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What Next?

Transferring the damage

Fannie Mae and Freddie Mac carried out their mission mainly by purchasing mortgages from lenders. They then either pooled these loans to create mortgage-backed securities, which they guaranteed against losses from defaults in the underlying mortgages, selling the mortgage-backed securities to investors; or retained them in their portfolios, along with other MBSs that they bought to hold as portfolio assets. In addition, they bought mortgages and MBSs (both each other's, and those issued by private companies) to hold in their portfolios. In 2007, Fannie and Freddie found that they could not sell their mortgage assets, since this would depress the prices of mortgage loans and MBSs still further; nor could they use retained earnings to bolster capital, as they had not made a profit since 2006. So they increased their purchases of mortgages and MBSs as investors came to distrust the market for these securities.

Until 2007, banks and other lenders also sold private label mortgage-backed securities. From mid-August there was a broad global reduction in the supply of credit for securities backed by subprime loans. Uncertainty about the decline in the value of subprime collateral, especially for private label securities (PLSs) and collateralised debt obligations (CDOs), led to liquidity in these markets virtually disappearing. Far fewer PLSs were issued in the third quarter of 2007, with the fourth quarter being even worse: only \$11.9bn subprime PLSs were issued. Investors became less willing to invest in any mortgage-related securities not backed by Fannie, Freddie or Ginnie Mae (always assuming that they understood what they were buying); the result was that the Enterprises' combined share of all mortgage-backed securities rose to over 75% in the fourth quarter of 2007. Their books of mortgage business rose by 14.3% in 2007 for Fannie and 15.1% for Freddie, over 2006. Fannie's total book of mortgage business rose to \$2.9 trillion and Freddie's to \$2.1 trillion.

Residential mortgage-backed securities (RMBSs) and other forms of structured finance related to mortgages had become ever more complex. Issuers bundled up large numbers of home loans into a loan pool, calculated the revenue stream coming into that loan pool from the individual mortgages, and then designed a "waterfall" that assigned the pooled revenues to specific "tranches" set up in a specified order.

The first tranche is at the top of the waterfall, and is the first recipient of revenues received from the mortgage pool and also the first recipient of revenues. The issuer creates a bond linked to the first tranche, which is then rated AAA. The next tranche is the second to receive revenues from the mortgage pool, and is linked to a security that might receive an AAA or lower rating and so on through the tranches, with lower ratings in each case until the equity tranche is reached; this does not have a rating, as it must cover the pool's initial losses. Almost every pool has some loans that default, so the equity tranche often offers a high rate of return to compensate for the risks.

CDOs are even more complex, typically including RMBS securities from multiple mortgage pools and other types of assets, such as corporate bonds or credit default swaps. These are the "cash" CDOs, to be differentiated from the "synthetic" CDOs, which do not contain actual assets but simply reference them. Initially, a CDO is divided into a series of tranches, each of which has a separate rating, with the highest rating reserved for the senior tranche; the middle tranches or the mezzanine tranches usually carry AA or BB, and the lowest or junk tranches are called the equity tranches. The senior tranche has the most predictable cash flow and is usually deemed to carry the lowest risk, but the lowest tranches only receive principal and interest payments when all the other tranches have been paid.

A CDO squared is a CDO that only uses other CDOs as collateral. The CDO cubed is a special purpose vehicle with securitization payments in the form of tranches. A CDO cubed is backed by CDO squared tranches, allowing the banks to resell the credit risk they had taken once again by repackaging their CDO-squared. The complexity of these operations baffled many bankers and others, leading to anxiety as to where the risk really lay. The CDOs cubed were in fact "triple derivatives," sometimes known as "derivatives on steroids."

All of these were typically sold in private placements. The more complex and opaque they became, the more they relied on credit ratings to be marketed, and the more investors did, as well.¹ The risks of subprime mortgages were understood, with academic research analysing the risks associated with one or more features, such as high LTVs. But in a rising market such risks were set aside, since house prices continued to increase. Optimism about how subprime mortgages would perform led to more than 90% of securitized subprime loans being absorbed into securities with AAA ratings.²

The vulnerability of leveraged or thinly capitalized investment positions, and the illiquidity of many structured credit markets, was exposed when trading was disrupted in June 2007. Investors had borrowed heavily or used derivatives to increase returns on capital, and that made investment strategies vulnerable to large market price movements. The main risk-management strategy was to trade rapidly out of a loss-making position, but this, of course failed when the markets became illiquid and no one was quite sure about the quality of the various financial instruments (and indeed the mortgages) they

had purchased. In fact, given the size of the subprime mortgage market (about half of the outstanding mortgages in 2008), the contagion would be worse than anyone anticipated.

Even at that late stage, policy makers seemed unable to relate their demand for lending to low- and moderate-income borrowers and “flexible” underwriting standards to subprime mortgages.³ The vast number of subprime mortgages, some 26 million, were divided into tranches which inevitably added to the degree of risk involved. About 47% of the mortgages held by Fannie and Freddie are subprime, which makes their conservatorship an expensive affair. The fact that the subprime market was so vast, meant that many more of the RMBSs and other financial instruments based on mortgages were “toxic” or contained more toxic elements than had previously been recognized. As that became known or suspected, investors lost confidence and refused to buy or could not sell, with the resultant damage. If the risks had then been ascertained to be relatively small, any market disruption could more easily have been handled and would have been much less damaging than the resultant lack of liquidity.

Counting the cost of Fannie and Freddie

Between November 2008 and the end of March 2011, the government made net payments to the GSEs of \$130bn. Additional cash payments are expected for several years to come. The Congressional Budget Office (CBO) takes the view that their conservatorship, which means ownership and control by the Treasury, makes them effectively part of the government, and so their costs should be part of the federal budget. However, the Administration’s Office of Management and Budget (OMB) treats them as non-governmental agencies for budgetary purposes. After consultation with the House and Senate Committees on the Budget, CBO decided that a fair-value approach to estimations of the subsidy costs would provide Congress with the most accurate picture.⁴

In August 2009, the CBO estimated that the cost of all of the GSEs’ mortgage commitments made in the fiscal year 2009, plus any new commitments made in that year, would come to \$291bn on a fair-value basis. Losses have increased to a certain extent because of the continued deterioration of the housing market. Although the subsidy rate has declined, and continues to do so, as the housing market recovers, costs will continue to increase. The assets and liabilities on the GSEs’ fair-value balance sheets provide an indication of how the costs arising from past commitments have changed since then: on March 31, 2011, the GSEs reported a fair-value deficit of \$187bn, so the net costs to the Treasury so far amount to \$317bn, representing increasing defaults on distressed mortgages and continued falls in the amounts recoverable following defaults.

The CBO estimates that the new guarantees the GSEs will make over the 2012–2021 period will cost \$42bn (on the basis of the March 2011 baseline

projections used for the CBO's analysis of the President's budget). The commitments are extensive. In 2010, as a result of the government's aid and explicit government guarantees, the two GSEs owned or guaranteed about half of all the outstanding mortgages in the US (including a significant share of subprime mortgages) and they financed 63% of new mortgages originated in that year. Including a further 23% insured by federal agencies such as the FHA, about 86% of new mortgages in 2010 carried a federal guarantee.⁵ In addition to direct support, the Treasury and Federal Reserve purchased nearly \$1.4 trillion in GSE-issued and guaranteed mortgage-backed securities. And it is even more complicated than that. Many of the losses Fannie and Freddie are expected to sustain in the coming years will go to pay the Treasury a 10% dividend on the preferred stock it received in exchange for the bailouts. FHFA estimates that 40–90% of those additional bailout costs will simply be used to pay that dividend, designed to limit losses to taxpayers. The National Association of Realtors is lobbying to end the "punitive dividend": "The problem is it's impossible for them to tackle their current problem if they can't rebuild the capital base, and they can't do that paying the dividend level."⁶

After conservatorship

The cost to taxpayers of supporting Fannie Mae and Freddie Mac and continuing their operations under conservatorship have led to the production of a wide range of proposals for the federal role in the secondary market in the future. Many proposals have been produced, with numerous variations on the themes of whether the federal government should continue to guarantee payments of certain types of mortgages or MBSs, and if so, what the scope, structure and pricing of those guarantees should be.

Fannie Mae and Freddie Mac were entirely excluded from the Dodd-Frank Act (Wall Street Reform and Consumer Protection Act, July 2010); the only requirement there is that the Secretary of the Treasury develop recommendations on ending the GSEs' conservatorship, and on the federal government's proper role in the nation's housing finance system. Secretary Geithner provided just such a report on February 11, 2011, setting out the Administration's position and guidance on the legislative proposals which the President would support.

Congress acts

Just before and after the report was published, about 20 bills were introduced in the House Committee on Financial Services, many of which were apparently bills tackling one or other aspect of past failings of Fannie Mae and Freddie Mac, but with no comprehensive reform proposals.

Some examples

Seven bills were introduced by the Republican members, which were all designed “to tie the hands of Fannie Me and Freddie Mac so that they are no longer a drag on the American taxpayers, a threat to our economic security and an impediment to private market growth and development,” according to Congressman Scott Garrett, Chairman of the Subcommittee on Capital Markets and Government Sponsored Enterprises. They included H.R.2436, which would prevent the Treasury from reducing the 10% dividend payment. Other bills would abolish the Affordable Housing Trust, ensure that another quasi-federal agency, a replica of the GSEs is not created, require the sale of non-mission-related assets, cap the bailout for the GSEs, make Fannie and Freddie subject to the Freedom of Information Act (from which they were exempt by their Charters), and prohibit taxpayer funding of GSE employee legal fees (since 2008, the bill for such legal fees for taxpayers has topped \$162m, including bills running into tens of millions for former executives who, according to their regulator, “knowingly and purposely manipulated earnings to increase their own compensation”). Other bills were designed to prevent predatory lending, to improve the GSEs’ mission, and to ensure the availability of reasonably priced conventional mortgages to borrowers in all economic cycles.

Response from the FHFA

In his testimony before the House Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises on May 25, 2011, the Acting Director, Edward DeMarco, commented on the various proposals. His reference to the application of the FOIA to Fannie Mae and Freddie Mac is interesting, because the Act was intended to apply to the operations or activities of government, whereas Fannie Mae and Freddie Mac are “still private companies operating in conservatorship. They did not cease to be private legal entities when they were placed into conservatorship.”⁷ With regard to the proposal to prevent the creation of a GSE replica, DeMarco pointed out that “under the current legislation, if Fannie or Freddie were placed into receivership, the FHFA would be required to establish a limited life regulated entity which would operate for up to five years. At the end of that time, *without Congressional action*, the Enterprises may be re-created under their current Charters.”⁸ The bill (introduced by Congressman Stiver) would indeed prevent the conservator from re-creating the current model of the GSE, and would ensure that once the Enterprises were wound down, no new entity with tax-payer support could be established. This would be a timely reminder to make sure that any reform bill ruled out any possibility of re-creating the GSEs.

In terms of legislation, very little has happened in the Senate Banking Committee, apart from the introduction of Senator McCain’s bill, which was

designed to impose various restrictions on the Enterprises' activities. It would phase out Fannie and Freddie, beginning in two years' time, increase the fees they charge, and cap their mortgage investment portfolios at £700bn. Senator Barbara Boxer also introduced a GSE reform bill in January. But neither bill was considered by the Committee, which has only held hearings on public proposals for the future of the housing finance system. Chairman Bachus said, "I've been criticized for waiting on the Administration. If they want to bring forth a comprehensive proposal, they have two or three weeks to do it."⁹ It is possible that legislation for the future of Fannie and Freddie will not be introduced until 2013, after the next Presidential election in November 2012. In the meantime, Timothy Geithner's proposals remain on the table.

The Treasury White Paper

Timothy Geithner, Secretary to the Treasury, introduced the White Paper, *Reforming America's Housing Finance Market*, in February 2011. The Administration simply sets out three options and certain criteria, which are as follows:

Option 1 Privatized system of housing finance with government insurance role limited to FHA, USDA and Department of Veterans Affairs' assistance for narrowly targeted groups of borrowers.

This option would dramatically reduce the government's role in insuring or guaranteeing mortgages, limiting it to the FHA and other programs targeted at creditworthy lower- or moderate-income borrowers, the vast majority of the mortgage market to the private sector. The ability of the government to step in to ensure access to capital during a crisis would be limited under this option.

Option 2 Privatized system of housing finance with FHA, USDA and the Department of Veterans' Affairs assistance for narrowly targeted groups of borrowers, and a guarantee mechanism to scale up during a crisis.

As with Option 1, the FHA and other narrowly targeted programs would provide access to mortgage credit for low- and moderate-income borrowers, but the government's overall role in the housing finance system would be dramatically reduced, although the government would also develop a backstop mechanism to ensure access to credit during a housing crisis. This would mean a having a minimum presence in the market during normal times, but being ready to scale up to a larger share of the market as private capital withdraws in times of financial stress.

Option 3 Privatized system of housing finance with FHA, USDA and Department of Veterans Affairs' assistance for low- and moderate-income borrowers, and catastrophic reinsurance behind significant private capital.

Under this option, the mortgage market outside the FHA and other federal agency guarantee programs would be driven by private investment decisions with private capital taking the primary credit risk. To increase liquidity in the mortgage market and access to mortgages for creditworthy Americans, as well as to ensure the government's ability to respond to future crises, the government would offer reinsurance for the securities of a targeted range of mortgages. Here Geithner envisages mortgages being insured by a group of private mortgage guarantor companies for which a government reinsurer would provide reinsurance, as long as certain conditions were met. A special premium would be charged for this to cover future claims and to recoup losses. This option has the advantage of providing the lowest-cost access to mortgage credit of all three. None of the three seems to envisage the continued existence of Fannie Mae and Freddie Mac.

The report does, however, contain various proposals designed to reduce the role of Fannie Mae and Freddie Mac in the mortgage system:

- Reduce the GSEs' market share by increasing the guarantee fees charged to lenders who sell mortgages to Fannie Mae and Freddie Mac. In return for this guarantee, Fannie Mae and Freddie Mac guarantee timely mortgage payments to investors that purchase their MBSs. This increase would reduce the profitability from selling mortgages to Fannie Mae and Freddie Mac, and could encourage selling mortgages to investment banks and other securitizers;
- Reduce both profitability and risk by increasing capital requirements for Fannie Mae and Freddie Mac. This would require them to purchase credit-loss protection from private insurers;
- Reduce the size of the GSEs by requiring Fannie Mae and Freddie Mac to liquidate their investment portfolios as required under their support contracts with Treasury; and
- Reduce Fannie Mae's and Freddie Mac's share of the secondary mortgage market by lowering the high-cost area conforming loan limits (currently \$729,750) to the HERA limits (\$625,500). (The Continuing Appropriations Act, 2011 extended the limit until the end of the year.)

Since the GSEs are in conservatorship, FHFA could implement all but the last without legislative action. Despite that possibility, Geithner resolutely refused to commit himself or the Administration to any one of the proposals in a House Financial Services Committee hearing. He was equally indecisive about the timing: that should be neither too soon nor too long delayed. Acting too hastily to wind down Fannie Mae and Freddie Mac could destabilize the housing finance market or disrupt the broader recovery. On the other hand, a long-delayed solution would not help. A failure by Congress to approve legislation within the following two years would "exacerbate" market uncertainty and leave many of

the “flaws in the market” unaddressed. The reason behind Secretary Geithner’s stress on the timescale could be that under the present legal framework and conservatorship, only a limited range of options are available, bearing in mind that but for the provisions of HERA, the two GSEs would have been insolvent, owing to the unanticipated but continuing losses from foreclosures. These include the “bad bank” option, which would mean that, given the lack of private investment, the federal government would have to purchase the nonperforming assets. Some would like to see the senior preferred stock dividends reduced, which would save about \$15bn annually but would also reduce the federal government’s income by the same amount. This would allow the GSEs to return to shareholder control but at the cost of government support, which would then lead to expectations of future government support with the consequent moral hazard, which the GSEs exploited in the past.

If the GSEs were to return to solvency, then the restructuring options would be to:

- Return Fannie Mae and Freddie Mac to their shareholders with little or no change in their Charters;
- Eliminate their GSE status and convert them into private corporations;
- Eliminate their GSE status and convert them into one or more government agencies;
- Make supplementary changes to support the secondary mortgage market, such as providing government reinsurance of MBSs, or encouraging the use of covered bonds.

None of these approaches come close to identifying the source of the problems: even if it were feasible, retaining the GSEs in some form runs the risk of creating similar havoc in the financial system in the future. By intervening once, the federal government has turned the implicit government guarantee into an explicit one, just as investors believed throughout the years, and were encouraged to believe (despite warnings to the contrary) by the CEOs and senior management of the GSEs. The Enterprises were able to exploit their dominant position in the market-place through the privileges given to them by their Charters. A much more radical approach is required, making use of the Geithner report, which does not envisage a future role for Fannie Mae and Freddie Mac.

The context for radical reform of the US housing market

Affordable housing ideology

Whereas home ownership is desirable for many individuals, it is not possible to bring it about for all American families, when individuals and families have

low and/or uncertain incomes and are not in a position to make a reasonable down payment and sustain monthly mortgage payments. The attempt to achieve these objectives involved setting “affordable housing” goals and encouraging what were euphemistically called more “flexible” underwriting standards. These standards were not set by the banking industry, realtors, mortgage companies, mortgage brokers, appraisers or any other elements of the mortgage finance industry on their own.

Following the Boston Handbook, Clinton’s National Partnership Strategy explicitly set out what those lower underwriting standards should be, making it clear that these were regarded as the appropriate standards by the government. Lack of cash for downpayments and lack of income should no longer be obstacles to owning one’s own home, so there should be financing strategies, “fueled by the creativity of the private and public sectors” to overcome them.

President Bush reintroduced a similar partnership in 2002: “We must begin to close this home ownership gap by dismantling the barriers that prevent minorities from owning a piece of the American dream,” setting out to create 5.5 million new minority home owners by the end of the decade. He did at least offer cash; between 2002 and 2006, the Administration spent \$412m on its American Dream Down Payment Initiative to help first-time home buyers with the costs associated with down payments, and a further \$176m on home ownership counseling to improve financial education and money management (of limited use, since in the last analysis, this cannot create income which is not there).¹⁰

The Presidents were not the only ones committed to the ideology. It was all-pervasive, with one lawmaker after another stating their public commitment to the belief, and countless others, economists, federal officials, bankers, brokers and realtors at least paying lip service to the Dream. Those wishing to restrain lending practices or to reduce subsidies to Fannie Mae and Freddie Mac were accused of making “affordable housing” more expensive for minorities and low- to moderate-income families and minorities. Many members of the House and Senate did not realize that more flexible underwriting standards inevitably opened the door to predatory and abusive lending practices; they sought to restrict the activities of such lenders, but on the grounds that they made lending more expensive for the groups in question. Their attempts to curb such lending were relatively ineffective anyway, partly owing to the difficulties of definition and successful court action.

The size of the subprime market, and Fannie and Freddie’s role both in encouraging its development and in benefitting from it, were confirmed by the Securities and Exchange Commission’s announcement that it had charged six former top executives with securities fraud, alleging that they knew and approved of misleading statements claiming the companies had minimal holdings of higher-risk mortgage loans, including subprime loans.¹¹ The details of the allegations, if proved, show that Fannie Mae and Freddie Mac made

a series of materially false and misleading public disclosures to promote the impression that both Enterprises had far less exposure to subprime and Alt-A mortgages than in fact existed between December 6, 2006 and August 8, 2008. Fannie Mae, for example, excluded its Expanded Approval loans, specifically targeted towards borrowers with weaker credit histories. The SEC also alleges that Fannie Mae's executives knew and approved of the decision to under-report Fannie Mae's Alt-A loan exposure, when on March 31, 2007 it declared that its exposure was 11% of its portfolio of Single Family loans: in fact, it was 18%.

The SEC alleges that the former executives and Freddie Mac led investors to believe that the firm used a broad definition of subprime loans and had disclosed all of its single-family exposure. But as of December 31, 2006, the single-family business was exposed to approximately \$141bn of loans described internally as "subprime" or "subprime-like," accounting for 10% of the portfolio; it grew to about \$244bn or 14% of the portfolio as of June 30, 2008. As argued elsewhere in this book, the failure to agree a proper definition of subprime loans was used to their advantage by Fannie and Freddie to obscure the issue of risky lending and its link with "affordable housing."

Fannie Mae and Freddie Mac have each entered into a Non-Prosecution Agreement with the SEC, which requires each company to accept responsibility for its conduct and not dispute the contents of an agreed Statement of Facts without admitting or denying responsibility. Each agreed to co-operate with the Commission's litigation against the former executives.

That the exposure to risky loans was much greater than admitted at the time is illustrated by the details of the allegations set out by the SEC in its Complaint. The public disclosures did not include the data on credit risk associated with Fannie's Expanded Approval and low- to moderate-income loans, which was reported to and tracked by senior management in terms of acquisition volume, delinquencies and credit losses, together with the loans that were reported when quantifying its "subprime" exposure in its public filings. In other words, all the information on loans and Fannie's strategy contained in internal documents does not correspond with the public filings. The Complaint sets out numerous examples of Fannie's lack of transparency in its disclosures. The case against Freddie Mac is a little different in that it adjusted its Loan Prospector program from 1997 to allow for subprime loans (described as A-minus loans) on the same terms as an "Accept" loan. Loan Prospector developed over time, but its strategy was to continue to purchase what it clearly knew were subprime loans, despite information provided to senior executives in meeting notes, warnings from its Enterprise Risk Management Committee and data from its LP Emulator, tracking the risks associated with subprime loans. The chief concern for Freddie Mac appears to have been the lack of adequate compensation for purchasing or guaranteeing risky loans.

These Complaints are highly significant, as they confirm that both Fannie and Freddie had far greater exposure to a subprime mortgage market than

anyone was prepared to acknowledge existed. As of June 30, 2008, Freddie had \$244bn in subprime loans, when investors were told it had only \$8bn. At the same time, Fannie had \$641bn in Alt-A loans (23% of the single-family loan guarantee portfolio), while investors were told that it only had \$300bn (11%). It is well-known that Freddie started acquiring subprime loans as far back as 1997 in order to meet HUD's housing goals; the Complaint discloses that Freddie had a coding system to track "subprime," "otherwise subprime" and "subprime-like" loans in its loan guarantee portfolio even when it denied having any appreciable subprime exposure. On the basis of the SEC Complaints, it is now possible to estimate Fannie and Freddie's high-risk loans at \$2 trillion. It also validates Ed Pinto's estimate that when the full force of the financial crisis hit in 2008, approximately 27 million or 49% of the 55 million outstanding single-family first mortgage loans had high-risk characteristics, making them far more likely to default.¹²

That such discrepancies between internal documentary information presented to senior executives and public statements, including statutory disclosures, were not discovered until 2011 reflects on the utter ineffectiveness of OFHEO and the FHFA; the dilatoriness of Congress in granting neither the resources nor the tools to the former in particular; and the effect on the mortgage markets of the "affordable housing" ideology, as implemented by the goals set by HUD. The responsibilities for the financial crisis go much wider than the executives identified in the SEC's Complaints.

For some, the 2008 financial crisis served to clear the minds of the affordable housing ideology. What has not attracted much attention is Secretary Geithner's statement in the introduction to the February statement, "our plan champions the belief that Americans should have choices in housing that make sense for them and for their families. This means rental options near good schools and jobs... and access to credit for those Americans who want to own their own home... and a helping hand for lower income Americans, who are burdened by the strain of high housing costs."¹³

Apparently having learnt nothing from the American housing crisis and the extensive damage it inflicted on the rest of the world, Prime Minister Cameron, when he announced a £930m injection into the housing market, said he wanted to make the 'dream of home ownership' a reality for more people. "You always remember that moment, if you've done it, when you get that key and you walk into your first flat. It's a magic moment. It's a moment I want everyone in this country to have, not just better off people".¹⁴ His words echo those of President Clinton's announcement of the National Home Ownership Strategy in 1995.

The scheme he announced is indeed limited, for now. It covers new build homes for about 100,000 first time buyers. It is accompanied by an 'ambitious scheme' to underwrite mortgages for new homes that would allow banks to cut deposits to 5% with the government and the builders sharing a proportion of

the risk of buyers defaulting on the mortgages with tax payers having to pick up a maximum of £1bn in liabilities. Government-backed insurance is a reminder of the activities of the Federal Housing Administration. Its insurance scheme is supposed to be self-financing, which was not the case, and indeed the FHA itself is teetering on the edge of insolvency. Cutting the required deposits to 5% is an understandable move with such high house prices, for which there are many reasons in the UK. But it does carry serious risks. The scheme is limited at present, but once established, political pressures of all kinds will intensify for the scheme to be extended. He would do better to consider the proposals put forward by David Miles, a member of the Monetary Policy Committee, for the use of various forms of outside equity funding, including shared ownership schemes and equity loans, enabling families to decide how much risk they wanted to take on.¹⁵ It is simply not possible, however desirable, for everyone to own their own homes. The American experience over the thirteen years from 1995 to 2008 amply demonstrated that. For once, the lessons of history should be surely be learnt.

A very early warning

The ideology blinded too many to the reality. “The ideal of home ownership is so integral a part of the American Dream that its value for individuals, for families, for communities, and for society is scarcely questioned ... However, critics of homeownership point out that the economic benefits of homeownership for lower income and minority families should also be balanced against its financial risks. The lower average incomes and educational achievement of these groups make them particularly vulnerable to economic downturns that can result in job loss and, eventually, foreclosure.”

The report also points out that “many external factors can affect whether and at what rate a home’s value increases or decreases. Changes in interest rates influence the demand for housing and its attractiveness relative to other investments. Regional economic downturns ... can severely depress housing prices. The dynamics of a particular housing market or the fortunes of a particular neighborhood can also be strong determinants of local home values.” It is a pity that President Clinton did not pay closer attention to these words in the report, which was prepared for him as part of the National Homeownership Strategy. The dangers of home ownership for those very families and minorities he wished to help are clearly spelt out, as well as the dangers arising from external factors over which families have no control whatsoever and are also ill-equipped to meet: for example, not having sufficient financial resources to ride out the storm. The Urban Policy Brief, commissioned by the Department of Housing and Urban Development, was prepared in August 1995.¹⁶

Other Presidents before Clinton had supported home ownership as part of the American Dream, but had not sought to use the agencies of the federal

government to turn the dream into a reality. President Clinton's plan (and to a lesser extent that of President Bush) was to ensure that all of the federal agencies, working together with all involved in the financing and construction of housing from every point of view, would encourage or promote home ownership for low-income families and minorities. Much more than that, he used the federal agencies and the GSEs, in particular, as the levers at his disposal to achieve the target. Five years later he could boast a home ownership rate of 67%; although minorities were still lagging behind, they also made gains. Clinton set the wheels in motion; Bush did little to stop the juggernaut of "affordable" or "subprime lending," which rolled on without any obstacles in its way. But when house prices began to fall and interest rates began to rise, almost half of all outstanding mortgages were revealed as subprime. The juggernaut shuddered to a halt.

The fault did not just lie with the banks, for as Professor Stan Leibowitz succinctly expressed it, "From the current handwringings, you'd think that the banks came up with the idea of looser underwriting standards on their own, with regulators just asleep on the job. In fact, it was the regulators who relaxed these standards, at the behest of community groups and 'progressive political forces'."¹⁷

Chairman Bernanke, in his description of the causes of the financial crisis, claimed that the "extended use of this model to finance subprime mortgages through securitization was mismanaged at several points, including the initial underwriting, which deteriorated markedly in part because of incentive schemes that effectively rewarded originators for the quantity rather than the quality of the mortgages extended."¹⁸ This seems to be an extraordinary statement, ignoring as it does the politicians' insistence on affordable housing at the cost of lowering underwriting standards. That was all undertaken with federal encouragement and approval. Fannie and Freddie's rush to purchase loans on volume not quality was all undertaken to boost their earnings. This is not to suggest that lenders, the originators, were not to blame, but their actions have to be seen in the context of two decades of federal policy.

In a statement to the House Subcommittee on Capital Markets, Insurance and the GSEs, Professor Lawrence White elaborated on the range of federal responsibilities: "The creation and expansion of Fannie Mae and Freddie Mac did not occur in a vacuum. They were, and continue to be, only one part of a much larger mosaic of governmental policies, at all levels of government, to encourage the construction and consumption of housing ... explicit subsidies for mortgage finance, through the FHA, the Department of Veterans Affairs, Ginnie Mae, as well as through some states' mortgage finance subsidy programs, implicit subsidies through the GSEs; specialized Charters for depository institutions [thrifts] that are expected to focus on residential mortgage finance ..."¹⁹ Not all of these helped to create the huge subprime

market, but this does emphasize the extent to which the federal government used so many of the federal agencies as a means of attaining its political aims. When it all went wrong, politicians both in the US and elsewhere sought to deflect attention from their own actions by the ever-popular sport of attacking and blaming the banks. Of course, many of the banks played their part as well, but the prime responsibility is a political one of seeking to increase home ownership at any price.

What happened to those minority and low-income home buyers?

It should be a sobering thought that so many people to whom they sought to extend the “benefits” of home ownership are suffering even more than before. It is true that some brought it on themselves by applying for “liar loans” or buying property carelessly, but many did not. The situation in the housing market is dire, with one in seven borrowers delinquent on their mortgages or already in foreclosure, and more than one in four mortgages underwater. Various analyses suggest that the number of foreclosures by the time the crisis abates could be anywhere between 8 and 13 million (out of 55 million mortgages outstanding in 2008). Here is one striking and thorough description of what the effects of the fall-out from the affordable housing policy can be when market and economic conditions change.

Julia Gordon in her statement to the House Subcommittee on Insurance, Housing and Community Opportunity, describes the effects of foreclosures not just on families losing their homes, but on whole neighborhoods which have effectively closed down. States and local authorities have both lost revenue and have had to face additional costs, as the large number of vacant properties attract crime, arson and squatters. For those who have kept up mortgage payments, the value of their property also falls as the foreclosure signs go up, with the losses ranging from 0.6% to 1.6% in value. The losses may be greater if, with the “no recourse” mortgages, the “owners” trash the property before returning the keys to the lender through the mail. Those who have owned homes and lost them not only suffer financial losses but also the loss of a roof over their head, and all the money and emotion spent in creating a home. The crisis also hits tenants, who are affected by foreclosures since banks now own the housing stock rather than landlords or investors; although tenants now have some legal protection, most will ultimately be forced to leave their homes. Some have been kept in their homes through permanent loan modification programs via government’s HAMP (Home Affordable Modification Program) or proprietary modifications, but the numbers in foreclosure continue to overwhelm those borrowers who have been helped. In the end the federal affordable housing programs have inflicted more pain and suffering than anything else on those it has sought to help.²⁰

The federal government and the housing market

In his report to Congress, Geithner sets out the role of private financial institutions in the housing finance market. "Private markets, subject to strong oversight and standards for consumer and investor protection, will be the primary source of mortgage credit and bear the burden for losses. Banks and other financial institutions will be required to hold more capital to withstand future recessions or significant declines in home prices and adhere to more conservative underwriting standards that require home owners to hold more equity in their homes. Securitization should continue to play a major role in housing finance subject to greater risk retention, disclosure and other key reforms."²¹

However, the report still contains signs of a lingering "affordable housing" ideology with its references to the "government's vital support for affordable housing in a more effective and transparent manner." All of the options involve government intervention, either in the form of insurance, the use of some of the existing federal agencies, or "catastrophic" reinsurance behind significant private capital. There are no clear details of what this would mean in practice, nor the extent to which government would be exposed to further costs at a time of crisis.

The continued use of the FHA to insure mortgages is yet another example of the involvement of a federal agency in making homes affordable to those who cannot afford to purchase a property. As such, it will be open to abuse, albeit on a smaller scale. The scandals of the seller down-payment fraud should not be forgotten, likewise the fact that the FHA Mutual Mortgage Insurance Fund teetered on the brink of insolvency even when its minimum reserve requirements were set at 2%. The FHA mortgage insurance program is designed to help low- and moderate-income families become home owners by lowering some of the costs of their mortgage loans. FHA mortgage insurance also encourages lenders to approve mortgages for otherwise creditworthy borrowers who might not be able to meet conventional requirements by protecting the lender against default. The meaning of "otherwise creditworthy" borrowers in this context is somewhat unclear. There is a direct endorsement program in place which allows lenders to underwrite and close the mortgage loan without prior HUD approval or review. Lenders are supposed to comply with all relevant HUD regulations and to evaluate the borrower's ability to repay the mortgage debt. However, many examples of fraud or failure to follow the required underwriting standards have come to light, partly through referrals from HUD to the Office of the Inspector General.²²

Some are worried about the present situation with the FHA, seeing it as another black cloud on the horizon. The annual actuarial report on its insurance fund shows that it was well below the statutory limit of 2% (0.5%) at the end of the fiscal year, 2010, a statutory specific percentage, which is itself quite inadequate for the risks taken on the FHA. Its market share of mortgage

originations is now 25%; it had inadequate systems and resources for a market share of 10–15%, and its insurance fund may become insolvent, faced with a continuing rise in foreclosures. Another bail-out may be required.

Once a federal agency is seen to be backing loans which the borrower cannot afford, or which politicians and community action groups think they *should* be able to afford, the whole sorry saga will begin again. The scheme is unlikely to provide a suitable basis for another attempt to provide mortgages to those on low and moderate incomes. Successive federal governments have failed to provide HUD with adequate resources for its oversight of its own programs, Fannie Mae and Freddie Mac, or the Federal Housing Administration. The reports of the Office of the Inspector General, both the brief reports on limited examinations of specific programs, and the overviews all reinforce the point time and time again. It seems to be a role that demands the utmost patience on the part of the Inspector General, as so many reports result in such little improvement.

Fannie Mae and Freddie Mac should be phased out of existence

The federal role in the secondary market was designed to achieve two public purposes: to help ensure a steady supply of financing for residential mortgages, and to provide subsidized assistance for mortgages for housing for low- and moderate-income families. As far as the latter is concerned, the subsidies made very little impact on the cost of loans for the target group. The government achieved the latter policy by using Fannie Mae and Freddie Mac to increase the liquidity of mortgages and mortgage-backed securities. The GSEs were thought to be essential for this purpose. But they are not.

The Enterprises had such a purpose when banks in the US were restricted to operating in only one state, and then only allowed to open branches with the approval of the regulators. In many states, banks were prohibited from operating more than one branch office. The result was that the banking system consisted of very small banks, even as late as 1994: in June of that year, there were 8,614 FDIC-insured financial institutions with deposits of less than \$100m.

The origins of the GSEs are to be found in the restructuring of the banking system after the Great Depression, with the establishment of the FHA in 1934, followed by splitting Fannie Mae into two parts, Ginnie Mae and Fannie Mae, in 1968. Fannie Mae then became the hybrid organization it is now, with competition from the then newly established Freddie Mac, created with the same purpose in 1970. Both GSEs were to ensure liquidity in the housing market by purchasing conventional, non-guaranteed loans originated by the Savings & Loans and other depository institutions, through buying the mortgages and repackaging them as bonds. Both grew rapidly during the

Savings & Loans crisis (1979–1981), which was partly due to very small thrifts, inevitably with a small deposit base, lending long and borrowing short. Then interest rates began to rise, and savers turned to the better interest rates offered by the money markets. Fannie Mae and Freddie Mac provided the remaining thrifts with liquidity and a means of selling their conventional loans and their adjustable rate mortgages, which were allowed after 1991. *Then*, the GSEs did have a role in providing liquidity to the market. That role is no longer necessary.

The banking system was transformed in 1994 with the passage of the Riegle-Neal Interstate Banking and Branching Efficiency Act, which allowed banks to operate widespread interstate branching networks, virtually for the first time in American history. Prior to the Act, there were only ten commercial banks operating a total of 30 branches across state lines. The bill led to a spate of mergers and acquisitions, creating many more large banks. Such banks do not need Fannie Mae and Freddie Mac to create liquidity. They can build up much larger deposit and savings bases, and sell their own private label securities. Chairman Greenspan spelt out as much in his testimony to the Senate Committee on Banking in 2004: “The key to developing markets was securitization, and Fannie and Freddie played a critical role in developing and promoting mortgage securitization ... Securitization by Fannie and Freddie allows mortgage originators to separate themselves from almost all aspects of risks associated with mortgage lending ... This development was particularly important before the emergence of truly nationwide banking institutions because it provided a dramatically improved method for diversifying mortgage credit risk ... During the 1980s, the GSEs led the private sector in innovation, and their contribution enhanced the stability of our financial markets. Mortgage securitization continues to perform this crucial function, and *its techniques have now been applied by the private sector in many markets ... Moreover, credit supply is far more stable today than it was because it is now founded on a much broader base of potential sources of funds. The aspiring home owner no longer depends on the willingness of the commercial bank or savings and loan association to hold his or her mortgage.*”²³ Any argument that the GSEs were no longer necessary would simply not have been heard at that time.

As the GSEs are being phased out over a number of years (a period which should be fixed, as otherwise there is a danger that the GSEs might be resurrected), and as the market slowly recovers, then the private mortgage market will eventually be able to fill the gap.²⁴ Professor Jaffee argues that the “private market mortgages will be intrinsically safer, with default and foreclosure outcomes that more closely resemble the European markets than the recent US experience.” He bases this on the argument that “mortgage default is costly to all parties” and that risk would be priced effectively, with the full cost of the risks being met by the banks and investors.²⁵ This might well be too optimistic a view, unless it is clearly recognized that the proper

functioning of the mortgage finance market will depend on good lending and underwriting practices properly enforced, with the “no recourse” option for mortgages being removed.²⁶

There are, however, two risks which were peculiar to the US mortgage market: the affordable housing ideology, and the lowering of underwriting standards which were part of it; and the implicit government guarantee for GSEs’ MBSs. The removal of these two elements would have the benefit of allowing the mortgage finance market to develop as a private market along European lines. Those looking to the future development of US mortgage finance are increasingly looking to the European markets (as opposed to the repeated refrain over the years that the US mortgage market was “world class” and “the envy of the world”). They note that many other industrialized countries without GSEs have achieved home ownership rates comparable with that of the US, or even higher.

Bernanke points out the difficulties in successful mortgage securitization. The conditions are that for the ultimate investors to be willing to acquire and trade MBSs, they must be persuaded that the credit quality of the underlying mortgages is high (or even know with a high degree of certainty exactly what the quality of such mortgages is), and that the origination-to-distribution process is managed so that originators, such as mortgage brokers and bankers, have an incentive to undertake careful underwriting. Because the pools of assets underlying mortgage-backed securities have highly correlated risks, including interest-rate, prepayment and credit risks, the institutions and other investors that hold these securities must have the capacity to manage their risks carefully. Mortgage-backed securities are complex amalgamations of underlying mortgages; they may also be difficult to price. So transparency about the underlying assets and the mortgage-backed security itself is essential.²⁷ The Chairman is undoubtedly entirely correct, but unfortunately these conditions were not met in the years prior to the crisis. Various aspects of the process were not regulated or were inadequately regulated, and that is where full and detailed regulatory preparation will need to be made. The private label MBS market virtually ceased to exist and is unlikely to return in the current circumstances, but presumably will do so in the future.

With fears about the safety of the private label MBS (and the array of complex financial instruments which also helped to bring about the collapse of the market), policy makers will no doubt consider the use of covered bonds. These are debt obligations issued by financial institutions and secured by a pool of high-quality mortgages and other assets, and are a major source of mortgage funding in a number of European mortgage markets with about \$3 trillion outstanding in 2008. Such instruments are subject to statutory and supervisory regulation, designed to protect the interests of covered bond investors from the risk of insolvency of the issuing bank. The government generally provides strong assurances to investors by having bank supervisors ensure that the cover

pool assets backing the bonds are of high quality and that the cover pool is well-managed. The market has survived the ongoing crisis well, but investors are aware that covered bonds cannot be regarded as risk free and both the bank's status and the country of the issuer are more serious considerations than they were in the past.

A look at homeownership rates in 2008 shows that despite all the efforts of the GSEs and the affordable housing programs, compared with Europe the US ranks only ninth out of 17 developed countries, even when home ownership was at its peak (67.8%).²⁸ Foreclosure rates are much lower in European countries compared with the higher levels of foreclosures in the US, even for the UK, Spain and Ireland. This is why some in the US are looking to Europe, as they see a fully privatized market operating successfully without the array of federal agencies and implicit government guarantees.

In doing so, they note that "no recourse" mortgages do not exist. In the US, legal access to recourse varies from one state to another: even where it is allowed, it is often not applied, at least until recently. The lack of recourse application arises because a bank must meet quite stringent consumer protection conditions before it can obtain a recourse judgment. Borrowers can always apply for a relatively easy bankruptcy. In Europe, it is possible for a lender to repossess the property, although it is not an option that lenders wish to exercise, except as a last resort; they prefer to renegotiate the terms of the loan, if possible. The "no recourse" approach, as noted, does mean that the borrower simply walks away from the property, often trashing it before s/he goes. From this, it can be seen that many aspects of alternative approaches are being examined in detail, and need to be examined in detail, before America takes the plunge into a world without Fannie, Freddie and all the other federal agencies. Policy makers in the US can see that other markets have not only functioned well without Fannie and Freddie, but most have survived in a somewhat better shape.

And the rest of the world?

The future of mortgage finance in the United States has become a matter of international concern, given the continuing global financial crisis, which clearly started with problems in the US subprime sector. One rarely-noticed feature of the crisis is that the subprime mortgage market was much larger than has generally been acknowledged, involving some 26 million out of the outstanding 55 million mortgages in 2008. The use of what were very often subprime loans as part of complex and opaque financial instruments, including mortgage-backed securities, with tranches of loans of varying quality, credit default swaps (CDSs), collateralized debt obligations (CDOs) and credit derivatives magnified the crisis. Risk assessments increasingly lacked clarity, and the incentives for due diligence, never very strong, became

weaker. Loan originators concentrated on volume in order to generate fees. Balance sheets had become more opaque. Reliance on wholesale funding increased systemic risk.

That was the background. Then falling house prices and higher interest rates led to a rising tide of defaults, and the very complex instruments, which had seemed such an innovative way of distributing risk, now undermined price discovery, freezing the market and bringing securitization to a halt. The use of CDOs and special investment vehicles meant that no one knew which banks and other financial institutions held which assets, or anything about their quality. As a result, banks were unwilling to lend to each other, thereby causing the credit crunch. That quickly spread to other advanced economies, because MBSs and other instruments were widely held by financial institutions as well as by central banks. Through these direct exposures and associated funding problems, banks throughout Europe were quickly affected, with some significant banks having to be rescued or merged with others.

The sheer size of the US financial market and its central role as an investment destination contributed to the rapid spread of the crisis. At the time, US financial assets constituted about 31% of global financial assets, and the US dollar share in reserve currency assets is about 62%. It is not, however, just a question of size, but also of confidence. It is sometimes argued that the direct exposure to US subprime was not so large as to cause the financial crisis, but that is to miss the point. It was both the complexity and the opacity of the new structured investment instruments, including the repackaging of US asset-backed securities, which made it difficult to identify counterparties' exposure to the subprime. The shock was further intensified by the fact that foreign banks had substantially increased their cross-border dollar liabilities in recent years, partly to fund their purchases of dollar assets, such as US asset-backed securities. To all of these issues, the facts of instant communication and media speculation should be added, as well as the interconnectedness of the banks and other financial institutions, especially between developed countries. All of these factors help to explain how a "domestic housing slump turned into a global financial crisis,"²⁹ and one which seems never-ending as it takes yet another twist and turn, with continuing anxieties about the safety and soundness of the banking system and sovereign debt.

All of this seems a far cry from the introduction of the National Homeownership Strategy in 1995. But that was the first step towards the unchecked and largely unregulated growth of the subprime mortgage market with all the consequences for the rest of the world. Then President Clinton said, "The goal of this strategy, to boost homeownership to 67.5% by the year 2000, would take us to an all-time high, helping as many as 8 million American families to cross that threshold ... *and we're going to do it without spending more tax money.*" If the former President were to say that again today, he would be greeted by hollow laughter echoing around the globe.