Revisions of the Thompson Memorandum and Avoiding the Stein Problems: A Review of the Federal Policy on the Prosecution of Business Organizations Note

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Note

ACHIEVING MEANINGFUL MORTGAGE REFORM

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Recent economic fallout has revealed that the United States mortgage industry needs reform. Unlike other similar industries, the mortgage lending industry lacked fundamental safeguards such as centralized regulation, adequate capital reserves, sufficient insurance backstops, and strict federal oversight. As a result, loose lending spawned reckless buying which, in turn, led to financial disaster. In the wake of catastrophe, the federal government intervened; regardless of whether federal intervention was necessary to prevent systemic calamity, the solution was insufficient to create long-term stability and exposed the economy to moral hazard. This Note explains what happened in the mortgage industry, how it affected the national economy, and what solution can be deployed to help avoid systemic risk in the future.

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ACHIEVING MEANINGFUL MORTGAGE REFORM

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I. INTRODUCTION

The United States has plummeted headlong into a financial bugaboo. For nearly a year, the media has labored to fix blame on top executives, bogus investment vehicles, inflated stock markets, and irresponsible investing. Contrary to the popular media, the core problem may not be the result of the typical age-old scapegoats. In 2008, financial trouble may have spawned primarily from one core problem—a broken mortgage lending legal system. This Note asserts that the United States' financial crisis is a result of our having relied on an out-of-date mortgage lending system created nearly a century ago—an entirely ancient system in light of today's intricate primary market mortgage products and risk-exposed secondary mortgage market products.[1]

The mortgage lending industry lacks fundamental industry safeguards, such as centralized regulation, adequate capital reserves, an insurance backstop, and strict federal oversight. As a result, the last decade has brought irresponsible lending, uninformed buying, careless underwriting, negligent securitization of mortgage loans (collateralized debt obligations), and reckless insurance of those securitizations (credit default swaps).[2] With all of the financial trouble, even some staunch supporters of deregulation have diverged from strict federalist doctrines to concede that something should be done.[3]

As a result, this Note suggests several possible solutions to the

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1 ALAN GREENSPAN, THE AGE OF TURBULENCE 507 (2008) ("Large losses suffered on securitized American subprime mortgages triggered the crisis, of course . . . ."); Henry Paulson, *Fighting the Financial Crisis, One Challenge at a Time*, N.Y. TIMES, Nov. 17, 2008, at A1 ("I have always said that the decline in the housing market is at the root of the economic downturn and our financial market stress. And the economy, as it slows further, threatens to prolong this decline, as well as the stress on our financial institutions and financial markets.").

2 The media's coverage of credit default swaps has focused primarily on the negligent use of swaps by banks as capital, the improper rating of swaps by rating agencies, and the careless issuance of swaps by insurance entities without retaining adequate reserves. Matthew Philips, *The Monster that Ate Wall Street*, NEWSWEEK, Oct. 6, 2008, at 46. While this Note neglects a full discussion of the mainstream credit default swap issues, it is still important to note that a more stable mortgage and real estate market would have prevented a full-blown meltdown of both the nation's collateralized debt obligations and credit default swaps—regardless of whether the products were sound or not. *Id.*; Paulson, *supra* note 1.

3 Edmund L. Andrews, *Greenspan Concedes Error on Regulation*, N.Y. TIMES, Oct. 24, 2008, at B1.

financial meltdown. Part II explains why the most effective way to address the nation's financial problem is to pursue reform in the mortgage lending industry. That section also describes how irresponsible mortgage lending and borrowing led the economy into the recent financial crisis and asserts that inadequate capital reserves, insufficient regulation, unsatisfactory secondary mortgage market accountability, and unacceptable mortgage-backed securitization all contributed to create the perfect financial storm.

Part III provides a framework for discussing viable solutions to the problem. An effective long-term financial solution must have at least three fundamental characteristics to be successful. First, the solution should be focused on mortgage reform. Second, the solution must be deployed on a federal level in order to achieve consistency and immediacy. And third, capital reserves—whether accumulated by institutions, industries, government, or insurance—are an essential element of the solution.

Part IV describes a possible solution to the country's financial problems—a solution that would not create moral hazard or systemic risk, as the government's recent solutions have. The proposal focuses on forming a governmental entity—the Federal Mortgage Insurance Corporation ("FMIC")—to concurrently regulate the mortgage industry and provide financial reserves. This section outlines how the FMIC would function, and compares similarly structured entities and industries: the Federal Housing Administration ("FHA"), the Federal Deposit Insurance Corporation ("FDIC"), and the private mortgage insurance industry ("PMI").

II. THE PROBLEM

Beginning with a subprime mortgage lending disaster, which was exacerbated by the fall of an irrationally exuberant housing market, the United States economy has sunken into one of the worst economic recessions in nearly a century.[4] The problem grew as a result of a series of major missteps that have paralyzed effective solutions moving forward.

First, the mortgage market began the domino effect. In retrospect, it is clear that the subprime mortgage market posed systemic risk because of loose regulation, lack of capital reserves, and lack of proper insurance.[5] Second, to address the problem, the government was forced to act hastily in three distinct phases: to avoid recession, to avoid contagion, and to avoid depression. While each of these phases may have been necessary, the solutions deployed in each effort fell short of providing proper long-

[4] Jon Hilsenrath et al., *Worst Crisis Since '30s, With No End Yet in Sight*, WALL ST. J., Sept. 18, 2008, at A1.

[5] *See infra* Part II.A. The above named mortgage problems spawned further disaster by exacerbating irresponsible mortgage-backed securitization of risky loans and negligent insuring of those securitizations by way of credit default swaps.

term solutions. In fact, each phase of government intervention may have actually contributed to future systemic calamity.[6] Third, disagreement as to how the government should have acted to curb systemic risk flowing from the mortgage market handicapped Congress. In light of convincing theories going in entirely different directions—usually based on militant partisanship—Congress has done little to stabilize the mortgage market through requirements of responsible lending, responsible reporting, responsible insurance, and proper hedging against industry risk.[7]

A. *How the Mortgage Market Caused Systemic Calamity in 2008*

It is difficult to say exactly when and how the United States' current financial problem began. Rather than a specific instance, the financial crisis came as a result of multiple events and factors. While much of the collateral damage in 2008 and early 2009 surfaced outside the spectrum of mortgage lending, there is little doubt that mortgages were among the most fundamental causes.

The first problem in the mortgage industry was insufficient regulation of risky loan products. During the 1980s, rates were high—as much as fifteen percent—and few could afford to buy a home.[8] In an effort to make loans more affordable, lenders began pushing adjustable rate mortgages ("ARMs").[9] These loans allowed buyers to contract for the home they wanted, find alternative funding, and get out before the "bad loan" began to ratchet up and cost more per month than the borrower could afford. In the 1990s, rates came down, and lenders continued to offer alternative lending packages, including no money down loans, subprime ARMs, and interest only loans.[10] During the next decade, these creative financing options became more and more popular and increasingly accessible. Consumer interest in "creative financing" was fueled significantly by the real estate boom that occurred between 2001 and 2008. By 2006, the National Association of Realtors ("NAR") reported that an astonishing forty-three percent of all first time home loans originated that year were interest only loans.[11]

Aggravating the problem, the twenty-first century ushered in a

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[6] *See infra* Part II.B.

[7] *See infra* Part II.C.

[8] *See* ERATE Historical Mortgage Rates, http://www.erate.com/mortgage_rates_history.htm.

[9] *See* Diana G. Browne, *The Development and Practical Application of the Adjustable Rate Mortgage Loan: The Federal Home Loan Mortgage Corporation's Adjustable Rate Mortgage Loan Purchase Program and Mortgage Loan Instruments*, 47 MO. L. REV. 179, 180 (1982); *see also* Ryan Barnes, *The Fuel that Fed the Subprime Meltdown*, INVESTOPEDIA, http://www.investopedia.com/articles/07/subprime-overview.asp (last visited Oct. 29, 2009).

[10] *See* Liz Moyer, *Beware Interest-Only*, FORBES, Dec. 7, 2005, http://www.forbes.com/services/2005/12/06/interest-only-mortgages-cx_lm_1207mortgage.html.

[11] Noelle Knox, *43% of First Time Home Buyers Put No Money Down*, USA TODAY, Jan. 18, 2006, at 1A.

multitude of creative ways to get into a home with no money down. This allowed borrowers to purchase homes with virtually no personal risk of loss. Some critics blamed politicians and political agendas for muddying the water by supporting risky lending—either by deregulation, at one end of the spectrum, or by pushing financial equality at the other. In any case, many companies, and even the federal government, made efforts to lower lending standards and aggressively worked to "help[] families realize the American Dream of homeownership."[12] The FHA even extended loans to first-time homebuyers with no money down through seller-funded downpayment programs.[13] Other lenders allowed buyers to obtain an 80% loan from one lender and a 20% loan from another, thus allowing 100% financing.[14] Still other lenders provided one hundred percent financing with a requirement to purchase private mortgage insurance to cover twenty percent of the loan.[15] Under these "no equity" scenarios, half of the nation's buyers were a short-downturn-in-the-market away from owing more on their homes than the home was worth. And that is just what happened. The result, by mid 2008, was that a greater percentage of people were upside down in their mortgages than during any time in history since the Great Depression.[16] And, with so many homeowners with little-to-no money invested into their homes (as a result of no money down mortgage lending) and zero to negative equity positions, foreclosures jumped dramatically.

Second, the mortgage securities market exacerbated the problem by encouraging subprime lending and even discouraging prime lending. In the 1930s the government created Fannie Mae to help fund the primary mortgage market.[17] Eventually this entity became a government-sponsored entity ("GSE"). Fannie provided a market for the sale of mortgagor obligations, which provided more capital to the primary market. The positive result was that more money flowing into the secondary market provided more money in the primary market—resulting in more home loans. This revolution in mortgages, created by the inception of a bona fide secondary market, provided a way to finance more mortgages and therefore begin the steep climb out of the financial dregs of the Great

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[12] Alphonso Jackson, Remarks at Access Across America Economic Empowerment Summit (Oct. 14, 2004), *available at* www.hud.gov/news/speeches/2004-10-14.cfm.

[13] *See* Federal Housing Administration, Neighborhood Gold Down Payment Assistance, http://www.fha-home-loans.com/neighborhood_gold_down_payment_assistance_program.htm (providing that the Gold Account is a type of escrow account/vehicle allowing the seller to contribute to the buyer's downpayment in a real estate closing).

[14] Dave Ramsey, *Is an 80/20 Mortgage a Good Idea*?, WORLDNETDAILY, Apr. 20, 2005, http://www.wnd.com/index.php?pageId=29928.

[15] *Id.*

[16] Edmund L. Andrews & Louis Uchitelle, *Rescues for Homeowners in Debt Weighed*, N.Y. TIMES, Feb. 22, 2008, at A1.

[17] About Fannie Mae, http://www.fanniemae.com/aboutfm/charter.jhtml (last visited Sept. 13, 2009).

Depression. When the secondary market needed more capital to buy loans from the primary market it would bundle the loans and sell mortgagor-payment-rights to investors. This securitization process by Fannie and other GSEs is known as mortgage-backed securitization.[18] The key to understanding why securitization corrupted the entire mortgage system is recognizing that the flow of money into the mortgage industry is based upon securitization. These pools of securitized loans include both prime and subprime loans. To increase investor interest in subprime loans, many Wall Street companies preferred that primary lenders gather less borrower documentation, making the borrower's profile more opaque and thus more attractive.[19] This provided primary market lenders with incentive to sell loans without mortgagor documentation—called "no doc loans" (applications lacking tax returns, income statements, bank statements, etc).[20] Thus, loose mortgage securitization standards spawned loose mortgage lending practices, which opened the door for fraud and irresponsible lending and borrowing.[21]

Third, a housing bubble developed as a result of low interest rates and low threshold loans. These two factors had been important barriers that kept real estate purchases down. With both barriers to entry eliminated, homebuyers rushed to take advantage of low interest rates set by the Federal Reserve (the "Fed") and for the first time ever subprime buyers were able to join the buying frenzy with little or no money down. The bubble became a problem when irrational exuberance deflated and prices subsequently declined.[22]

Normally when a person loses their job, or their adjustable rate mortgage adjusts and makes the loan too expensive, the owner can just sell

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[18] U.S. Securities and Exchange Commission, Mortgage-Backed Securities, http://www.sec.gov/answers/mortgagesecurities.htm (last visited Sept. 13, 2009).

> Mortgage backed securities (MBS) are debt obligations that represent claims to the cash flows from pools of mortgage loans, most commonly on residential property. Mortgage loans are purchased from banks, mortgage companies, and other originators and then assembled into pools by a governmental, quasi-governmental, or private entity. The entity then issues securities that represent claims on the principal and interest payments made by borrowers on the loans in the pool, a process known as securitization. Most MBSs are issued by the Government National Mortgage Association (Ginnie Mae), a U.S. government agency, or the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), U.S. government sponsored Enterprises.

Id.

[19] Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 2048–49 (2007).

[20] *Id.*

[21] *See id.* at 2049 (discussing the securitization of mortgage loans and the connection with subprime lending); ROBERT SHILLER, THE SUBPRIME SOLUTION: HOW TODAY'S GLOBAL FINANCIAL CRISIS HAPPENED AND WHAT TO DO ABOUT IT 1–10 (2008) ("The stage was perfectly set for unscrupulous mortgage originators to lend to low income people who were likely to default, and for mortgage securitizers to sell the soon-to-default mortgages off to unsuspecting investors.").

[22] *See* SHILLER, SUBPRIME SOLUTION, *supra* note 21, at 1–10.

their home. But, after the housing market boomed and then subsequently deflated, many owners owed the bank more for their home than the market was willing to pay. As a result, a person whose life circumstances required them to sell their home was forced to either pay the difference (often an impossible proposition for an already financially distressed seller) or stop making full payments and take steps toward inevitable foreclosure. A report in late 2008 found that among persons who purchased homes between 2003 and 2008, 29% owed more on their home than the home was worth.[23] Approximately twelve million homeowners faced a serious risk of foreclosure by late 2008, representing nearly sixteen percent of all homeowners in the country.[24] And, in 2008, foreclosure filings were up approximately 81% from 2007 and 225% from 2006.[25]

Fourth, the mortgage problem became a disaster because lending institutions were undercapitalized, insufficiently insured, and held and offered portfolios that were not properly diversified. There were several ways in which the lending institutions failed to hedge against risk: (1) they did not invest in collateral that tends to rise in value when other collateral tends to decrease (hedge); (2) they failed to purchase sufficient insurance against expansive assets for which they were exposed; (3) they failed to develop the necessary reserves to facilitate liquidity in times of crisis; and (4) they failed to underwrite conservatively. Importantly, the cost of foreclosure became even greater during the economic downturn, because the value of the collateral declined. In a stable economy, banks can expect to lose an average of 29% of the loan amount in the process of foreclosing on a house to recoup the collateral funds.[26] In 2008 and much of 2009, banks were losing approximately 44% of the loan amount, as a result of significant market decline.[27] Unfortunately, as of late 2008 only about 10% of the country's mortgage debt was insured,[28] and among insured lenders, most are only insured up to 20%.[29] This means that the average lending institution is exposed to significant risk, and more importantly, in

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[23] James R. Hagerty & Ruth Simon, *Housing Pain Gauge: Nearly 1 in 6 Owners "Under Water*,*"* WALL ST. J., Oct. 8, 2008, at A5.

[24] *See id.* (noting that twelve million homeowners were underwater).

[25] Stephanie Armour, *2008 Foreclosure Fillings Set Record*, USA TODAY, Jan. 15, 2009, at 1B; *see also* Stephanie Armour, *Foreclosures Up: 1 in 84 Homes Affected in First Half of Year*, USA TODAY, July 16, 2009, at 3B (reporting nearly two million foreclosures during the first six months of 2009).

[26] Damian Paletta et al., *U.S. Steps Up Help for Homeowners*, WALL ST. J., Nov. 12, 2008, at A3.

[27] *Id.*

[28] *See* discussion *infra* Part IV.A. (discussing data illustrating that mortgage insurance is primarily provided by three entities: the Federal Housing Administration, the Veterans Administration, and the private mortgage industry: Together these three providers of insurance insure approximately $1.5 trillion in debt. Comparatively, the nation's consumers currently have over $13 trillion in outstanding mortgage debt.).

[29] MORTGAGE INSURANCE COMPANIES OF AMERICA, 2008–2009 FACT BOOK & MEMBER DIRECTORY 6 (2008–09) [hereinafter MICA FACTBOOK] (discussing that private mortgage insurance companies generally cover twenty percent).

an era where companies are "too big to fail," this problem puts the entire economic system at risk.

Thus, in the wake of mortgage catastrophe, the government was forced to seize and bail out Fannie Mae and Freddie Mac—mammoth secondary market mortgage holders—by dedicating two hundred billion dollars of taxpayers' money.[30] Only a few weeks later, Congress voted to allow the Treasury to bail out banks and other financial intermediaries linked indirectly to the mortgage market by passing a bill to inject seven hundred billion dollars into the economy.[31] The Secretary of the Treasury, Henry Paulson, stated that he, too, believed the mortgage lending institutions and the products they sold were at the root of the financial crisis: "The underlying weakness in our financial system today is the illiquid mortgage assets that have lost value as the housing correction has proceeded. . . . As we all know, lax lending practices earlier this decade led to irresponsible lending and irresponsible borrowing."[32]

B. *Why Recent Government Action Has Not Provided a Viable Solution*

Another significant part of the 2008 financial problem was that the government reacted, as opposed to acted, and was forced to do so hastily, as opposed to thoughtfully. The government's overall "plan" emerged in three distinct phases: (1) to stop recession; (2) to stop contagion; and (3) to avoid depression. Each of these steps was defensive—as opposed to offensive—and was prompted by plans to stop the financial crisis from spreading. While these phases have been somewhat effective, government intervention has failed to address the crux of the financial problem—the need for meaningful reform in the mortgage industry. The government's actions within each of these phases of government intervention has provided a short term solution for a long-term problem. More specifically,

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[30] Pedro Nicolaci Da Costa, *Fannie, Freddie Bailout Greeted with Cautious Optimism*, REUTERS, Sept. 8, 2008, http://www.reuters.com/article/topNews/idUSN0527106320080909.

[31] Alan S. Blinder, *Got $700 Billion? Sweat the Details*, N.Y. TIMES, Oct. 11, 2008, at BU1.

[32] Henry Paulson, U.S. Dep't of the Treasury, Remarks at the Press Room, Sept. 19, 2008, *available at* http://www.ustreas.gov/press/releases/hp1149.htm. Paulson continued:

> What began as a subprime lending problem has spread to other, less-risky mortgages, and contributed to excess home inventories that have pushed down home prices for responsible homeowners.
>
> A similar scenario is playing out among the lenders who made those mortgages, the securitizers who bought, repackaged and resold them, and the investors who bought them. These troubled loans are now parked, or frozen, on the balance sheets of banks and other financial institutions, preventing them from financing productive loans. The inability to determine their worth has fostered uncertainty about mortgage assets, and even about the financial condition of the institutions that own them. The normal buying and selling of nearly all types of mortgage assets has become challenged.
>
> These illiquid assets are clogging up our financial system, and undermining the strength of our otherwise sound financial institutions.

Id.

each government initiative has failed to provide protection against future systemic financial failure, and in some instances, government action has actually increased market exposure to systemic calamity.

1. *Avoid Recession*

First, in order to slow recession, the Fed cut interest rates for several consecutive months until it finally reached one percent on October 29, 2008.[33] That ultra-low rate represented the lowest rate—and as such was arguably the most drastic Fed action—since Dwight Eisenhower was president.[34] Ever since the stock market crash of 1929, the Fed has been under significant pressure to lift rates when the country's finances tighten.[35] The theory is that after an economic bubble bursts, or after a major catastrophe (like the recent precipitous decline of housing prices and simultaneous spike in foreclosures), the market slows because investors are hesitant to inject capital into a risky economy—effectively declining to throw good money after bad and banks horde money in order to shore up capital reserves. The result causes a negative feedback loop that ultimately leads to recession. Investor caution results in less capital in the secondary mortgage market, which leads to less capital in the primary mortgage market. This chain reaction creates an increasingly difficult financial environment for homebuyers to qualify for loans. If qualifying for a home loan becomes increasingly difficult, then there is less demand for homes in the market; this results in less building of homes and prices are then lowered to compete against the increase of homes for sale (high supply, low demand). This process causes builders and construction workers to lose jobs, which results in an economy with even fewer buyers. Thus, the whole system is cyclical. So, when the Fed lowers interest rates it allows banks to more easily borrow funds from the Fed's discount window or through the Federal Reserve Fund, and the process injects capital into the slowing economy to stop the negative feedback loop.

But, when the Fed is forced to lower interest rates considerably, it

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[33] Mark Thomas, *Fed Cuts Target Rate to One Percent*, ECON. VIEW, Oct. 29, 2008, http://economistsview.typepad.com/economistsview/2008/10/fed-cuts-target.html ("The pace of economic activity appears to have slowed markedly, owing importantly to a decline in consumer expenditures. Business equipment spending and industrial production have weakened in recent months, and slowing economic activity in many foreign economies is damping the prospects for U.S. exports. Moreover, the intensification of financial market turmoil is likely to exert additional restraint on spending, partly by further reducing the ability of households and businesses to obtain credit.").

[34] Rupert Cornwall, *Half Point Cut Takes U.S. Into Interest Rates Lowest Level Since Eisenhower*, INDEP. BUS., Nov. 7, 2008, http://www.independent.co.uk/news/business/news/halfpoint-cut-takes-us-interest-rates-to-lowest-level-since-eisenhower-era-616173.html.

[35] MILTON FRIEDMAN, FREE TO CHOOSE 79–83 (1980) ("The stock market crash was important, but it was not the beginning of the depression . . . . These depressing effects of the stock market crash were strongly reinforced by the subsequent behavior of the Federal Reserve System . . . . [T]he fed's actions were hesitant and small. In the main, it stood idly by and let the crisis take its course—a pattern of behavior that was to be repeated again and again during the next two years.").

exposes the economic system to risk, because it is one of the most effective means for fighting recession—and once it is used, it is used. This concept led Alan Greenspan to refer to raising interest rates in anticipation of economic trouble as building "a bit of insurance"[36]—that is, by raising interest rates, the Fed is able to prepare the effectiveness of its weapon for use in times of economic trouble. Supporting this theory, others have warned, "the Fed probably would want to stop short of zero, so it saves its precious ammunition."[37] With the rates already at record lows during 2008 and 2009, the Fed's strongest tool for jumpstarting the economy was exhausted. In sum, the Fed correctly lowered interest rates to avoid recession, but the U.S. economic system would be less volatile and would be exposed to less risk if this action was not the first measure taken (or the first measure available)—since it may also be the last hope.

In the past, we have seen that different industries are so massive that turbulence within one industry can derail the entire market. The bank panic of 1907 seized the entire economy; the stock market crash of 1929 set off the Great Depression; the mortgage and housing fallout of 2007 has similarly slowed the entire financial system—banks, stocks, lenders, builders, and the auto industry have all begun to fail as a result.[38] For this reason, systemic risk is best restrained by establishing capital reserves, insurance, and financial safeguards within each individual market within an economy. By stabilizing individual companies, industries, and markets we can ensure that entire economies do not totally collapse and set off nationwide financial failure. Serially cutting interest rates—effectively giving out free government loans—only precipitates irresponsible lending and leaves the economy exposed to greater risk.

2. *Avoid Contagion*

The second phase of government action was to avoid contagion. As the financial crisis continued, the government was forced to take additional action to contain the deterioration of the financial markets, due to a few bad assets and failing companies. Many companies in dire straits were considered by the government to be "too big to fail"—that is, companies that were so big that bankruptcy would cause a domino effect and slow or stop the entire economy. This concept of too big to fail did not originate

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[36] GREENSPAN, *supra* note 1, at 201–02.

[37] Jeannine Aversa, *How Low Can the Fed Go On Interest Rates?*, INT'L BUS. TIMES, Oct. 29, 2008, http://www.ibtimes.com/articles/20081029/analysis-how-low-can-fed-go-on-interest-rates.htm.

[38] GREENSPAN, *supra* note 1, at 513 ("Why for the first time in eight decades, did banks and the securities markets get hit hard simultaneously? The answer appears to be that both now draw increasingly on the same sources of funds. For much of the twentieth century, savers' deposits, largely insured by the federal government, were the main source of funding for banks, while securities firms relied on investors for their short-term funds. Savers are legendarily "passive"—for instance, in the late 1970s, even as interest rates on safe, short-term investments climbed into double digits, many bank customers doggedly kept their money in fixed rate 5.5 percent passbook accounts.").

with the 2008 financial crisis; rather, it was introduced during the Dot Com Era. In 1998, one of Wall Street's largest and most successful hedge funds—Long Term Capital Management ("LTCM")—was saved by the Fed because it was seen by many as too big to fail:

> [The New York Fed] literally gathered top officials of sixteen of the world's most powerful banks and investment houses in a room; suggested strongly that if they fully comprehended the losses they would face in a forced fire sale of LTCM's assets they would work it out; and left. After days of increasingly tense negotiations, the bankers came up with an infusion of $3.5 billion for LTCM.[39]

This injection of money under the direction of the Fed gave LTCM enough capital to sell off its assets in an orderly way and close its doors without causing systemic calamity. *The New York Times* announced the Fed's intervention on the front page: "Seeing a Fund as Too Big to Fail, New York Fed Assists Its Bailout."[40]

Early in 2008, Bear Stearns began to show signs of financial instability. After fully considering the size of Bear Stearns and its influence on the market, the Treasury Secretary began attempts to broker a shotgun marriage with another large intermediary.[41] With some work, JP Morgan Chase offered to purchase the failing institution, but only after the government contributed an extra twenty-nine billion dollars to make the merger work.[42]

In the wake of the Bear Stearns bailout, the government elected to provide taxpayer support for Fannie Mae and Freddie Mac.[43] The

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[39] *Id.* at 195.

[40] Gretchen Morgenson, *The Markets; Seeing a Fund as Too Big To Fail, New York Fed Assists Its Bailout*, N.Y. TIMES, Sept. 24, 1998, at A1. Indeed, the *Times* article described the Fed's action:

> The Federal Reserve Bank of New York has helped organize the rescue of a large and prominent speculative fund, indicating that regulators recognize that the failure of such a fund would damage already fragile world markets. Under an agreement reached late yesterday, the fund, Long-Term Capital Management L.P. of Greenwich, Conn., received a cash infusion of more than $3.5 billion from a consortium of commercial banks and investment firms. The fund, whose founder is John Meriwether, a former vice chairman of Salomon Inc., and whose partners included two Nobel prize winners, is said to be have a portfolio worth $90 billion. The deal came after representatives of 16 banks and brokerage houses met at the offices of the Federal Reserve Bank of New York in downtown Manhattan. It is extremely unusual for the Federal Reserve to get involved in the bailout of such a fund, known as a hedge fund, a virtually unregulated type of investment firm, which despite its name, speculates in high-risk trades in markets around the world.

Id.

[41] Kate Kelly, *Bear Stearns Neared Collapse Twice in Frenzied Last Week*, WALL ST. J., Mar. 29, 2008, at A1.

[42] Landon Thomas, Jr. & Eric Dash, *Seeking Fast Deal, JP Morgan Quintuples Bear Stearns Bid*, N.Y. TIMES, Mar. 25, 2008, at C1.

[43] Zachary A. Goldfarb et al., *Treasury to Rescue Fannie and Freddie: Regulators Seek to Keep Firms' Troubles From Setting Off Wave of Bank Failures*, WASH. POST, Sept. 7, 2008, at A01.

government seized and supported the two entities—with the use of taxpayer dollars—when their books began to show a catastrophic financial future.[44] The government effectively placed Freddie and Fannie into "conservatorship"—a euphemism for declaring bankruptcy—and provided a government bailout.[45]

During just one year, the government has committed hundreds of billions of dollars to bailing out dozens of companies: (1) $45 billion to the Bank of America; (2) $50 billion to Citigroup; (3) $70 billion to AIG; (4) $85 billion to the auto industry—General Motors and Chrysler; (5) $7 billion to GMAC bank; (6) $25 billion to JP Morgan Chase; and (7) $25 billion to Wells Fargo.[46]

The problem with the steps the government has taken to stop contagion is that it has effectively made institutions that are "too big to fail," bigger. In the case of Morgan Stanley, Goldman Sachs, and American Express, the government has allowed these entities access to the Fed's discount window without requiring compliance to the stricter bank holding company standards, for two years—maybe more.[47] Without the government's money giveaway and money-sweetened merger techniques, these entities would likely have been split up and sold, resulting in fewer "too big to fail" companies. Ultimately, propping up mammoth institutions on the brink of tumbling into smaller institutions may only put off and increase the damage of an inevitable financial cataclysm.

3. *Avoid Depression*

During the latest phase, the government acted to avoid depression.[48] Accordingly, the Secretary of the Treasury, Henry Paulson, presented a seven hundred billion dollar bailout plan for American corporations.[49] With an increasing number of too big to fail companies failing, the Treasury and Fed created a plan that would allow federal funds to be allocated largely at Paulson's discretion and primarily as funds for bailouts

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[44] *Id.*
[45] *Id.*
[46] Matt Erickson et al., *Tracking the 700 Billion Dollar Bailout*, N.Y. TIMES, June 24, 2009, http://projects.nytimes.com/creditcrisis/recipients/table.
[47] Kristin Jones, *Why is Everyone Becoming a Bank Holding Company*?, PROPUBLICA, Nov. 12, 2008, http://www.propublica.org/article/why-is-everyone-becoming-a-bank-holding-company-1112 ("The Fed has said that the companies have two years to comply with the stricter regulations on bank holding companies, and it will allow extensions of a year at a time.").
[48] In some respects these "phases" overlapped and could be seen as one grand effort to avoid depression. Although, as the economy worsened and contagion inevitably spread (or threatened to spread) Congress became increasingly willing to act aggressively to avoid widespread economic depression—as displayed in the final months of 2008.
[49] Henry Paulson, *Text of Draft Proposal for Bail Out Plan*, N.Y. TIMES, Sept. 20, 2008, http://www.nytimes.com/2008/09/21/business/21draftcnd.html.

and to purchase troubled assets.[50] Secretary Paulson and Fed Chairman Bernanke both testified in front of Congress to garner support for the bailout strategy. They proposed several arguments to garner support for the plan, including that: it would stabilize the economy, it would improve liquidity, it would provide a comprehensive strategy, it would bring immediate action, it would have a broad impact, and it would stimulate investor confidence.[51]

Another course of action taken by the government to avoid depression was to inject capital into the market through the country's largest banks.[52] On October 13, the chief executives of the country's nine largest banks filed into a conference room where Secretary Paulson told them all that the government was forcing them to accept government share purchases.[53] The nine banks included Bank of America, JPMorgan Chase, Wells Fargo, Citigroup, Merrill Lynch, Goldman Sachs, Morgan Stanley, Bank of New York Mellon, and State Street.[54]

The problem with the government's final course of action was that for decades owners of private corporations have enjoyed significant profits and the public has not shared in those profits. Now, in an effort to avoid depression, the Fed and Treasury were acting as insurers and socializing the losses of the country's largest institutions. If the government is proving that these institutions need insurance, then it makes sense that they should be properly insured—and more importantly that the premiums should be paid by the institutions, not taxpayers. Privatizing profits and socializing losses creates moral hazard.[55]

To date, the government has failed to attach proper requirements (like requiring future insurance or significantly increased capital requirements) upon those institutions that are receiving handouts. This "government insurance" in the form of a "bailout plan" without a requirement that the institutions commit to an industry insurance in the future, exposes the nation to rampant moral hazard and ultimately to increased systemic risk.

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[50] Daniel Gross, *How the Bail Out is Like a Hedge Fund*, SLATE, Oct. 1, 2008, http://www.slate.com/id/2201340/.

[51] Ben Bernanke, Address Before the Senate Committee on Banking, Housing, and Urban Affairs (Sept. 23, 2008), *available at* http://www.treas.gov/press/releases/hp1153.htm.

[52] Mark Landler & Eric Dash, *Drama Behind a Banking Deal*, N.Y. TIMES, Oct. 15, 2008, at A1.

[53] *Id.*

[54] *Id.*; Deborah Solomon et al., *U.S. to Buy Stakes in Nation's Largest Banks*, WALL ST. J., Oct. 14, 2008, at A1.

[55] Daniel Henninger, *Welcome to 'Moral Hazard'*, WALL ST. J., Oct. 2, 2008, at A17 ("'Moral hazard' dates back hundreds of years in obscurity, but its use eventually settled inside the insurance business in the 19th century. The French call it *risque moral*. Back then, it really was taken to mean that reducing risk too much exposed people to the hazard of poor moral judgments. If an insurer charged too little for a policy to replace farms in the English countryside, Farmer Brown might be less careful about cows knocking over oil lamps in the barn.").

C. *Finding the Middle Ground for Dealing with Systemic Risk*

Another hurdle to hedging against systemic risk by reforming mortgage law is dealing with the polarized opinion about how to deal with systemic risk. It is true that fundamentally dissimilar perspectives will usually balance our federal economic agenda, but diametrically opposed ideals can significantly retard the progress of efficient and helpful industry reform.

1. *One View: It Is Not Congress's Job to Govern Mortgage Reform*

Generally speaking, conservative thinkers want the government to shrink and impose less regulation. This perspective is rooted in the idea that the free market will provide its own oversight and that investors will look out for themselves and protect their assets as long as government does not take away critical hedging tools. From this federalist perspective, it is not the central government's job to quell systemic risk. Rather, it is the federal government's job to protect the citizen's right to invest, buy, and sell. Promoters of this school of thought agree that the very act of financial self-protection, by everyone in a free market, provides the optimum safeguard against systemic calamity.[56]

Defenders of conservative free market thinking assert that the recent mortgage meltdown was exacerbated by market-meddling-liberals who required low income financing and rallied around concepts of "housing for everyone"—even those who could not afford a home.[57] One of the most prominent and ardent supporters of the free market correction theory is—or, rather, was—Alan Greenspan, who preached deregulation for decades while he labored as Federal Reserve Chairman. While he acknowledged that markets could become inflated and instable, he also believed that investors interested in preserving their own cash would protect themselves—and thus protect the economy. Contributing to free market thinking, many economists believe that "markets have become too complex for effective human intervention," and "the most promising anti-crisis policies are those that maintain maximum market flexibility."[58]

Thus, in light of possible mortgage reform, conservative thinking warns that Congress's meddling with regulation and market constraints would potentially superficially kink and clog market efficiencies, which in

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[56] GREENSPAN, *supra* note 1, at 489, 523.

[57] The Mortgage Lender, Implode-O-Meter, http://ml-implode.com/sfdpacampaign.html (last visited Oct. 15, 2009) (rallying opposition to a recent congressional efforts to lower thresholds for consumers in the housing market).

[58] GREENSPAN, *supra* note 1, at 489, 523 ("[Governments and Central banks are] unable to effectively thwart the waves of speculation, the best strategy is to ensure that our markets at all times have enough flexibility and resilience, unencumbered by protectionism or rigid regulation, to absorb and mitigate the shock of crisis.").

turn would expose the economy to greater systemic risk.[59] Additionally, in an increasingly complex and fast-paced marketplace, free marketers may assert that that government intervention—in an industry like mortgage lending—would only slow production and provide no real ability to anticipate or quell systemic risk.[60]

2. *Another View: It Is Congress's Job to Head Mortgage Reform*

On the other hand, liberal thinkers assert that the financial crisis of 2008 is a verdict against the failed policies of the Bush administration and the conservative ideals of deregulation.[61] Supporters of this school of thought are persuaded that the federal government should intervene and be an active regulator of markets in order to safeguard against systemic risk. Additionally, liberal thinkers believe that necessary regulations extend to health care, job security, and ultimately wealth distribution—balances that keep the free market from imploding. Under this line of thinking, mortgage regulation should be centralized and be conducted by the federal government.

Prominent Yale scholar Robert Shiller asserted that market exuberance should be dealt with by (1) influence, (2) statute, and (3) ongoing regulation. Shiller asserted that economic bubbles are the result of investment ignorance, fueling media influences, and conflicts of interest.[62] In his book *Irrational Exuberance*, he suggested that economic experts, government authorities, and trusted leaders of our country, have the responsibility of blowing the whistle on inflated prices and dangerous

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[59] Dorit Samuel, *The Subprime Mortgage Crisis: Will New Regulations Help Avoid Future Financial Debacles?*, 2 ALB. GOV. L. REV. 217, 255 (2009) ("In general, it is the free markets, unencumbered by regulations, that are more creative and experience the fastest growth. . . . A heavily regulated market might have lower volatility, but it is also more cumbersome and slow in developing new and creative financial products that stimulate growth. The solution to our financial problems is not to invest our resources in a new and restrictive system of regulations that is not flexible enough to keep pace with a complex, innovative and increasingly global financial world."); GREENSPAN, *supra* note 1, at 174–75 ("A stock market boom, of course, is an economic plus—it predisposes businesses to expand, makes consumers feel flush, and helps the economy to grow. . . . Only when a collapsing market might threaten to hamstring the real economy is there cause for people like the Treasury Secretary and the Chairman of the Fed to worry. . . . [This] sort of disaster happen[ed] in Japan, where the economy was crippled from a stock and real estate collapse in 1990.").

[60] GREENSPAN, *supra* note 1, at 490 ("In today's world, I fail to see how adding more government regulation can help. Collecting data on hedge fund balance sheets, for example, would be futile, since the data would probably be obsolete before the ink dried. . . . I have been dealing with financial market reports [within private equity funds] for almost six decades. I would not be able to judge from such reports whether concentrations of positions reflected markets in the process of doing what they are supposed to do or whether some dangerous trading was emerging. I would truly be surprised if *anyone* could.").

[61] Mark Shields, *The Verdict is In on Deregulation*, LEDGER ENQUIRER, June 6, 2009, http://www.ledger-enquirer.com/sunday_voices/story/740725.html; John Gard, *Economic Crisis Marks Final Verdict on Deregulation Policies Championed*, HIGHBEAM, Oct. 3, 2008, http://www.highbeam.com/doc/1P3-1569171261.html.

[62] ROBERT SHILLER, IRRATIONAL EXUBERANCE 203–33 (2000).

speculation before they reach systemic proportions.[63]

Accordingly, while the country's real estate prices were overheating and the mortgage lending industry was negligently successful, Shiller responded in 2008 by writing a book entitled *The Subprime Solution: How Today's Global Financial Crisis Happened and What To Do About It*. In his book, Shiller called for a complete restructuring of the country's financial systems.[64] According to this line of thinking, the mortgage lending system overhaul should begin with increased regulation, legislation, and oversight.

3. *The Dilemma: Finding Middle Ground and Moving Forward*

One of the dilemmas that has consistently stagnated mortgage reform in the United States is that there are such stark differences in fundamental beliefs about how to make the industry more efficient and less volatile. These opposing opinions have stalemated mortgage reform for decades. In fact, mortgage reform has been largely unsuccessful and unpopular until recent years.

Part of the genius of a two-party system is that there is usually a middle ground that opposing schools of thought can agree upon in order to move forward with reform. Fortunately, with mortgage reform, the traditionally narrow middle ground may be temporarily broadening in light of the recent catastrophic financial issues now facing the country. A prime example is the fact that some staunch deregulators are gravitating toward the middle.[65] In early November of 2008, Alan Greenspan testified before the House Committee that he had perhaps been wrong to rely on the self-correcting ability of the free market—particularly in regard to wanton mortgage spending.[66] When Greenspan was asked if he thought he had been wrong about promoting deregulation for nearly two decades, he answered by admitting "partially."[67]

Thus, just as in the days of the Great Depression, catastrophe has ripened sentiment to pursue significant reform of a system that is obviously in great need of it. Formerly opposing parties are beginning to agree on the few fundamental elements of successful mortgage reform: that is to say

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[63] *Id.*

[64] SHILLER, SUBPRIME SOLUTION, *supra* note 221, at 107–69 (proposing that Congress instigate several programs, including (1) a new organization modeled after the Home Owners' Loan Corporation established in 1933; (2) a new information infrastructure (including improved financial disclosure of mortgage backed securities); (3) "new markets" to increase real estate liquidity (including a residential home-price futures market); and (4) new retail risk management institutions (including home equity insurance).

[65] Andrews, *supra* note 3.

[66] *Id.* ("Those of us who have looked to the self-interest of lending institutions to protect shareholders' equity, myself included, are in a state of shocked disbelief . . . . Yes, I've found a flaw [in my past ideology and logic]. I don't know how significant or permanent it is. But I've been very distressed by that fact.").

[67] *Id.*

there is widespread agreement that *some* regulation should be added, that capital reserves are absolutely necessary,[68] and that insurance is needed to protect the taxpayer from being the primary insurer.[69] The next step is to create an agreeable reformative framework upon which both regulatory agendas and deregulatory agendas can agree.

III. GUIDELINES FOR A WORKABLE SOLUTION

Before proposing a solution to the current financial calamity, it is helpful to first outline the general characteristics of a plan that would best resolve the problems that exist to avoid a similar crisis in the future. This section proposes three basic and general characteristics that represent a non-radical middle ground that could be adopted by both deregulators and regulators alike.

A. *The Solution Must Target Mortgage Reform*

As the previous section made clear, many of the country's financial problems stem from loose lending statutes that allowed irresponsible lending practices, which precipitated naïve, foolish, or selfish mortgages. Lending laws have evolved slowly because mortgage law has been primarily a state responsibility.[70] Even though the day-to-day oversight of mortgage lending has been primarily governed by individual state law, during the last half-century Congress has begun to impose a few broad restrictions that have served as benchmarks, or industry minimum standards. Unfortunately, these broad federal benchmarks were not sufficient to screen fraudulent lending, creative financing, subprime lending, and even predatory lending. It would seem that the federal statutory benchmarks must be increased in order to be effective in today's modern economy. This section briefly outlines each of the major federal mortgage lending laws and provides a few reasons for reforming—or at least extending—each of these federal benchmarks.

1. *The Truth in Lending Act*

The Truth in Lending Act ("TILA") was enacted by Congress in 1968 to achieve greater transparency in lending laws.[71] Congress hoped that "economic stabilization would be enhanced and the competition among the various financial institutions and other firms engaged in the extension of consumer credit would be strengthened by the informed use of credit."[72]

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[68] Congress recently conceded the need for capital reserves by accepting Secretary Paulson's radical trillion-dollar plan to bailout Wall Street.

[69] Jonathan Koppell, *A Failure Tax*, N.Y. TIMES, Sept. 18, 2008, at A27.

[70] *See infra* Part III.B.2.

[71] Truth in Lending Act, 15 U.S.C. § 1601 (2000).

[72] *Id.*

Since 1968, additional regulations were added to the Act, most notably, Regulation Z.[73] The main thrust of Regulation Z was to provide increased disclosure to assist consumers in deciding between varying types of loans. This increased transparency provided increased consumer education and made significant steps toward preventing loan fraud. According to Regulation Z, the lender must disclose the federal annual percentage rate ("APR"), disclose finance charge requirements, adhere to credit provisions, provide rights of rescission, and adhere to stricter advertising schemes.[74] Perhaps the most popular provision is the borrowers right to rescission within three days of signing the loan documents—also known as the "buyer's remorse provision."[75]

While TILA has provided many useful foundational guidelines for requiring creditors to disclose the costs of credit, it does not sufficiently warn borrowers about the intricacies of mortgage financing.[76] Admittedly, the lending process is complicated and ensuring that mortgagors are fully informed would be a daunting task. However, other industries have begun to provide innovative means for informing consumers. For example, some student loans explain terms and obligations by video; other student loans teach by testing the loan applicant's understanding during each segment of the educational process. Less expensive student loan tutorials provide reading material accompanied by a similar exam format. Likewise, TILA could be modernized to move from passively disclosing lender information to actively teaching the consumer. A heightened comprehension standard imposed by the federal government would lead the mortgage industry to take steps toward achieving the increased conventional wisdom that Shiller predicted would work to slow irresponsible investing.[77]

2. *The Real Estate Settlement Act*

The Real Estate Settlement Act ("RESPA") was created by Congress in order to accomplish two goals: first, to ensure that consumers would be provided with "greater and more timely information on the nature and costs of the settlement process" and second, to protect consumers from unnecessarily high settlement charges caused by "certain abusive practices" that had developed all over the country.[78] The regulations enumerated in RESPA fall under four primary categories: (1) to require

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[73] 12 C.F.R. § 226.1 (2009).

[74] *Id.*

[75] Truth in Lending Act, 15 U.S.C. § 1635(a) (2000).

[76] Lisa Keyfetz, *The Home Ownership and Equity Protection Act of 1994: Extending Liability for Predatory Subprime Loans to Secondary Mortgage Market Participants*, 18 LOY. CONSUMER L. REV. 151, 173 (2005) ("The statute requires creditors to provide borrowers with standard disclosures regarding the costs of credit. However, TILA was not created to respond to the deceptive and abusive practices which developed specifically in the home-equity market.")

[77] SHILLER, IRRATIONAL EXUBERANCE, *supra* note 62, at 224–33.

[78] The Real Estate Settlement Act, 12 U.S.C. § 2601 (2000).

disclosure prior to the day of the closing; (2) to eliminate kickbacks and referral fees that cross industries and undermine client representation; (3) to reduce the escrow amounts required for taxes and insurance; and (4) to increase lender recordkeeping to facilitate transparency.[79] Among the most well-known of the RESPA requirements is that the lender must provide each buyer with a previously-prepared government agency booklet.[80] Also, the lender must include a good faith estimate the specific charges the borrower is likely to incur should he or she determine that the loan is satisfactory.[81] The statute also requires that a Uniform Settlement Statement ("HUD form") be provided to "conspicuously and clearly itemize all charges imposed upon both the borrower and all charges imposed upon the seller, in connection with the settlement."[82]

While RESPA includes many notable requirements, it fails to specifically curb questionable fees and practices that commonly deceive buyers—particularly subprime buyers. Among the questionable practices that have managed to slip through the cracks of RESPA is the yield spread—a bonus paid to lenders for selling higher rates which is often not disclosed to the consumer. Additionally, policing of RESPA requirements is rare; for example, closing documents are often prepared the day of settlement, leaving insufficient time for meaningful disclosure of all the facts.

3. *The Home Ownership and Equity Protection Act*

The Home Ownership and Equity Protection Act ("HOEPA") was adopted by Congress in 1994.[83] HOEPA was established primarily to combat predatory lending.[84] The law prohibits loans from including certain abusive terms, and also expands TILA's disclosure requirements. Unlike TILA, which applies to every residential mortgage loan, HOEPA applies only to a certain class of "High Cost Mortgages."[85] Under HOEPA, certain problematic mortgages trigger red flags which require heightened regulation and disclosure requirements. These triggers include: (1) high-cost mortgages, negative amortization loans, or zero interest loans; (2) loans that subject the borrower to high cost late payments; (3) loans that have high-penalty interest rates; (4) loans that include balloon

[79] *Id.*

[80] *Id.* § 2604(a)–(b).

[81] *Id.* § 2604(c).

[82] *Id.* § 2603. This form was later created by the division of Housing and Urban Development and came to be known as the HUD form. Ironically, the government-established HUD form is less than intuitive and arguably not conspicuous about back end fees and kickbacks that do not *directly* affect the buyer or seller's bottom line. *See infra* Part IV.B.2. (discussing the covert "yield spread premium" and its *indirect* effect on the borrower's monthly payments).

[83] The Homeownership and Equity Protection Act, 15 U.S.C. § 1639 (2000).

[84] Keyfetz, *supra* note 76, at 173–76.

[85] *Id.*

payments beyond five years; and (5) loans to candidates that are qualified strictly by collateral without regard to the borrower's ability to make the predetermined payments.[86]

While many of the provisions are significant, a major criticism of HOEPA is that the triggers are not inclusive enough to stop most predatory lending that occurred throughout the subprime lending crisis and that the statute of limitations is too limiting.[87] As a result, HOEPA did not have enough "teeth" for most loans and allowed the extensive predatory lending to occur under the radar of the HOEPA "trigger requirements."

4. *The Fair Housing Act*

The Fair Housing Act of 1968 was passed by Congress as Title VIII of the Civil Rights Act.[88] This act requires owners, sellers, landlords, and maintenance companies to give equal opportunity to all classes of people in the housing market.[89] The focus of the statute is to provide equal rights for those seeking to purchase or rent real property, access broker representation, and utilize marketing services. The statute specifically protects individuals of different "race, color, religion, sex, familial status, or national origin."[90]

From a general perspective, this statute has provided significant protection for the classes defined therein. However, in the mortgage lending industry specifically, minorities are often the target for egregious subprime loans, termed by some as predatory loans. In fact, fifty percent of all subprime loans were issued within African American neighborhoods as compared to only nine percent in neighborhoods where whites were the majority.[91] Admittedly, Congress has worked to update some of these

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[86] 15 U.S.C. §§ 1639(a)–(c), (h); Emily Jeffcott, *The Mortgage Reform and Anti Predatory Act of 2007: Paving a Secure Path for Minorities in the Midst of the Sub Prime Debacle*, 10 ST. MARY'S L. REV. ON MINORITY ISSUES 449, 465–68 (2008).

[87] Keyfetz, *supra* note 76, at 189–90. Moreover:

> HOEPA's triggers, which are either set far above market interest rates, or are incredibly difficult to calculate, and therefore only capture a small percentage of the subprime home equity loan market. . . . [T]he statute contains several significant limitations: (1) A one-year statute of limitations for damages and three-year statute of limitations for rescission; (2) HOEPA's strict liability rescission remedy only applies to violations of HOEPA, rather than to "all claims and defenses" for the damages remedy; and (3) HOEPA's augmented due diligence requirement is ambiguous. In part, these limitations resulted unintentionally from sloppily drafting HOEPA within TILA's existing structural and remedial scheme. At the same time, the limitations were intentional compromises between advocates for borrowers and lenders. Either way, these limitations, along with HOEPA's very high triggers, have combined to leave few borrowers with the ability to take advantage of the rights created by HOEPA's assignee liability provisions.

Id.

[88] The Fair Housing Act, 42 U.S.C. §§ 3601–31 (2006).

[89] *Id.* § 3604.

[90] *Id.*

[91] Jeffcott, *supra* note 86, at 498 ("In totality, the subprime lending market has caused not only enormous damage to minorities and their communities, but also significant damage to the world

older federal laws in order to deal with predatory lending and egregious subprime lending.[92] But, these proposals offer only minor changes in specific products or limited practice areas. Additionally, current proposals for mortgage reform offer solutions with little to no federal infrastructure to provide centralized oversight, regulation, and follow up.

B. *The Solution Should Be Administered on the Federal Level*

The argument over which level of government should regulate each aspect of American life began during the 1700s and has persisted in politics to this day. The controversy over whether the federal or state governments should oversee mortgage reform has received similar attention.[93] While Congress has enumerated many broad mortgage regulations, critics maintain that these restraints have not been specific or expansive enough to curb the widespread predatory lending, irresponsible buying, and unjustified speculation.[94] In an effort to fill the federal regulatory gaps, some states have become increasingly aggressive in regulating the industry, and as a result—for example—approximately half of the states have developed some type of legislation to combat predatory lending.[95] In light of the nationwide financial crisis of 2008—which arguably stemmed from the country's inadequate mortgage regulation—the question of whether Congress should take additional regulatory steps, or leave the individual states to regulate, has become especially pressing. Perhaps the most important question in determining whether state or federal jurisdiction should head mortgage reform is the one posed by

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market. Because state regulation is limited, it is necessary to promulgate effective federal legislation that will tackle the roots and continuing effects of subprime lending.").

[92] In October of 2007, Bradley Miller sponsored a bill to amend TILA called the Mortgage Reform and Anti-Predatory Lending Act which was designed to address many predatory lending problems that occurred during the previous decade since TILA. The Mortgage Reform and Anti-Predatory Lending Act, http://www.thomas.gov/cgi-bin/bdquery/D?d110:4:./temp/~bdEcWL:@@@D&summ2=m&|/bss/d110query.html (last visited Oct. 1, 2008). In May of 2007, the Senate briefly considered and sent to committee another bill named the Borrower's Protection Act ("BPA"). The BPA attempts to establish a fiduciary duty between the mortgage broker and borrower in order to protect the borrower. The bill also established standards for assessing whether or not a borrower has the ability and financial capacity to repay a loan. The Borrower's Protection Act, http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_cong_bills&docid=f:s1299is.pdf (last visited Oct. 1, 2008).

[93] *See* Lloyd Wilson, *Sometimes Less Is More: Utility, Preemption, and Hermeneutical Criticisms of Proposed Federal Regulation of Mortgage Brokers*, 59 S.C. L. REV 62, 62 (2007) ("Regulatory responses to predatory lending have from the outset raised two interrelated questions: What kinds of regulations will best combat predatory lending and Who should enact those regulations? The former question asks what types of loan terms and lending practices should be proscribed or prescribed; the latter question asks which level of government, federal or state, is in the better position to make the policy judgments that inform the regulation of mortgage lending activities.").

[94] *See supra* Part III.A. (describing current federal mortgage laws and outlining some inefficiencies and shortcomings); *see also* Christopher L. Peterson, *Federalism and Predatory Lending: Unmasking the Deregulatory Agenda*, 78 TEMP. L. REV. 1, 7–8 (2005).

[95] Peterson, *supra* note 94, at 5.

Christopher Peterson:

> Is [] lending [reform] most akin to family law, criminal law, and small purely local commercial ventures, and therefore, most appropriately addressed by the states? Or, does [] lending more closely resemble foreign policy or interstate commerce and, accordingly, merit federal oversight? Or finally, is this a mixed-federal question deserving of shared responsibility?[96]

Some hold that relying on states to regulate mortgage lending has created a dizzyingly disparate patchwork of regulatory practices that has failed to ensure consistent consumer protection.[97] Conversely, others insist that federal attempts to regulate the mortgage industry through preemptive efforts have backfired and effectively worked to deregulate mortgage law in states that have made progressive strides toward mortgage reform.[98] The result—for the time being—is that mortgage regulation has become a delicate mixture of both federal and state oversight. This framework for legislation has caused state and federal authorities to point fingers at one another to take action, and has resulted in sluggish reform. This Note asserts that mortgage reform should be advanced by the central-federal government.

1. *Supreme Court Precedent*

Three landmark cases help provide a foundation and framework for any discussion dealing with whether to limit or expand federal legislative authority. In the first case, *McCulloch v. Maryland* the Supreme Court considered whether Congress had authority to create a federal bank and whether Maryland had the power to tax that bank.[99] The former question—most pertinent to this Note's proposal to create a Federal Mortgage Insurance Corporation—was answered by Justice Marshall who outlined four arguments supporting Congress' authority to charter a federal bank: (1) Congress had authority because of precedent stemming from the fact that it was a power previously used; (2) Congress had authority because states did not retain ultimate sovereignty evidenced in their ratification of the Constitution; (3) Congress had authority because the Constitution provided broad powers to Congress to enable it to perform in

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[96] *Id.* at 8 (discussing a series of questions about mortgage regulation that the author believes are important and pressing. Peterson, however, did not presume to answer the question: "I take no position on the level of government from which predatory lending policy should emanate.").

[97] *See* Jeffcott, *supra* note 86, at 455–56 ("The current legislation aimed at regulating subprime lending and preventing predatory lending has proven largely ineffective. . . . Because these statutes have not provided the necessary protection to borrowers, states have been forced to enact their own anti-predatory legislation, which has resulted in highly uneven practices among the states.").

[98] *See* Peterson, *supra* note 94, at 8.

[99] 17 U.S. (4 Wheat.) 316, 401 (1819).

a multitude of varying circumstances; and (4) Congress had authority under the necessary and proper clause.[100] The *McCulloch* decision helped set early precedent for construing congressional powers broadly, allowing Congress to intervene where activities had a substantial effect on interstate commerce.[101] This broad construction of the Constitution continued into the twentieth century.[102] In fact, between 1937 and 1995 the Supreme Court did not find a single congressional statutory enactment outside constitutional limitations.[103]

It was not until 1995 that the Supreme Court began taking steps to restrain Congress's power to legislate under the commerce power. In *United States v. Lopez*, the court considered whether Congress had authority to legislate the "Gun-Free School Zones Act" under the commerce clause.[104] The court identified three categories of activities that Congress had power to regulate under the commerce clause: (1) the channels of interstate commerce; (2) the instrumentalities of commerce; and (3) activities that have a "substantial relation" to commerce among the several states.[105] While *Lopez* narrowed congressional legislative power under the commerce clause, the Court emphasized that the primary reason for the narrowing was because the statute dealt with matters that did not "substantially affect" interstate commerce.[106] Along this vein, there is no question that the past mortgage crisis substantially affected interstate commerce.

Another case that may provide some indication of the Supreme Court's perspective on Congress' ability to legislate mortgage matters is *United States v. Perez*.[107] In *Perez*, the defendant—a lending institution—claimed that Title II of the Consumer Protection Act was not constitutional because Congress did not have authority to regulate the lending of intrastate money.[108] The Court countered that Congress had the authority because certain types of loans—though traditionally local—had a national affect.[109]

Assuming that there is a rational basis for Congress to believe that mortgage lending activities have a sufficient effect on intrastate commerce, the argument for centralized reform is strong. Even though commerce clause arguments against centralized reform are relatively weak, there are several policy arguments—both supporting and opposing centralized

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[100] *See* ERWIN CHEMERINSKY, CONSTITUTIONAL LAW: PRINCIPLES AND POLICIES 233–37 (2d ed. 2002); *see also McCulloch*, 17 U.S. at 410–17.
[101] CHEMERINSKY, *supra* note 100, at 232.
[102] *Id.* at 234.
[103] *Id.*
[104] United States v. Lopez, 514 U.S. 549, 551 (1995).
[105] *Id.* at 558–59.
[106] CHEMERINSKY, *supra* note 100, at 266.
[107] 402 U.S. 146 (1971).
[108] *Id.* at 146–47.
[109] *Id.* at 156–57.

reform—that may transcend the issue of whether congress has the power or not.

2. *The Argument for State-Based Regulation*

One argument for state based legislation asserts that, to date, Congress's mortgage preemption statutes have proven largely ineffective because they are proposed under the guise of federalism when the underlying action is destructive deregulation.[110] This argument suggests that bipartisan politics favoring deregulation, under the pretense of federalism, have waylaid Congress from enacting mortgage reform with strong utility.[111] Thus, many of the federal preemptive laws are without force and end up providing the mortgage industry with more latitude than the states originally provided. In this way, federal mortgage legislation can be—and arguably has been—more destructive than helpful.

Another argument is founded on the idea that the states have a greater capacity to legislate for the needs and intricacies of their own complicated economies than Congress.[112] In *Gregory v. Ashcroft*, the U.S. Supreme Court found that pure federalism—state-based regulation—increased the opportunity for citizens to be involved in the democratic processes.[113] Scholars in this camp insist that government regulation on a smaller scale increases communication between the elected officials writing the statutes and the citizens that are affected by the ensuing laws.[114] This line of reasoning provides justification for the relatively lax mortgage laws in states that sold less real estate during the destructive subprime era while simultaneously justifying the stringent subprime laws in states that had a five-hundred percent increase in subprime lending during 2000–06.[115] In this way, states with different characteristics can retain the ability to pass varying degrees of mortgage regulation.

Another argument assumes that allowing individual states to create separate mortgage laws provides the most effective means of experimenting with new law. Supporters of this reasoning assert that the state legislative-laboratory is the crowning virtue of federalism.[116] This argument also provides that state level decision making is less stifled and

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[110] Peterson, *supra* note 94, at 8.

[111] *Id.*

[112] *See* Baher Azmy, *Squaring the Predatory Lending Circle*, 57 FLA. L. REV. 295, 392 (2005) ("[The] value of federalism is that it promotes the democratic ideal because state governments are more closely in tune with their citizens and therefore more accountable and responsive to local constituent needs.").

[113] Gregory v. Ashcroft, 501 U.S. 452, 458 (1991); Azmy, *supra* note 112, at 392.

[114] Azmy, *supra* note 112, at 391–92.

[115] *Id.* at 301.

[116] *See id.* at 390–93 (explaining that the state laboratory is the best forum for legislation; but, this argument assumes that regulation from the top down—federal—is tailored to preempt the more effective, fair, and efficient result that is inevitably discovered through the state trial and error process).

thus more innovative and open to experimentation. Justice Brandeis stated that federal efforts to trump individual state experimentation would have an adverse affect on the innovation and success of the federal system; that the state laboratories provide risk management in preparing, conceiving, and cultivating law that can be later implemented on a federal level.[117] Supporters of a state based regime insist that even if federal legislation is the answer, it should be stayed for several years or even decades in order to allow for further evaluation and reflection on varying state reforms currently in flux.[118]

And, finally, there is the age-old argument first posed by early anti-federalists—supporters of a decentralized government as originally instituted in the Articles of Confederation—that state governments are an important check on the central government and minimize the "likelihood of tyranny" in mortgage reform.[119]

3. *The Argument for Federal Based Regulation*

Despite persuasive arguments for state-based regulation, the several arguments supporting centralized federal reform within the mortgage industry prove more convincing. First, state legislation is a slow process and does not provide the requisite nationwide solutions to curtail a widespread meltdown of the nation's economic framework. This has been especially evident during the latter half of 2008. Though many states began altering mortgage laws as early as 2000, no single state's actions were enough to prevent the country's widespread market crisis.[120] The original Framers knew that complete sovereignty of states would be a slow and ineffective way to govern the country and thus, after just ten years under the Articles of Confederation—the ultimate federalist regime—the states ventured to create a centralized government to regulate, govern, negotiate, tax, and legislate.

Second, history has shown that an industry can be more stable and simultaneously increase in efficiency when the federal government provides capital reserves. For example, the general success of the FDIC and the Fed as stabilizers of our increasingly complex economy is evident.

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[117] *Id.* at 301 (quoting New State Ice Co. v. Liebmann, 285 U.S. 262, 311 (1932) (Brandeis J., dissenting)).

[118] *Id.* at 393–94 ("[N]o uniform national solution should be imposed until more data is available to evaluate whether the state reforms have worked or will work. More specifically, evaluation factors should include: (i) whether the variety of state options have worked in their jurisdictions to ameliorate predatory lending or whether unscrupulous lenders have been successful, as they often are, in circumventing state restrictions and (ii) whether state laws have been or would be counterproductive, as the banking industry has suggested, by increasing compliance costs and liability risks to greatly that legitimate subprime credit is driven out of the communities which the predatory lending laws were intended to help.").

[119] *Id.* at 391.

[120] *See supra* note 95 and accompanying text (discussing individual state reform, obviously none of which stayed the market crisis during 2008).

Both of these institutions have the ability to provide funds in times of economic volatility and turmoil and each successfully functions in its role to stabilize the economy.[121] On one hand, from a utilitarian perspective, it is wise to leverage federalist ideals and allow states to develop innovative and original legislation by trial and error. On the other hand, it is important for Congress to evaluate and implement the tried and proven state mortgage laws on a national scale. Major mortgage reform was first implemented following the depression and has since had nearly eighty years of state reformation. Now, in the wake of significant need for nationwide mortgage reform, Congress should use its authority to build on past regulatory ideas (e.g., TILA, HOEPA, FHA), past state innovations in mortgage law, and past modes of insurance (e.g., FDIC, FHA,VA) to provide a solution (e.g., the FMIC).

Third, federal legislation would provide consistency where different state governments currently vary significantly, a problem that exposes some consumers to "under-protection" and others to "overprotection."[122] Consider for example, that while some states have "acknowledged that lending abuses are occurring within their borders" they have still not adopted the necessary laws.[123] In contrast, other states have enacted laws that have been so restrictive that lenders have become reluctant to move forward with any type of subprime loans—thus ostracizing the state's subprime borrowers.[124] A well-considered centralized regulatory regime, constructed with past federal laws and programs, would establish a stronger and more consistent foundation for customized state regulation.

Therefore, there is little question about whether Congress has the "constitutional power" to lead-out in mortgage reform. And, though there are several strong arguments for allowing states to continue leading out in mortgage reform, the magnitude of the recent mortgage crisis has dimmed the luster of the federalist ideal championing decentralized mortgage regulation. The mortgage lending industry has proven during 2008 that it needs significant reform, consistent interstate regulation, and large centralized capital reserves in order to be reliable and self-sustaining.

C. *The Solution Must Be Capable of Providing Large Amounts of Capital*

There are dozens of ways to stabilize an industry through regulation, oversight, and risk management, but when calamity strikes, industries require access to capital reserves. Most agree that a sharp downturn in a

[121] Sheila Bair, FDIC Chairman, Address at the 75th Anniversary Kick Off Press Conference, (June 16, 2008), *available at* https://www.fdic.gov/news/news/speeches/archives/2008/chairman/spjun1708.html ("Since the FDIC was created, there have been no significant bank runs.").

[122] Azmy, *supra* note 112, at 374–78.

[123] *Id.* at 376–77.

[124] *Id.* at 378.

market—as a result of a housing market bubble collapse, for example—is most effectively dealt with by an injection of capital; however, the question of where that capital should come from is a different matter.[125] The bank run of 1907, the Great Depression, the stock market crash of 1987, the dot com crash of 2000, the Japan Crisis, and Mexico's Peso Crisis all attest to the fact that capital reserves can be the best solution when systemic calamity is inevitable.[126] Lawmakers, scholars, industry professionals, and the nation's taxpayers are left to decide on the source from which the money should come. Is the best solution to have the government bail out financial intermediaries like Fannie Mae and Freddie Mac when the market plummets? Is the answer to have every financial intermediary morph into a bank holding company (insured by the FDIC) and allow access to consumer deposits and the Fed's discount window?[127] Whether capital comes from a government bailout or whether insurance companies are formerly set up to mitigate risk, history has shown that a struggling

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[125] FRIEDMAN, *supra* note 35, at 79–86, 91 (arguing that one of the greatest mistakes during the Great Depression was the Federal Reserve's hesitation to inject capital into the market); Press Release, Financial Services Agency, Global Financial Crisis and Japan's Experience in the 1990s (Oct. 25, 2008), *available at* http://www.fsa.go.jp/en/announce/state/20081025.html.

[126] The Japan Crisis and the Mexico Peso Crisis have been repeatedly cited by United States' economists as quintessential examples of the positive effects of large-scale capital infusion during times of systemic calamity. *See* Martin Fackler, *In Japan, Financial Crisis is Just a Ripple*, N.Y. TIMES, Sept. 19, 2008, at C4; *see also* Dr. Takafumi Sato, Comm'r of the Fin. Servs. Agency, Remarks at the Symposium on Building the Financial System of the 21st Century (Oct. 25, 2008), *available at* http://www.fsa.go.jp/en/announce/state/20081025.html. Describing similarities to the U.S. economic crisis and the Japan economic crisis, the Commissioner of Financial Services offered this opinion:

> [U]ndercapitalization of financial firms needs to be addressed, by injecting public funds if necessary. Prompt and sufficient recapitalization is needed if a financial firm becomes undercapitalized as a result of the disposal of bad assets. In cases where a sufficient amount of capital cannot be raised on a market basis, recapitalization with public funds is effective as a final safety net. While capital injection does put taxpayers' money at risk, it may end up with benefiting taxpayers if successful. In Japan, the government injected 12.4 trillion yen in 37 banks, of which 9.2 trillion yen has already been repaid, of which capital gains amount to 1.3 trillion yen. These are on top of a cumulative dividend income of 770 billion yen as of end-March 2008. In this respect, I welcome the decision of the U.S. government to commit 250 billion dollars to recapitalize the financial firms. At the same time, the authorities should be flexible in responding to new, additional developments. Losses could grow further, because the adverse effect of the deteriorating real economy could hit financial firms if a substantial amount of bad assets remain on their balance sheets.

Id.; *see also* Edwin M. Truman, *The Mexican Peso Crisis: Implications for International Finance*, Federal Reserve Bulletin 199–205 (Mar. 1996), *available at* http://www.federalreserve.gov/pubs/bulletin/1996/396lead.pdf (discussing the decision by Congress to contribute up to $40 billion to stop the financial bleeding in Mexico during the 1994 Mexico Peso Crisis).

[127] *See* Jones, *supra* note 47 (discussing that as a result of the financial crisis, several major companies—Morgan Stanley, Goldman Sachs, and American Express—have become bank holding companies in order to take advantage of the insurance offered to depositors through the FDIC. This change in entity type allows the corporation to more easily access depositor's money. Additionally, as a bank holding company, the federal government insures the depositor financing so the process of obtaining capital is not as volatile as the investor market—and certainly a more reliable avenue for income during economic turmoil. Also, companies that morph into bank holding companies can take advantage of the TARP plan and the Federal Reserve's discount window.).

industry can usually gain footing as long as it has access to capital. Conversely, history has also shown that large companies and industries that face an economic downturn coupled with clogged capital flow, fail.[128] In the words of prominent economist Milton Freedman: in times of crisis the key is "expanding the money supply."[129] From a historical perspective, when a large and indispensible industry has failed—such as the mortgage lending industry—the central government has been forced to provide capital.

One way to create emergency capital is to force big companies to pay for their own insurance in the form of a "failure tax." In a recent *New York Times* article, Jonathan Koppell opined that "the Federal Reserve and the Treasury Department are acting like insurance claims adjusters, selectively providing assistance when a company's failure seems too much for the financial markets to withstand."[130] As a result, Koppell suggested that investment banks and other large companies should be required to pay premiums for catastrophic risk insurance, similar to government imposed flood, bank, and crop insurance.[131] Koppell proposed that the concept of imposing an insurance premium on big companies should be appropriately named the "failure tax."[132] Koppell's idea may be worth debating because, after all, the government's $700 billion bail-out plan is a type of "failure tax" for big corporations—with premiums imposed on all the wrong people. The truth is that Koppell's idea is not all that novel. Congressmen, who lived through the Great Depression and felt the adverse effects of market illiquidity, created the FDIC insurance program to provide the very type of industry insurance Koppell called for in his article. Similarly, many of those same lawmakers established the FHA insurance program to promote market confidence and lender reserves.[133]

A second method for building catastrophic capital reserves would to force individual lending institutions to increase their reserves. This regulatory regime could emulate the relatively new banking regulations set forth under Basel II.[134] Through the creation of Basel II, several prominent countries agreed to require their banks to carry a certain percentage of capital for each asset, depending on how that asset was weighted on an

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[128] Andrew Sorkin, *Lehman Files for Bankruptcy; Merrill Is Sold*, N.Y. TIMES, Sept. 15, 2008, http://www.nytimes.com/2008/09/15/business/15lehman.html?pagewanted=all.

[129] FRIEDMAN, *supra* note 35, at 70–79.

[130] Koppell, *supra* note 69.

[131] *Id.*

[132] *Id.*

[133] Additionally, lawmakers who suffered through the bank run of 1907 formulated the Federal Reserve to be a lender of last resort.

[134] Press Release, OCC Approves Basel II Capital Rule (Nov. 1, 2007), *available at* http://www.occ.gov/ftp/release/2007-123.htm.

index that determined general risk levels.[135] The index requires banks to weigh credit risk, market risk, operational risk, interest rate risk, and liquidity risk—against capital reserves.[136]

It is no secret that the federal charter for Fannie, Freddie, and Ginnie requires a similar kind of risk based capital requirement, but these requirements are obviously not sufficient in light of the recent government bailout. The problem with simply doubling the risk based capital requirement for mortgage lending institutions nationwide is the impracticability and wasteful result of requiring several trillion dollars be set aside in a savings account to hedge against risk. More money being set aside means fewer loans, fewer homeowners, and inefficient lending.

A third method for creating catastrophic financial reserves would be to use the full faith and credit of the U.S. government as the source of capital. In effect, this is the model that the country has been using. As previously noted, this model socializes risk and privatizes profits: it effectively creates moral hazard.

Finally, another way to create emergency capital may be by morphing the concept of the "failure tax" into a federal-government-required insurance program. Emergency capital reserves can be best realized by requiring institutions to pay for their own insurance: industry paid insurance is resourceful, fair to the taxpayer, and effective as an opponent of risk. The FDIC is a prime example of the practice of these principles. Banking institutions contribute a small percent of each deposit to the FDIC and the insurance entity agrees to take on the liability should the company require financial assistance. While the insurance is for the depositor, the institutions—which create the systemic risk—are the primary parties responsible for paying the premium.[137] Insurance premiums trend upward as a result of increased risk; thus fundamental insurance principles deter moral hazard (as opposed to government bailouts that increase moral hazard). Importantly, paying insurance premiums would not require companies or industries to excessively gather cash in order to hedge against risk. The Institutions that would potentially utilize the funds would be paying for the "capital reserve," and thus notions of equity would be

[135] *Id.* at 8 ("Capital helps protect individual banks from insolvency, thereby promoting safety and soundness in the overall U.S. banking system. Minimum risk-based capital requirements establish a threshold below which a sound bank's risk-based capital must not fall. Risk-based capital ratios permit some comparative analysis of capital adequacy across banks because they are based on certain common assumptions. However, supervisors must perform a more comprehensive review of capital adequacy that considers the risks that are specific to each individual bank, including those not incorporated in risk-based capital requirements. In short, supervisors must ensure that a bank's overall capital does not fall below the level required to support its entire risk profile.").

[136] *Id.* at 8–18.

[137] There are two ways to consider how the insurance "expense" is paid. From the less obvious perspective, the payment is internalized by the depositor in light of the fact that decreased interest rates available on deposits into the institution are the ultimate result of the FDIC expense.

served.

IV. THE PROPOSED SOLUTION

The United States' legal framework for mortgage lending is insufficient: oversight is sporadic, state laws are inconsistent, federal laws are inadequate, lenders and banks are under-insured, and the federal government has erroneously become the primary insurer. This section proposes that the federal government create a centralized entity to regulate, oversee, and insure the nationwide mortgage industry: the entity could be appropriately named the Federal Mortgage Insurance Corporation ("FMIC"). The FMIC could be required to meet all the ideals set forth in the previous sections,[138] by providing mortgage reform, industry stability, capital reserves, and uniform federal mortgage lending laws. The next two sections outline how this entity could function and the benefits it would potentially provide the lending industry.

A. *Capital Reserves by Insurance*

Assuming that the mortgage industry would benefit from capital reserves derived from insurance during a time of financial crisis—as discussed in the previous section[139]—the natural ensuing question would be, "Who would pay for the insurance, and how would the FMIC manage the insurance program?"

To answer the question, it is important to note that some mortgage loans are already insured. That said, most mortgage debt in the country is not insured. Several different entities and industries have provided insurance for mortgage loans during the past century. First, the FHA, created during the Great Depression, currently insures some first-time-homebuyer loans that meet certain criteria.[140] Second, the Veterans Administration ("VA") insures some mortgage home loans for those who have participated in the military.[141] Third, the PMI industry insures the greatest number of home loans in the country; but this insurance covers only twenty percent of the loan amount.[142] Finally, the recently enacted Hope for Homeowners ("HFH") legislation retroactively insures distressed homeowner mortgages where lenders are willing to write down a portion of the principle—though this program has only been marginally

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[138] *See supra* Part III (discussing the three ideal guidelines for a solution: mortgage reform, federally based guidelines, and large capital reserves).

[139] *See supra* Part III (discussing guidelines for a solution).

[140] About the Federal Housing Administration, http://portal.hud.gov/portal/page?_pageid=73, 1828027&_dad=portal&_schema=PORTAL (last visited July 29, 2009).

[141] Department of Veteran Affairs, http://www.va.gov/about_va (last visited Oct. 16, 2009).

[142] MICA FACTBOOK, *supra* note 29, at 14.

successful.[143] The industry's massive requirements for capital during a large market failure—such as that which occurred during 2008—cannot likely be serviced through any of these entities (or industries) because of the limited goals and scope of each. The following subsections describe the insurance characteristics of the FMIC.

1. *FMIC to Insure Loans Exceeding Fifty Percent of Property Values*

In order to properly curb the systemic risk posed by the mortgage industry, the FMIC must provide insurance for at least fifty percent of mortgage loan amount. As stated earlier, most home loans are not fully insured, but among the home-loans currently insured, most are covered by the PMI industry. Unfortunately, the private insurance industry only provides insurance for between five to twenty percent of the full loan amount.[144] While this protection provides relative mortgage lender support in most market conditions, recent real estate bubble deflation in several states—including California and Florida—has reached nearly forty percent value declines.[145] After making interest payments, paying attorney costs, and absorbing losses due to under-maintenance, banks in 2008 were losing an average of forty-four percent of the mortgage loan amount.[146] Thus, losses on privately insured assets far outweighed private mortgage insurance compensation.[147]

Thus, the federal government should require the FMIC insurance on all home loans that exceed fifty percent loan to value ("LTV").[148] This

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[143] Paletta et al., *supra* note 26 (discussing the marginal success of the Hope for Homeowners program that was initiated in an effort to slow foreclosures, but requires the lender to take losses up front).

[144] MICA FACTBOOK, *supra* note 29, at 14.

[145] Brad Davidson, *Median Price Heading South of 400K*, Oct. 6, 2008, *available at* http://www.socalbubble.com/ ("The median price continues to fall and if the trend holds it should be under $400,000 by year's end. That will be close to a forty percent decline.").

[146] Paletta et al., *supra* note 26. To reiterate the need for extensive mortgage industry insurance, common sense shows that a precipitous fall in housing prices (a bubble burst as a result of irrational exuberance) could easily trigger each of the factors that would inevitably lead to widespread market failure. The cycle begins with a (1) drop in housing prices (2) that increases foreclosures (3) and increases the average losses by lenders in each foreclosure, (4) the banks panic and cut back lending, (5) real estate sales slow, (6) housing prices drop further, (7) and the cycle continues. Thus, each housing bubble that reaches sufficient magnitude will inevitably lead to secondary market failure as long as proper insurance (or an alternative capital reserve) is not in place.

[147] There are other ways to "insure" a loan not evaluated in this Note. Some banks allow the borrower to leverage one hundred percent of the mortgage value while as long as the first loan for eighty percent remains in "primary position." In this scenario, the mortgagor is able to obtain a twenty percent loan from a second institution at a much higher interest rate. This "80/20" loan structure puts the secondary market investor in essentially the same position as though the mortgagor had purchased twenty percent private mortgage insurance. This loan structure is acceptable under Fannie Mae's charter. But, this "insurance" proved similarly insufficient during 2008, when the average foreclosure cost in the nation rose to forty-four percent of the loan amount—more than double the "insured" (secondary loan) amount.

[148] For example, consider three hypothetical buyers that each purchase three different houses on the same street for $100,000: Buyer A, Buyer B, and Buyer C. A pays $100,000 in cash. A is exempt

insurance would not be required on homes with forty-nine percent LTV or less. Similar to the government standards currently imposed on the PMI and FHA programs, the FMIC insurance payments and coverage would automatically cease once the LTV dropped below fifty percent.[149]

2. *FMIC to Insure All Qualifying Loans*

In order to provide a meaningful capital reserve, the FMIC must insure *all* loans that exceed fifty percent loan to value. This characteristic of the FMIC is an important addition to the previous section in light of the fact that the government already provides "one hundred percent insurance" for home loans that qualify through the FHA. But, because of stringent FHA borrower requirements, the FHA only insures a small portion of the home loan industry: the FHA insures approximately $680 billion of the $13 trillion in outstanding mortgage debt.[150] Stated differently, the FHA insures approximately five percent of the nation's mortgage debt.[151] However, the relatively small number of FHA insured loans have not been an indication of the program's success in its sphere. The FHA has not aspired to be a large institution in order to provide support against systemic risk.[152] In fact, FHA and VA loans purposefully exclude many prime buyers in order to focus on subprime needs.[153] The FHA limiting criteria include the requirement that the mortgagor must occupy the home within sixty days of purchase, purchase a home within the price range set by the administration, and purchase either a single-family residence or duplex,

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from contributing to the FMIC insurance premiums because she has no LTV on her house and she poses zero risk to the lending industry. B pays $60,000 in cash and receives a loan from a lender for $40,000. B is exempt from contributing to the FMIC insurance program because in the event that the lender must foreclose on her house to recoup the $40,000 loan, B has $60,000 in equity—which is the equivalent of sixty percent insurance on the loan. C pays $10,000 in cash and receives a loan for $90,000. C must contribute to FMIC insurance premiums because if the house is foreclosed—foreclosure costs the lender an average of forty-four percent in today's economy—the lender will only have the equivalent of ten percent ($10,000) insurance on the home. The FMIC would continue to require insurance contributions until C pays another $40,000 in principal. When C only owes $50,000 on the house, the FMIC payments would stop b/c the lender could use C's $50,000 equity as insurance on fifty percent of the loan.

[149] Current federal law requires that when the LTV reaches the private mortgage insurance carrier's coverage amount (traditionally twenty percent) the insurance carrier must automatically cease billing the consumer. MICA FACTBOOK, *supra* note 29, at 20. This automatic trigger is a safeguard for consumers that historically would pay for needless insurance long past its coverage, without realizing that the insurance payment was a part of their monthly mortgage payment. This is true for FHA insured loans as well.

[150] Review and Outlook, *The Next Fannie Mae: Ginnie Mae and FHA Are Becoming $1 Trillion Subprime Guarantors*, WALL ST. J., Aug. 11, 2009, at A16; U.S. DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES: 2008, at 735 (2008); Federal Housing Administration Website, http://portal.hud.gov/portal/page?_pageid=73,1&_dad=portal&_schema=PORTAL (last visited Dec. 15, 2008).

[151] U.S. DEP'T OF COMMERCE, *supra* note 150, at 735.

[152] About the Federal Housing Administration, http://portal.hud.gov/portal/page?_pageid=73,1828027&_dad=portal&_schema=PORTAL (last visited Oct. 16, 2009).

[153] *Id.*

three-plex, or four-plex.[154]

As previously discussed, the PMI industry provides a significant portion of the United States' mortgage insurance. During 2007, the PMI industry was obligated to approximately $800 billion of insurance, which represented approximately six percent of the mortgage debt in the country.[155] Thus, after combining both the federal government insurance and private insurance program coverage,[156] most of the mortgage debt in the country remains uninsured. During the 1980's, the PMI industry paid approximately six billion dollars in claims to its policyholders.[157] During the 1990's, the PMI industry paid approximately eight billion dollars in claims.[158] During just one year—2008—industry wide losses reached several hundred billion dollars while the mortgage insurance industry only paid out approximately $15 billion.[159] While the PMI industry is not large enough to quell systemic risk, it has shown notable resilience during tough economic times. The achievements of both the FHA and PMI industries provide some testimony of the likely success that the FMIC would have if it functioned on a larger scale. Additionally, in light of the inability of the FHA and PMI insurance programs to quell widespread home loan calamity, the FMIC must provide insurance for all home loans that meet the fifty percent LTV standard in order to meaningfully curb systemic risk.[160]

3. *FMIC Premium Payments*

There are several ways the FMIC could potentially raise funds to pay for the government sponsored loan insurance. The most practical model may be to require the borrower to pay a mortgage insurance premium monthly until the LTV drops below fifty percent. The FHA program and the PMI industry currently rely on this model to pay insurance premiums and have shown that the payment does not prove so onerous as to deter

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[154] FHA.com, FHA Limits, http://www.fha.com/lending_limits_state.cfm?state=CONNECTICUT (last visited July 29, 2009) (enumerating the restrictions on applicants that qualify for FHA insurance including, for example, restrictions on housing prices for Hartford Connecticut: $440,000 for a single family residence; $563,250 for a duplex; $680,850 for a triplex; and $846,150 for a four-plex).

[155] U.S. DEP'T OF COMMERCE, *supra* note 150, at 735; *see also* MICA FACTBOOK, *supra* note 29, at 23.

[156] U.S. DEP'T OF COMMERCE, *supra* note 150, at 735.

[157] MICA FACTBOOK, *supra* note 29, at 13.

[158] *Id.* at 14.

[159] MORTGAGE INSURANCE COMPANIES OF AMERICA, 2009–2010 FACT BOOK & MEMBER DIRECTORY 15 (2009–10) (discussing that in 2008, during the housing market collapse, mortgage insurers paid out approximately $15 billion in claims); Yalman Onaran, *Subprime Losses Top $379 Billion on Balance-Sheet*, BLOOMBERG, May 19, 2008, http://www.bloomberg.com/apps/news?pid=20601087&sid=aK4Z6C2kXs3A&refer=home.

[160] This concept holds true, assuming that the PMI industry does not change to accommodate fifty percent LTV coverage, and the FHA program does not change to accommodate all home loans.

buyers.[161] Not only are the premium payments palatable for the borrower, but the government has been able to retain solvency in the FHA program for the last several decades.[162]

4. *FMIC Capital Reserves*

To effectively avoid a future repeat of the 2008 mortgage industry failure, the FMIC must keep reserves that exceed projected needs. Using the example of the FHA program, the federal mortgage insurance entity could feasibly retain reserves that allow it to remain solvent even in times of extreme market volatility. The FHA is a mortgage insurance entity that has shown that this is possible. On June 17, 2008 the FHA Commissioner Brian Montgomery claimed that:

> Currently, FHA is solvent. In fact, we have a reserve of about $21 billion. However, as a result of our annual re-estimate, we had to book an additional of $4.6 billion in unanticipated long-term losses, mostly due to the increased number of certain types of seller-funded loans in the FHA portfolio. Let me repeat: FHA is solvent.[163]

The FDIC provides another example of a federally based insurance program created primarily to provide and manage capital reserves for an industry.[164] In late 2008, the FDIC was busy managing receiverships and brokering the acquisition of failing banks with larger stronger banks.[165] This pandemic was spurred by the subprime mortgage years earlier in the same decade: during 2005, no banks failed; during 2006, no banks failed; during 2007, seven banks collapsed; and, during 2008, at least twelve

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[161] About the Federal Housing Administration, http://portal.hud.gov/portal/page?_pageid=73,1828027&_dad=portal&_schema=PORTAL (last visited Oct. 16, 2009). Incidentally, FHA borrowers represent some of the most "leveraged" and "subprime" buyers in the market. This is largely because the program focuses on providing housing for those who would not be able to qualify otherwise—particularly in respect to saving a down payment. The success of the FHA one-hundred-percent insurance program and its monthly insurance payments are a testament to the likely success of an FMIC required fifty-percent insurance program on all loans paid for in a similar manner.

[162] Brian Montgomery, Comm'r of the FHA, Remarks at the National Press Club (June 9, 2008), *available at* http://www.hud.gov/news/speeches/2008-06-09.cfm.

[163] *Id.*

[164] The FDIC was created in 1933 under the Glass Steagall Act to restore confidence in the banking system after more than 4000 banks failed. *See* History of the FDIC, http://www.fdic.gov/about/history/index.html (last visited Sept. 13, 2009). According to the Act, the depositor insurance program was organized to safeguard against bank runs and bank failures that helped tip off the great depression. The FDIC functions as an, "independent agency of the federal government, [it] was created in 1933 in response to the thousands of bank failures that occurred in the 1920s and early 1930s." Who Is the FDIC?, http://www.fdic.gov/about/learn/symbol/index.html (last visited Sept. 13, 2009).

[165] David Evans, *FDIC May Need $150 Billion Bailout as More Banks Fail,* BLOOMBERG, Sept. 25, 2008, http://www.bloomberg.com/apps/news?pid+206011038&sid+amZxIbcjZISU&refer=us.

banks failed.[166] With so many banks struggling in 2008, the FDIC used up its reserves—even to the extent that some economists speculated that the FDIC would need nearly $200 billion to avoid borrowing from the Treasury before the end of 2009.[167] The FHA and the FDIC programs have a long history of maintaining capital reserve infrastructure during tough economic times and provide important precedent for establishing rules and guidelines for future government entities to do the same—entities such as the FMIC.

B. *Mortgage Loan Regulation*

The FMIC would most effectively regulate mortgage lenders by applying baseline underwriting, resell, and securitization requirements. Lenders who currently require buyers to purchase private mortgage insurance look to the insurance carrier to set the guidelines for underwriting their loan. In fact, the PMI industry brags that, "[m]ortgage insurers were designed to be review underwriters. Because they are in the first loss position on insured mortgages, they are the second set of eyes looking at potential loans to check and see if is safe for both the investor and the borrower."[168] This same model is utilized by the United States' dual banking system, where both national and state banks that seek federal insurance agree to abide by the guidelines and regulations outlined by the FDIC. By providing federal insurance for the mortgage industry, the FMIC could also set the minimum standards for mortgage brokers, primary lenders, secondary lenders, and securitization. Like the FDIC, the FMIC's primary goal would be to provide insurance yet, like the FDIC, it could simultaneously examine and supervise financial institutions that it insures.[169] In this way, the FMIC would force compliance to a host of regulations without meeting the opposition that would inevitably come if its primary purpose was regulation. That said, the FMIC could provide

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[166] *Id.* Contributing to the problem, in September 2008, IndyMac bank failed and became the most expensive bank failure in the FDIC's history at $32 billion. *Id.* Just one week later, Washington Mutual followed suit with assets of nearly $310 billion. *Id.* Luckily, as receiver, the FDIC brokered the purchase of Washington Mutual with JP Morgan on Sept. 26, 2008. *See id.*; *see also* Eric Dash & Andrew Ross Sorkin, *Government Seizes WaMu and Sells Some Assets*, N.Y. TIMES, Sept. 25, 2008, http://www.nytimes.com/2008/09/26/business/26wamu.html?_r=1.

[167] Evans, *supra* note 165. The FDIC requires insurance premiums at approximately one percent of all deposits. This is a relatively small percentage. Exacerbating this disparity in insurance liability versus reserve insurance capital, Congress recently passed a bill that temporarily increased insured bank accounts from $100,000 to $250,000. Congress increased coverage to reassure investors/depositors and encourage depositors to leave excess funds in the banks to keep banks capitalized. However, as a result of the FDIC's fast depleting funds, they are considering increasing the one percent premium, which would potentially counteract Congress' efforts to capitalize banks at a critical economic time.

[168] MICA FACTBOOK, *supra* note 29, at 14.

[169] Who is the FDIC?, *supra* note 164.

either *direct* or *indirect* regulation.[170] Whether a direct or indirect regulator, the FMIC would be a central regulation entity and set the standards for underwriting, capitalization, consumer education, back end fees, broker education, and subprime fees—prerequisites to qualifying for insurance coverage.

Thus, one of the most important roles of the FMIC would be to provide an efficient, consistent, and uniform source of loan regulation in an age when loan packages are evolving daily. During the past decade, nearly every major regulatory body in the federal government, that has anything to do with mortgages, has publicly acknowledged the need for major mortgage regulation reform.[171] The following sections outline a few new regulatory schemes that the FMIC could implement in an effort to stabilize and strengthen the mortgage industry and, ultimately, the national economy. Some of these changes are large scale, and some would be very specific and detailed.[172]

1. *FMIC and a Dual Lending System*

With the creation of the FMIC, Congress could consider the possibility of a "dual lender system" to mirror the "dual banking system." For decades, the banking system has operated with some banks regulated by state governments and others by the federal government. Similarly, lenders—like banks—could operate under the same model and decide whether to be regulated and insured under federal or state laws. At first glance, this concept may appear to undermine this Notes's thesis which calls for developing a centralized federal mortgage entity. But, if the federal FMIC program offered sufficient incentives, the country could potentially arrive at the same end (centralized regulatory regime) having imposed significantly less coercive means ("incentives" for participation instead of "compulsory" adherence). In other words, just as most major banks have gravitated toward the federal protection and regulation offered by the FDIC, so might mortgage lending institutions gravitate toward the

[170] The FMIC regulation practices could be roughly modeled after the FDIC, which is an *indirect regulator* of financial institutions. In other words, while the Office of the Comptroller of the Currency is the official regulator of banking institutions, the FDIC imposes the minimum capitalization requirements that most often force banks into receivership. Alternatively, the FHA—under the Housing Urban Development—provides its own lending standards and is an example of a *direct regulator* of loans processed under its insurance policies.

[171] Peterson, *supra* note 94, at 5 (discussing the several federal agencies that have publicly called for further lending regulation, including the Fed's Board of Governors, HUD, FTC, OCC, FHFB, OTS, NCUA, OFHEO, FDIC, GAO, and the DOJ).

[172] Rather than give a long list of possible regulatory concepts that could be implemented with the advent of the FMIC, this section provides a few concepts that could be implemented by the new entity. In each subsection, I have attempted to provide a short discussion of why the proposed change in regulation would be useful, as well as how it would work. There are dozens more regulatory ideas that could (and perhaps should) be added, but I have included just a few specific proposals to start (or perpetuate) the national regulatory reform conversation.

same benefits offered by the FMIC. A glaring difference between the two industries (banking and mortgage) that could potentially stifle the movement of lenders from state to federal governance, is that unlike the FDIC, consumers would not directly benefit from the FMIC insurance coverage. Thus, consumers would potentially apply less pressure on lending institutions to register with the FMIC in order to receive federal insurance coverage. But this shortfall is not conclusive because investors would play a significant role in the decision.

Lending institutions would potentially receive a great deal of pressure from investors concerned with the stability of mortgage backed securities and stocks. Additionally, Congress could pass legislation requiring lending institutions to insure at least fifty percent of all loan products. These two factors would provide incentive to lending institutions to consider the federal FMIC insurance and governance, and would simultaneously coerce reform in the *private* mortgage insurance industry to provide insurance products that extend fifty percent coverage.

Notably, the FDIC boasts that it is, "the primary federal regulator of banks that are chartered by the states that do not join the Federal Reserve System."[173] This fact may suggest that were the country to adopt a dual lending system, state-lending institutions may prefer to adhere to the federal regulations imposed by the FMIC—whether or not the institution participated in the federal insurance program.

The appeal of a dual lending system is that it could be the only way to appease those who may oppose the creation of the FMIC as a complete reformation of the mortgage lending industry under federal jurisdiction.[174] Under a dual lending system, the FMIC would provide incentives for mortgage lenders to adhere to centralized federal mortgage laws, become sufficiently insured, and stabilize capital without jeopardizing federalism or forcing nationwide adherence to a new regulatory regime.[175]

2. *FMIC Required Disclosure of Yield Spreads*

Through TILA, the Real Estate Settlement Act, and HOEPA, Congress has successfully required increased lender disclosure and borrower understanding.[176] But, in the case of yield spreads, these regulations fall short of their intended purpose.

When the average consumer meets with a mortgage lender to begin the

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[173] Who is the FDIC?, *supra* note 164.

[174] *See supra* Parts II.C., III.B. (discussing the opposing viewpoints concerning mortgage reform).

[175] This "dual lending" regulatory regime is strictly an idea to help catalyze negotiation between opposing political viewpoints: those who are calling for a large-scale federal solution and those who prefer state sovereignty and institutional independence. That said, while the proposal for two systems of regulation may help increase the widespread attractiveness of the proposal, it is not likely the most efficient method.

[176] *See supra* Part III.A. (discussing TILA, the Real Estate Settlement Act, and HOEPA).

loan process, the borrower is often barraged with many intricate details. Preliminary talks revolve around the consumer's credit history, salary, length of employment, tax returns, and current debt-to-income status. Accordingly, most initial meetings with a lender turn out to be more of a "borrower interview" than a "mortgage lender interview." Those buyers who are not savvy in the process find the experience—wrought with heaps of paperwork, a steep learning curve, and incomprehensible legal and financial jargon—intimidating. Among the most important parts of an initial meeting with a lender is the moment where the lender provides the "rate quote." Differing brokers will regularly quote varying rates according to the buyer's credit, job, and payment history. Unbeknownst to non-savvy borrowers, the rate quote is arguably the most important distinction between lenders and is a primary purpose of "interviewing lenders." Many consumers believe the mortgage broker's job is simply to quote the lowest rate for which the consumer can qualify. Many consumers assume that the rates are set solely by the Fed and that banks and mortgage brokers lend to similar buyers at the same rates—which is not true. There are many competing forces at play when the mortgage broker quotes a rate to a potential borrower. First, lenders have incentive to quote low rates in order to win borrower trust. But, lenders are usually also given incentives via lender "yield spreads," which provide kickbacks to mortgage brokers for quoting rates higher than the rate for which the buyer is qualified. In other words, a yield spread is essentially a fee paid by the lender to the mortgage broker for quoting an interest rate that exceeds the interest rate for which the buyer is qualified.

Defenders of the yield spread claim that the fee is of no concern to the consumer because the lender pays the back end fee. Critics claim that the consumer pays for the fee over the course of the loan and therefore deserves full disclosure.

Two minor requirements could drastically alter the yield spread controversy. First, the FMIC could require lenders to provide full disclosure by providing rate sheets for the borrower to sign. These rate sheets would simply show the consumer the established rate, the rate the consumer qualified for, and the rate the mortgage broker offered the consumer. Second, the FMIC could require a "fee disclosure sheet" that would disclose the fee being paid to the mortgage broker and the amount the borrower will pay over the life of the loan as a result of the increase in rate. When full disclosure of a fee will largely eliminate the fee, there is little question about whether the fee should be legal or not.

3. *FMIC Required Consumer Education*

Bolstering the proposal to require mortgage brokers to provide meaningful disclosure about fees, but reaching more broadly, the FMIC could require that an informational program accompany each loan that exceeded a fifty percent LTV ratio. This process could be completed either by paper or electronically. Currently, many colleges and universities across the country require students to complete online tutorials in order to access student loans. These tutorials increase awareness about fees, loan restrictions, prepayment penalties, balloon payments, late charges, and interest rates. Specific to mortgages, a program or paper tutorial required by the FMIC could explain simple nuances that relate to the consumer's type of loan, including: types of amortization, risks of reverse amortization, risks of no-interest loans, fees accompanying refinancing, and consequences of adjustable rate mortgages.

4. *FMIC Required Suitability Standards*

Requiring suitability standards within the mortgage lending market means to require mortgage brokers to ensure that loans are suitable for the circumstances of the borrowers that receive them.[177] Generally, suitability doctrines are associated with stockbrokers; but, more recently, suitability requirements have been applied in the insurance industry. Some scholars argue that the insurance industry's recent adoption of the suitability requirement provides impetus for suitability in the mortgage industry.[178] One of the major concerns with imposing suitability requirements in the lending industry is that since brokers work for lenders, they cannot simultaneously represent the borrower. In this way, critics claim that mortgage broker allegiance to the lender (employer) creates a conflict of interest. Conversely, those who support extending the suitability doctrine counter that seventy percent of loans are extended by mortgage brokers who have a stark negotiating advantage over their clients and a financial incentive to dupe their clients.[179]

Additionally, some state regulators have already begun requiring pseudo-suitability requirements through creative regulation. For example, if a regulator perceives that a loan was not suitable for a client then some

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[177] Frank A. Hirsch, Jr., *The Evolution of a Suitability Standard in the Mortgage Lending Industry: The Subprime Meltdown Fuels the Fires of Change*, 12 N.C. BANKING INST. 21, 21–22 (2008).

[178] Kathleen C. Engel & Patricia McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1331–35 (2002) (describing the evolution of the insurance industry to adopt the suitability requirement beginning with the *Anderson v. Knox* decision in 1961 through a period where several states adopted the doctrine: Finally, the National Association of Insurance Commissioner ("NAIC") recommended that "all states adopt a suitability requirement for the sale of life insurance and annuity products." The SEC justified adopting the suitability doctrine because "disclosure does not provide adequate protection to investors. In the seminal case of *Phillips & Co.*, the SEC imposed a suitability requirement because 'disclosure requirements and practices alone had not been wholly effective in protecting the investor.'").

[179] Lloyd T. Wilson, Jr., *Sometimes Less is More: Utility, Preemption, and Hermeneutical Criticisms of Proposed Federal Regulation of Mortgage Brokers*, 59 S.C. L. REV. 61, 63 (2007) (noting that mortgage brokers originate approximately seventy percent of all residential mortgage loans, have unique access to borrowers and incentive to extract high fees, and have been identified as primary participants in predatory lending).

regulators make the theoretical jump to assert that the same loan undermines the lending system and is therefore illegal. "Historically, absent special mitigating circumstances, lenders do not even owe borrowers the duty of care to avoid negligence in the lending process, although some regulators take a contrary position based upon their primary goal to ensure safety and soundness to the banking system."[180]

As a result, some states have begun gravitating toward actually requiring suitability standards of mortgage lenders.[181] For example, a recently enacted statute in Maine imposes suitability requirements that hold the mortgage broker responsible for (1) determining whether the borrower is able to make the scheduled payments during the course of the loan and (2) verifying employment, income, and credit.[182] Similarly, the FMIC could reasonably require that mortgage brokers accept suitability requirements in exchange for insurance on the loans they write.

5. *FMIC Required Securitization Standards*

The FMIC could also provide standards and information regarding the securitization of the products it insures. For several years, scholars have opined that by regulating home loan securitization standards, the federal government could effectively stifle funds that support the subprime mortgage problem.[183] During the last decade, securitization was a precipitating factor because it facilitated the renewing of funds for predatory loans by way of investment.[184] The problem was that Wall Street firms securitized home loans without regard to either the fairness or the quality of the loan.[185] Several negative externalities derive from unregulated home loan securitization. First, securitization of subprime loans often provides funds for small lenders who are statistically more likely to participate in loan abuses because they are not heavily regulated.[186] Second, negligent securitization provides incentives to lenders and mortgage brokers to continue unfair loan practices by providing a secondary market for them to shift their risk.[187] Third, investors' demands for higher returns on subprime loans encourage lenders to gouge subprime borrowers.[188]

To date, it remains unclear whether this is a mortgage industry

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[180] *Hirsch, supra* note 177, at 22–23.
[181] *Id.* at 25.
[182] *Id.* at 31.
[183] Engel & McCoy, *supra* note 19, at 2039–40.
[184] *Id.*
[185] *Id.* at 2040–41; SHILLER, SUBPRIME SOLUTION, *supra* note 21, at 136 (discussing the difficulty of evaluating the risk of securities and the unscrupulous mortgage originators that were allowed to lend to borrowers that were likely to default).
[186] *Id.* at 2041.
[187] *Id.*
[188] *Id.*

problem or an SEC problem. The FMIC could at least provide guidelines by which loan products are created and require a heightened standard for all products that are resold to the secondary market.

6. *FMIC Required Down Payment and Elimination of Gold Accounts*

In the distant past, most lenders required a down payment before approving a borrower to qualify for a loan. This down payment served as proof of the buyer's commitment to the purchase, and his or her ability to save up for the investment; it also mitigated the lender's risk. Most lenders required the money to come from the borrower's own bank account, which forced the borrower to show a savings history over several months. In other words, most lenders prevented borrowers from using gifts, grants, or friends to provide the down payment on real property.

Recently, the FHA and VA programs have insured loans that require three percent down payments. Compared to other loans, this is a relatively small amount. Even more surprising, these specialized government loan programs allow buyers to borrow and receive gifts to pay the down payment. In fact, the "gift" need not come from a family member or friend, it can come from the seller. In such transactions, the seller "donates" the three percent down payment to a "Gold Account" and the down payment is paid to the buyer's mortgage lender from the Gold Account.

There are several problems with the current government-sponsored down payment program. First, the program creates incentive to buyers, sellers, lenders, and appraisers to commit "white-lie loan fraud." For example, suppose a desperate-to-sell homeowner markets his or her $350,000 home for a six month period. Further, suppose that the homeowner meets an equally desperate buyer that has longed to buy a home, but does not earn enough to save a sufficient down payment. The buyer and seller find a "win win solution" wherein both get what they want at the expense of societal externalities. The buyer offers the seller $375,000 for the home (well above the value and asking price of the house) and the seller agrees to pay the buyer's closing costs and the buyer's down payment.[189] The buyer gets the house of his dreams without paying a dollar out of pocket and the seller gets full price for the house—even after paying the buyer's requests. At first glance, only one entity loses, the lender; but in the case of federal loans (FHA) and loans packaged and sold to federal entities (Ginnie Mae), the lender is actually the American

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[189] This transaction is considered loan fraud in most states and by most lenders, unless the seller's contribution passes through a federally approved seller contribution plan available only in dealing with FHA (i.e., government) loans. Although, notably, there are many legal products offered by lenders, which allow borrowers one-hundred percent financing: eighty-twenty loans, ninety-ten loans, and one hundred percent loans.

taxpayer. Additionally, the higher sale price on the home inflates neighborhood prices and triggers a housing bubble. The problem is exacerbated by the fact that, if the buyer cannot make his payments (either because his ARM begins to increase, or he loses his job), he will not likely be able to find a buyer at the inflated $375,000 price range—particularly in the 2008–09 market where real estate bubbles have collapsed. Thus, in addition to providing insurance, the FMIC could provide thresholds for acceptable loan products and appropriate down payments.[190]

7. *FMIC Required Foreclosure Practice*

During 2008 and 2009, millions of houses ended up in the queue for foreclosure. While each state deals with foreclosure differently, and each lender has different foreclosure policies and procedures, a few ineffective practices occur throughout the country. The FMIC could require lenders to participate in programs designed to waylay foreclosures—or even streamline foreclosures—in order to curb insurance claims for foreclosure losses and stabilize our country's volatile real estate market.

Foreclosures are caused by a myriad of reasons, but all of the reasons start with a homeowner's desire to sell. Several circumstances force homeowners to sell: lost jobs, employment relocation, adjustable rate mortgage rate changes, divorce, college, etc. When someone is forced to sell and cannot find a buyer to pay the amount owed on the house, the person is forced into foreclosure. Sometimes, in the case of a short sale, a distressed seller can appeal to the mortgage lender to accept a buyer's offer for a percentage of the loan amount, regardless of the fact that the seller owes more than the purchase price. If the home cannot be sold through normal means, and it cannot be "short-sold," then the bank must foreclose on the property. Approximately ninety days later the bank will usually attempt to sell the home at foreclosure sale for a decreased price to investors. If the home does not sell for cash it becomes a bank owned property and the bank either holds the property in its portfolio or unloads the property to other investors for a nominal price.

These steps to foreclosure—and beyond—have become commonplace

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[190] For example, the FMIC could require five percent—to pick an arbitrary number—that would at least provide some threshold safeguard against the systemic externalities precipitated by both mass loan manipulation and lender's incessant desire to create increasingly risky loan products in order to achieve short term personal gains. Also, it is notable that after the initial writing of this Note the government has suspended the seller contribution program; however not apparently due to societal externalities but because of cost of foreclosure. Shaun Donovan, Remarks at the 6th Annual Housing Policy Council Meeting (May 7, 2009) *available at* http://www.hud.gov/news/speeches/2009-05-07.cfm ("Note that at the beginning of the current fiscal year, seller funded down payment assistance loans accounted for 14 percent of all FHA loans outstanding, but generated 31 percent of all FHA foreclosures and 31 percent of all losses on foreclosed-properties. Looking forward, we estimate that without the elimination of this program, FHA would have needed an FY 2010 appropriation of over $2.5 billion. Instead, we project that FHA will return to the tax payer over $1.7 billion.")

in our lending system because they represent the path of least resistance for banks. However, if the government were to provide insurance, the insurance entity could do more than just hedge against bank losses; it could set the standard for bank actions that must be performed before issuing the insurance claim. A different set of "foreclosure practices," sculpted by the government, could favor the entire economy. A few examples of possible reform within the foreclosure structure, that could potentially help the market from entering a negative feedback loop, are provided below.

First, the FMIC could require the bank to accept certain short sale offers when a distressed seller has appropriately proven that foreclosure will inevitably ensue. In many states, bank short sales are ineffective and the process is inefficient. Short sales often fail and banks stubbornly push on to foreclosure because it is an easier event to explain to bank investors.[191] Meanwhile, payments continue to go unpaid, the property deteriorates, and often the market continues to soften. By forcing the bank to cooperate early in the foreclosure process (short sales), the FMIC could effectively eliminate a large number of foreclosures and mitigate industry losses.

Second, the FMIC could require banks to provide a forty-five-day grace period for qualified buyers who wish to bid at foreclosure auctions. Currently many jurisdictions require investors to pay cash within twenty-four hours of the foreclosure auction. The "here and now" mentality of banks effectively precludes the general public from participating in the foreclosure process. Investors that search for properties at forty, fifty, and sixty cents on the dollar pull down the bank's ability to recoup debt, drop the value of foreclosed real estate, and simultaneously harm the resale market. The FMIC could revolutionize the foreclosure market by allowing a forty-five day window to qualified buyers who provide $10,000 in non-refundable earnest money to close on a foreclosure property. Additionally, the process fails to draw on the buying power of the entire market. Many of the nation's state foreclosure systems extract homes from those who are poor and then open the bidding process only to those who are rich and have hundreds of thousands of dollars of cash to invest.

These FMIC requirements could decrease the number of homes pushed into foreclosure every year and decrease the crippling effect foreclosures

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[191] In a typical short sale, the bank must receive sufficient documentation to show that the seller is truly "distressed" in order to appease management and investors. This requirement is only the first of the hurdles. Perhaps the largest complication is that often the broker price opinion (an inexpensive bank appraisal) is higher than a deflated market will support (partly because the appraisal is often based on comparable sales during *past* months). Thus, legitimate short sale offers are often rejected by lending institutions. On the other hand, when a property is foreclosed, the bank and investors in the bank expect less from the property and are more willing to cut their losses. But the problem remains that the market for foreclosed properties is significantly smaller and more picky. Thus, forcing banks into short selling at reasonable losses would be better for the lender, seller, buyer, and, ultimately, the market as a whole.

have on the market.

V. CONCLUSION

The FMIC proposal provides a strong foundational cornerstone for further discussion and illustrates a viable and workable solution that draws on major legal and economic principles—proven in other markets—that would most likely stabilize the mortgage market. Granted, the program would be difficult to analyze before implementing. Extensive deliberation, debate, and research would be required in order for Congress to fully analyze the effects that such a large-scale program would have on the market. Fortunately, consideration could begin with detailed research on the similarly large-scale reformations that developed in the wake of the Great Depression: the SEC, FDIC, FHA, and the Fed. Similar to the proposal for the FMIC, many of the past federal efforts to create centralized regulation and capitalization in various industries were spurred on by a looming market meltdown.[192]

While it is difficult to anticipate every effect the FMIC might have, some market reactions can be confidently anticipated. For example, the FMIC insurance premium payments—paid either by consumers, lending institutions, or both—would undoubtedly slow lending in the mortgage market. The effect of a slowed lending industry would in turn slow the housing market and perhaps cause a slight drop in market prices (because sellers would inevitably struggle to find qualified buyers).[193] On the other hand, investor confidence would significantly increase and the demand for mortgage-backed securities—insured by a government entity—would likely create a counteracting influx of investor cash.[194] The result would be an increase in the availability of loans, which would catalyze market growth. Thus, even though insurance premiums may potentially slow market forces, investor confidence would likely counterbalance negative effects.

Admittedly, there are other alternative solutions. Each alternative solution—and each variation of the FMIC—would inevitably be accompanied by positive and negative effects and repercussions. But, the FMIC does represent a more thorough and long-term solution than is

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[192] The Fed was created in response to the frequent bank runs early in the century. FRIEDMAN, *supra* note 35, at 76.

[193] This same cause and effect cycle is perhaps illustrated most notably by the 2008 housing market: (1) panic among banks slowed lending which slowed buying; (2) slowed buying required sellers to lower prices; (3) lower prices devalued bank collateral on issued loans; and (4) deflating bank assets undermined the stability of lending institutions at the very point when foreclosures began to increase.

[194] Investor response would likely increase because even though the government was "partly" involved in mortgages before, the relationship between the government and secondary market lenders Fannie and Freddie—"government sponsored entities"—was always too ambiguous for full investor confidence.

currently before Congress. In other words, it is a solution that exceeds the recent knee-jerk reactions of Congress to simply avoid recession, avoid contagion, and avoid depression. The United States deserves a long-term solution that the FMIC could provide.[195]

The FMIC solution thoroughly weighs many of the most important mortgage industry shortcomings and provides workable answers that place the burden of capital reserves on the industry—not the taxpayer. The FMIC addresses the most fundamental—and incidentally the most difficult—problems within the mortgage lending legal system: insufficient capital reserves, decentralized regulation, inconsistent state standards, slipshod disclosure, inadequate consumer education, and taxpayer insurance. For these reasons, the time has come to seriously consider implementing large-scale reform to provide long-term solutions for the mortgage industry.

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[195] The FMIC solution is more reliable than the haphazard bailout of the mortgage industry with taxpayer capital. It is more comprehensive than the current sporadic state efforts to patch up an insufficient predatory regime. And it avoids creating greater systemic risk by morphing bankrupted financial entities that are "too big to fail" into even *bigger* companies.