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Introduction

The full impact of the financial crisis of 2008 still reverberates around the globe. The crisis was triggered by events in the US subprime mortgage market of 2007–2008, and quickly spread to other financial markets, sometimes unrelated, but also often connected through the banks' activities in the wholesale market. The purpose of this book is to analyse the causes of the development of a vast subprime market in the United States. The mortgage market has reached the point where almost nine out of ten mortgages are currently insured or guaranteed by the US government.

Turning the dream into reality

The American dream of home ownership had always been part of aspirations articulated by successive governments in the USA, but it was not until President Bill Clinton took office that any President sought to turn the dream into a reality for millions of families. Clinton introduced the “affordable housing” ideology in his 1995 “National Homeownership Strategy,” designed in part to cut federal expenditure on public housing, but also to respond to claims that banks discriminated against minorities. The aim was to increase home ownership by entering into a partnership with all those involved in the process of making mortgages available. President Clinton did not just involve the private sector, but also used existing legislation and the long-established federal agencies.

Using federal agencies and Government Sponsored Enterprises (GSEs)

The Federal Housing Administration, the Veterans Administration and the “Government Sponsored Enterprises” (the Federal Home Loans Banks System, Fannie Mae and Ginnie Mae) were all created as part of the 1930s “New Deal” to get the mortgage market functioning again after the Great Depression. The agencies had evolved over time, but from the mid-1990s onwards were co-opted into increasing home ownership amongst minorities and low- to moderate-income groups.

The Community Reinvestment Act, 1977

The CRA was originally designed to prevent “red-lining” by banks and other financial institutions. The Act was readily to hand and only required

amendments in order to incentivize lenders to increase their lending to minorities and low- to moderate-income groups; to those, in other words, who could not meet the usual loan-to-value, credit scores or debt-to-income ratios required by the so-called conventional 30-year fixed-rate mortgages with some 20% down payments. The move away from that type of mortgage had already begun in the early 1980s: a wide range of mortgages, including adjustable rate mortgages, were no longer banned under state laws.

The carrot for the lenders was the regulatory seal of approval, that is, being rated as “outstanding” in their compliance with the requirements of the Community Reinvestment Act, as amended, to lend to less creditworthy families or those without any credit rating at all. Such a rating meant that their plans to merge or acquire other banks would be approved by the regulators. Interstate banking had been illegal until the Riegle-Neal Act, 1994 took effect. Thus the Community Reinvestment Act contributed to the subprime debacle.

Fannie, Freddie and the Housing and Urban Development Department

In this book, attention is inevitably focussed on Fannie Mae and Freddie Mac, but the role of the “other” Government Sponsored Enterprises should not be neglected: the Federal Home Loan Banks system, consisting of the twelve banks which provide stable, on-demand, low-cost funding enabling lenders to make home loans. The FHLBs ran into difficulties as well, through bad management and poor supervision. The government agency responsible, which was also part of the Housing and Urban Development Department (HUD) and so subject to political direction, is the Federal Housing Administration (FHA), which insures mortgages made by lenders to qualifying borrowers against default. Operating at the lower end of the mortgage market, the FHA insures a disproportionate number of black and Hispanic and low- to moderate-income borrowers, often in inner-city areas. In the context of the affordable housing ideology, the FHA was prepared to insure loans with deposits as low as 3% and to accept seller funded down payments until a long history of fraudulent activities in the market finally came to light and ended this practice. But Fannie and Freddie were the key players.

From the beginning of their existence, Fannie and Freddie only operated in the secondary market. They did not make any home loans themselves, but were chartered by Congress to provide a stable source of funding for housing finance throughout the country. They carried out that “mission” by purchasing the home loans from the originators, the lenders, and then packaging those loans into mortgage-backed securities (MBSs). The MBSs were then sold to investors, along with a guarantee against losses from defaults on the underlying

mortgages; or held in portfolio, financed by the agency debt which the GSEs issued.

The Secretary for Housing was the “mission regulator” for Fannie Mae and Freddie Mac. This involved setting the housing goals, that is, the proportion of mortgages for low- and moderate-income families they were expected to buy each year, goals established as a result of complex and bureaucratic formulae, but which increased each year, until the goal for 2008 was 57%. The first set of affordable housing goals was finalized in 1996 for the years 1996–2000, and the process continued throughout the Bush Administration, following his announcement of the “Blueprint for the American Dream” in 2002.

Fannie and Freddie became the dominant players in the market, in terms of both size and political power, forming partnerships with banks of all kinds that were lending to minorities and low- to moderate-income families. The partnership agreements meant that banks could sell the mortgages to Fannie and Freddie, paying the guarantee fees in exchange for removing the default risk from their own books. The Government Sponsored Enterprises spent millions of dollars on lobbying, using every means possible to attack politicians who sought to limit their power, and rewarding many Congressional members of the banking and financial services committees, which were responsible for the way in which Fannie and Freddie operated, by sponsoring housing projects for affordable housing in their constituencies.

The signals from government were clear enough: lend to minorities and less well-off families, and adjust underwriting standards to increase home ownership amongst these groups. But Fannie and Freddie had a pivotal role in the mortgage market, and so must bear a major part of the blame. They were out of control. They exploited the weakness of their regulator and engaged in dubious accounting practices, whilst amassing huge fortunes for their top executives. All the time, they proclaimed their commitment to affordable housing and were aided and abetted in their activities by Presidents and politicians alike.

So lend they did: banks, thrifts and mortgage brokers, safe in the knowledge that they need not retain the risks. Fraud and predatory lending practices were rife, not just on the part of banks, but also brokers, appraisers, loan servicers, builders and borrowers. Mortgages were packaged in ever more exotic financial instruments. The regulators failed to act to prevent predatory lending until it was too late: the Commodities Futures Modernization Act, signed into law in December 2000 by President Clinton, exempted over-the-counter trading in derivatives, including credit default swaps, from regulation.

A few voices in Congress, outside in the community and in the banking sector were raised in protest, but they were not heard whilst more and more people could buy their own homes; the affordable housing ideology blinded the rest. Much was hidden whilst house prices continued to rise, but as they faltered in 2006 and began to fall throughout 2007, and interest rates rose, the

extent of the subprime market dawned slowly. Decisive action was too late to prevent the collapse of the mortgage market, with its misery for millions both in the USA and elsewhere.

As pivotal players in the market, Fannie Mae and Freddie Mac must take a large slice of the blame. But above all, it was the distortion of the banking sector to achieve political ends that ultimately caused the crisis. Politicians, with their unthinking political stances, must, perhaps for the first time, take the lion's share of the responsibility. The vast subprime market, out of which others created over-complex, opaque financial instruments, selling them with only an eye to profit throughout the world, was the child of the affordable housing ideology.