McDonald, Oonagh. "The Subprime Market Grew and Grew and No One Knew."
Fannie Mae and Freddie Mac: Turning the American Dream into a Nightmare. London:
Bloomsbury Academic, 2012. 243–265. *Bloomsbury Collections*. Web. 26 Apr. 2023. <<http://dx.doi.org/10.5040/9781780930039.ch-011>>.

Downloaded from Bloomsbury Collections, www.bloomsburycollections.com, 26 April 2023,
12:08 UTC.

Copyright © Oonagh McDonald 2012. You may share this work for non-commercial purposes
only, provided you give attribution to the copyright holder and the publisher, and provide a link to
the Creative Commons licence.

The Subprime Market Grew and Grew and No One Knew

Confusion over subprime lending

The language used in describing various kinds of mortgages throughout the period was misleading. Fannie Mae and Freddie Mac were the largest purchasers of “conventional” single-family first mortgages in the secondary mortgage market. The term “conventional” refers to loans that are insured or guaranteed by the federal government. The FHA insures residential mortgages, and the Department of Veterans Affairs (VA) and the Rural Housing Service (RHS) guarantee them. Then conventional single-family loans are often described as being “conforming” or “non-conforming,” where the former term means under the loan limits for loans which Fannie and Freddie could buy. Those limits changed from year to year, as house prices rose, but the GSEs were, in theory, not allowed to purchase mortgages above that dollar limit. They did admit to purchasing “jumbo” loans; that is, loans above the “conforming” limit, during the years after the introduction of the National Homeownership Strategy.

Conforming loans

“Conforming” loans were “underwritten according to the standards of Fannie Mae and Freddie Mac”, a notion which certainly requires further examination. The term “conforming” implies that the loans conform to certain underwriting standards, but it also has a much narrower meaning, and Fannie Mae played on this ambiguity by constantly referring to the loans Fannie bought as having to “conform” to their standards; it is clear from the comments of regulators and politicians that they usually understood it to refer to the quality of the loan, not its amount. Non-conforming loans would have balances above the dollar limit for that year; these were often called jumbo mortgages and were not underwritten according to the GSEs’ underwriting standards.¹ For most people, the loans for single-family homes would be under the limit, which in the late 1990s and in the early part of the following decade looked as though it was more than enough for the purchase of a new single-family home, based on the median price for the whole of the USA. It did not, however, take account of the wide variations in prices in cities such as New York and the District of Columbia, and the “sand” states

(California, Florida, Nevada and Arizona), where house prices soared well above the conforming loan limits. That was especially true between 2004 and 2006, a source of complaint by some members of Congress especially in those years.² A jumbo loan will be described as “non-conforming,” but that is only in relation to the loan limits and *may* not indicate anything further about the credit quality of the loan. It could be a loan to a borrower with the income and appropriate credit rating, who wishes to purchase a more expensive home than the average-priced home in an expensive urban area, such as Washington DC or New York.³

Conforming loans and credit quality

The notion of conforming loans should not therefore be taken to indicate any features of the loan which would enable the assessment of its credit quality. As we saw in Chapter 4, the criteria in use up to 2005 were too limited and did not identify the relevant features of subprime lending, defining them as higher-priced loans and loans from lenders which were on HUD’s list of subprime lenders. As John C. Dugan, Comptroller of the Currency, pointed out in his evidence to the Financial Crisis Inquiry Commission in 2010, “OCC analysis has found that national bank subprime origination during the period preceding the financial crisis was small relative to the total subprime market. However, some analyses by others have reached conflicting conclusions, finding significantly higher percentages of overall subprime lending. To some extent the existence of conflicting estimates is not surprising. Developing precise estimates of subprime lending is difficult because comprehensive data for the market *simply do not exist, from either public or private sources*. Statements about subprime activity also suffer from lack of agreement at a more basic level regarding how to define “subprime” or other variants of non-prime loans.”⁴

The situation was further complicated by the fact that Fannie Mae classified a loan as subprime if the mortgage loan was originated by a lender specializing in the subprime business, or by subprime divisions of large lenders.⁵ This reduced the number of its subprime loans considerably. Similarly, when the Federal Reserve studied the performance of subprime loans, they defined them as subprime if they were reported as high-interest loans under the Home Owners Protection Act (HOPA), which again reduced the number of subprime loans to a very small number. This was important, since when the Federal Reserve studied the performance of CRA loans, they excluded a large number of loans that did not carry interest rates that fell into the HOPA category. The confusion arose, partly for the reasons set out above, but also because many of the participants and reporting agencies used definitions based on the way in which the lender or securities issuer classified the loan, rather than on its objective characteristics.

Subprime loans and lack of data

The acknowledgement of this failure is significant, as it shows quite clearly that the regulators were unaware of the growth of the subprime market. However, they cannot have thought it important to improve data collection by requiring further basic information, such as the credit rating of borrowers, debt-to-income ratios and loan-to-value, for example. Concerns had been expressed about predatory lending, but this was inadequately defined, given regulatory knowledge of the various types of mortgages which were available. It was well known that the size of down payments had been reduced to 5% or 3% or zero in many cases, for example with FHA loans. Some economists applied various modeling techniques to HMDA data in order to identify the proportion of subprime loans, which tended to show that this was quite low and hence unlikely to cause problems; indeed, some argued that subprime loans were just as likely or even less likely to lead to delinquency or foreclosure than prime mortgages, but that was during a period of continually rising house prices and low interest rates. What all failed to take on board was that they simply did not have the raw data. Had HMDA been designed to record the relevant data, from President Clinton's extension of the Community Reinvestment Act, then the risks involved would have become clearer at a much earlier stage. But while the HMDA data were continually examined and analysed, no amount of analysis can bring the raw data into being if they are not there in the first place. No matter how sophisticated and erudite the analyses, how up-to-date the models, the necessary input was simply not available. The trouble was that such work helped to disguise what was really happening in the market.⁶

Belatedly recognizing these issues, the Comptroller in his opening statement pointed out that "poor underwriting practices ... made credit too easy. Among the worst of these practices were the failure to verify borrower representations about income and financial assets; the failure to require meaningful borrower equity in homes in the form of real down payments; the offering of 'payment option' loans where borrowers actually increased the amount of their principal owed with each monthly payment; and the explicit or implicit reliance on future house appreciation as the primary source of loan repayment, either through refinancing or sale.

"In short, at the beginning of the 21st century, the US system for mortgage finance failed fundamentally (yet was so often described as 'world-class' and the 'envy of the world' in the hearings of the House and Senate Committees). The consequences were disastrous not just for the borrowers and financial institutions in the United States, but also for investors all over the world due to the transmission mechanism of securitization ... One [reason why this happened] is that for many years, home ownership has been a policy priority ... we tolerate looser loan underwriting practices ... if they make it easier for people to buy their own homes, sometimes even turning a blind eye to them".⁷

It's too difficult to define subprime loans

In addition to the limitations of the data collected, many commentators and analysts argued that it was difficult to define “subprime” loans, which obviously made it difficult to determine the extent of subprime lending. For many years, researchers and analysts defined risky loans as those loans reported under HMDA that were originated by lenders on the HUD list of subprime lenders, using the assumptions that all loans from these lenders were risky, and no loans from other lenders were risky.⁸ This was clearly inadequate, because it helped to obscure the risks that were being taken.

To understand what is meant by subprime mortgages, it is first useful to examine the loans which were being offered, apart from the traditional prime mortgage with 80% LTV and a fixed-rate 30-year mortgage. These included adjustable rate mortgages, many of which were short-term hybrids; that is, the interest rate was fixed for the first two or three years and then became an adjustable rate tied to market interest rates. The initial fixed rate of such mortgages is often called a “teaser” rate, because the interest rate on the mortgage is designed to rise by two or more percentage points after the initial period ended. They were sometimes popularly described as 2/28^{ths}, where the “2” referred to the initial two years of fixed interest rates and the “28” referred to the following 28 years of adjustable interest rates. Other adjustable rate mortgages were floating rate mortgages, where the interest rates varied from the beginning of the loan as market rates changed, and long-term hybrids, where the interest rates were fixed for the first five, seven or ten years before becoming adjustable rates.

Other types of mortgages included “balloon” loans, which could take the form of a short-term mortgage, perhaps 10 years, for which the borrower had to make regular payments and then a final “balloon” payment as one large instalment at the end of the term. They could also be set up as a 30-year fixed-rate mortgage, either as interest only or partially amortizing the mortgage, with an embedded option for a final large instalment. The advantage would be lower rates throughout the life of the mortgage.

At first, Alt-A loans seemed to be quite simple to define as “alternative to agency” and typically loans where the borrower would not provide complete documentation of his or her assets or the amount or source of his or her income. Other characteristics of this classification might include the following: (i) a loan-to-value in excess of 80%, but lacking primary mortgage insurance; (ii) secured by non-owner-occupied property or a debt-to-income ratio above normal limits, or an LTV above permitted thresholds in combination with other factors.⁹ Nomura gives examples of Alt-A loans from one lender, whose standard program allows for a maximum LTV of 75% on a \$400,000 “stated income” loan to a top-tier borrower. The same lender’s Alt-A program allows such a loan to have an LTV as high as 95% but does not allow cash-out

refinancing on properties that are second homes or vacation homes. Nomura notes that this approach defines Alt-A loans by what they are not, an approach which, as Nomura states significantly, means that the “*regular programs have expanded the scope of their offerings with the result that many of the loans that would not have qualified several years ago would qualify today.*”¹⁰ By the late 1990s, reduced or no documentation loans were lender driven rather than borrower driven, according to Nomura’s analysis, with the key issue being whether or not stated income, stated assets and debt-to-income ratios were verified by the lender. Some loans were agreed even though neither assets nor income were verified (apart from a verbal verification of employment), that is, the NINJA loans (no job, no income and no assets). These were probably quite a small proportion of subprime loans, but a proportion which it is difficult to calculate.

Nomura also comments on the “futility” of the effort to define alt-A mortgages on their interest rates relative to contemporaneous conforming loans, since at any time the range of mortgage interest rates on newly originated conforming loans can span several hundred basis points. Some borrowers pay points to get lower interest rates on their loans, and others may accept an above-interest market-rate so that they have “negative points” at the closing of their loans. The same options are available to Alt-A borrowers; hence the interest-rate factor alone is insufficient and may not be relevant. It is all a matter of the terms of the loan. Even in 2003, Nomura noted that “the future of Alt-A is unclear. The GSEs have made major inroads by means of their automated underwriting systems ... [and] already, the GSE ‘encroachments’ into the Alt-A sector have severely blurred the once sharp line that divided ‘conforming’ mortgage loans from all others.”¹¹

All of this shows that the problem of defining subprime lending did not in fact exist: it is a matter of a set of criteria: high loan-to-value, high debt-to-income ratio, and low credit score of the borrower. If the loan fulfils one or more of these criteria, then it is a subprime loan with a higher risk of default. That is clear from the history of the US mortgage market over the years between 1995 until the collapse of the market in 2008.

Subprime mortgages and borrowers

This all became clear in 2008. Writing in that year, Christopher Mayer and Karen Pence, noting the turmoil in the markets, said, “It was not supposed to work out this way. Securitization and other innovations in mortgage markets led to new loan products with the potential to make home ownership easier and more accessible to buyers who could not access credit previously through conventional means. These so-called subprime and near-prime mortgage products allowed buyers with lower credit scores, smaller down payments, and/or little documentation of income to purchase houses. These new products

not only allowed new buyers to access credit, but also made it easier for home owners to refinance loans and withdraw cash from houses that had appreciated in value.”¹²

This marked a final recognition that subprime mortgages should have been clearly defined in terms of the credit quality of the loan, which would have focused on three features: the loan-to-value; income and debt-to-income ratio; and the credit score of the borrower. The credit status of the borrower may include a range of factors such as recent delinquencies, foreclosures, judgments, bankruptcies and comparably high debt-to-income ratios; a lack of continuity in employment or low incomes, as well as the source of the income, whether from salaries, welfare benefits, child support or alimony; and/or impaired credit or no credit history at all. Credit history and prepayment risk are amongst the factors which should be taken into account in arranging the mortgage and in pricing it.

Of course, much was written and discussed regarding subprime lending almost from the start. An early paper by Robert Avery and others quotes the analysis carried out of loans made under affordable home loan programs, which GE Capital Mortgage Insurance Corporation (GEMICO) had insured. The outcome of GEMICO's analysis was that “delinquency rates on loans extended to borrowers with ‘good’ credit histories have been lower than the baseline. Conversely, delinquency rates have been particularly high among loans in which the borrowers had marginal credit histories,¹³ high ratios of debt payment to income and no cash reserves.”¹⁴ Fannie Mae and Freddie Mac announced their intention to move into the subprime market in response to the new housing goals set for them by HUD, to take effect from 2000. At that stage, the GSEs claimed that they only purchased about 14% of the subprime loans originated, but even then “market analysts expect that within the next few years the GSEs could purchase as much as 50% of the overall subprime mortgage volume.” Furthermore, it is not always clear what was meant by “subprime.” HUD maintained a list of subprime lenders, and classified subprime loans as loans originated by those lenders.

Some subprime lenders stressed that assessing the risks involved is done on an individualized basis, rather than an automated process, but the GSEs stated that they would improve their automated processes on the basis of the subprime loans they purchased and would move into the market in a “slow and prudent manner a reinsurance from Fannie Mae accepted with approval in a paper prepared by K. Temkin and others for HUD's policy review. The report recommended the introduction of risk-based pricing, based on the underlying risk of the borrower. Temkin's paper is primarily concerned with the forthcoming role of the GSEs in the subprime market, it is another early indicator of the risks involved in subprime lending, and remarkably prescient about the risks to the GSEs.” Although Temkin's paper is primarily concerned with the forthcoming role of the GSEs in the subprime market, it is another early indicator of the risks involved in subprime lending.

Predatory lending and subprime lending

When predatory lending resurfaced as an issue in 2000, the Senate Banking Committee held two hearings in July, 2001. Despite listening with sympathy to witnesses: individuals who had been victimized by predatory lenders, their concerns were that a sharp distinction should be made between predatory lending practices and subprime loans; because “there are people who have credit problems who still need and can justify access to affordable mortgage credit. They may only be able to get mortgage loans in the subprime market, which charges higher interest rates.” Others expressed similar concerns, such as Senator Gramm, who was anxious that without a clear definition of predatory lending, the Senate might put in place “policies that destroy a market that is serving an increasing number of people.” He explained that his strong feelings were due to his mother’s experience: she had three children and no husband but borrowed the money to buy a house at 50% above the market rate, and still paid off the loan. To such Senators and Congressmen, the availability of subprime lending and the importance of home ownership was such a strong and deep emotional issue that they could not see beyond it to the dangers ahead.¹⁵

Senator Gramm had produced his paper for the Committee on predatory lending practices, based on information received from the regulatory authorities. This concluded that not only was there no definition under federal law of the term “predatory lending,” but that the distinction between subprime lending and predatory lending is often blurred; the regulators had no organized system of collecting loan level data on predatory lending.¹⁶ This lay behind his view that the attempt to curb abusive practices could limit access to home ownership through subprime loans. Similar views were shared by the House Financial Services Committee, which conducted a hearing on predatory lending, at which many members of the Committee expressed the need to exercise caution over introducing further restrictions on predatory lending in case it inadvertently limited access to affordable housing.¹⁷ Several bills were introduced in the 109th Congress, but no action was taken on any of the bills, so there were no further attempts to curb predatory lending apart from the Federal Reserve’s amendments to Regulation Z to broaden the scope of loans subject to the Home Ownership and Equity Protection Act (HOEPA), which required lenders to document and verify income for loans covered by the Act.¹⁸

The Federal Reserve and other regulatory agencies did not take further action against predatory lending until 2008, and even then it was limited.¹⁹ The key point here is that for many lawmakers, access to affordable housing was more important than identifying and banning predatory lending. They did not take on board the fact that, even though (in their view) the expansion of subprime lending provides credit access for many people unable to obtain prime loans, it also triggered a rise in exploitative and predatory practices. Hence, even in 2002, HUD noted the extremely high foreclosure rates on

subprime loans, suggesting that predatory lending was a serious problem and that many subprime borrowers were entering into mortgages they could not afford. These concerns were identified before the subprime bubble, as were the links between subprime and predatory lending, in that the former all too easily gave rise to the latter.²⁰

The GSEs and the subprime market

The belief that loans purchased by the GSEs were not subprime loans arose partly from the use of the term “conforming,” and partly from the way in which the CEOs of both companies referred to their automated underwriting standards as though they had set standards for mortgages to which lenders should aspire. In other words, the impression was somehow conveyed that the GSEs purchased prime loans. That this is not the case can be seen by first examining the Charters under which Fannie Mae and Freddie Mac operated. Section 305 limits the amount of the loan to 80% of the value of the property at the time of purchase, and required that any mortgage with a loan to value of over 80% at origination has private mortgage insurance. This applies to “conventional” mortgages; that is, “a mortgage other than one which has the benefit of any guaranty, insurance or any other obligation by the United States or any of its agencies or instrumentalities.”²¹ But beyond that, there were no statutory limitations on or means of measuring the credit quality of mortgages which could be purchased. Indeed, Section 1719 of Fannie’s Charter stated: “The operations of the corporation ... shall be confined ... to mortgages which are deemed by the corporation to be of such quality, type, and class as to meet, generally, the *purchase standards imposed by private institutional mortgage investors*.”

The Minimum Safety and Soundness Requirements accompanying the Charter took the form of general guidelines, and these seemed to place the onus for assessing underwriting and credit quality on the Enterprise, even when updated in 2005. They stated that “an Enterprise should establish and implement policies and procedures to adequately assess credits before they are assumed and monitor such risks subsequently to ensure that they conform to the Enterprise’s credit risk standards on an individual and an aggregate basis.”²²

The guidelines further required the Enterprises to have “prudent underwriting requirements,” to consider the borrower’s ability to repay, to take account of the implication of a contract with a service provider for their credit risk, and to have procedures in place for identifying and managing declining credit quality. They should also have procedures in place to identify, monitor and evaluate its credit exposures, and to have procedures for handling counterparty risk from engaging in hedging activities and the use of derivative instruments. These comprehensive guidelines should have led to sound risk

management procedures. But they required conformity to the Enterprise's credit risk standards, which was obviously the weak link in the chain. In effect, the lawmakers gave Fannie Mae and Freddie Mac a free hand in the purchase of mortgages: a freedom they exercised from the start.

They knew the risks and went ahead anyway

It is clear, both from the programs that the GSEs initiated following the introduction of President Clinton's National Homeownership Strategy in 1995, and from the announcements they made about the changes to their programs (which were designed to promote lending to low- and moderate-income families, and to assist lenders "in their efforts to accurately assess the risks associated with combining various underwriting flexibilities"), that they were always players in the subprime market. They were players in terms of their mortgage purchases, and the "strategic alliance" agreements they made with a relatively small number of lenders.

For Freddie Mac, that began in 1994 with its Affordable Gold Loans program. Fannie Mae had a similar program, the Community Home Buyers Program. These loans were not written according to traditional underwriting standards; for example, for those in which the borrowers were allowed to meet part of the minimum down-payment requirement with funds from a third party, the delinquency rate from 1994 to February 1996 was about four times higher than for the peer group of traditional loans. Other "Affordable Gold Loans" originated in 1994 show a delinquency rate about 50% higher than for the peer group.²³ In other words, right from the start of the Presidential commitment to "affordable homes," it was known that such homes could only be affordable by lowering underwriting standards (flexible underwriting standards), and that the GSEs would purchase such loans. The risks were also recognized from the start, but ignored by many politicians.

According to a report in the *New York Times* in September 1999, Fannie Mae, "under increasing pressure from the Clinton Administration to expand mortgage loans among low and moderate income people" set up a pilot program involving 24 banks in 15 markets to "encourage those banks to extend home mortgages to individuals whose credit is generally not good enough to qualify for conventional loans," which was then designed to become a nationwide program in the following spring. Indeed, such a program would have been required by then, if Fannie Mae was to reach the housing goals set by HUD for 2001 onwards of increasing the purchase of mortgages for low- to moderate-income families to 50% of all mortgages purchased.

Thrift institutions and mortgage companies were "also pressing Fannie Mae to help them make more loans to so-called subprime borrowers." They were pushing at an open door. Franklin Raines said, "Fannie Mae has expanded home ownership for millions of families in the 1990s by reducing the down-payment

requirements. Yet there remain too many borrowers whose credit is just a notch below what our underwriting has required who have been relegated to paying significantly higher mortgage rates in the so-called subprime market.”²⁴

In March 2000, Franklin Raines announced the \$2 trillion American Dream Commitment, which would involve new mortgage products, processes and partnerships to close the home-ownership gap between minorities and women-headed households and the majority white population. The emphasis would be on low-cost mortgages on flexible terms. It would enable banks to meet their CRA goals by giving them a suite of mortgage options for low- to moderate-income families.

In particular, the Commitment offered the Timely Payment Rewards mortgages, which were based on “Expanded Approval”, an option within the automated underwriting system for those with less-than-perfect credit, past credit problems, or minimal funds for a down payment. A minimum payment of \$500 from their own funds was required, or 3% of the loan amount, which could come (as with the FHA) from gifts, grants, or unsecured loans from relatives, employers, public agencies or non-profit organizations. This approval applied to standard fixed-rate loans, such as 30-year, and 5/1 and 7/1 ARMS, but only the former were eligible for a reduction of 1% in the interest rate for timely payments. By March 2001, Fannie Mae reckoned that they had facilitated \$190bn for home mortgages.²⁵ Their Desktop Underwriting had processed over 25 million loan submissions in 2001.²⁶

In February 2003, Washington Mutual entered into an agreement with Fannie Mae to boost home lending by \$85bn over five years to minorities and to low- and moderate-income families. Washington Mutual would originate the loans and sell them to Fannie Mae, the \$85bn being part of the \$375bn the thrift pledged to lend in September 2001 over a ten-year period to low- and moderate-income census tracts, the largest commitment of its kind by a financial institution.²⁷

With regard to Freddie Mac, it is clear that the decision had been taken right from the start to purchase loans designed to meet the needs of those on low to moderate incomes in the Affordable Gold program. That and other arrangements became more important as HUD’s goals became more demanding from 2001 onwards. Other drivers were in place as well: competing with Fannie Mae, the larger and formidable opponent for market share, and restoring confidence after the massive accounting fraud was exposed.

Richard Syron, former President of the Federal Reserve Bank of Boston, was appointed to take over the management of Freddie Mac in 2004. In meeting the HUD goals, however, he was prepared to take risks and rejected internal warnings that the company was financing questionable loans that threatened its financial health. In an interview with the *New York Times*, David Andrukonis, then Chief Risk Officer, stated that he had sent a memo to Richard Syron, warning him that Freddie Mac was financing questionable loans that threatened its financial health. Later in a meeting with Mr Syron,

he reiterated his warning, stating that Freddie Mac's underwriting standards "were becoming shoddier and that the company was becoming exposed to losses." However, Mr Syron refused to consider any means of reducing Freddie Mac's risks. Mr Andrukonis also briefed the Risk Oversight Committee of the Board of Directors, but did not share the memo with them. Donald Solberg, Head of Capital Compliance and Oversight at Freddie Mac, advised Mr Syron to maintain a substantial capital cushion, and continued to recommend that until 2007, when he left the company; but again the advice was ignored.²⁸ In response, Mr Syron and Mr Mudd, Chief Executive of Fannie Mae, both maintained that "one of the reasons why the firms hold so many bad loans is that Congress has leaned on them for years to buy mortgages from low-income borrowers to encourage affordable housing. Freddie Mac warned regulators that affordable housing goals could force the company to buy riskier loans."²⁹

They did have a point, in that affordable housing for very low and low-to-moderate income groups would inevitably mean the application of different underwriting criteria, since obviously those whose incomes fell into the categories defined by the CRA and by HUD could not afford to put down 20% of the value of the property and take on a fixed-rate 30-year mortgage. Richard Syron was well aware of that, since it was he who signed off the Boston Handbook in 1992 on lending to low-income families and minorities. He may also have been influenced by his own background as a son of poor Irish immigrants, who were only able to buy their own home by virtue of a VA loan and by sharing it with another family.³⁰

Some of their partnership arrangements

The banks from which the Enterprises bought most of their loans were also among the top ten subprime lenders. In 2006, this list consisted of the following:

- 1 HSBC Finance
- 2 New Century Financial, CA
- 3 Countrywide Financial, CA
- 4 Citimortgage, NY
- 5 WMC Mortgage, CA
- 6 Fremont Investment & Loan, CA
- 7 Ameriquest Mortgage, CA
- 8 Option One Mortgage, CA
- 9 Wells Fargo Home Mortgage, IA
- 10 First Franklin Financial Corp, CA
- 11 Washington Mutual

This was the list as at 2006,³¹ but by April 2007, New Century had filed for bankruptcy. Other lenders selling to the Enterprises included Chase Home Finance and Lehman Brothers.

Contrary to widely held views, Fannie Mae and Freddie Mac were able to purchase such loans, as there was nothing in their Charters to prevent them from doing so. In addition, HUD's mission goals essentially required the GSEs to purchase ever-increasing proportions of lower-quality loans. Many analysts point both to the increase in riskier mortgages between 2004 and 2007 for many lenders, and to the GSEs' increased purchases of such mortgages in that period. This increased the risk in their portfolios, but that risk was ignored by politicians in particular. It was easier to ignore the ever-increasing risks, because aggregate US housing prices increased every month from July 1995 to May 2006.

Even where regulators were aware of the decline in underwriting standards, for example, the Office of the Comptroller of the Currency as a result of its 2005 survey, little action was taken.³² The OCC discovered the "easing of underwriting standards" in a quarter of the banks surveyed; that is, 28% had eased standards, 10% tightened and 62% made no change, but this was a considerable increase from 2004, when the number easing standards was 13%. "Notably, this is the first time in the survey's 11-year history that examiners reported a net easing of retail underwriting standards, concentrated in home equity products and residential real estate lending ... and affordable housing loans also experiences some easing. According to examiners, banks continue to ease retail standards primarily because of increased competition."³³ The OCC, however, considered that for such banks, appropriate risk management procedures were in place.

The result was that between 2004 and 2007, large national banks continued to make large numbers of low- and no-documentation loans and subprime ARMSs that were solely underwritten to the introductory rate. In 2006, for example, fully 62% of the first lien home purchase mortgages made by National City Bank, NA and its subsidiary, First Franklin Mortgage were higher-priced subprime loans. The bank did not face receivership because a merger with PNC Financial Services Group took place in October, 2008, following further losses of \$729 m in the third quarter: PNC announced that it was pleased to have been selected by the Treasury to prevent another collapse, and received federal funds to facilitate the purpose. Other large national banks were also deeply involved in the subprime market, including Citibank, the third-largest bank in the US in 2005; it took over Argent Mortgage, which then became Citi Residential Lending in September, 2007 for subprime lending, but had to dismantle it in May 2008. Wachovia Corporation originated both low- and no-documentation loans through its two mortgage subsidiaries, so that it became the twelfth-largest Alt-A lender in the USA by 2007. Write-offs of these loans increased so much and so quickly that the parent company reported its

first quarterly loss for many years, due to rising defaults on option ARMs. When this became public, it led to many customers quietly withdrawing their accounts from the bank after the Lehman Brothers' collapse. Again, to avoid receivership in late September 2008, Wachovia was sold to Wells Fargo.

Washington Mutual, the largest thrift institution with \$300bn in assets, was regulated by the Office of Thrift Supervision. On September 25, 2008, it became the largest depository institution in the US to fail, collapsing in the wake of the Lehman Brothers bankruptcy. It was seized by the government and sold to JP Morgan Chase in 2008. By June 30, 2008, over one-quarter of Washington Mutual's subprime loans which were originated in 2006 and 2007 were at least 30 days overdue. This was not surprising, following the later discoveries about its conduct of business over the preceding years (in spite of the fact that the OTS examiners were stationed permanently on site.) In the mid-2000s, the bank made a conscious decision to focus on high-risk mortgages, which produced higher profits. It increased its securitization of subprime loans sixfold, mainly through Long Beach Mortgage Corporation. Over four years, the bank and Long Beach increased their securitization of subprime mortgages from about \$4.5bn in 2003 to \$29bn in 2006. From 2000 to 2007, they securitized at least \$77bn in subprime loans. Their loan officers were paid according to the volume not the quality of their loans, and were paid more for higher-risk loans. They were also paid more if they got borrowers to pay higher interest rates, even if they were entitled to a lower rate. It was described as the bank that could not say "No," but borrowers certainly paid for it.³⁴

Countrywide Home Loans Inc (Countrywide), ranking third in the top 20 subprime lenders in 2006, was one of the closest companies to Fannie Mae. In 2005, one in every four loans purchased by Fannie Mae was from Countrywide and one in every ten by Freddie Mac. This was a mutual interdependence, since almost half of Countrywide's mortgages were sold to Fannie Mae. In addition, Countrywide used Ginnie Mae to guarantee another third of its loans, which meant that about 90% of the loans it originated were bought or guaranteed by the federal government, part of the reason, no doubt, for its spectacular growth. From 2000 onwards, as the mortgage market boomed, no other company pursued growth in home loans more aggressively than Countrywide, which became a \$500bn mortgage-producing machine with 62,000 employees, 900 offices and assets of some \$200 billion. It had also managed to move from being supervised by the OCC by changing its Charter in March 2007, so that it was subject to less onerous regulation by the Office of Thrift Supervision.

The company almost collapsed in 2008 as it faced an array of law suits. In February 2008, the United States Trustee filed a suit against it concerning a pattern of bad practices in a bankruptcy case, followed by a request for the Bankruptcy Court in Atlanta to sanction the company. This was followed by another suit by the state of Illinois on the grounds that the company had

defrauded borrowers by selling them costly and defective loans that quickly went into foreclosure. Ten other states were about to bring similar actions. This led to an \$8.4bn loan relief plan for 400,000 borrowers. Countrywide was responsible for about 20% of mortgages granted in the previous few years, so more law suits would follow. A sale to the Bank of America was sought and finally agreed in July 2008.

Fannie Mae and Freddie Mac dominated the secondary market in the number of loans it purchased and either retained in its portfolios, or sold on to investors. They clearly had all kinds of partnerships with the main subprime lenders, but when they dominated the market, what proportion of the market did they purchase, and what was the size of the subprime market by 2008? In answering these questions, the first step is to examine the contributions of the GSEs and other federal agencies to the subprime and Alt-A market.

Federal agency contributions to the subprime and Alt-A market

The brief description above of the kind of strategic alliances into which Fannie Mae and Freddie Mac entered, together with their obligation to meet the “affordable housing” goals, altering their underwriting requirements in order to achieve them and to gain market share, indicates increasing purchases of subprime and Alt-A loans. Fulfilling the affordable housing goals inevitably meant reducing the down-payment requirements, credit scores and debt-to-income ratios. Indeed, when the agencies offered their Expanded Guidance for Subprime Lending Programs in 2001, they both stated that “responsible subprime lending can expand credit access for consumers” and described “subprime” as referring to the credit characteristics of individual borrowers, of which an illustrative but not exhaustive list was given. Such characteristics would properly be summed up in a FICO score of 660 or below.

Hence, assessing the numbers of subprime loans for the federal agencies involves a definition, which encapsulates these features. The definition covers self-denominated subprime by the originator or the securities issuer, or placed in a subprime private MBS or with a rate of interest higher than HOPA, or loans with FICO scores of below 660, a demarcation line first recognized in 1995, as defined in Freddie Mac’s industry letter.³⁵ It can be argued that the GSEs implicitly recognized this when listing the serious delinquency rates by FICO score, where the lowest rate is 11.32% compared with 1.78% for prime loans.³⁶ Alt-A loans may be self-denominated by the lender or placed in an Alt-A, but with the primary characteristics of low or no-documentation or with an LTV in excess of 80% but without primary mortgage insurance.

Other such loans included adjustable rate mortgages (ARMS) which began with a low rate of interest, which then increased after a certain number of

years. These were known as “teaser” rates, as they were used to entice buyers into mortgages that they may not be able to afford. The rates would then be adjusted in accordance rates and margins, which were structured so that the rate was adjusted upwards. Other types of mortgages may have appeared attractive, as the monthly payments would have been affordable, but were subject to negative amortization, as they would not have covered all the interest on the mortgage. There were many variations of loans on offer, such as hybrid mortgages, with fixed rates for a number of years after which interest rates were adjusted each month; no down payment or low downpayments of 5% or less of the value of the property, or loans with flexible underwriting requirements or higher debt-to-income ratios. This range also included high combined LTV, where a combined first and second lien was used to reduce the down payment required. This lending commonly involved an 80% first and a 20% second loan.

On the basis of these definitions, Pinto assesses the federal government and federal agency contributions:

Subprime and Alt-A loans	\$ in billions	Number of loans in millions
Fannie Mae	\$1,077	7,026
Freddie Mac	\$758	4,913
FHA/VA/Rural Housing	\$537	4,760
FHLB	\$50	0.313
CRA & HUD program	\$512	2,240
Total	\$4,622	26.7

Mr Pinto justifies these figures as follows:

Step 1 At the end of June 2008, Fannie held \$36bn in self-denominated subprime private MBS with an average principal balance per loan of \$153,400 for 235,000 loans, plus \$30bn in self-denominated Alt-A private MBS with an average principal balance per loan of \$171,269 for 0.175m loans.

At the same time, Fannie’s single-family mortgage credit book of business holdings of subprime by characteristic loans, self-denominated Alt-A and Alt-A covered a range of high-risk whole loans, which consisted of loans with FICO scores <620, FICO of 620–659, negatively amortizing loans, interest-only loans, loans with an Original LTV>90%, loans with combined LTV>90%, and self-denominated Alt-A.³⁷

Step 2 Pinto notes that Fannie and Freddie’s disclosures about these seven loan types have evolved over time, and that this has generally resulted in

additional information being provided. By Q.2.2009, Fannie listed six of the seven product features in its “Credit Profile by Key Product Features,” but also provided additional information about loans where more than one feature was provided.³⁸ This gave individual dollar amounts for each of the six features (all but Combined LTV>90%), and a subtotal which eliminated any double counting. Although Freddie does not provide so much detail, the information Fannie provides helps to rule out double counting for Freddie as well.

The conclusion of Step 2 is that by the end of June 2008, Fannie’s six key product features came to \$1,214 trillion gross dollars and 7.944 million gross loans. Pinto then multiplies by 80% to adjust for duplicates, which gives \$971 billion and 6.354 million net loans.

Step 3 To this has to be added Fannie’s seventh and final key category, Combined LTV>90%. What should also be noted is what Fannie said in its 2007 10-K:

“In recent years there has been an increased percentage of borrowers obtaining second lien financing to purchase a home as a means of avoiding paying primary mortgage insurance. Although only 10% of our conventional single-family mortgage credit book of business had an original average LTV ratio greater than 90% as of December 31, 2007, we estimate that 15% of our conventional single-family mortgage credit book of business had an original combined average LTV ratio greater than 90%. The combined LTV ratio takes into account the combined amount of both the primary and second lien financing of the property. Second lien financing on a property increases the level of credit risk (on the first lien) because it reduced the borrower’s equity in the property and may make it more difficult to refinance. Our original combined average LTV ratio data is limited to second lien financing reported to us at the time of origination of the first mortgage loan.” It is interesting to note the word “estimate” in this statement; a word which surely should not be there, given the virtues of the DU automated system, which Fannie Mae constantly extolled. That should either have given an accurate figure or rejected such mortgages as being too risky. Reliance on estimates would inevitably have made risk management more unreliable.

To return to Pinto’s analysis, based on the above and on subsequent filings, this category provides an estimated \$133bn of Fannie’s portfolio of loans with a combined LTV>90%.³⁹ However, since no overlap information has been provided, the overlap has been conservatively estimated at \$40bn. The result for Fannie is that the net amount of various categories of subprime loans is \$1,011 trillion and the net number of loans is 6.616 million.

He performs a similar analysis for Freddie Mac, with the resulting totals based on the same categories as Fannie Mae. Freddie held \$82bn in self-denominated subprime private MBS, with an average principal balance per loan of \$153,400 for a total of 0.535 million loans. It held a further \$41bn

in self-denominated Alt-A private MBS, with an average principal balance per loan of \$175,961 for a total of 0.233 million loans. Its single-family credit guarantee portfolio of business holdings subprime by characteristic loans, self-denominated Alt-A and Alt-A by characteristic loans totaled \$752bn on June 30, 2008 with the same seven types of high-risk loans as Fannie Mae. Multiplying \$752bn by 80% to allow for duplicates gives a figure of \$602bn and 3.939 million net loans, basing the average loan size as \$152,814; that is, the same as Fannie's average, as Freddie Mac does not give such a figure.⁴⁰

Freddie's seventh category (Combined LTV>90%) is estimated to be \$33bn, based on an initial \$110bn, but estimating the overlap at 70% yielding the figure of \$33bn on the assumption that these loans have an average balance equal to Fannie's average loan amount of \$152,814 for key product features gives a net 0.216 million loans.

Thus for all these categories of loans, the net dollars are \$635bn and the net number of loans is 4.155 million.

The other two categories, the Federal Housing Administration (FHA) and Veterans Administration (VA), had 3.492 million and 1.122 million loans outstanding, with average balances of \$103,300 and \$150,000 respectively. For the FHA, 83% consisted of high original LTV lending and about 70% had a FICO of <660. This results in \$537bn in net loan dollars from the FHA and VA plus rural loans with a total of 4.76 million loans.⁴¹

The contribution of the Federal Home Loan Bank System was much less, but it was reported as holding \$76bn in private MBS as at the end of June 2008. It is not clear what the constituent elements of this portfolio were, but Pinto considers it reasonable to assume that 66% of the total, or \$50bn, would be backed by Alt-A and subprime loans. If the average loan amount was \$160,000 (an average based on Fannie Mae and Freddie Mac's holdings of private MBS and Alt-A private MBS), this gives 0.313 million loans.⁴²

The impact of the Community Reinvestment Act must also be taken into account, although many deny that it had any part in the crisis at all, perhaps because its scope was limited, and partly because the lenders were allegedly unregulated mortgage companies. The latter claim is not entirely true, since some of the leading banks, and indeed subprime lenders, were included, such as the Bank of America, JP Morgan Chase, Citibank, Wells Fargo and banks and thrifts with which these banks merged or which they purchased. The incentives built into the CRA requirements have already been described in detail, together with its effects on bank lending.

In 2007, the National Community Reinvestment Coalition (NCRC) published a report, which showed that from 1994 to 2007, CRA commitments came to \$4.5 trillion, of which 94% were made by the above banks. The outlier was Countrywide, acclaimed as the first mortgage lender to enter into a voluntary agreement for "Fair Lending Goals" with HUD. It became the third largest lender in 2004, and then either the largest or second largest

Alt-A lender; by 2007 it accounted for 29% and 18% of Fannie and Freddie's acquisitions respectively.⁴³

Many of the CRA commitments were fulfilled, largely due to the agreements the banks had made, commitments, totaling \$3.5 trillion between 1993 and 2007; but these loans were not tracked in any organized manner. About half of these loans went to Fannie and Freddie to meet their affordable housing requirements; about 10% were insured by the FHA; and about 10% were sold as private mortgage-backed securities. Most of the rest remained on the balance sheets of the four largest banks, where by 2009 and 2010 many showed higher default rates than prime mortgages. The CRA delinquency rates did not show up while interest rates were low and house prices continued to rise. Fannie's delinquency rate on its \$900bn high-risk mortgages, 85% of which were affordable housing loans, was 11.36% at September 30, 2009 as compared with the 1.8% delinquency rate on its traditionally underwritten loans. The CRA loans were fixed rate and did not have higher interest rates; as with some of the other subprime loans, they inevitably had other high-risk characteristics such as small down payments and low FICO scores. CRA lending had a slow-burn effect and was indeed a contributory factor, as shown especially by the acquisition of Countrywide.

According to Pinto, by the middle of 2008, there were almost 27 million subprime loans in the financial system, which accounts for almost 50% of all mortgages. Over two-thirds of these were held or guaranteed by federal agencies such as the FHA and the GSEs (12 million) and by US banks (about 2.2 million). That is about half of the outstanding first mortgages, estimated at 55 million, a figure which is derived from the National Delinquency Survey and the Mortgage Bankers Association, Q2, 2008. The NDS survey contains 45.4 million first mortgages, covering about 80-85% of outstanding first lien mortgages.⁴⁴ The Federal Reserve reports that the dollar amount of outstanding first lien mortgages at June 30, 2008 was \$9.42 trillion. If the calculations regarding the number of subprime mortgages are correct, then they reveal the enormity of the problem which was fostered over the years, particularly since 1995. The very complexity of the calculations and the variety of the data bases, none of which are complete, that have to be taken into account show the difficulty for the Administration, federal agencies and regulators, and the Federal Reserve of getting any sort of handle on the size of the problem. No one was looking at the growth of the subprime market, especially with regard to the involvement of the GSEs, for a number of reasons.

James Lockhart described his "significant supervisory concerns" in his letter to Richard Baker, accompanying OFHEO's annual report to Congress. The work involved was not confined to rectifying the accounting irregularities, but every aspect of the GSEs' conduct of business. The analysis of their 10-Q SEC returns, as set out above, was only possible in the case of Fannie Mae, whose first filing took place on November 9, 2007, and with Freddie Mac,

the first quarterly report, 10-Q, was filed on July 18, 2008. OFHEO stated in the 2008 report that the Enterprises filed their first clean (that is, properly audited) annual financial statements in a timely manner for the first time for four years. Even then, the 2008 report to Congress refers to concerns about the effectiveness of the remediation processes for both Fannie Mae and Freddie Mac.

The key point here, however, is that the filings prior to 2007 on the part of Fannie Mae cannot be regarded as being reliable, but that the information provided in Fannie Mae's Q2 10-K filing does occur after much remedial work had been carried out on its accounting procedures and other systems (although much remained to be resolved.) As Pinto points out, more investor information was provided than hitherto. The information gap for four years or more meant that the increase in subprime and Alt-A loans purchased by the Enterprises could not be traced with any degree of certainty. Even so, OFHEO reported that "during the past several years, Fannie Mae relaxed its underwriting standards, but not as much as many market players ... but credit losses resulted from their relaxed underwriting standards ... Management has made significant changes to better manage credit risk, including tightened underwriting standards, increased pricing, improved loss control practices and decreased exposure to distressed servicers." Yet earlier in the report, OFHEO cited credit risk management as an ongoing area of concern, noting that the projects were mostly complete, but scheduled for completion by the end of 2008, and other OFHEO requirements such as tightening underwriting standards would not become effective until March 2008.

The report continues: "Loans booked in the last few years have shown relatively unchanged profile characteristics in terms of FICO, loan-to-value, and level of credit enhancement. However, Fannie Mae increased its exposure to non-traditional mortgages and risk layering."⁴⁵ Asset credit quality deterioration in the single-family business accelerated in the second half of 2007, with losses exacerbated by both higher volume and loss severity in defaulted loans, which led to the reserves being increased for guarantee losses to \$3.3bn at year-end 2007 with a \$2.8bn provision in the fourth quarter of 2007. OFHEO recognized some of the growth of Fannie Mae's purchases of subprime and Alt-A loans, but it was too little and too late, obscured by years of false accounting and total mismanagement of the Enterprises.

It was not, after all, until September 2007, and at the direction of OFHEO, that the Enterprises adopted and implemented the bank interagency guidance on non-traditional mortgages and subprime mortgages. These now apply to all the mortgages that the Enterprises directly hold and guarantee, but also the underlying mortgages in private label securities that they acquire. The unanswered question throughout is this: given the sheer volume in 2007 of loans and MBSs purchased and guaranteed, how was compliance checked; and how was compliance checked in the past, when the 25 million loans in a year

were processed through the automated underwriting system (DU), given the inadequacies of Fannie Mae and Freddie Mac's systems and controls? Given OFHEO and HUD's paucity of staff and other resources, no one else was in a position to check on compliance, and indeed, guidance of any kind on subprime lending was not agreed by the federal regulatory agencies until 2004 (and even then, weakly enforced.)

In his testimony before the Senate Banking Committee in February 2008, Lockhart was able to give a more up-to-date picture of the increased risks in an unprecedented market for the GSEs.⁴⁶ Their market share rose to record levels in the fourth quarter of 2007 to \$5.1 trillion; that is, their debt and guaranteed MBSs, to which should be added the rapidly growing FHLBanks' debt of about \$1.2 trillion. So, \$6.3 trillion in debt, compared with the public debt of the United States of \$5.1 trillion (of which \$700bn is owned by the Federal Reserve.) US debt in public hands at the end of 2007 was \$4.4 trillion. In the third quarter of 2007, the Mortgage Bankers Association reported that the delinquency rate was 5.6%, the highest since 1986. In the face of such challenging conditions, Lockhart reported, the Enterprises were securitizing loans at \$100bn a month, but the risks implicit in such securitization and the extent of them would emerge more clearly later in the year.

The risks were not quantified even in that report to the Senate Committee. Some of the increase in losses Fannie and Freddie began to experience in 2007 was "because they lowered underwriting standards in late 2005, 2006 and the first half of 2007, by buying more non-traditional mortgages to retain market share and compete in the affordable market." The departure from the traditional market was nothing new, as the strategic alliances into which the GSEs entered showed, and their announcements about reducing down-payment requirements as far back as 1999. Lockhart noted that "they also have very large counterparty risks, including seller/services, mortgage insurers, bond insurers and derivative issuers."⁴⁷ In 2006, the Enterprises agreed to restrict the growth of their portfolios and to keep the capital levels 30% higher than the minimum required by law; that made it 3.25% of assets rather than 2.5% legal minimum, but this was still low compared with other financial institutions. In addition, given losses in earnings in 2007, they had only 1.2% of equity backing their mortgage exposure.

It is simply not true to say that the entry into the subprime market was a late development. In an early paper, provided for the Office of Housing and Policy Development, the authors point out that the "GSEs are increasing their business, in part, in response to higher affordable housing goals set by HUD in its new rule, established in October, 2000. *In the rule*, HUD indentifies subprime borrowers as a market that can help Fannie Mae and Freddie Mac achieve their goals, and help establish more standardization in the subprime market."⁴⁸ Indeed, Title XIII of the Housing and Community Development Act, 1992 called for a study of the "implications of implementing underwriting

standards that would (a) establish a down-payment requirement for mortgagors of 5% or less (b) allow the use of cash on hand as a source for down payments and (c) approve borrowers who have a credit history of delinquencies if the borrower can demonstrate a satisfactory credit history for at least the 12-month period ending on the date of application for the mortgage.” Such a study was commissioned by HUD; the authors found that both Fannie Mae and Freddie Mac had indeed adopted more flexible guidelines, such as Fannie Mae’s introduction of their Flex 97 product, which required a borrower to make only a 3% down payment if the borrower had a strong credit history.⁴⁹

That was from the beginning, but by 2000, they had expanded their purchases to include Alt-A, A-minus and subprime mortgages in addition to private-label mortgage securities. Fannie Mae implemented the Expanded Approval System and Freddie Mac expanded its Loan Prospector system to accommodate risk-based pricing. Subprime and Alt-A mortgages gave the GSEs a real opportunity to expand their businesses.⁵⁰ As these markets exploded over the next six years, Fannie Mae and Freddie Mac took full advantage of the opportunities, as the above analysis shows.

Even as late as 2007, Fannie Mae sought to give the impression that its standards, as incorporated in its underwriting programs, were above those of the rest of the market. Daniel Mudd stated that Fannie Mae “has a history of working with lenders to serve families who don’t have perfect financial profiles ... we see it as part of our mission and our Charter to make *safe mortgages* to such people ... We also set conservative underwriting standards for loans we finance to ensure the homebuyers can afford their loans over the long term.” He then referred to Tom Lund, then head of the single-family mortgage business, who said in early 2005, “One of the things we don’t feel good about right now as we look into the marketplace is more homebuyers being put into programs that have more risk ... Does it make sense for borrowers to take on risk that they may not be aware of? Are we setting them up for failure?”⁵¹ Sadly, no one on the House Committee asked what exactly they were doing about purchasing such loans, or whether or how they imposed their “higher” standards on lenders whose mortgages or MBSs they bought. It was yet another part of the image presentation of being “best in class,” as the interviews both Daniel Mudd and Tom Lund subsequently gave to the Financial Crisis Inquiry Commission showed that their concerns about subprime and Alt-A loans did not prevent them from buying them, as indeed they had from the start.

In his interview, Mr Lund claimed that in response to the increasing government pressure to meet housing goals (which were increased yet again in 2004), such as lowering the risk level for a borrower through the DU “bump” (lowering the credit risk of a borrower). If the borrower met a housing goal, then the risk level would be ‘bumped up’ to 2, and the loan would be priced as such by Fannie Mae. This explains why so many loans purchased by Fannie were in fact risky loans, despite Fannie’s assurances that loans had to meet ‘their

standards'. They reduced the equity requirements for home buyers, and bought bulk loans that contained housing goal loans. His concerns were expressed to HUD, but the goals were still increased, and could only be met if borrowers were taking up option ARMS and low- or no-down-payment loans. However, despite an apparent decision not to move further into the subprime market in June 2005, it seems that his anxieties were ignored; the corporate goals he was given at the beginning of 2006 meant that Fannie Mae would become more aggressive in purchasing Alt-A loans, and that continued after August, 2007.⁵²

In a similar interview, Mr Mudd made it clear that there were constant changes to the type of products Fannie Mae purchased and guaranteed, and that subprime and Alt-A products were purchased before he joined the company in 2000, at first as a relatively small proportion of their purchases, but as the decade continued, many new products came onto the market. It was a constant process of development beginning in the mid-1990s, in which Fannie Mae would buy some of the new kinds of loans, which gave them access to the data, then buy whole loans and offer the product to some lender customers, developing that line of business over time. He argued that 2005 was not therefore a moment when the company decided to increase purchases of non-traditional mortgages, but that there was a real explosion of Alt-A, subprime, interest-only mortgages and other "affordability" products. The rapid expansion in the market gave them little alternative but to participate by buying these loans in order to fulfil their role of providing liquidity in the market.⁵³ The tone and content of the information given in the interview is quite different from his testimony to the House Financial Services hearing.

It should be borne in mind that for Fannie Mae, the period in which they embarked on their most aggressive strategies to purchase mortgages and mortgage assets with questionable underwriting standards, that is, between 2003 and 2006, was the one in which they had to restate all their financial reports from 2001 onwards. It was a period at the end of which, the OFHEO report still described the Enterprises as remaining classified with "significant supervisory concerns." Freddie Mac was still not in a position to register with the SEC, but had produced timely financial statements with a clean audit opinion. Fannie Mae had filed clean financial statements for 2007. Having registered with the SEC, it produced its third quarter report (Form 10 Q) in November 2007 and filed its annual report on Form 10K in February, 2008. This is why the Pinto analysis relies on Fannie Mae's June 2008 10 Q report, because of the progress made in its production of financial statements. It should also be borne in mind that during the whole period from 1999 onwards, the problems with both Fannie Mae and Freddie Mac ran much deeper, to the whole way in which the organizations were managed. The overriding principle was to maximize earnings, and any other aspect of the business was subordinated or distorted to achieve that end. An indication of that is the reference made by Mr Lund to altering the credit status of a borrower.

Even by 2007, the GSEs' risk management procedures left much to be desired. It is indeed hard to see why anyone believed the protestations and assurances about the GSEs' standards and the quality of the loans they bought, as right up to conservatorship they were badly managed and had barely got their financial reporting into any kind of order. Conservatorship was soon to follow, with not only the size but also the content of the GSEs' portfolios being key factors. The private label securities and investments in assets collateralized by subprime and Alt-A mortgages probably precipitated their collapse, with private label securities contributing significantly; in many cases their value fell as much as 90% from the time of purchase.

By 2007, it should have been clear that a serious crisis was developing. Chairman Bernanke in his May speech referred to the sharp increase in foreclosure rates in subprime mortgages with adjustable interest rates, which then accounted for two-thirds of the first-lien loans or 9% of all first-lien loans outstanding. This was against a background of house prices decelerating or even falling in some areas, whilst interest rates on loans moved upwards, reaching their highest levels for many years in mid-2006. Once again, the Federal Reserve stated that "the expansion of subprime mortgage lending has made home ownership possible for households who in the past might not have qualified for a mortgage ... minority households and households in lower-income Census tracts have recorded some of the largest gains in percentage terms." Relying on HMDA data, the Chairman said, "We believe the effect of the troubles in the subprime sector on the broader housing market will likely be limited."⁵⁴ The failure even then to recognize the risks of subprime lending and all the issues raised in this chapter will be pursued in the next.