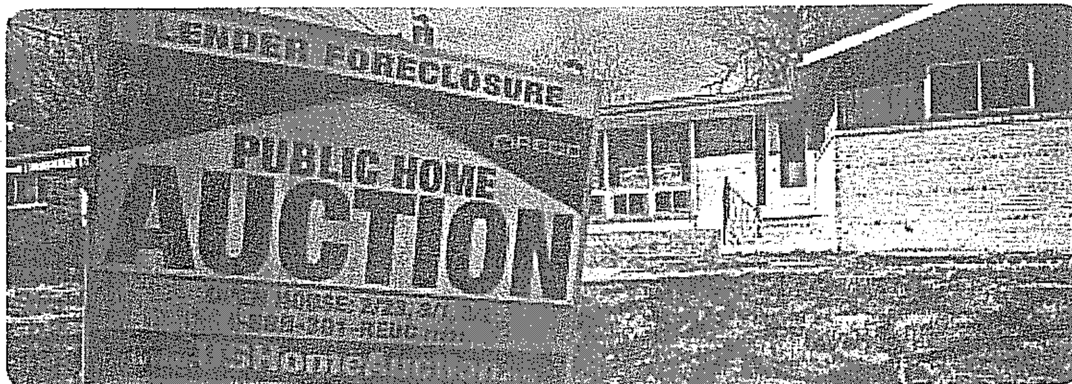
Reckless Endangerment

By Ed Dodson



The past few years have been difficult in the extreme for Fannie Mae and Freddie Mac. Because of the concerns of international investors over the safety and soundness of bonds and guarantees issued by the GSEs, the U.S. government moved in to take over management of their activities. The market value of the stock issued by the GSEs disappeared almost overnight. Mortgage-backed securities they issued began to trade at prices based on anticipated but not realized performance problems. The steep declines in the value of these assets left the GSEs with insufficient net worth at a time when raising capital became next to impossible. But, that is only the most recent chain of events reported on by Gretchen Morgenson and Joshua Rosner.

What seemed like an overnight meltdown actually had been coming on for over three decades. The GSEs were both actors and victims, and from what the authors report a good deal of the blame for Fannie Mae's eventual downfall rests with the actions of James A. Johnson during and even after his tenure as Fannie Mae's CEO. Morgenson and Rosner write:

"Johnson's position atop Fannie Mae gave him an extraordinary place astride Washington and Wall Street." [p.5]

As a former long-time employee of Fannie Mae, what I can say with a high degree of certainty is that the senior management teams at the two GSEs consistently failed to recognize or understand the true nature of property markets. They ignored the market signal of intensifying property speculation that always precipitates regional and segment crashes. The GSEs became casualties of and willing participants in an inherently dysfunctional and poorly regulated credit-driven property market. They were far from alone, however.

The aspirations and decisions made by Jim Johnson never really affected my work in a direct manner (or in a manner that I was aware of). I was hired by Fannie Mae in late 1984 to help supervise a small team of review underwriters working out of the Regional Office in Philadelphia. Prior to joining Fannie Mae, I had been in charge of mortgage lending for Provident National Bank in Philadelphia. Early in 1984 this bank merged with Pittsburgh-based PNC Bancorp. The head of my division soon informed me that our bank's mortgage originations and servicing activities would be taken over by PNC's mortgage banking subsidiary. As the nation's financial institutions were in the midst of consolidations triggered by Reagan-era deregulation, I looked around for a new employer.

Interestingly, what brought me to contact Fannie Mae regarding a possible position was an exchange of letters with David Maxwell, Fannie Mae's CEO. Maxwell had appeared as a guest on the television program 'Adam Smith's Money World' where he provided his perspectives on the state of the U.S. housing market. I wrote to George Goodman, host of the program, expressing the view that the only effective means of stabilizing both the property markets and the economy was to change the way government raises its revenue. My thinking had recently been greatly influenced by studying the works of the 19th-century political economist Henry George, who made the case for the taxation of the rent of land and not taxing other assets, income flows and commerce. George Goodman forwarded my letter on to David Maxwell, who wrote to me that he was in agreement with Henry George's position and that he had written on the subject while working toward his law degree at Harvard.

Thus, to me David Maxwell sounded like the kind of leader I would like to work for.

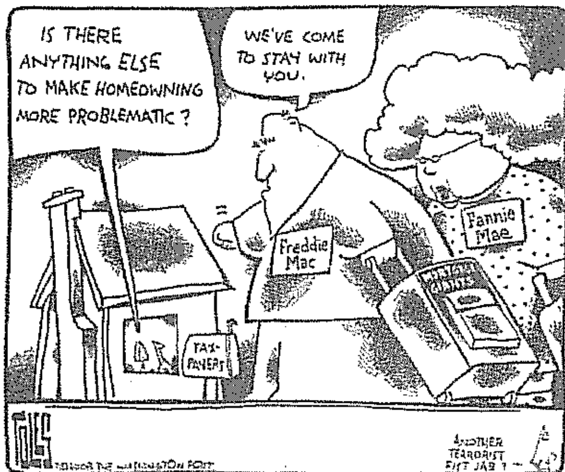
Based on my first-hand experience at Fannie Mae during the 1985-1995 decade, I challenge the authors on their assertion that:

"... all of the venerable rules governing the relationship between borrower and lender went out the window, starting with the elimination of the requirements that a borrower put down a substantial amount of cash in a property, verify his income, and demonstrate an ability to service his debts." [p.3]

No evidence to support this assertion is provided in the 300 plus pages that follow, at least not where my former employer is concerned. The day-to-day interaction of my group with our Marketing teams involved constant risk management assessment and analysis of lender performance on several key levels.

No organization worked harder than Fannie Mae toward the objectives of establishing uniform eligibility and creditworthiness standards or in the use of plain language promissory notes and mortgage instruments across the United States. Our programs were offered in all markets at all times, provided through an approved list of lenders able to originate and service mortgage loans according to our standards. The quality of the business we were purchasing (and later securitizing) was constantly monitored.

The effort to train our institutional clients and mortgage bankers on these issues and to hold them accountable was ongoing and intense. We required approved lenders to perform post-purchase quality control reviews on the loans they closed, and we regularly selected a portion of every lender's loans for our own review. Any loan that experienced what we termed an "early payment default" or defaulted within the first three years was closely examined to determine whether the borrower and property met eligibility requirements and



creditworthiness standards. Any loan found to involve material misrepresentations or evidence of fraud was put back to the lender for repurchase. Lenders were sometimes suspended or permanently terminated as a consequence of consistent patterns of noncompliance. On more than one occasion my counterparts and I were called upon to testify against indicted persons in cases of criminal fraud related to mortgage originations.

Fannie Mae's charter required an additional layer of protection against the possibility of heavy losses from mortgage loan defaults. Any loan with an original loan-to-value ratio greater than 80 percent required private mortgage insurance. The private mortgage insurers established their own eligibility criteria and priced (i.e., established premium levels) for the risk. Under all but the most serious recessionary conditions, the presence of private mortgage insurance spread the risk in a way the mortgage finance sector was sufficiently capitalized to handle. The authors make only one reference to the role played by private mortgage insurers, and that regarding PMI Group's decision to stop writing insurance on a major subprime lender.[p.212]

This is not to say the executives of Fannie Mae, Freddie Mac, the private mortgage insurers or the lending institutions and mortgage bankers with which they did business acted wisely, even where they did not engage in criminal fraud or deceptive financial reporting practices. Clearly, almost none of the participants in the 1990s explosion in mortgage loan volume were organizationally prepared to prudently manage the dramatic increase in business that occurred. Systems support became a major challenge and required an enormous commitment of financial resources and people to meet financial reporting requirements and compliance with governmental oversight.

In the midst of what was happening to business volumes, history provided ample evidence that property markets are cyclical, and that rapidly rising property prices – particularly when fueled by readily-available and inexpensive credit – will eventually so stress an economy that a crash occurs. What I had learned from closely studying the economic literature was that the most recent crash was inevitable because property prices were escalating at the same time that household incomes were stagnating or falling and household savings rapidly eroding. What was not inevitable was the heights from which the crash occurred. The origin of the credit-fueled period of intense property speculation goes back to the early 1970s and the creation of the first money market funds, followed by the removal of one level of regulation after another. The authors fall short in their analysis, in my opinion, by ignoring the successful efforts by the financial industry lobbyists to remove strong government oversight at the very time Fannie Mae was launched as a quasi-public corporation. From this perspective, what happened to Fannie Mae and

Freddie Mac was inevitable. It was not a question of whether, but when the crisis would occur.

The 1970s proved to be financially-challenging years for the GSEs. The rising costs of raising funds in the global credit markets resulted in negative spreads for every portfolio lender and for the GSEs. The GSEs faced the age-old problem of having to borrow from sources willing to lend only for short periods while purchasing mortgage loans with a 30-year term (and an expected life of around 12 years). Circumstances worsened as depositors pulled their funds from the Thrifts and commercial banks to take advantage of higher yields offered by the new money market funds. This problem was only partially solved when the U.S. Congress finally lifted restrictions on mortgage loan interest rates and permitted the Thrifts and banks to issue their own certificates of deposit to compete with the money market funds. In the meantime, thousands of savings banks and savings and loan associations – the traditional sources of mortgage loans in their communities – closed their doors.

The playing field did not suddenly become level. Commercial banks always had the advantage of diversification of risk – making consumer loans, issuing credit cards, and offering credit to businesses at rates of interest that reflected the potential for default and volatility of their cost of funds. The Thrifts, on the other hand, remained saddled with their low-yielding portfolios of residential mortgage loans. With deregulation, many Thrifts sought to improve their financial position by moving into business sectors dominated by the commercial banks. For many of the Thrifts, their inexperience in these other sectors resulted in high levels of default, insolvency and dissolution or acquisition. The criminal actions of opportunistic and unscrupulous individuals who managed to gain control of some Thrifts worsened what was already a serious crisis. The GSEs were able to provide some relief to the commercial banks and Thrifts by purchasing their residential mortgage loan portfolios, although such purchases were made at a deep discount in order to compensate for the spread between the stated and current market yield requirements.

One of the factors that softened the financial impact and permitted these portfolio transactions to occur was the ability of the selling lender to record losses not at the time of sale but as each homeowner made the monthly mortgage payment. Amortizing losses over the life of the mortgage loan meant that a time might return when market interest rates would fall closer to the stated promissory note rate, or even return to par, so that no loss at all had to be recorded.

At the time I joined Fannie Mae in 1984, the company was losing around $1 million each day because of the negative spread between its cost of funds and the interest income generated by its loan portfolio. The company's stock was trading, as I recall, for $1 a share. Thousands of thrifts and some commercial banks were in a similar position.

The Federal Reserve System made matters worse in 1979 by taking the advice of economist Milton Friedman and abandoning efforts to keep interest rates stable in favor of trying to control the money supply. The U.S. economy was already experiencing stagflation driven by OPEC-induced rising fuel costs and heavy tax burdens on goods producers. Interest rates skyrocketed, causing the housing sector to come to a screeching halt. Existing homeowners stayed put and builders halted new construction. Selling one's home and repaying a 5 percent mortgage loan made no sense when the rate on a new mortgage loan might be as high as 15 percent. For the GSEs and the Thrifts the desperate need was to develop new sources of income.

Two innovations appeared just as the economy was beginning to recover from the depth of recession.

First, the regulators approved the origination of mortgage loans with periodic adjustments in the rate of interest. The adjustable rate mortgages (ARMs) matched the duration of interest rate yields with interest rate risk by linking periodic adjustments to a stated index (e.g., one-year U.S. Treasury obligations). As conditions in the general economy improved and interest rates declined, ARMs enabled qualified homebuyers to close on new homes, with the prospect of eventually being able to refinance into an affordable fixed-rate mortgage loan down the road. Fannie Mae and Freddie Mac introduced ARM products that provided a high level of consumer protection against enormous rate increases at the time of a rate adjustment. These so-called "rate capped-ARMs" soon became the industry standard.

Second, the regulators approved a proposal by the GSEs to pool mortgage loans together as specific collateral for a new kind of financial assets, a mortgage-backed security (MBS), essentially an amortizing bond to be sold by Wall Street to investors. Mortgage-backed securities appeared just as the Reagan administration pushed through measures further deregulating the financial services sector and significantly lowering the marginal tax rates on the nation's highest income recipients and on misnamed "capital gains" (misnamed because actual capital goods rarely, if ever, sell for more than their depreciated value). Thus, in addition to land, real estate, the stock and bond markets, billions of dollars in new-found disposable income found their way into the new MBS market. The GSEs put their stamp of approval on the underlying collateral (i.e., the mortgage loans) originated by lenders who met minimum capital requirements, were deemed capable of servicing the loans they originated and were regularly monitored by the GSEs. Fannie Mae and Freddie Mac now had a new source of income – guarantee fees – in return for representing and warranting to investors

that the underlying mortgage loans met GSE eligibility and creditworthiness standards.

Interest rates on long-term mortgage loans gradually came down during the early 1990s as fears of inflation lifted. Thus, what I would describe as a window of affordability opened, but only briefly, before the inventory of unsold properties was moved by realtors. Residential real estate once again gradually became a seller's market in those parts of the United States with significant increases in population. Property markets in much of Florida, Nevada and California quickly overheated and got even hotter. As property prices increased, realtors once again advised potential homebuyers that the time to buy was now – before prices rose even higher. Higher income households aggressively entered second home markets with expectations of a huge capital gain after just a few years of holding income-producing properties.

Inventories of newly-constructed homes found buyers, and the pace of new construction increased (although few builders broke ground without a sales contract and mortgage loan commitment in hand). Millions of homeowners who had purchased their properties when interest rates were high refinanced, either lowering monthly mortgage payments by hundreds of dollars or shortening the term of their loan from 30 years down to as few as 15 years. As property values inched upward, many homeowners also refinanced credit card and installment debt, refurbished or expanded their homes, or simply took cash to pay for their children's college expenses or other personal expenditures. We can trace a good deal of the economic expansion to the side-effects of such a huge number of refinancings rather than any increases in household income. The authors correctly trace some of this refinance activity to the Tax Reform Act of 1986:

"While most individual deductions had been eliminated in the Tax Reform Act of 1986, the mortgage interest deduction remained a sacred cow." [p.72]

Yet, there was a dark threat building to erase the illusion of prosperity. Almost any economist questioned could explain that the mortgage interest deduction (and other subsidies) were capitalized by market forces into higher property (meaning "land") prices. Essentially the same market dynamics operated when the minimum cash down payment by homebuyers was reduced and what are called "qualifying ratios" (i.e, the housing expense-to-household income or total obligations-to-income ratios) were increased. Few noticed. Or, if they did notice and tried to express concerns, no one in a position of decision-making authority was interested or prepared to do anything to tame the nation's spiraling land markets.

By 1994, when I moved into a new position as a business manager and market analyst within the relatively new Housing & Community Development (HCD) group at Fannie Mae, the volume of business we were doing increased beyond anyone's most optimistic forecasts. We were all scrambling to strengthen our internal systems and controls, and all around the company task forces were established to lift what was a rather sleepy and bureaucratic company into a technology-driven financial giant. We were plagued by computers that could not transfer data one to another and other shortcomings that impacted our ability to make timely and accurate assessments of the profile of our business volumes. This does not suggest we did not make a determined effort to do so, however. As the authors report, the challenge was significant:

"... between 1993 and 1996, Fannie's portfolio of loans that it kept on its own books doubled form $156 billion to almost $300 billion. From March 1996 through December of that year, the company's loan portfolio grew by almost 10 percent." [p.77]

More important than the dollar volume of this business was the profile of the loans. While there was a significant increase in the loans made to first-time homebuyers and to minorities, the real measurement of possible risks associated with loan delinquencies was the weighted average loan-to-value ratios of the business. Consider that even when mortgage insurance was in place (again, required for all loans with an original loan-to-value ratio above 80 percent), some loss was forecasted for any loan with an effective (i.e., current) loan-to-value ratio above 70 percent. How much loss depended on typical variables, such as the length of time between borrower default and resale of the property following acquisition at foreclosure sale, property condition and the general strength of the property market where the property was located. With the nation coming out of recession in the early 1990s, these shared risks were viewed as manageable and adequately reserved for. We were accumulating a remarkable amount of data on the characteristics of borrowers in specific markets as a predictor of performance. Despite the general perception as

repeated by the authors, credit scores were only one component of a much broader analysis. A trend that I found most troubling was the absence of cash reserves after closing that characterized a growing number of transactions. People were scraping together every dollar they could to meet down payment and settlement costs, with nothing left in the bank for any emergency that might arise.

While it is true that "the percentage of loans the company purchased with a loan-to-value ratio of greater than 90 percent rose from 6 percent.in 1992 to 19 percent three years later,"[p.78] this must be put into perspective by looking at Fannie Mae's full book of business where the weighted average loan-to-value ratio was still under 75 percent. Moreover, almost all of the higher loan-to-value ratio business volume involved 30-year fixed rate mortgage loans, conventionally underwritten and "top loss" protected by private mortgage insurance.

The authors make the case that many decisions made by Jim Johnson and the management group were made with a view of maximizing their own compensation packages. In hindsight and based on what I have read in this book and other sources, this does seem to be an important component of the strategies handed down to us as employees for implementation. And, of course, the disclosures of accounting irregularities became an unfortunate reason why the company's executives spent so much time and energy before Congressional committees. Once this process began it became increasingly difficult to continue our mission focus in quite the same way. The authors tell us:

"Indeed, to make its earnings-per-share targets and trigger the all-important executive pay bonanzas, Fannie had to resort to accounting fraud." [p.118]

More alarming from a public perspective, perhaps, is the argument that maximizing compensation required that the company retain a far lower level of capital as reserves for loan losses than should have been the case given the risk exposure of the business. Morgenson and Rosner note that:

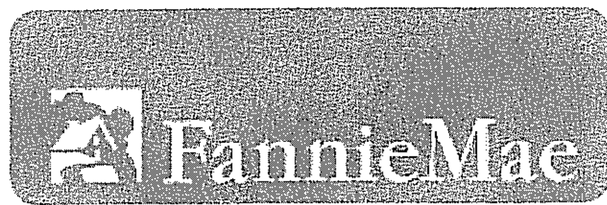
"Fannie Mae held capital of only 3.64 percent of its assets. By comparison, the ratio for banks insured by the FDIC stood at 8.22 percent at that time." [p.119]

One reason for the difference in reserve requirements not addressed by the authors is that the assets of Fannie Mae were almost entirely residential mortgage loans or mortgage-backed securities collateralized by loans conventionally originated and underwritten to secondary market (i.e., GSE) standards (and protected by private mortgage insurance as the charter requires). Under normal economic circumstances, residential mortgage loans out-perform many of the classes of assets held by commercial banks.

In a sense, the financial strength of Fannie Mae during the 1990s developed despite the actions of Jim Johnson and others described by the authors. This is but one of the numerous studies published in the last to years to take on the ideologically-based and greed-driven calls for deregulation of financial services. Only those who feed on such power would fail to recognize the threat of interlocking boards of directors, for example. Stephen Friedman of Goldman Sachs serving on the Fannie Mae board, and Jim Johnson serving on the Goldman Sachs board is but one indication of just how tight is the control of our economic structure in the hands of a self-selected few. Knowing what we know about Goldman Sachs, we should not be shocked by the report by the authors that Goldman "even helped Fannie manipulate its accounting." [p.120]

What is missing from this book is any recognition for the sincere efforts by the majority of people working at Fannie Mae (or Freddie Mac, for that matter) to make a positive impact on the lives of millions of people by helping them achieve lasting home ownership. We were constantly engaged with local advocacy groups to make prudent changes in our mortgage loan products. Moreover, the people who managed and staffed our Partnership Offices did their best to balance the charge to forge strong ties with influential politicians with real on-the-ground changes in neighborhoods and communities.

The internal analyses to which I was privy extensively evaluated the scope of risks associated with expanding or initiating market penetrations where Fannie Mae had not been present in any significant way. Where performance data was not available internally, such data was acquired from third parties with experience originating and servicing loans characterized by high loan-to-value ratios, cooperatives and condominiums or manufactured housing units as property types, where down payments came from conditional grants and so-called "soft second" mortgages held by government agencies, and other unusual factors. What is true is that Fannie Mae (and Freddie Mac) were not in a position to fully price for risk based on what the analytical models called for. Doing so would have adversely affected those segments of the population considered to be underserved – minorities, women and first-time homebuyers. A policy of average pricing imposed a slight premium cost on those borrowers with the highest degree of creditworthiness in order to make financing more affordable to those who reported lower incomes and minimal savings.



What is certainly true is that with the 1990s new faces constantly arrived at the company. Departments and divisions underwent a series of reorganizations. Position descriptions were rewritten to more closely confirm to those of our counterparts working on Wall Street and in the banking sector. New priorities were adopted and analyzed year-to-year, in an effort to redirect resources for maximum efficiency. As profitability returned and climbed, Jim Johnson, took the company in an aggressive new direction. Our Housing and Community Development group (the name of the group changed to more accurately describe its role) began to expand all across the United States, covering every regional market in the U.S. with an office within the geography charged with developing strong relationships with public and private stakeholders focused on meeting affordable housing and community revitalization needs. The authors describe this expansion as an offensive strategy designed to ensure that no member of the U.S. Congress would feel comfortable criticizing Fannie Mae without hearing from a broad spectrum of local Fannie Mae partners and beneficiaries. On the whole, elected officials felt good they were helping to bring new investment dollars into their districts:

"By supporting housing initiatives that lawmakers could take credit for in their home districts, Fannie provided publicity for the very congressmen and women whom it relied on for help and protection in Washington." [p.61]

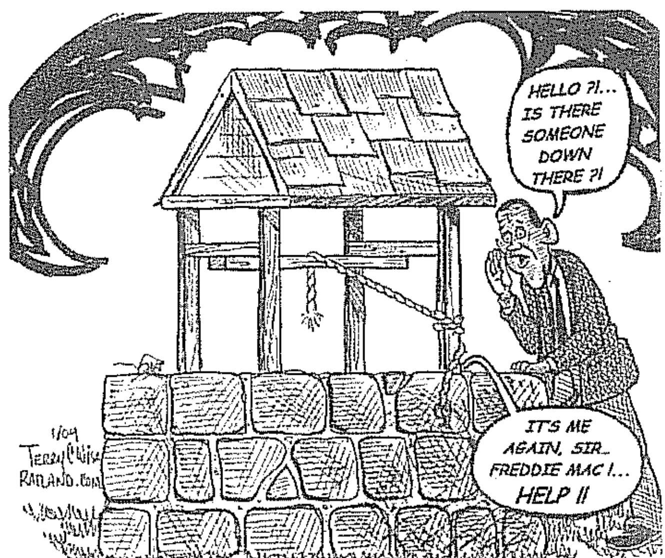
No doubt this is, in part, the case. Yet, the company recruited and hired several hundred people to run the "Partnership Offices" who were devoted to helping communities develop affordable housing units, stabilize neighborhoods and revitalize distressed economic circumstances. In my experience, even those who brought political rather than housing experience to their positions became important advocates for the people they believed they were hired to serve. Were they happy to earn a meaningful income and to share in the increasing value of the company's stock? Of course. We sincerely hoped to do well by doing good.

My counterparts across the country and I analyzed and re-analyzed our eligibility criteria and creditworthiness guidelines in an effort to make homeownership attainable for minorities and younger adults. We met repeatedly with community leaders and listened to their perspectives on how to make up the ground in homeownership rates for groups discriminated against for decades. Members of Congress pressed us to do even more, and so new innovations were brought to the market each year. Managing risk and (to the extent possible) pricing for risk was integral to the expansion of the company's book of business and its role as guarantor in the mortgage-backed security market. Unfortunately, as I note above, much of this effort focused on the trees and missed what was happening to the forest.

What hardly anyone I worked with or came into contact with during my professional work appreciated was that market forces were constantly adding stress to a very vulnerable economic system and that property markets were at the center of the instability. With every innovation we made to expand the pool of qualified homebuyers, land prices rose. With every fall in interest rates, land prices rose. These increases in land prices were reported as an increase in the median price of housing, and as a decline in the housing affordability index. Yet, at the end of almost every year, the GSEs announced an increase in the maximum loan amount we would purchase or securitize, compliantly adding fuel to the speculative nature of land markets. Gradually, we moved deeper and deeper into what had been the jumbo market largely reserved for bank portfolio lending. What received little attention or concern was the fact that what people were purchasing and financing each year was less a house and more a parcel of land. And, as property prices rose to levels threatening the volume – and profitability – projections demanded by Wall Street stock analysts, the GSEs had to come up with even more aggressive product designs that reduced or eliminated the amount of cash savings borrowers needed to purchase a home.

The authors assert that Fannie Mae and Freddie Mac were pushed by Andrew Cuomo into the subprime mortgage market after Cuomo became director of HUD in 1997, and that the GSEs

"... were being told to lower the underwriting standards for the loans they bought or packaged into securities. As such, Fannie and Freddie would no longer restrict themselves to good-quality loans. Pushed to buy subprime loans, the degradation of underwriting standards was now under way." [p.114]



What actually occurred in my experience is that what we did was to examine our eligibility criteria and our underwriting guidelines to determine where changes or flexibilities made sense based on how people actually worked, lived and handled their ongoing expenses. None of these changes was made casually or without ongoing re-evaluation based on borrower performance. Importantly, none of these changes opened the door for lenders to deliver what have become known as "subprime loans." Fannie Mae and Freddie Mac rated some of this business "Alt-A" when borrower creditworthiness characteristics did not quite measure up to A grade paper; but, the differences were minor by comparison to the criteria permitted on subprime loans being originated outside of the GSE environment.

Admittedly, by 2005 an increasing portion of Fannie Mae's business was coming from market segments where default risk was considerably greater than even a few years earlier. We were actively cultivating mortgage brokers to generate mortgage loans that met our requirements, and we were trying to increase the quantity of business coming from credit unions, minority-owned banks and the community banks who were traditionally portfolio or FHA lenders. We were working to counter the effect of mergers and acquisitions within the financial services sector, the impact of which was that only a small number of institutions accounted for the overwhelming majority of Fannie Mae's business. When one customer accounts for, say, 10 or 15 percent of your total business volume, the leverage shifts considerably in favor of what that customer asks for. In the MBS market, this translated into the size of the guarantee fee charged on a particular book of business. An objective analysis of the risk characteristics of loans being securitized might call for a guarantee fee of 50 basis points; however, to keep the customer's business might require accepting a much lower guarantee fee. The decision is a difficult one: expose the company to greater risk of loss, or lose market share to Freddie Mac, the Federal Home Loan Banks, or to a private placement MBS rated by a bond rating firm and marketed directly by Wall Street.

In the midst of all this frenzy, a huge segment of the mortgage market affecting the GSEs was totally beyond their control. FHA had fought to increase its own loan limits in an effort to attract a part of the conventional market and thereby offset its higher risk business with loans that traditionally perform much better. New marketing techniques attracted millions of homeowners to companies offering mortgage loans to people who had problems with their credit. Many of these companies engaged in predatory lending practices and outright fraud. As we now know, the bond rating companies essentially ignored the underlying risks associated with this business so that Wall Street could bundle the loans and market the securities to yield-hungry investors. As the authors report, Alan Greenspan and others refused to be influenced by the facts:

"A belief had arisen during the late 1990s that bankers had so improved their risk-management and loss-prediction techniques that regulators could rely on them and their financial models to develop capital standards. Not everyone agreed – certainly the FDIC rejected the notion. But the Fed was among those regulators who were more than willing to put the bankers in the driver's seat." [p.129]

This house of cards began to collapse after 2005, and the meltdown of the system continues despite the infusion of over a trillion dollars by the Federal Reserve System and the Federal government. However, what happened to Fannie Mae and Freddie Mac need not have happened, even though the decision by the GSEs to expose themselves to greater risk by increasing their maximum loan limits amounted to a self-fulfilling market failure. Regardless of whether Fannie Mae and Freddie Mac survive as corporate entities, the most important and immediate regulatory reform required is to prohibit any financial institution that accepts government-insured deposits from making loans for the purchase of land or accepting land value as collateral for borrowing. Fannie Mae, Freddie Mac, and the Federal Home Loan Banks must also be prohibited from purchasing or securitizing mortgage loans that involve funding for land acquisition or the financing of debt secured by land value. Special consideration is warranted for those mortgagors victimized by predatory lending or fraudulent lending practices, but this must be done in a manner that does not ignite a new period of rising land prices. This one change will do more to protect the bankers from themselves and the taxpayers from imprudent bankers than any other regulation introduced. Homebuyers would be required to save toward a significant down payment and to cover normal closing costs. To the skeptic who sees this as unworkable, I offer the reminder that only a few decades ago the maximum loan-to-value ratio for most mortgage loan transactions was 80 percent. Buyers essentially purchased land parcels for cash and borrowed the funds to purchase their home.

When property prices crash, what crashes is land value. Absent a broader economic downturn and a rapid increase in unemployment, property prices will not generally fall back to where they were at the beginning of the most recent property market cycle. Even when developers are unable to recover their full development costs (i.e., not just construction but land acquisition costs), raw land costs do not fall to zero. Landowners are not going to just give land away to developers to permit profitable housing construction. Some developers with sufficient cash reserves are able to land bank so they can continue to stay in business even when property prices have fallen significantly. Developers who have acquired land for development at the top of the land market soon default on construction loans, their land and partially-completed development projects become Other Real Estate (ORE) of the construction lenders following foreclosure or acceptance of a

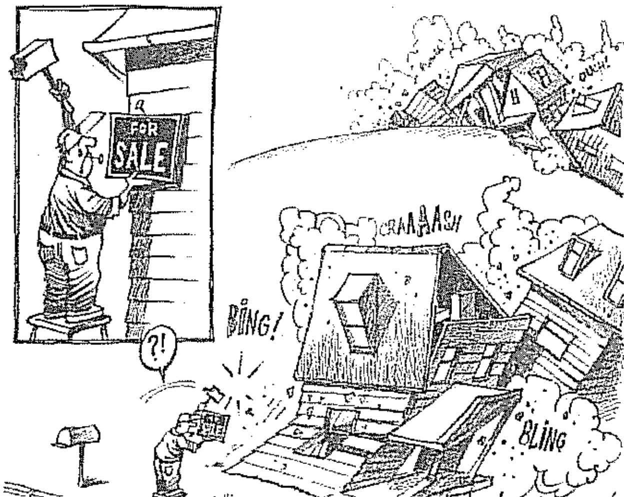
deed in lieu of foreclosure. Many developers and many lenders overexposed to real estate lending end up in bankruptcy. As the authors point out, the bankers essentially lobbied successfully for the regulatory environment that allowed them to make the worst possible investment decisions:

"... reducing capital requirements would also leave the banks in a more perilous position if they loans and investments went bad. And thanks to the elimination of Glass-Steagall, banks were now allowed to extend and expand their operations almost without limit. such expansion increased the likelihood of losses in the years ahead." [p.130]

As had happened with the savings banks and savings and loan associations following the creation of money market funds, the commercial banks ventured into areas of business about which they knew little. They became recipients of billions of dollars deposited with them by overseas investors (including governments generating huge export surpluses). Among their uses of these funds was to go acquire smaller banks and – most disastrously – finance companies, mortgage brokerage firms and second mortgage lenders. They strengthened these companies with cash and turned them loose on the public. The impact accelerated in the late 1990s:

"Subprime lending was already growing fast – between 1997 and 2000, HUD said, the number of home purchase applications backed by subprime mortgages more than doubled, from 327,644 to 783,921. [p.136] ...

Armed with financial incentives to generate high-fee and high-interest subprime mortgage loans, mortgage brokers and mortgage bankers responded. Millions of homebuyers were steered away from conventional loans they actually qualified for and into subprime mortgage terms that would bring disaster upon them within a few short years. The impact on Fannie Mae and Freddie Mac was also disastrous, but not because Fannie and Freddie were acquiring or securitizing huge numbers of subprime mortgage loans:



"The percentage of mortgage securities made up of loans that exceeded the dollar limits on mortgages financed by Fannie and Freddie – known as nonconforming mortgages – would rise from 35 percent in 2000 to 60 percent in 2005." [p.137]

The private-placement MBS volumes skyrocketed because investors did what they always do; they sought above-market rates of return and relied on the soothing comments of Wall Street brokers as assurance the risks were negligible.

Another part of the story that needs to be emphasized is that a major reason mortgage loan volumes doubled and then doubled again was because of repeated refinancings to take advantage of falling rates of interest. Everyone involved became increasingly dependent on fee income. And, in the conventional market competition brought these fees down to very low levels per transaction. Portfolio investors such as Fannie Mae and Freddie Mac were experiencing declining interest income that could only be made up by guarantee fees charged to lenders whose loans were pooled together as collateral for mortgage-backed securities. As I recall, all other sources of revenue were inconsequential. As the banks and Wall Street and the mortgage brokers siphoned off more and more potential conventional business into their private placement MBS, the business model for the GSEs began to self-destruct. And, as the authors note, the Federal Reserve Board provided the banks with all the incentive they needed to throw hundreds of billions of dollars more into the private placement MBS market:

"Between December 2000 and July 2003, the Fed made a crucial decision that, although not fretted about at the time, contributed mightily to the mortgage lending craze. It slashed its Federal Funds rate, the most closely watched interest-rate benchmark, from 6.5 percent to an unheard-of 1 percent." [p.138]

As the authors explain, Jim Johnson (either listening to his team or directing them) came up with a way to raise capital by creating "a series of debt issues that mimicked Treasury securities ... with maturities of three years, five years, and ten years." [p.138] This gave Fannie Mae a competitive advantage over Freddie Mac, allowing Fannie Mae to recapture some of its lost market share even as the total conventional business was declining. To some extent, this bought Fannie Mae time to try to develop strategies in response to the threat from Wall Street and the banks.

Morgenson and Rosner spend some time describing industry opposition to any legislation that would protect consumers from the widespread predatory lending practices commonly imposed on minorities, the elderly and other low-income consumers. The authors' research and interviews apparently failed to discover the efforts made by Fannie

Mae to rid the industry of these destructive practices. Strong anti-predatory lending laws were very much in the common interest of the general public and the GSEs.

In Pennsylvania, as one example, our Philadelphia-based Housing & Community Development group worked very closely with the state banking commissioner, William Schenck, to identify participants in a predatory lending scheme involving a large-scale development in the Northeastern part of the state. Testifying in June of 2004 before the House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises (Committee on Financial Services), Fannie Mae's Senior Vice President, Zach Oppenheimer, offered this:

"At that time, Fannie Mae owned or guaranteed close to 8,300 mortgage loans in Monroe County and the surrounding area. We immediately formed an internal team to identify the nature and cause of the alleged problems, begin to take action to appropriately remedy the situation, and to assist affected homeowners with their mortgage loans. ...

"In order to help homeowners whose loans we own, we committed to working with borrowers, through our lender partners, to make every reasonable attempt to keep families in their homes. We directed our servicers not to foreclose on any property in the area until they had reviewed the original appraisal and loan documents for irregularities, and we granted a moratorium on foreclosures for up to 60 days. For homeowners who could—who wanted to refinance their Fannie Mae-owned loans but could not, because of valuation issues, we even designed and offered a special refinancing program for them. ...

"Since the end of 2000, we have managed to reduce our foreclosure rate in this area by more than half, and the trend continues lower. Since 2001, our loan workout ratio, which measures the percentage of defaulted loans that we were able to cure without foreclosure, has averaged more than 60 percent, far exceeding the State rate in Pennsylvania of 45 percent. But not withstanding these challenges, Fannie Mae has remained committed to providing mortgage loan liquidity here in Monroe County, and has increased our investments in this region from the 8,300 loans that I mentioned, to more than 10,000 loans today."

This type of involvement in response to the attack on communities by predatory lenders was widespread within our division at Fannie Mae. How much worse the situation would have become without this level of commitment is, perhaps, impossible to measure. Absent strong government oversight of the mortgage origination industry, Fannie Mae's internal controls and ongoing review of the financial and performance thresholds of its lender partners served as one of the most effective safeguards available. The fact that these safeguards failed, in the end, should tell us that credit-fueled property markets are highly susceptible to organized, criminal fraud and to the consequences of our inherently dysfunctional economic system.

As a society we have it in our power to tame our boom-to-bust economic cycle by doing what is required to make land markets competitive in the same way the markets for labor, capital goods and even credit respond to what economics describes as the price mechanism.

Nowhere in this book is there any mention of land speculation as a major contributing factor to the financial and economic meltdown. I am not surprised, of course, because only a handful of economists have taken the time to distinguish between the "housing" bubble and the actual "land market" bubble. Too many economists actually call for measures that will bring about a renewed increase in property prices. While this will bail-out property owners and the banks to some extent, the effects on the U.S. economy will not be uniformly positive.

I used to say that what most of my colleagues and I did was to come into work each and every day to put our collective fingers in the dike, to hold back as best we could the inevitable disaster looming over the horizon. What the authors of Reckless Endangerment have done is document some of the reasons our challenge was essentially an impossible one. To once more defer to Henry George, he astutely observed that we seek to satisfy our desires with the least exertion, which translates into monopolistic behavior in the economic realm and moral relativism in the political realm. The evidence presented in this book strongly suggests that these character traits are widely held by those who achieve high political office or emerge atop corporations.

During my years at Fannie Mae, I did what I could to raise the level of awareness among my colleagues of the dysfunctional nature of our land markets. Early on, I wrote a long memorandum on the subject to David Maxwell, reminding him of our earlier exchanges. He responded with some encouragement but, to my knowledge, never commented externally on the need for changes in our system of taxation. At one point, I even spent an hour or so in discussion with Larry Small, at the time President of Fannie Mae, expressing my concerns about the long-term risks associated with the rise in property prices. Although he seemed to grasp what I was saying, he never followed-up with me in any way.

One additional effort I made was to discuss with the head of our research group the need for capturing land values in our data base as a leading indicator of where the property markets were heading. Our lenders submitted to us the property value assigned by appraisers on every transaction. All that was needed was to require one additional data element

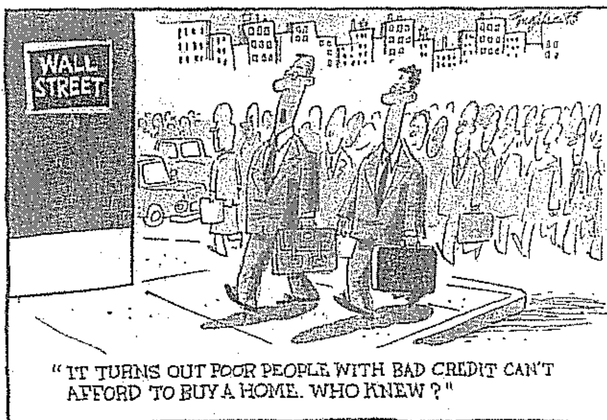
on land value, available on each appraisal report. I suggested this information could be acquired universally by requesting that the Congress amend the Home Mortgage Disclosure Act to require lenders to report land value on every mortgage loan closed. Just when there seemed to be sincere interest in this idea, the Congressional hearings on Fannie Mae's accounting practices convened. A few years before my retirement, I did achieve a minor breakthrough of sorts.

The Vice President I reported to in the Housing and Community Development group agreed with me that the taxation of land values was an important component to increasing the supply of affordable housing. I was able to develop a presentation on the issues and began delivering this presentation at meetings organized by our offices in cities such as Pittsburgh and Buffalo. Unfortunately, this was also the time when Fannie Mae's Chairman, Franklin Raines and the CFO, Tim Howard, were forced to step down because of serious accounting and reporting irregularities. With the company under intense regulatory and Congressional scrutiny, there was energy left to work on the broader issues I was raising.

What decisions were made after my retirement regarding the nature of the business Fannie Mae would consider I cannot say with any certainty. Many of my former colleagues in the Housing & Community Development group soon left the company or were reassigned to new responsibilities. The business climate and the company priorities were, I gather, quickly changing in order to respond to the financial and regulatory challenges faced. When the authors write:

"Millions of risky loans made by Countrywide and sold to Fannie Mae would contribute mightily to the downfall of Johnson's former company." [p.184]

I have a difficult time accepting that the credit risk management culture within Fannie Mae allowed my colleagues to simply roll over and ignore the marginal quality of the loans being originated by mortgage brokers and channeled through Countrywide.



"IT TURNS OUT POOR PEOPLE WITH BAD CREDIT CAN'T AFFORD TO BUY A HOME. WHO KNEW?"

The answer to the question:

"Will a debacle like the credit crisis of 2008 ever happen again?"

Yes!

During my last few years at Fannie Mae one of my own responsibilities was to support the marketing efforts of Countrywide's branch office in Philadelphia. Perhaps Countrywide's activities in the City of Philadelphia were uncharacteristic of business the company generated in California and other markets, but my monthly review of the loans Countrywide brought to us from the Philadelphia market did not reveal any of the troublesome characteristics associated with subprime mortgage loans. Countrywide's branch manager was committed to increasing the amount of business to first-time homebuyers and to minorities, but the variances detailed in our contract with Countrywide were comparable to what had been granted to other major lenders. From my perspective at the time, Countrywide was doing a credible job helping us meet our mission goals in a prudent manner.

Toward the middle of 2004, as I approached completion of my twentieth year at Fannie Mae, I decided the time had come to retire so that I could devote most of my energy to the issue I raise above – changing the means by which government raises its revenue. I certainly share the authors' concerns that the "cast of characters that helped create the mess continues to hold positions or are holding jobs of even greater power." [p.304] And, the answer to their question: "Will a debacle like the credit crisis of 2008 ever happen again?" [p.304] is, Yes! The real message of this book is that entrenched wealth and entrenched power in the United States are combined to prevent the kinds of political and economic reforms needed. Gretchen Morgenson and Joshua Rosner deserved recognition for adding an important perspective to the story of our societal decline. On behalf of the unheard thousands of my former colleagues, I can say we tried and tried hard to do well by doing good. **The game was rigged against us and still is.**