

FANNIE MAE AND HOUSING FINANCE

<http://knowledge.wharton.upenn.edu/article/don't-reform-housing-finance-reinvent/>

Comments by Ed Dodson, Cherry Hill, NJ, 12-3-13
in response to Knowledge@Wharton website article by Richard Morris, "Don't Reform (cont'd on pg. 9)

Housing Finance - Reinvent It", on what to do about Fannie Mae and the housing finance system, November 21, 2013.

I congratulate Richard Morris for expanding the debate over the nation's housing finance system. My own history included twenty years at Fannie Mae as manager of a team of review underwriters and later as a business manager performing market analyses in the Housing & Community Development group. Mr. Morris arrived the year after my retirement early in 2005. Prior to joining Fannie I spent several years managing the residential mortgage lending program for a large regional bank. So, many of the risks described in his article are those my colleagues and I grappled with on a daily basis.

What was most unique about Fannie Mae, from my perspective, was its charter as a shareholder owned company with a public mission and a very restrictive set of investment options. When I joined Fannie Mae at the end of 1984, the company was in serious financial trouble. It bought and held fixed rate mortgage loans at a time when the cost of funds was skyrocketing. Fannie was in the same situation as the thousands of thrifts scattered across the country - bleeding red with no regulatory relief in sight.

Fannie's presence as part of the secondary mortgage market allowed mortgage originators to pass on interest rate and even credit default risk; when loan volumes were relatively low, Fannie's underwriters would look at each and every loan file before approving a purchase. However, as my own generation of "baby-boomers" reached adulthood and began to enter the work force and create new families, transaction volumes forced the industry to adjust. Delegated underwriting, shared risk structures and what were called "post-purchase reviews" by Fannie were introduced in response.

The same demographic shifts also added fuel to what had always been a speculation-driven part of the economy - land markets. As new suburban developments went up around every major urban center, the asking price for still vacant land doubled and doubled again in only a few years time. A handful of city planners and economists who had some expertise in the operation of land markets offered warnings and advice to policymakers. Rarely did their input have an effect. And, as we know, the countryside everywhere retreated under the pressure of sprawling demand for land. Developers kept going further out from the regional center to find land at a reasonable cost. Local governments looked to the state and federal governments for funding to help shoulder the cost of putting in new roads, bridges, sewage treatment plants, sewer lines, utilities and water

systems. Few gave much thought to the possibility that economic recession and "tax reform" would combine to bring an end to the era of revenue sharing initiated during the Presidency of Lyndon Johnson and continued on through Jimmy Carter.

What frustrated me as I began to work in the housing finance sector was the knowledge that most of problems we faced could have been avoided. I never forgot what a city planner in Central Pennsylvania had told me in the early 1970s. He explained the consequences of intense land speculation. More importantly, he explained how the way we taxed real estate caused land prices to skyrocket, imposing heavy stresses on the general economy so that about every 18 to 20 years we would experience a recessionary bust.

When I was given the responsibility at my bank for our CRA investments, this problem became quite evident. Infrequent and inaccurate property assessment actually penalized lower income households, whose property values had fallen but whose assessments remained fixed. With rare exceptions were property assessments in a community maintained at a consistent percentage of market value. For a long list of common sense reasons, the fairest and most economically efficient means of raising revenue from real estate was to tax the value of land only. I learned from the city planner that a handful of Pennsylvania city governments had actually moved moderately in this direction by applying a higher rate of taxation on land values than on houses and other buildings. I hoped that during my career I might be able to support this approach as I worked with distressed communities. Over the years, writing papers on the subject and even testifying before city councils, only the rare elected official could grasp how important this policy change could be.

The reason for telling the above story is that my desire to join Fannie Mae was, in part, based on an exchange of letters I had in 1982 or 1983 with the then Chairman and C.E.O., David Maxwell. Reaching out to Mr. Maxwell after viewing an interview of him with George Goodman (on Adam Smith's Money World), he informed me that he was quite familiar with the tax policy proposals I embraced and was in full agreement. If any company seemed to have good reason to work for such a change it was Fannie Mae. Non-inflationary economic expansion was just what a company required when borrowing short-term and lending long-term.

As it turned out, a combination of the Reagan recession and product innovation slowly brought Fannie out of its financial black hole. Cash was raised by selling off whole loans, but the losses were allowed to be amortized over the remaining life of the loans rather than immediately recorded. The adjustable rate mortgage was introduced, stimulating investor interest in mortgage-backed securities that offered protection against interest-rate risk. And, Paul Volcker's policies at the Fed gradually brought interest rates back down to single-digits. Deregulation did the rest, particularly the role played by money market funds and REITs providing the credit to anyone who showed the least bit of ability to act as a real estate developer.

Those of us in the trenches observed many warning signs. Year after year Fannie and Freddie increased maximum loan limits in order to sustain transaction volumes. This only added more fuel to the speculative character of the residential property markets. By the time of the 1989 crash property appraisals in some markets were (continued on page 10)

FANNIE MAE (from page 9)

reporting land-to-total value ratios greater than 50%. In short, consumers were paying as much or more for land as for the housing unit itself. And, then, of course, the S&L meltdown occurred. Delinquencies and REO climbed but these problems were kept manageable by a growing team of specialists in this part of the business.

By this time several economists had entered my circle of contacts, and they were warning that the next downturn would be far worse. The historical data indicated that the next crash would occur beginning in 2007 and continuing getting worse through 2010. I was not convinced for the simple reason that there was no one national property market in the U.S. Our recent history was one of boom in one region even as other regions were busting. Labor and capital moved from low growth or no growth regions where the prospects were brighter. For example, California's skyrocketing property prices and taxes opened the door for the economic diversification of Las Vegas and new growth in places such as Phoenix, Seattle and Portland. My attitude changed after the British economist Fred Harrison recruited me to provide research assistance for a book on the next crash that would be published in 2005. In one of the great ironies of modern social policy, the creation of a uniform secondary mortgage market that simultaneously took over a huge portion of the former jumbo market and funded the sub-prime business formerly the province of finance companies and second mortgage lenders brought on a nationwide crash. Fannie tried but failed to side-step the direction the market took by allowing Wall Street to build market share with private label MBS that increasingly ignored conventional creditworthiness standards and was often plagued by systemic fraud.

I remember hoping that the collapse of Wall Street's shell game would not bring down the GSEs. I knew, as Dan Mudd would later testify, that Fannie's Alt-A business was far less risky than the sub-prime loans Countrywide and other lenders had generated. But, investors almost immediately abandoned the entire MBS market. Fannie was forced (I surmise) to mark down assets to market value and book the losses and had no real hope of raising additional capital as the stock price collapsed. Before long the sub-prime collapse expanded to a general financial crisis, business contraction, layoffs, rising unemployment, eviction notices, and millions of foreclosures. Almost unanimously, economists and analysts said the "housing" market was in free fall. Actually, what was falling everywhere were the unsustainable land prices. In some markets (e.g., parts of Cleveland and Las Vegas and new condominiums scattered throughout Florida) demand collapsed which pulled property prices down well below the depreciated value of actual housing units.

At that point, the one measure regulators should have pushed through was to prohibit any financial institution that accepted government insured deposits from extending credit for the purchase of land or acceptance of land value as collateral for any borrowing. What (cont'd next column)

this would have done is to deny the property markets of the fuel to reignite a return to land price escalation. Property prices had already fallen. With this one change in regulation, buyers would be required to accumulate savings sufficient to make a 20 percent cash down payment (as was once the case before the introduction of private mortgage insurance).

Instead of taking steps to keep the land markets from yet another destabilizing climb, our state and federal governments and the Federal Reserve combined forces to stimulate demand sufficient to pull property prices back up to levels that would protect banks for further losses and enable at least still employed homeowners to refinance out of high cost mortgage loans.

As I see the problems, the measures proposed by Mr. Morris do not in any meaningful way focus on the real causes.

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