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K Street, Save Main Street, and You Will  
Save Wall Street - and Paulson - as Well

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## **BAILOUTS, BUY-INS, AND BALLYHOO: FORGET K STREET, SAVE MAIN STREET, AND YOU WILL SAVE WALL STREET – AND PAULSON – AS WELL**

**Robert C. Hockett\***

It is now widely heard upon Wall Street, K Street, Main Street and beyond that the U.S. financial system is faced with a sort of “financial 9/11.” Some now accordingly urge that a manner of “financial U.S.A. Patriot Act” be passed quickly. Treasury Secretary Paulson, Fed Chairman Bernanke, and other Administration officials urge Congress to confer nearly unreviewable discretion upon Treasury, that it might employ up to \$700 billion or more in federal funds for the purchase of illiquid assets now seizing up credit markets. Mr. Bush has addressed the nation from the White House several times in recent days, urging support of Treasury’s proposal. He tells us ominously – and perhaps not inaccurately – that our incomes, our life savings, our homes and even our neighborhoods are threatened. He has summoned Congressional leaders, and even Senators McCain and Obama, to White House “summits” on the crisis. And Senator McCain has twice spoken of “suspending” the presidential campaign. Tonally speaking, it all sounds a bit eerily familiar.

Meanwhile, in response to these developments, unsurprising objections have been raised. Some balk at the breadth of discretion, as well as the Iraq-rivaling volume of money, that Treasury’s proposal would place at the Secretary’s discretionary disposal: Paulson, they note, could buy *any* assets under the plan, from anyone – even his erstwhile investment bank colleagues or “cronies” now out for gravy. Others object the proposal in any event affords Wall Street a pass on improvident, “speculative,” even “predatory” investment practices at Main Street’s expense. They also note Treasury’s likelihood of retaining the same firms that partly have *wrought* the present crisis, to hold and manage those assets the plan contemplates Treasury’s purchasing. Still other objectors observe that Treasury’s plan does nothing for those Main Streeters whose deceptively marketed home mortgages now face default, and whose prospective defaults lie at root of the present troubles. Some in this camp also wonder whether Treasury’s plan isn’t simply a retread of Bush’s original plan to gut Social Security, resurfacing in a new guise: Bail out Wall Street, including private insurance firms, so that nothing will be left in the fisc to bail out social insurance. Finally, some even cry out that Treasury’s proposal raises the frightening specter of “financial socialism.”

Would it be churlish to say, in the midst of this drama, “hold on there fellas!” and point out that all of the shouting is both unnecessary and misdirected? I think not. For lost in the burning barn, trading floor style hubbub is an obvious solution right under our noses. It is a solution, moreover, that avoids all the objections just cited as well as another that’s not yet been raised, which I shall describe in a moment. The obvious solution is to restore, at least temporarily and possibly permanently, the business of low-

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\* Associate Professor of Law, Cornell Law School. Much of the history cited here is recounted in greater detail in Robert Hockett, *A Jeffersonian Republic by Hamiltonian Means*, 79 S. CAL. L. REV. 45 (2005).

end mortgage finance, refinance, financial counseling, and mortgage securitization to those still existing agencies which made low-end mortgages possible in the first place, then handled the bulk of them for decades: I refer to the Federal Housing Administration (FHA), working in tandem with its originally government-sponsored and recently re-federalized sibling enterprises (GSEs), Fannie Mae and Freddie Mac, along with Ginnie Mae. Treasury's new plan for bailout long has been *these* institutions' bailiwick.

Think back and recollect recent history for a moment: The institutions I cite here were breathtakingly innovative when first introduced at the end of the Hoover and start of the Roosevelt Administrations. They were founded, moreover, precisely in order to address our last economy-wide home-foreclosure crisis – and the Depression it deepened or caused. FHA afforded mortgage insurance for the first time in our history, showing possible and indeed profitable what long had been thought quite impossible. The standards that FHA imposed as condition upon that insurance gave rise both to nationwide quality standards in new housing stock, and to a nationally standardized fixed rate mortgage instrument – the now familiar, but theretofore unheard of, 30 year mortgage. (Previously one had to put at least 50% down on a home purchase, and had to refinance every few years.) That standard instrument for its part made securitization possible, and Fannie, then Freddie and Ginnie, were government-founded precisely in order to “make” that secondary market, hence to complete default-risk markets and thus render home finance widely available to virtually all working Americans.

FHA and its securitizing GSE siblings performed these coordinate functions, *for decades*, remarkably well – before it was given over to Wall Street, which got into the act only once Washington and Main Street had showed it for profitable. For FHA and its GSE siblings quickly transformed us from a nation in which fewer than 40 percent owned their own homes, to a true “stakeholder” nation in which nearly 70 percent do. They can do it again. And in so doing they can save both Wall Street and the broader financial economy as well – all in a manner quite free and clear of the objections now understandably raised to the Bush Treasury's proposal.

Here is how: First distinguish two very different components of the present “crisis.” The core, and initiating, component is a comparative minority of subprime-mortgage-backed securities (MBSs) of now questionable worth, held along with other assets by a good many financial institutions (FIs). These securities are now widely thought to be “toxic” because many – but not all and not even a majority – of the mortgages that back them are troubled. The latter are troubled, in turn, because many were improvidently – in some cases even misleadingly or “predatorily” – extended by private “mortgage bank” lenders working both outside of FHA's ambit, and free of depository institution regulation. Many of these mortgages included very low “teaser” rates of repayment at the front end, followed by “ballooning” rates that kicked in shortly thereafter. Many to whom these were marketed did not know what they were getting into, and the mortgage originators often did nothing either to warn them or check on their abilities to pay. Nor did they consider the interests of purchasers of these mortgages in the secondary markets, who widely assumed the due diligence had been done. For it seems to have been thought, per a classic “bubble” mentality, that fast-rising home prices

both (a) would more than make up for the risk of subprime defaults, and (b) would never turn downward.

The second and peripheral, but now growing component of the present crisis is psychological. It is a case study in Stiglitz's and Weiss's credit rationing problem – or, more familiarly, Akerloff's "market for lemons" problem: We have a financial market made jittery by uncertainty over *what portions* of various FIs' portfolios are *held* in the form of the troubled mortgage-backed securities. Even those who well know or suspect that the full volume of MBSs is worth more per unit than the least valuable portions thereof, in jittery times assume they hold a large portion of "lemons." The greater and longer enduring these jitters, the more reluctant FIs grow to lend, and the more prone investors become in the short run to undervalue affected institutions' portfolios – even what might be the "good" portions thereof. The more that investors accordingly seek to shed stakes in these institutions, in turn, the more rapidly the *remaining* such stakes lose *their* short-run values. A classic and all too familiar "downward spiral" ensues; a self-fulfilling prophesy, in fact: The psychological component of the problem ultimately grows larger than the initiating component, even though causally tied to and rooted in it. And this spiral is instrumentally facilitated and augmented, of course, by short-selling practices and short-term market-value accounting of asset portfolios.

What is the solution, and what do FHA and its GSE siblings have to do with it? Simple: Immediately reverse the downward spiral by directly addressing the cause at its core – the bad mortgages and the securities they back. This is in essence what Paulson's plan contemplates. Do so, however – or see to it that Paulson does so – through precisely those instrumentalities originally created and still best equipped to deal with low-end mortgages and the securities they back. Those are, as mentioned above, FHA and its recently refederalized siblings, Fannie and Freddie. This way you not only address the core problem directly and avoid the objections now facing Treasury's plan: You also straightforwardly cabin the peripheral psychological problem, by "signaling" clearly to all that the *real* problem is discrete, containable, and now well contained.

Now, what would it be to "address" the core and peripheral problems through FHA and its GSE siblings? How, that's to say, would the plan work in detail? Well, several variations are possible, and some are already on offer – for example, by Mike Barr at the Center for American Progress, by Bob Shiller at Cowles, by Senator Dodd and Representative Frank, and even by me. Half of what most urgently needs doing now is common to all of these plans, and even to the one sensible part of Treasury's plan now before Congress. I'll specify both halves of what's most important, however, by reference to my own plan. I'll do so because this is naturally the plan I know best, and because this plan's the one that I think can most quickly and readily be effected by institutions we already have. For what I propose is precisely what these institutions already *did* – again, for decades – before we embarked on a few poorly designed, inadequately regulated privatizations.

First, then, as proposed by Treasury, we purchase the perceivedly "toxic" MBSs now said to be "clogging" the market. But we do so, not via essentially unfettered

Treasury action apt to keep “Wall Street’s” – and K Street’s – interests closer to heart and more immediately in mind than “Main Street’s,” while lacking current institutional capacity to hold MBS portfolios in any event. We do it instead through our originally national, and now newly refederalized, GSEs – which already are in the business of holding these securities. These institutions, recall, pursuant to their originally well cabined home-ownership-spreading mandates, *made* the secondary markets in mortgages in the first place. Indeed they once constituted them entirely. They still hold, moreover, the great bulk of mortgages backing MBSs, and indeed hold the best of them. Through these institutions, then, purchase outstanding MBSs back from key FIs at a rate greater than currently undervalued market, but lower than more “fundamental” discounted cashflow value. That way the benefiting FIs still lose something – in effect, we diminish moral hazard concerns by effectively “coinsuring” or exacting a “deductible” – but continue to function and extend credit. Then when stability returns and market values come back into line with the mean, Fannie and Freddie can resell many of the purchased securities and recover their outlays. They might even come out ahead – as they routinely did before their rushed, moral-hazard-occasioning privatizations. If there’s concern that this still gives the benefiting FIs too great a boon, require that an equity stake be given the purchasing GSE as well – a sort of “buy-in” of the sort lately recommended by Luigi Zingales.

Second, simultaneously, and just as crucially, through FHA immediately commence refinancing arrangements with, and financial counseling for, those owner-occupied home-buying borrowers whose mortgages back the repurchased MBSs. At least do that for all of those who, thanks to misleadingly packaged, privately offered mortgages, in the wake of the 2006 real estate slump now find themselves in over their heads. Why do this through FHA? Easy: Just as the MBS buybacks described in the previous paragraph are Fannie’s, Freddie’s, and Ginnie’s original bailiwicks, so are mortgage financing, refinancing, and financial counseling FHA’s original and continuing bailiwick.\* Moreover, as owner-occupied home-ownership-spreading always has been and remains FHA’s institutional mission, we can be reasonably confident that it will have the best interests of home-buyers now unnecessarily faced with foreclosure at heart. We can also expect FHA to be more *effective and efficient* a workout-arranger than would be bankruptcy judges suddenly called upon to blue-pencil mortgage contracts in the manner now vaguely envisaged by some members of Congress. Indeed FHA, long the principal home-ownership-spreading and sole self-financed agency of our federal government, is *ideally* situated to oversee nearly *all* aspects of our dealing with the present crisis.

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\* Bob Shiller has recently proposed founding a new Home Owners’ Loan Corporation (HOLC) like that founded by the Roosevelt administration to afford refinancing to defaulting mortgagees in 1933. That is a fine idea in substance, in my estimation, but I think it unnecessary and indeed apt to be more complicated than I propose. The reason is that HOLC was phased out in 1935 once FHA, founded in 1934, was instituted to take over its functions and discharge new ones as well. Ever since then, FHA has guaranteed qualifying privately extended mortgages against default, has extended loans of its own and arranged refinancings per the HOLC model, and afforded financial counseling services. See Hockett, *Jeffersonian Republic by Hamiltonian Means*, supra, headnote. Since it’s been doing this at no cost to the fisc since its founding, it seems to me simpler just to channel today’s troubled owner-occupied home-mortgages to it, rather than founding a new institution operating in parallel.

Note that, in contrast to Treasury's plan now before Congress, the FHA/GSE plan I have just sketched would not involve placing any government instrumentality in charge of any asset, activity, or market with which it is not already intimately and extensively engaged: There is no problem of over-delegation or new "nationalization" here of the sort that need worry those now objecting to possible promotion of Secretary – or "Comrade" – Paulson to a sort of "Homeland Financial Security Czar" or "Financial Commissar."<sup>\*</sup> Nor does the FHA/GSE plan ignore distressed home buyers, or reward predatory lenders or improvident investors: To the contrary, it places these concerns center stage, and in doing so also, collaterally, addresses *all* real concerns currently facing the financial markets *at large*. Instead of purporting to protect Main Street by rescuing Wall Street as Treasury's current proposal does, that's to say, it "flips" the relation and rescues Wall Street *by* rescuing Main Street. And in so doing, it avoids every problem cited above in connection with all the objections we are now hearing to Treasury's proposal.

The FHA/GSE plan that I here propose *also* avoids an *additional* problem occasioned by Treasury's plan, which does *not* appear yet to have been noticed: Ominously couched and urgently advocated as it is in diffuse, plenary terms, Treasury's plan and its present style of advocacy reinforce a potentially tragic and yet avoidable public misperception. That is the perception that some foggily indefinable and unforeseeable, hence pervasive and paralyzing, financial "infection" has suddenly come to afflict us from nowhere. This dispiriting and unnecessary misapprehension reinforces that very sense of panic and powerlessness which I suggested above represents both the largest and most readily reversible component of our current financial distress. It is as if someone were seeking to make us all feel as we did while the dust was still hanging on the twelfth of September, 2001. "Fuzzy math," fuzzy mandate, fuzzy faux fix.

Yet as I've argued, the problem is not at all fuzzy; it is clear and distinct. It is thus readily amenable to discrete, clearly contoured solution – through existing instrumentalities within whose long-existent and constitutionally legitimate mandates it already falls. Those are institutions we founded during the late Hoover and early Roosevelt years to address essentially the same problem we face now – a home finance crisis that preceded the 1929 stock market crash and then caused or deepened a "Great Depression." Clean up the core mortgage and MBS problem through precisely those core agencies we first founded, during that last great housing crisis and associated Depression, to handle what amounts to essentially the same problem we face now. Then all the large and diffuse peripheral problems now being debated in Congress, in the press, and even "out in the street" by protesters who have been intermittently demonstrating on Wall Street since the White House's first "summit" will quickly take care of themselves. Ignore K Street and save Main Street, and you'll have saved Wall Street to boot.

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<sup>\*</sup> If the government "bought-in" as well, per the Zingales proposal, by taking an equity stake in bailed out FIs, there might be some lingering complaints of this sort. I see not need at this point to hold strong feelings one way or the other about this. I don't think the "buy-in" scenario is clearly necessary at this point, but I'd not feel any special fears about it were it shown to be helpful.