cure this problem—what appeared to be a legislative gap in the Corker-Warner Bill—by requiring that any approved credit risk-sharing mechanism be “fully funded.”²¹⁵ In the context of the Regulated Bond Guarantor Structure, the FMIC would apparently meet this directive by exercising its authority to set capital standards for regulated guarantors that require the guarantors to “hold 10 percent capital.”²¹⁶ Nonetheless, the possibility seems to remain that disproportionate losses in one part of a guarantor’s book could render the guarantor insolvent before it assumes 10% of the losses on an FMIC-backed MBS.

C. Prudential Regulation

The Senate Proposal contemplates that the FMIC, not unlike the FDIC, will also serve as a regulator over participants dealing in markets insured by the FMIC.

1. FHFA Powers and Duties

The most conspicuous difference between the Johnson-Crapo and Corker-Warner drafts, perhaps driven by political appearances, is the introduction in Johnson-Crapo of Title I, which consists of a mere single provision requiring that the FMIC “take all steps necessary to dissolve and eliminate” Fannie Mae and Freddie Mac.²¹⁷

Beyond this political stunt, however, Johnson-Crapo takes a more measured approach to wrapping up both the GSEs and FHFA. First, the Johnson-Crap Bill would establish FHFA as an entity within the FMIC.²¹⁸ It would

²¹⁵ Johnson-Crapo Senate Bill, *supra* note 24, at §§ 302(b)(1)(C), 302(b)(1)(D)(i)–(ii).

²¹⁶ *Id.* § 311(g)(1)(A).

²¹⁷ Compare Johnson-Crapo Senate Bill, *supra* note 24, at § 101, with Corker-Warner Senate Bill, *supra* note 20, at §§ 501–502.

²¹⁸ Johnson-Crapo Senate Bill, *supra* note 24, at § 402.

then compel the FMIC Board of Directors and the continuing FHFA Director, with the help of a “Transition Committee,”²¹⁹ to “cooperate and coordinate . . . to facilitate and achieve an orderly transition from housing finance markets facilitated by the [GSEs] to housing finance markets facilitated by the [FMIC] with minimum disruption in the availability of credit.”²²⁰ Finally, it would direct the FHFA Director to take actions and prescribe regulations necessary to wind down the GSEs.²²¹ When the FMIC, at the discretion of its Board, determines that it can assume all of its responsibilities as set forth in the Johnson-Crapo legislation, the FHFA would cease operations.²²²

2. Mortgage Insurers and Bond Guarantors

For largely historical reasons beyond the scope of this Note, the insurance industry remains mostly regulated at the state level.²²³ This current regulatory outfit extends to both the mortgage insurance industry and bond guaranty industry.²²⁴

The Senate Proposal appears to envision that the FMIC support a federal entrance into the regulation of mortgage insurers and bond guarantors that deal in securities that the FMIC backstops.²²⁵ This regulation would extend to the

²¹⁹ *Id.* § 404.

²²⁰ *Id.* § 402(e).

²²¹ *Id.* § 604(a).

²²² *Id.* § 601. *See also id.* § 2(32)(A)(iii).

²²³ *See, generally*, 15 U.S.C. § 1012 (2012); 2 APPLEMAN ON INSURANCE § 8.01 (2014); Lissa L. Broome & Jerry W. Markham, *Banking and Insurance: Before and After the Gramm-Leach-Bliley Act*, 25 IOWA J. CORP. L. 723, 761–65 (2000).

²²⁴ *Strong Regulator Hearing*, *supra* note 23, 35–39 (statement of Kurt Regner, Assistant Director, Arizona Department of Insurance, on behalf of the National Association of Insurance Commissioners).

²²⁵ *See* Johnson-Crapo Senate Bill, *supra* note 24, at §§ 311, 313; Corker-Warner Senate Bill, *supra* note 20, at §§ 211, 214. However, for private mortgage insurance, the state insurance regulator would still wield primary authority. *See* Johnson-Crapo Senate Bill, *supra* note 24, at § 313(d).

development of “capital standards and related solvency standards.”²²⁶ For guarantors in particular, these capital standards would have to be at least “10 percent” of its insurance portfolio,²²⁷ a requirement connected to the legislation’s mandate that credit risk-sharing mechanisms be fully funded.²²⁸ Although the Proposal would require coordination between federal and state regulators in forming a regulatory scheme,²²⁹ it remains unclear the extent to which this federal entrance would shift the federal-state balance of power in this area.

3. Aggregators and Servicers

The Senate Proposal also envisions that the FMIC oversee “aggregators”—a term that appeared to rope in participants currently called “issuers”²³⁰—as well as servicers who deal in FMIC-covered securities.²³¹ The regulation of these entities, particularly servicers, appears to respond to widespread pre-crisis inadequacies and subsequent foreclosure-related litigation.²³²

In addition to approval standards, FMIC duties and responsibilities would extend beyond the examination and enforcement model of regulation that FHFA currently employs. At a hearing before the Senate Banking Committee that considered the Corker-Warner Bill, Alfred M. Pollard, General Counsel of the FHFA, testified:

²²⁶ Johnson-Crapo Senate Bill, *supra* note 24, at § 309(b).

²²⁷ *See id.* § 311(g).

²²⁸ *See supra* Part III.B.3.

²²⁹ *See, e.g.*, Johnson-Crapo Senate Bill, *supra* note 24, at § 311(a)(4).

²³⁰ *See id.* § 2(44). Johnson-Crapo may choose the term “aggregator” over “issuer” because the Bill contemplates a new form of MBS issuance through the Securitization Platform that would convert the current role of “issuer” into the role of “aggregator.”

²³¹ Johnson-Crapo Senate Bill, *supra* note 24, at §§ 312, 314; Corker-Warner Senate Bill, *supra* note 20, at §§ 212, 213.

²³² *See, e.g.*, Nelson D. Schwartz & Shaila Dewan, *\$26 Billion Deal Is Said to Be Set for Homeowners*, N.Y. TIMES, Feb. 9, 2012, at A1, A15.

The range of FMIC's duties and responsibilities represents a movement away from traditional examination- and enforcement-based supervision to a multi-faceted construct that covers availability and transparency of information, standard-setting to enter and participate in the market, supervision of participants, access to credit and the secondary mortgage market, insurance of securities and establishment and operation of databases including a mortgage data repository.²³³

For servicers, this new model would include the establishment of national servicing standards,²³⁴ which would presumably complement, from a secondary market perspective, the CFPB's consumer protection initiative in this area.²³⁵ For aggregators, this model of regulation would require compliance with the credit risk-sharing mechanisms and various other standards.²³⁶ For aggregators that are not already FDIC-regulated,²³⁷ this regulation would also include capital standards.²³⁸

D. Alternative Housing Finance Reform Proposals

Some commentators and policymakers have put forward proposals for housing finance reform as alternatives to the Senate Proposal.²³⁹ The central question that divides all

²³³ *Strong Regulator Hearing*, *supra* note 23, at 27 (statement of Alfred M. Pollard, General Counsel, Federal Housing Finance Agency).

²³⁴ *See* Johnson-Crapo Senate Bill, *supra* note 24, at § 314(a)(1); Corker-Warner Senate Bill, *supra* note 20, at § 212(a)(1).

²³⁵ Mortgage Servicing Rules Under the Real Estate Settlement Procedures Act (Regulation X), 12 C.F.R. § 1024 (2014).

²³⁶ *See* Johnson-Crapo Senate Bill, *supra* note 24, at § 312(a); Corker-Warner Senate Bill, *supra* note 20, at § 213(a)(1)(C).

²³⁷ *See* Johnson-Crapo Senate Bill, *supra* note 24, at § 312(d)(2).

²³⁸ *Id.* § 312(g).

²³⁹ *See, e.g.*, TREASURY REPORT, *supra* note 12 (forwarding three proposals representing varying degrees of government involvement in housing finance); Protecting American Taxpayers and Homeowners Act of 2013, H.R. 2767, 113th Cong. (2013) (forwarding proposal to eliminate the GSEs without considerable replacement entity); Housing Opportunities

housing finance reform proposals is the size of the government footprint in housing finance. More incisively, the question is whether a government guaranty is essential to a functioning mortgage market.²⁴⁰

Although this Note focuses on the Senate Proposal offered by Senators Johnson, Crapo, Corker, and Warner, a brief explanation of the alternative approach of Republican members of the House of Representatives adds some context to the ongoing debate.²⁴¹ The Protecting American Taxpayers and Homeowners Act, or “PATH Act,” currently under consideration in the House, provides the strongest contrast to the Corker-Warner approach. Introduced by Rep. Scott Garrett (R-NJ), the PATH Act would abolish the GSEs and replace them with a non-profit national mortgage market utility.²⁴² The utility would operate a securitization platform intended to standardize issuances²⁴³ and serve as a repository for the registration and use of mortgage-related documents,²⁴⁴ but would not be permitted to originate, service, insure, or guarantee any mortgage or MBS.²⁴⁵ Essentially, the PATH Act seeks to extricate the government from securitization business activities (leaving mortgage

Move the Economy Forward Act of 2014, H.R. ____, 113th Cong. (2014) (discussion draft, Mar. 27, 2014) (forwarding proposal similar to the Johnson-Crapo Senate Bill); *Private Label Securitization Hearing*, *supra* note 23, at 8 (statement of Adam J. Levitin, Professor of Law, Georgetown University Law Center) (suggesting another template for reform might be “based on amending the charters for the existing GSEs”).

²⁴⁰ FHFA STRATEGIC PLAN, *supra* note 14, at 10.

²⁴¹ Because the HOME Forward Act, the House Democrats’ alternative to the PATH Act, mirrors the Johnson-Crapo Senate Bill for most material purposes, it will not receive independent attention in this Note.

²⁴² Protecting American Taxpayers and Homeowners Act of 2013, H.R. 2767, 113th Cong. § 311 (2013).

²⁴³ *Id.* § 313.

²⁴⁴ *Id.* § 331.

²⁴⁵ *Id.* § 312(c)(1). *See also id.* § 321(5) (defining “qualified security” as a security that, among other things, “is not guaranteed, in whole or in part, by the United States Government”).

markets in purely private hands), while maintaining an entity to develop a standardized private market.

IV. RECOMMENDED CREDIT RISK-SHARING MECHANISM

This section begins by describing what the goals of the credit risk-sharing mechanism should be. It then provides a normative explanation of why the Credit-Linked Note Structure best suits these goals. Finally, in light of key features revealed by that explanation, this section describes why the Senate Proposal is superior to the PATH Act currently under consideration in the House.

A. Goals

1. For Borrowers: Maintain Cost Efficiencies of the TBA Market

Since the crisis, a diverse range of commentators has come to the defense of a little-known but hugely important market that now stands behind nearly all mortgage funding in the United States, the so-called “to-be-announced” or “TBA” market (“TBA Market”).²⁴⁶ The defenses generally acknowledge the important function of the TBA Market in keeping mortgage rates affordable for borrowers, as well as the importance of a government guaranty scheme that supports the mortgage loan fungibility that undergirds the TBA Market. A brief description of the TBA Market is illuminating.

Whether they stem from the whole loan conduit line of business or the lender swap transaction line of business,²⁴⁷

²⁴⁶ See, e.g., *Private-Label Securitization Hearing*, *supra* note 23, at 8–9 (oral testimony of Adam J. Levitin, Professor of Law, Georgetown University Law Center); *Hearing on the Future of Housing Finance—A Review of Proposals to Address Market Structure and Transition Before the H. Comm. on Fin. Servs.*, 111th Cong. 48–49 (2010) (statement of Kenneth E. Bentsen, Jr., Executive Vice President, Public Policy, Securities Industry and Financial Markets Association).

²⁴⁷ See discussion *supra* Part III.C.

all GSE MBSs carry two important features. First, they carry a government guaranty on principal and interest. Second, they comprise mortgages that meet the GSE underwriting guidelines.²⁴⁸ As such, investors recognize that GSE MBSs are essentially fungible—not unlike physical commodities—because each carries the same guaranty as any other, regardless of the underlying pool of mortgages. Growing out of this recognition, the TBA Market, like a commodity futures market, is a forward market dealing in GSE MBSs.²⁴⁹ The TBA Market allows issuers and investors to contract to deliver GSE MBSs at a future date, settling as many as ninety days later, without actually identifying the mortgages in the MBS pool.²⁵⁰ In fact, at the time that the investors purchase the GSE MBSs in TBA contracts, the mortgages backing the bonds may not yet even exist.²⁵¹ The TBA contracts specify only six parameters: the issuer, maturity, coupon, par amount, settlement date, and price.²⁵²

The TBA Market is important for banks, particularly small banks, that originate mortgages. First, because of its deep liquidity, the TBA Market gives originators the ability to cheaply hedge against interest rate risk, thereby allowing originators to offer borrowers a fixed-rate product good for some thirty to ninety days.²⁵³ This hedge facilitates the “rate locks” now familiar to borrowers. Second, because sale and delivery are determined in advance, the TBA Market eliminates originators’ need to “warehouse” loans on balance

²⁴⁸ *Hearing on H.R. _____, the Private Mortgage Market Investment Act Before the H. Comm. on Fin. Servs., Subcomm. on Gov’t Sponsored Enters.*, 112th Cong. 86–87 (2011) (statement of Tom Deutsch, Executive Director, American Securitization Forum).

²⁴⁹ See Michael E. Murphy, *Fannie Mae and Freddie Mac: Legal Implications of a Successor Cooperative*, 10 DEPAUL BUS. & COM. L.J. 171, 177–78 (2012).

²⁵⁰ *Id.* at 178.

²⁵¹ *Id.* The sale of unidentified mortgages is legal due to a GSE exemption from compliance with disclosure requirements of the Securities Act of 1933. *Id.*

²⁵² *Id.*

²⁵³ *Id.*

sheet while shopping them on the secondary market.²⁵⁴ These features serve to reduce transaction costs for originators, thereby lowering mortgage rates for borrowers.

For the reasons above, general agreement has coalesced around the assertion that the TBA Market provides a benefit to borrowers sufficient to warrant its maintenance or replacement with a similar market mechanism.²⁵⁵ In fact, the Johnson-Crapo Bill reiterated the importance of the TBA Market to the Senate Banking Committee by requiring that the FMIC “consider whether the approval of any credit risk-sharing mechanism will impair the operation and liquidity of forward market executions of [MBSs], such as the To-Be-Announced market”²⁵⁶ Therefore, the TBA Market—and the fungibility that allows the market to flourish—should weigh heavily upon considerations made to identify risk-sharing mechanisms ideal for the FMIC.

2. For Investors: Produce Attractive Investment Products

Because the GSEs assume the credit-default risk for GSE MBSs, investors in the GSE MBS markets assume only prepayment risk and interest-rate risk. This limited risk assumption means that GSE MBS investors need not expend high costs developing sophisticated models to gauge the probability of borrower default on the myriad loans that underlie GSE MBSs. Instead, these investors need only price the risk that interest rates will fluctuate adversely to their

²⁵⁴ *Id.*

²⁵⁵ See *Hearing on H.R. _____, the Private Mortgage Market Investment Act Before the H. Comm. on Fin. Servs., Subcomm. on Gov't Sponsored Enters.*, *supra* note 248, at 87 (statement of Tom Deutsch, Executive Director, American Securitization Forum) (“[A]ny reform of the GSEs which does not accommodate, or suitably replace, the existing GSE MBS TBA market will undoubtedly impact mortgage originators and borrowers both severely and negatively.”); *Senate Banking Committee Housing Finance Reform Hearings*, *supra* note 23.

²⁵⁶ Johnson-Crapo Senate Bill, *supra* note 24, at § 302(b)(1)(E).

portfolios. In other words, GSE MBSs currently provide a safe outlet for so-called “rates investors.”²⁵⁷

“Rates investors” stand in contrast to “credit investors,” who are investors willing to take on the risk of borrower defaults.²⁵⁸ Because of the complexity required to determine default risk on thousands of idiosyncratic loans within a mortgage pool, credit investing is generally recognized to be a more difficult pursuit.²⁵⁹ Accordingly, rates investors would likely leave a market before assuming the burdens of credit investing.

Any housing finance reform initiative must acknowledge the critical contributions of rates investors in supplying capital to fund borrowers nationwide. Potential risk-sharing structures should seek to retain the participation of rates investors in housing finance while also luring the credit investors required to achieve the FMIC’s policy goal of offloading 10% of the first-loss credit risk.

3. For Society: Reduce Taxpayer Exposure to Credit Risk

Prior to conservatorship, the GSEs benefited from preferential tax treatment, lower capital requirements, and a widely perceived government guaranty.²⁶⁰ This government guaranty became explicit after the GSEs collapsed in 2008. Through agreements made by the FHFA (as conservator of

²⁵⁷ See *Hearing on Essential Elements of Housing Finance Reform Before the S. Comm. on Banking, Hous., & Urban Affairs*, *supra* note 23, at 59 (statement of Richard Johns, Executive Director, Structured Finance Industry Group) (“Limiting the government’s involvement in the market by changing or ending the current infrastructure must account for the critical contribution that rates investors make to the Agency Market and their historic aversion to credit risk, as well as the limited pool of private capital available to fund credit risk.”).

²⁵⁸ *Private-Label Securitization Hearing*, *supra* note 23, at 43 (statement of Adam J. Levitin, Professor of Law, Georgetown University Law Center).

²⁵⁹ *Id.* at 5.

²⁶⁰ TREASURY REPORT, *supra* note 12, at 8.

the GSEs) with the Treasury, the GSEs drew over \$187 billion to support their guaranty business.²⁶¹

From their statements, key policymakers believe that this bailout has implicated fundamental values of fairness and permitted an unsustainable fount of moral hazard. For example, President Obama stated the following regarding the actions of the GSEs:

For too long, [Fannie Mae and Freddie Mac] were allowed to make huge profits buying mortgages, knowing that if their bets went bad, taxpayers would be left holding the bag. It was “heads we win, tails you lose.” And it was wrong. And along with what happened on Wall Street, it helped to inflate this bubble in a way that ultimately killed Main Street.²⁶²

Policymakers from both political parties agree that housing finance should not command the degree of public support that it ultimately required after 2008. Given this political reality, any housing finance reform initiative must definitively address how to eliminate taxpayer support for the housing market.

Thus, the delicate risk-sharing mechanisms that the Senate Proposal sets forth should be carefully studied with an eye toward the taxpayer purse. Structures that leave open the chance that the FMIC may have to assume losses within the first 10% subordinate position ultimately make more likely a repeat of September 2008, in which the Treasury had to assume the losses of the GSEs as guarantors. Therefore, such structures should receive heavy scrutiny.

²⁶¹ FED. HOUS. FIN. AGENCY, DATA AS OF AUGUST 8, 2014 ON TREASURY AND FEDERAL RESERVE PURCHASE PROGRAMS FOR GSE AND MORTGAGE-RELATED SECURITIES 2 tbl.1 (2014) available at <http://perma.cc/LGD4-HS3P?type=pdf>. It must be noted that the GSEs' dividends distributed to Treasury now exceed their initial draws, leading some commentators to assert that the GSEs have “paid back” Treasury, albeit nearly six years later. For more information on the GSE dividends, see *supra* Part II.C.

²⁶² Remarks at Desert Vista High School in Phoenix, Arizona, 2013 DAILY COMP. PRES. DOC. 201300550 (Aug. 6, 2013).

B. Solution: Credit-Linked Note Structure

The Credit-Linked Note Structure, through its innovative use of credit derivatives, provides an ideal credit risk transfer mechanism serving the goals of investors, borrowers, and taxpayers. As such, should the Senate Proposal or another similar proposal pass Congress, the FMIC should designate the Credit-Linked Note Structure its favored credit risk-sharing mechanism and craft a regulatory scheme accordingly.

First, for taxpayers, the Credit-Linked Note Structure provides a prudentially sound method for ensuring that taxpayers do not assume the credit liabilities of the FMIC. Credit-linked deals require that credit investors pay the principal amount at risk to the credit-linked note issuer upfront. This principal will be returned to the investors depending upon the performance of the referenced mortgage pool. Therefore, the protection is fully funded: the CLN issuer will already possess the private capital required to absorb the first-loss position at the time that defaults in the reference pool pile up.

This outcome contrasts with that of the Regulated Bond Guarantor Structure, in which the FMIC would require that bond guarantors assume the credit risk. Bond guarantors pay insured bondholders out of their own capital reserves when credit losses occur. So the degree to which the FMIC is protected from taking a first-loss position depends on the strength of the bond guarantors' probability of loss models governing their capital reserves.

The Johnson-Crapo draft legislation attempts to strengthen the Regulated Bond Guarantor Structure by establishing the FMIC as a safety and soundness regulator over the bond guarantors and enabling the FMIC to require that guarantors hold capital of 10%—an attempt to “fully fund” the private first-loss position. Nonetheless, the possibility remains that disproportionate losses in one part of a guarantor's book could render the guarantor insolvent before it assumes 10% of the losses on an FMIC-backed MBS. This possibility alone should be dispositive: one of the main lessons of the crisis was that prudential regulators,

much like the FHFA and OFHEO, may easily be blind to latent risks lurking disproportionately in dark corners of the financial system.

Second, for borrowers, the Credit-Linked Note Structure allows for the undisturbed, continued operation of the TBA Market because it contemplates no changes in the guaranty for the “real” MBSs underlying the TBA Market. Instead, the structure would offload the first-loss credit-risk position for the real securities through the issuance of credit-linked derivative notes that reference the real securities. Therefore, the Credit-Linked Note Structure would have no impact on the TBA Market.

This outcome contrasts with that of the Senior-Subordinated Structure, which would require that the FMIC assume no credit risk for the subordinate 10% piece of the “real” securities issued. Because of this “guaranty hole,” the securities issued would carry decidedly differing credit risks, thereby destroying the fungibility of the final product. Although the senior piece of the real security may still carry a guaranty necessary for TBA Market access, the subordinate piece would certainly not qualify, thereby shrinking and complicating the TBA Market. This exact concern undergirded the GSEs’ recent decision not to employ the Senior-Subordinated Structure in their experimental risk-sharing transactions of 2013.²⁶³ Although it remains unclear the extent to which a Senior-Subordinated Structure would damage the TBA Market, any damage would unnecessarily harm borrowers’ access to credit.

Thirdly, the Credit-Linked Note Structure provides attractive and well-tailored products for investors. The Credit-Linked Note Structure very efficiently isolates rate-related risk from credit-related risk. Such isolation facilitates tailoring and allows investors to receive the exact risk exposure that they desire. While rates investors could

²⁶³ See *Risk Transfer Hearing*, *supra* note 23, at 30 (statement of Laurel Davis, Vice President for Credit Risk Transfer, Fannie Mae); *Risk Transfer Hearing*, *supra* note 23, at 26 (statement of Kevin Palmer, Vice President, Freddie Mac).

still participate in the market for the real MBS issued, credit investors would be welcome to participate in the CLN issuances that isolate the credit risk in the reference pools.

This outcome also contrasts with that under the Senior-Subordinated Structure. There, neither rates investors wary of credit risk nor credit investors wary of rates risk would invest in the subordinate first-loss piece. This commingling of disparate risks unnecessarily weakens investor appetite for the product, and may chase away the rates investors required to support a robust housing finance market.

C. Criticism of Lack of Credit-Risk Sharing in PATH Act

The Credit-Linked Note Structure in the Corker-Warner Bill also compares favorably to the purely private scheme contemplated in the PATH Act, which suffers from nearly all of the infirmities of the Senior-Subordinated Structure mentioned above. First, the lack of a government guaranty under the PATH Act may preclude the operation of the TBA Market, which requires fungibility.²⁶⁴ When a government guaranty is replaced entirely with private credit enhancement, no matter how strong, credit risk that is idiosyncratic and loan-specific enters the equation. This credit risk would undermine, if not foreclose entirely, the fungibility between MBSs required for the commodity futures-like TBA Market. For this reason, coupled with disclosure problems that obstruct credit risk due diligence, some commentators doubt that a purely private market could support the availability of the 30-year fixed-rate

²⁶⁴ See *Hearing on a Legislative Proposal to Protect American Taxpayers and Homeowners By Creating a Sustainable Housing Finance System Before the H. Comm. on Fin. Servs.*, 113th Cong. 132 (2013) (statement of Tom Deutsch, Executive Director, American Securitization Forum).

mortgage for any but the most creditworthy jumbo borrowers.²⁶⁵

The PATH Act would also drive pure rates investors out of the housing finance markets. For the reasons catalogued above, rates investors seek only fixed-income assets and hesitate to bear any credit risk. Although private credit enhancement can mitigate credit risk, it remains uncertain whether risk-averse rates investors will trust these mechanisms, given their ineffectiveness during the financial crisis.

Finally, worth noting is the fact that the PATH Act holds little chance of becoming law. It currently marshals no Democratic support in the House of Representatives,²⁶⁶ and carries a significant number of provisions politically infeasible for Democrats.²⁶⁷ While this lack of political support does not bear on the merits of the proposal, its realistic implications are germane when discussing the future of housing finance. Unlike the PATH Act, the Senate Proposal enjoys bipartisan support,²⁶⁸ as well as the support of the Obama Administration,²⁶⁹ and holds a relatively

²⁶⁵ See *Private Label Securitization Hearing*, *supra* note 23, at 50–51 (statement of Adam J. Levitin, Professor of Law, Georgetown University Law Center).

²⁶⁶ See *Hearing on a Legislative Proposal to Protect American Taxpayers and Homeowners By Creating a Sustainable Housing Finance System Before the H. Comm. on Fin. Servs.*, *supra* note 264, at 3 (statement of Rep. Maxine Waters, Ranking Member, H. Comm. on Fin. Servs.) (“I am deeply disappointed in the radical and unworkable discussion draft that is before us today as well as the lack of interest in making this a bipartisan effort.”).

²⁶⁷ See, e.g., *Protecting American Taxpayers and Homeowners Act of 2013*, H.R. 2767, 113th Cong. § 407 (2013) (repealing the Dodd-Frank credit risk retention provision).

²⁶⁸ See *Senate Banking Committee Housing Finance Reform Hearings*, *supra* note 23.

²⁶⁹ Remarks at Desert Vista High School in Phoenix, Arizona, 2013 DAILY COMP. PRES. DOC. 201300550 (Aug. 6, 2013). (“[R]ight now there’s a bipartisan group of senators working to end Fannie and Freddie as we know them. And I support these kinds of reform efforts.”).

strong probability of becoming law despite a highly polarized Congress.

V. PROPOSAL TO REVIVE PRIVATE-LABEL SECURITIZATION: A FIDUCIARY DUTY ON TRUSTEES

Before this Note concludes, this Part forwards one final proposal to hasten the return of the private-label securitization (“PLS”) market as a complement to the FMIC regulatory apparatus of the Senate Proposal. This aim is intricately connected to the foregoing discussion on the Senate Proposal because the revival of the PLS market would promote the central policy goal behind the Senate Proposal: privatizing credit risk without stanching the availability of credit. Because credit risk is fully privatized in PLSs, as opposed to only 10% privatized in the proposed FMIC system, the success of the PLS market would be a highly desired outcome to the drafters of the Senate Proposal.

A. Background on PLSs and PLS Trustees

PLSs have traditionally been the outlet through which non-conforming loans—those loans that do not meet the GSE underwriting guidelines—access the capital markets. While the most attractive PLSs have been those comprising strong loans that merely exceed the conforming loan limit (so-called “jumbo loans”), PLSs have also famously allowed “subprime” borrowers to access affordable rates.²⁷⁰

Germane to this Note²⁷¹ is the role of the PLS trustee: in PLS transactions, one entity, typically a bank that

²⁷⁰ See *Private-Label Securitization Hearing*, *supra* note 23, at 29–31 (statement of Martin S. Hughes, Chief Executive Officer, Redwood Trust, Inc.); *Private Label Securitization Hearing*, *supra* note 23, at 45 (statement of Adam J. Levitin, Professor of Law, Georgetown University Law Center).

²⁷¹ A full description of the complex operation of private-label securitization is beyond the scope of this Note. For more information, see Guseva, *supra* note 97.

specializes in corporate trust work, agrees to serve as trustee over the pool of loans comprising the deal.²⁷² The basic function of a PLS trustee is twofold. First, the trustee must carry out the provisions of the pooling and servicing agreement (“PSA”), which governs the PLS transaction.²⁷³ Second, the trustee must protect the interests of investors.²⁷⁴ The trustee holds the assets for the benefit of investors and is recognized under New York law (which governs most PLSs) as the “party-in-interest” for defending the interests of the investor-beneficiaries.²⁷⁵

One set of provisions in PLS PSAs that trustees are required to enforce on behalf of investors (which are particularly important to the credit investors in PLS markets) is the group of representations and warranties (“R&Ws”) regarding the mortgage loans contained in the trust. These R&Ws set forth conditions regarding the quality of each loan contained in the pool.²⁷⁶ When a loan is found to breach the R&Ws, the trustee is required to enforce the R&Ws against the loan seller by demanding that the seller repurchase the loan from the trust at par.²⁷⁷

Since the financial crisis and its accompanying investor losses, some investors have alleged that MBS issuers placed many individual mortgage loans into MBS trusts in breach of the R&Ws.²⁷⁸ And, in connection with these alleged breaches,

²⁷² *Private-Label Securitization Hearing*, *supra* note 23, at 46 (statement of Adam J. Levitin, Professor of Law, Georgetown University Law Center).

²⁷³ David J. Askin, *The Rating of Mortgage-Backed Securities*, in *THE HANDBOOK ON MORTGAGE-BACKED SECURITIES* 497, 548 (Frank J. Fabozzi ed., 1985).

²⁷⁴ *Id.*

²⁷⁵ Jonathan Wishnia & Scott Walker, *RMBS Putback Litigation 2012: Actions By or Against the Trustees?*, *TOTAL SECURITIZATION*, Oct. 17, 2011, at 1.

²⁷⁶ See AM. SECURITIZATION FORUM, *ASF PROJECT RESTART: ASF MODEL REPRESENTATIONS AND WARRANTIES 2* (2009).

²⁷⁷ See *id.*

²⁷⁸ See, e.g., Complaint at 6–7, 67, 123, 134, 160, *Am. Int’l Grp., Inc. v. Bank of Am. Corp.*, No. 652199/2011 (N.Y. Sup. Ct. Aug. 8, 2011).

investors contend that PLS trustees have failed to adequately defend the investors' rights.²⁷⁹

Perhaps the foremost impediment blocking the return of institutional credit investors to PLSs is the investors' suspicion that the conflicts giving rise to the PLS trustees' failure to enforce the R&Ws have not been resolved.²⁸⁰ The conflict stems from the broad question of what duty trustees owe investors. Although traditional trustees owe a broad fiduciary duty to beneficiaries,²⁸¹ PLS trustees argue that they owe a more limited duty, bounded by the obligations within the four corners of the PSA.²⁸² Further, PLS trustees contend that their role is generally administrative.²⁸³ Herein lies the battle between the investors and the trustees.

B. Current Litigation Over the Duty of PLS Trustees

The question of what duty PLS trustees owe investors is the subject of several litigations in state and federal courts. Emblematic is the conflict,²⁸⁴ laid bare in an arcane proceeding, between American International Group ("AIG") (the investor), on the one hand, and Bank of America ("BOA") (the issuer) and Bank of New York Mellon ("BNY Mellon") (the trustee), on the other.²⁸⁵ In this dispute, a group of investors in BOA-issued MBSs, along with BNY Mellon as trustee, entered into a settlement agreement with BOA that required BOA to pay \$8.5 billion to the trusts and

²⁷⁹ See, e.g., Gretchen Morgenson, *Who Has Your Back? Hard to Tell*, N.Y. TIMES, Nov. 17, 2013, at BU1.

²⁸⁰ See *Private-Label Securitization Hearing*, *supra* note 23, at 35 (statement of John Gidman, President, Association of Institutional Investors).

²⁸¹ See, e.g., *Mercury Boating Club, Inc. v. San Diego Yacht Club*, 557 N.E.2d 87, 95 (N.Y. 1990) ("We have described a fiduciary's duty as requiring '[n]ot honesty alone, but the punctilio of an honor the most sensitive' (citation omitted). This strict standard is the usual and appropriate measure of a trustee's fiduciary obligations . . .").

²⁸² *Wishnia & Walker*, *supra* note 275, at 1.

²⁸³ *Id.*

²⁸⁴ See *id.*

²⁸⁵ See Morgenson, *supra* note 279.

BNY Mellon to abandon claims relating to R&W breaches for those trusts.²⁸⁶ But some other investors, including AIG, objected that the settlement was too low.²⁸⁷ Nonetheless, BNY Mellon entered into a special proceeding, under Article 77 of New York Civil Practice Law and Rules,²⁸⁸ seeking judicial approval of the settlement.²⁸⁹ The dispute morphed into a debate not only on whether BNY Mellon sufficiently attempted to enforce R&W breaches, but also on whether BNY Mellon sufficiently negotiated to acquire the best possible settlement on behalf of investors.²⁹⁰ The Article 77 proceeding raised a number of concerns, including potential conflicts of interest relating to BNY Mellon's relationship to BOA as well as BNY Mellon's questionable methodology for arriving at the \$8.5 billion figure.²⁹¹

After an odyssey of the kind peculiar to the U.S. federal system,²⁹² the case ended up back in New York state court, which issued a decision earlier this year.²⁹³ In relevant part,

²⁸⁶ See Settlement Agreement, In the Matter of Bank of New York Mellon for an order pursuant CPLR § 7701, No. 651786/2011, 2014 WL 1057187 (N.Y. Sup. Ct. Jan. 31, 2014).

²⁸⁷ See, e.g., Second Amended Complaint, Knights of Columbus v. Bank of N.Y. Mellon at 1–3, No. 651442/2011 (N.Y. Sup. Ct. May 28, 2013). Although AIG was not party to the foregoing complaint in particular, that complaint was exemplary of the allegations against BNY Mellon.

²⁸⁸ N.Y. C.P.L.R. § 7701 (McKinney 2012).

²⁸⁹ Petition, *supra* note 286, at 1.

²⁹⁰ See Morgenson, *supra* note 279, at BU1, BU4.

²⁹¹ Gretchen Morgenson, *Watchdogs Without Any Bark*, N.Y. TIMES, June 16, 2013, at BU1, BU5.

²⁹² The plaintiffs initially removed the case to federal District Court in the Southern District of New York, which denied the defendants' motion to remand to state court based on federal jurisdiction under the Class Action Fairness Act ("CAFA"). On appeal, the Second Circuit reversed the District Court's denial of the defendants' motion to remand, vacating the decision on CAFA and sending the case back to New York state court. *BlackRock Fin. Mgmt. Inc. v. Segregated Account of AMBAC Assurance Corp.*, 673 F.3d 169, 180 (2d Cir. 2012).

²⁹³ In the Matter of Bank of N.Y. Mellon, for an order pursuant CPLR § 7701, No. 651786/2011, 2014 WL 105718711 (N.Y. Sup. Ct. Jan. 31, 2014). The court also ruled that BNY Mellon did abuse its discretion with

the trial court ruled that BNY Mellon did not abuse its discretion as trustee with respect to its conduct during the settlement negotiations and its surrender through the settlement of its loan repurchase claims.²⁹⁴ But the case may not be over yet: news reports suggest that AIG intends to appeal.²⁹⁵

Nonetheless, the New York state Article 77 litigation may not be as important as connected federal litigation in the Southern District of New York, *Retirement Board of the Policemen's Annuity and Benefit Fund of Chicago v. Bank of N.Y. Mellon*, regarding the effect of the federal Trust Indenture Act of 1939 ("TIA")²⁹⁶ on PLS trustees.²⁹⁷ In that litigation, a pension fund and other investors also sued BNY Mellon, regarding the same BOA trusts, for violations of the TIA, which imposes the high "prudent man" standard on debt trustees "in case of default."²⁹⁸ In response, BNY Mellon argued, as a threshold matter, that it was not subject to TIA duties because the underlying trust represented not debt but equity, outside the TIA scope.²⁹⁹ For this proposition, BNY Mellon relied on Securities and Exchange Commission ("SEC") staff interpretive guidance offered on the SEC website, which states, "Certificates representing a beneficial ownership interest in a trust . . . are treated as exempt from the Trust Indenture Act"³⁰⁰ The District Court, however,

respect to certain loan modification claims, which were thereby excluded from the settlement. *Id.* at *25–30.

²⁹⁴ *Id.* at *28–29.

²⁹⁵ Michael Corkery, *Bank Pact on Bonds That Soured Is Approved*, N.Y. TIMES, Feb. 1, 2014, at B7.

²⁹⁶ 15 U.S.C. §§ 77aaa–77bbb (2012).

²⁹⁷ *Ret. Bd. of the Policemen's Annuity & Benefit Fund v. Bank of N.Y. Mellon*, 914 F. Supp. 2d 422, 423 (S.D.N.Y. 2012).

²⁹⁸ 15 U.S.C. § 77ooo(c) (2012).

²⁹⁹ *Policemen's Annuity*, 914 F. Supp. 2d at 427. *See* 15 U.S.C. § 77ddd (2010) ("The provisions of this title shall not apply to . . . any security other than . . . a note, bond, debenture, or evidence of indebtedness . . .").

³⁰⁰ Sec. & Exch. Comm'n, Div. of Corp. Fin., *Trust Indenture Act of 1939*, U.S. SEC. & EXCH. COMM'N (May 3, 2012), <http://perma.cc/LYD8-WRGH>.

rejected BNY Mellon's argument, citing case law and an Internal Revenue Service Notice intended to help distinguish debt and equity securities,³⁰¹ and applied the TIA.³⁰² With the application of the "prudent man" standard of the TIA, the Court then rejected BNY Mellon's demurrer.³⁰³ Given the "novel and complex" issues of law, however, the Court certified a BNY Mellon interlocutory appeal to the Second Circuit,³⁰⁴ where the case remains *sub judice*.³⁰⁵

C. Proposed Fiduciary Duty Through TIA Clarification

Before the Second Circuit acts, however, the Johnson-Crapo Bill, or some other vehicle, could provide PLS investors the legal protection they seek by simply codifying the District Court's *Policemen's Annuity* decision. The Bill could simply amend the TIA to make clear that heightened TIA duties do apply to trustees overseeing PLS transactions federally, and should prohibit trustees from having certain conflicts of interest with their investors.³⁰⁶ Such action would definitively alter the relationship of the PLS trustee to PLS investors from that of a contractual counterparty to that of a fiduciary.

Although increasing trustees' liability would not come without cost, such action appears necessary to lure institutional credit investors back to PLS markets. Therefore, if policymakers seek to revive the fully privatized PLS market as a complement to the FMIC system, they

³⁰¹ I.R.S. Notice 94-47, 1994-19 I.R.B. 9.

³⁰² *Policemen's Annuity*, 914 F. Supp. 2d at 429.

³⁰³ *Id.* at 431-33.

³⁰⁴ *Ret. Bd. of Policemen's Annuity & Benefit Fund v. Bank of N.Y. Mellon*, 11 Civ. 5459(WHP), 2013 U.S. Dist. LEXIS 20214, at *15-17 (S.D.N.Y. Feb. 14, 2013).

³⁰⁵ *See Ret. Bd. of the Policemen's Annuity & Benefit Fund v. Bank of N.Y. Mellon*, No. 11 Civ. 5459(WHP), 2014 U.S. Dist. LEXIS 105805, at *5-6, *17 (S.D.N.Y. July 30, 2014).

³⁰⁶ *See Private-Label Securitization Hearing*, *supra* note 23, at 57 (statement of Adam J. Levitin, Professor of Law, Georgetown University Law Center).

should take this action as part of the Johnson-Crapo housing finance reform effort to allow both markets to flourish in parallel.

VI. CONCLUSION

The question before housing finance reformers is whether, in the wake of Fannie Mae and Freddie Mac's failure, a government guaranty is essential to the healthy functioning of U.S. mortgage markets. On this question, the Senate Proposal steers a middle course. Though it acknowledges that private capital must assume a first loss position on credit losses, the Proposal provides a framework through which a government agency, the proposed FMIC, can play an active role in housing finance to the benefit of borrowers, investors, and taxpayers. This Congress or the next should therefore adopt the Senate Proposal.

Moving forward, policymakers should use the Johnson-Crapo and Corker-Warner framework to hasten the return of private capital to MBS markets. First, within the realm of MBSs covered by the FMIC regulatory apparatus, policymakers should give preference to the credit-linked note transaction structure, as previewed in recent GSE credit-risk sharing deals. This structure would retain the benefits that borrowers reap from a functioning TBA Market while providing maximum prudential security to taxpayers. Second, for private-label securitizations beyond the realm of the FMIC regulatory apparatus, policymakers should enhance the legal duties that PLS trustees owe investors to ensure that investors view the PLS market as a viable complement to an FMIC-based system.

These two initiatives together should enable borrowers to continue to access affordable interest rates, provide investors attractive, risk-tailored investment opportunities, and assure taxpayers that they will not again be called upon to rescue the housing finance system.