SUMMARY AND COMMENTS ON THE BOOK

The Mortgage Wars, by Timothy Howard

By Edward J. Dodson, Cherry Hill, NJ

For twenty years, from the end of 1984 to early in 2005, Tim Howard and I were employed by the same company, Fannie Mae. We both held positions with management responsibilities, yet we never met or had a conversation. As his treatment of the origins and ramifications of what he refers to as *The Mortgage Wars* makes clear, he sat at the table with individuals who possessed enormous power and influence over the financial and economic affairs of the United States. He provides keen insights into the actions, motivations and personalities of a succession of men who came to run Fannie Mae during the most turbulent decades since the Great Depression. Reading his book took me back to the work I was performing in the trenches of the secondary market for residential mortgage loans.

We are told about his own background and career advancement. He had come to Fannie Mae in 1982 from Wells Fargo Bank, where he served as senior financial economist. At that time, I was managing the residential mortgage lending program for a large commercial bank, waiting for interest rates to come down so that more people would begin to re-enter the housing market. And, as he began his work for Fannie Mae the company 'was losing a million dollars a day."[vii] What our two companies had in common were portfolios of fixed rate mortgage loans bleeding red ink as the gap between portfolio yield and current cost of funds widened. These were difficult times for many of us in the housing sector.

My future was redirected during 1984, when merger with another (larger) bank led to transfer of all mortgage originations and servicing to the mortgage banking subsidiary of the senior partner in the merger. After overseeing the transfer, I began to explore the market for a position appropriate to my skills and interests. Unexpectedly, that led me to Fannie Mae.

A few years earlier I discovered that I had a latent social conscience. One of my responsibilities at the bank was to work with community groups in compliance with the Community Reinvestment Act. Working with neighborhood groups struggling to counter the consequences of urban decay, I began to study what economists, city planning experts and others had offered to explain why so many parts of so many cities and were continuing to decline. In 1980, I found what I was convinced were the answers in the writings of a nineteenth-century political economist named Henry George. What Henry George presented was an analysis that stressed the central importance of land markets in an economy. Equally important, he offered a convincing set of arguments and historical evidence on behalf of his fundamental policy reform: the societal collection of the potential annual rental value of land in lieu of taxes on the other two factors of production – labor and capital goods.

Sometime later, I happened to view a segment of the television program Adam Smith's Money World, hosted by George Goodman. His guest was the then chairman of Fannie Mae, David Maxwell, who talked about some of the economic challenges the nation faced, including rising homelessness and poverty. I wrote to George Goodman suggesting the need for a more in-depth discussion of these problems and summarized my view on the role played by the nation's dysfunctional land markets. Goodman forwarded my letter on to David Maxwell, who wrote to me expressing his agreement with my analysis, telling me that he had written extensively on Henry George while in law school.

When the time came to seek a new employer, I remembered David Maxwell's letter and decided that Fannie Mae might be a place where I could do well while doing good. The one problem was that I was not really interested in moving to Washington, D.C. to work in some capacity at the headquarters. A Fannie Mae regional office was located where I lived, so I made a call, obtained an interview and within a few days was offered the position of assistant supervisor of quality control. This was not the type of position I really sought, but I hoped other opportunities would open once I was inside the company. And, if not, in a few years I would move on.

As I began my new responsibilities, David Maxwell, Tim Howard and the other members of the company's management team were engaged in a fight to save the company from bankruptcy. To explain how this all unfolded, Tim Howard provides a primer on the history of "housing" financing in the United States and why the Federal government felt compelled to establish a publicly-owned secondary market for residential mortgage loans.

For mortgage lenders the problem of interest rate risk always existed. Taking in revenue from loan originations and servicing while passing on the interest rate risk to the government solved the long-standing balance sheet problem of lending long and borrowing short. The problem was somewhat mitigated by government limits on the interest rates thrifts and banks could pay on savings accounts, at least until money market mutual funds began to draw away depositors in search of higher yields on their savings.

The general details of what followed during the 1980s is well-documented in numerous other books. Regulatory reforms, too late for many of the nations savings institutions, removed many of the restrictions on their business activities, "allowing thrifts selling low-rate mortgages to spread their losses on those sales over a 10-year period." [p.26] Fannie Mae in 1982 was itself essentially a very large savings institution. David Maxwell solved one of company's major revenue problems by requiring lenders to enter into mandatory commitments to deliver loans, the lenders subject to penalties if they failed to do so. Regulators helped mitigate the interest rate risk issue by allowing mortgages loans to carry adjustable rates of interest. As market interest rates fortuitously began to fall in the mid-1980s, Fannie Mae's financial position gradually

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improved, driven by market acceptance of the company's mortgage-backed securities, which brought in significant guarantee fee income to the company.

As the financial stresses lessened, the political stresses intensified as President Reagan filled key government and regulatory positions with the proponents of what they embraced as "free market" measures. What Tim Howard describes is an environment charged by ideological bias on the part of opponents who possessed only a vague understanding of Fannie Mae's business or the secondary mortgage market, generally. My own study of economics and the financial markets convinced me that the bias and confusion over the link between public policies and market outcomes was almost universal. In response to speeches made by David Maxwell and Roger Berk (the then President of Fannie Mae), I wrote them a long memorandum expressing my concerns, a memorandum that was courteously acknowledged but which generated no serious response.

One aspect of the business for which Tim Howard and I shared responsibility with hundreds of other employees was the quality of the mortgage loans the company was purchasing or guaranteeing. By the time I joined the company, Fannie Mae no longer prior approved the loans acquired or securitized. There was neither the staff nor the systems to continue this practice. So, lenders made representations and warranties to Fannie Mae that the mortgage loans they originated met Fannie Mae's eligibility and creditworthiness criteria. A small percentage of the loans were selected for what we called a "post-purchase review" to determine not simply that the individual loans met our requirements but that the lender consistently produced loans that did so.

What we learned was that few of our lenders were able to consistently generate loans in which the creditworthiness and default risk were accurately determined. The result was a steady stream of communications requiring lenders to repurchase loans or agree to do so should the borrower become delinquent. Although we required our lenders to perform their own internal quality control reviews, lender managements rarely gave this function the appropriate level of independence, support and expertise to perform well. In our own case at Fannie Mae, we experienced great difficulty recruiting experienced underwriters, as such individuals were in short supply and in great demand by mortgage lenders. It is also worth noting that even during the mid- to late-1980s internal systems support for this "quality control" function were almost non-existent. There was a period of time when so many loan files were coming into our office for review that we were forced to simply take a quick look at the credit report and property appraisal, make an immediate judgment about the loan quality and discard all but a few loan files revealing obvious problems requiring detailed analysis.

As interest rates for the standard 30-year fixed rate mortgage loan began to fall after 1984, loan volume (including an expanding refinance activity) rapidly increased. Lender staffs were stretched thin and loan quality suffered. The only solution was to develop the technology to return to the era of prior approval of loans, or close to it. As Tim Howard states, despite a tightening of underwriting standards in 1985, credit losses continued to mount through 1988. However, the steps taken at the direction of David Maxwell to gain control over the company's various forms of risk achieved a remarkable turnaround. By 1988, as Tim Howard recalls:

"Our underwriting was solid, our guaranty fee pricing was comfortably covering our credit losses, and the capital we held to back our credit guarantee business was growing rapidly. [p.46] ...Fannie Mae was poised to earn a billion dollars in 1990." [p.47]

The company had been very close to running out of time:

"We had been insolvent on a market-value basis early in the decade, and we could have run through all our capital had interest rates not come down when they did." [50]

What had been driving interests rates for several years was a determination by Paul Volcker at the Federal Reserve to reduce the demand for credit – and thereby halt inflation – by allowing interest rates to climb. The beneficiaries, of course, were those with cash to put into the money market funds or bank certificates of deposit. Owners of residential properties carrying mortgage debt at much lower rates of interest had a very powerful incentive to stay where they were and wait for rates to fall once Volcker was confident inflation had been drained from the economy.

At the same time, thousands of savings institutions were closing their doors, plagued by losses caused by "overinvestment in ... commercial and residential real estate development and construction lending" [p.48] and other high-risk investments for which their managements had no experience or expertise. Insider lending to board members also proved to be the cause of heavy losses. Newly-constructed condominium buildings and second home developments sat unsold and were taken over by lenders with no prospects of resale without a significant write-off. The collapse of residential land values in the nation's "oil belt" also created wide swaths of empty houses and condominiums for which there were no buyers at any price. Faced with this crisis, the U.S. Congress created "the Resolution Trust Company (the RTC), to liquidate the assets of failed thrifts." [p.48]

Although Tim Howard does not write about Fannie Mae's working relationship with the RTC, we were soon actively reviewing the residential mortgage loan portfolios acquired by RTC from the failed savings institutions. I was one of the people temporarily transferred to our marketing group to help evaluate loan quality. Generally speaking, although many of these lenders used nonconforming documentation and inconsistent methods of underwriting borrower creditworthiness, these loans were performing and were not the cause of the financial problems experienced by these institutions.

I do not recall that David Maxwell or Tim Howard ever came to our regional office to (continued on page 12)

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explain to employees what was happening in Washington. Reading the details as provided by Tim Howard I certainly appreciate the reasons. Even with and perhaps because of the improving financial performance by Fannie Mae, the Reagan-Bush teams pressed for "full GSE privatization" and one of the great regulatory missteps of the last forty years: "reliance on rating agencies to perform duties normally left to regulators." [p.56] Admittedly, our own internal systems were far from perfect, but we were engaged in a continuous effort to improve them.

Legislation passed in 1992 established a new "safety and soundness" regulator, the Office of Federal Housing Enterprises Oversight (OFHEO). From this point on Fannie Mae would have a "housing goal" to achieve a 30 percent loan volume to low- and moderate-income households (essentially in competition with FHA/Ginnie Mae). The nation's taxpayers were to be better protected by a new "risk-based capital standard" imposed on Fannie Mae (and Freddie Mac). The effect on Fannie Mae was immediate:

"The 1992 act was landmark legislation. It transformed Fannie Mae's capital from a political liability into an economic asset, and it laid the foundation for the explosion in business growth and profitability we would experience over the next dozen years. In so doing, however, it also sowed the seeds of the mortgage wars." [p.59]

By this time I was back in the quality control group, promoted and managing a somewhat larger team of review underwriters and taking a lead role in lender training efforts. Outside the company, I benefitted by close association with a number of economists whose investigations into business cycles and property markets challenged the conventional wisdoms that generally prevailed.

Tim Howard describes how David Maxwell chose Jim Johnson as his successor, bringing Johnson aboard at vice chairman at the beginning of 1990. Under Johnson's leadership the mission to expand access to affordable housing was given nearly equal emphasis with the purely financial goals. Beginning in 1994, Fannie Mae began to open offices staffed by two or three people with important political connections and/or advocacy credentials in the non-profit environment committed to affordable housing and community revitalization. Backed by a pledge to allocate $1 trillion to previously underserved communities and households, the new "partnership offices" would "work with lenders, public officials, housing advocates, and others to expand our outreach at the local level."

Jim Johnson expanded the office of the chairman to include two vice chairs, bringing in Frank Raines and Larry Small to help manage the innovation-driven business growth in this highly politicized environment. Deregulation of the banking sector also presented serious business challenges, as more and more of the mortgage loans were coming from fewer and fewer lender customers. As Tim Howard observes:

"Bank consolidation and concentration transformed the mortgage industry. The independent mortgage banking company virtually disappeared during the 1990s." [p.89]

Such a concentration of market share in just a handful of banks changed the dynamics of the relationship with Fannie Mae. Were the banks dependent on us as a primary means of securitizing the loans they originated? Or, were we now dependent upon them to continue to work through us to put a stamp of approval on the loans to ensure investor confidence? Internally, this created a degree of conflict between our marketing and risk management staffs. The result was a series of reorganizations that added risk managers to each marketing team.

A new Director of Housing & Community Development led the initiatives for our part of the country from the regional office. As part of the new team, I was moved over into the position of business manager to provide support from the credit side of the company as we worked to integrate more flexible criteria into the loans we sought to meet our housing goals. The absence of savings was a serious obstacle for many households, followed by periodic income interruptions due to seasonal employment changes, minor to severe credit problems and documentation of income coming from cash for service employment. Reaching the consumer became an important component of the company's strategy for ensuring people were ready to become homeowners and to take on the obligations of long-term mortgage debt. However, for many households who lived in rented units, their housing expenses prevented them from accumulating savings. Fannie Mae had to find a way to offset the risk of down payments as low as 3 percent of a property's purchase price. Tim Howard describes the solution:

"Our strategy for managing the risk of higher-LTV lending was a combination of loss mitigation initiatives and increased amounts of private mortgage insurance (MI)." [pp.68-69]

Another essential strategy was an increasingly reliance on data analysis. Performance data on loans originated over several decades revealed various strengths and weaknesses in traditional underwriting criteria, helping to identify areas where greater flexibility was warranted and where a tightening of existing criteria was needed. In 1994, the company introduced its proprietary automated underwriting system, which made it far more difficult for lenders to obtain approval of loans that were poorly underwritten, contained misrepresentations of income, employment or credit history, or involved outright fraud (a long-standing problem in the commission-driven mortgage originations business). As the years passed, the mission-rich book of business grew and performed within acceptable levels of defaults and losses. How we managed this business was an important reason (made clear, as Tim Howard states, by comparing the performance of the mortgage loans made by banks to meet Community Reinvestment Act obligations).

The growing *apparent* strength of the economy and the property markets, particularly, was the other important reason. Despite his training in economics, Tim Howard expresses nothing in this book to indicate he recognized in escalating property prices the building stresses associated with the cyclical nature of land markets. He was far from alone in his blindness to the certainty of a property market crash on the horizon.

Even Frank Raines, who left Fannie Mae in September of 1996 to take on the role of OMB director under Bill Clinton, failed to see the dangers ahead. Federal government revenues had recovered (continued on page 13)

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sufficiently to meet current obligations, generating discussion of where investment opportunities would be if and when the Federal government retired its long-term debt and managed to regularly balance the budget. A false prosperity was being embraced as somehow systemic in design, whereas rising land prices should have been recognized as a sign that speculation rather than real economic growth was at work.

When Frank Raines returned to Fannie Mae in May of 1998 in preparation for succeeding Jim Johnson at the beginning of 1999, the state of the economy was made even more unstable as a result of the *de facto* repeal by Alan Greenspan of the Glass-Steagall separation of commercial and investor banking activities. At the same time, Greenspan and Larry Summers (Secretary of the Treasury) sought to use whatever means they could to curtail Fannie Mae's market penetration. Tim Howard describes this as ideological blindness to the actual facts of how Fannie Mae generated its profits.

To set the stage for his explanation of what happened to the market for mortgage-backed securities in 2008, Howard provides a succinct historical overview. Most importantly, for the better part of two decades, maximum loan limits dictated which loans would be pooled for securitization by Fannie Mae and Freddie Mac and which would find their way into "private label" securities issued by Wall Street. Here, again, the credit fueled and speculation driven land markets across the country altered the mix, as nearly every year Fannie and Freddie increased the maximum loan limits to accommodate the rising cost of land. In a strategy to recapture market share, Wall Street firms and the banks concentrated on higher risk business that provided investors with higher (nominal) yields than GSE mortgage-backed securities provided. The banks received higher fees upfront, and investors were ostensibly protected from loss by senior-subordinated structures creating highly-rated tranches for the most risk-adverse investors. These investment structures worked only if the basis for pricing risk was a true disclosure of the risk characteristics of the underlying mortgage loans.

Investors succumbed to good salesmanship and what Alan Greenspan would famously describe as "irrational exuberance." Howard reminds readers of what occurred in the manufactured housing sector, where "in a move to increase mobile home affordability in the early 1990s, the industry had moved to 20 and 30-year loans, often with low down payments." [p.129]

Analysts understood that a manufactured housing unit tends to lose its value (i.e., to depreciate) over time when compared to stick-built or even modular housing units, which tend to be better maintained and have major systems replaced when needed. Still, manufactured housing must be placed on a plot of land, and over time land tends to increase in value or recover its value in the event of a general market collapse. A key difference is that the households who generally purchase a manufactured housing unit place the unit on leased land or on land in a rural area where land costs are a small fraction of the cost of land in a suburban subdivision. Land price appreciation was not likely to create much equity when these properties were resold. Moreover, owners were less able to take advantage of falling interest rates by refinancing their mortgage loans because appraised values would reflect depreciation based on the age of the unit.

Sales of manufactured housing units soared during the Clinton boom years but fell significantly after 1999. Clinton's economic expansion did not reach far beyond the financial sector, and many of the households who purchased manufactured housing units were already at risk before taking on (what was for them) an unsustainable level of mortgage debt. As a few astute analysts predicated, "servicers of manufactured housing loans found it hard to sell foreclosed mobile homes at any price." [pp. 130-131]. Then, as now, some markets experience something approaching total collapse, where there demand simply disappears. By 2002 Fannie Mae's executives were regretting the company's $10 billion investment in the "supposedly riskless AAA-rated tranches" of these very same private label mortgage-backed securities. The extent to which the underlying mortgages involved serious misrepresentation or outright fraud was never determined. A hard lesson was learned, but not by everyone:

"The Federal Reserve and Treasury, incredibly, drew no lessons whatsoever from this experience. Their unwavering commitment to a free-market alternative to the mortgage securitizations of Fannie Mae and Freddie Mac seemingly made it impossible for them to acknowledge the obvious and irremediable flaws in the private-label securitization mechanism they championed." [p.131]

No one receives greater criticism in this book than Alan Greenspan, who, writes Howard, "was a world-class economist who almost certainly knew better." [p.135] Howard is referring to Greenspan's assertions that Fannie Mae's cost of funds was subsidized by the cash flow from mortgage loans held in portfolio and his refusal to entertain what Howard and Frank Raines tried to convey as the facts of the matter. As Howard writes:

"To understand why it was false ... all one had to do was look at bank balance sheets: in 2001, banks held over $200 billion in GSE debt as assets, which they financed with their own borrowings." [p.136]

Greenspan's shortcoming and his subjective views were actually much more dangerous to the economy than is revealed by his actions toward the GSEs. More directly, Fannie Mae was forced into battle with OFHEO over how the company would do business. The Texas lawyer who took over OFHEO in 1999, Armando Falcon, expected Fannie Mae to quietly comply with whatever new requirements he decided were needed. When this did not occur, the stage was set for greater conflict ahead.

Tim Howard decides the reprieve experienced after the Democrats recaptured seats in the U.S. Senate. He also notes that the company's commitment to significantly expand minority home ownership was embraced by President George Bush. Not surprisingly, vocal opposition came from the subprime lenders:

"Subprime lenders' true complaint ... was that by taking their best loans – and ones that never should have been in their market in the first place – we were hurting the economics of their business without hurting ours." [p.143]

Even the large conventional mortgage lenders stepped up their attacks on Fannie Mae, through FM Watch, fearful of a transfer of profits from themselves to (continued on page 14)

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the GSEs. The *Wall Street Journal* was a consistent ally in a campaign of misinformation. Interestingly, Tim Howard lists one internal improvement after another made in response to criticisms in which the company's management found merit. This included voluntary registration of common stock with the Securities and Exchange Commission as well as changes in internal controls. By this time, the feeling within Fannie Mae was that the business risks were well understood and effectively managed. More threatening was "political risk," which was reflected in the company's stock values.

The remainder of the book provides important insights into the culmination of events that led to the transfer of control over Fannie Mae to government conservatorship. The most challenging to grasp for most readers is his explanation of how the 2001 changes in accounting for derivatives affected the recording of derivative-related expenses from an "historical cost basis" to "current market value" (rising and falling with changes in interest rates). The problem, as explained by Howard, was that not all assets were marked to current market value, creating an "artificial volatility in ... GAAP earnings." [p.151] Because of compliance with FAS 133, "our GAAP financial results made our business look risky."[p.152]

OFHEO then spooked investors by publicly warning it might force Fannie Mae to reposition its balance sheet to control and minimize duration gap. Howard assured investors this was a manageable issue and the company did what needed to be done to bring the duration gap down. With this one crisis past, Howard was asked by Raines to perform a comprehensive analysis of Fannie Mae's interest rate and credit risks, which was completed in mid-2003, followed by measures to strengthen the company's capacity to withstand what were viewed as extraordinary levels of stress. In Howard's view, the company was now poised for whatever volatility the markets might throw at the company.

The story now shifts from what was happening at Fannie Mae to the final climax of the Mortgage Wars – the rise and fall of Wall Street's gamble to redirect consumers away from the conventional mortgage loans securitized by the GSEs and into the arms of mortgage brokers who guaranteed to secure financing to anyone who applied, who asked few questions and who provided even less documentation of income, employment and creditworthiness. Howard does not provide any statistics regarding the extent to which subprime mortgage loans were approved without a reasonable expectation of repayment, but the subsequent default ratio suggests a very high percentage involved outright fraud.

Despite the growth in subprime lending, Fannie Mae's own business volumes continued to grow in the environment of low interest rates, stimulating millions of property owners to refinance existing mortgage debt. Then, fearing inflation, the Federal Reserve allowed interest rates to rise; refinance activity slowed dramatically. Lenders desperate to keep transaction volumes up now moved into the subprime purchase money market. Not only did lenders relax their underwriting standards but went so far as to introduce an interest-only adjustable rate mortgage product. Since borrowers were qualified, as Tim Howard states, "at the interest-only payment," [p.172] anyone who cared about loan performance had to recognize the risk of default once the loan began to amortize and borrowers were hit with *payment shock*. Higher fees paid to mortgage originators ensured that a higher and higher percentage of the purchase money mortgage loans being originated were being pooled into private-label mortgage-backed securities. Lenders took the business to Wall Street for one simple reason, writes Howard:

"The price a lender received for selling mortgages through a private-label MBS was heavily influenced by the number and relative sizes of the junior tranches that were required to get AAA and AA ratings on the rest of the tranches. The fewer and smaller the junior tranches in a private-label deal, the better the price to the lender. the reason we were losing business to the private-label market was that the rating agencies were assessing the new loan types and risk combinations as being less risky than we thought they were." [p.173]

I remember that when our lenders brought some of this business to us for pricing, our "black box" for risk-based pricing came back with guarantee fee requirements that would be called for on junk bonds. No one I had contact with on a daily basis thought this was anything but toxic business. Tim Howard explains how Wall Street firms enticed investors by yet another innovation -- the creation of the collateralized debt obligation. Suffice it to quote Tim Howard here: "It seemed like alchemy but few questioned it." [p.174] The rating agencies closed their eyes, recorded new fee income, and issued AA ratings on the newly-formed CDO tranches. By the middle of 2004, "so much new business had shifted to this market that ... fully half of all MBS issues were private-label securities." [p.175] Now, the question was what would Fannie Mae do in response?

(to be concluded in the next GroundSwell issue)

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SUMMARY AND COMMENTS ON THE BOOKTHE MORTGAGE WARS BY TIMOTHY HOWARD

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(Concluded from the March-April 2014 GroundSwell)

There was not much choice but for Fannie Mae to become a larger investor in private-label securities. To the company's shareholders the news was of declining earnings growth, turning flat in 2005. However, cautious about the quality of the underlying mortgage loans, Fannie Mae asked for much more than was asked for by the typical investor. There were no well-capitalized companies making representations and warranties that the business was as stated. Investment in subprime private-label MBS was not the way to strengthen the company's asset base or revenue stream. What, then, could Fannie Mae do?

"Having lost to the private-label market the ability to influence the types of loans being made to borrowers, our job now had become to maintain our credit discipline and protect ourselves as best we could so that when the private-label market finally succumbed to its excesses (as it inevitably would), we would be in a position to step back in and help the recovery process." [p.178]

As was soon to unfold, what actually happened proved to be a very different sort of response by the government to the financial collapse precipitated by the key subprime players. Frank Raines began to work with George Bush's new Secretary of the Treasury, John Snow, on legislation that would provide a new regulator within Treasury. Snow could not get concurrence from the White House economic policy team and blindsided Frank Raines with Treasury's demand for prior approval of the roll-out of any new products or initiatives. Bush conveyed his intention to veto any bill that did not include these restrictions. The ideological winds were once again gathering force in the cause of GSE privatization. Alan Greenspan took the opportunity to join in, prompting Tim Howard to conclude:

"Greenspan's comments … were so wildly off base economically that they must have had a purpose politically." [p.189]

As described by Tim Howard, the company's very existence was hit with one frontal attack after another, the most serious being the potential by Treasury to "set absolute limits on our debt issuance." [p.193] This position was affirmed by the Justice Department, but Fannie Mae's declining portfolio left Treasury with no reason to act. At the same time, HUD called upon Fannie Mae to meet ever higher mission goals. And, at OFHEO, Armando Falcon initiated "a review of Fannie Mae's accounting … that would require us to restate our earnings." [p.194] In response, Howard began working with Goldman Sachs on the possible restructuring of the company, with no clear path to any changes that would "be better for our stakeholders – home buyers and our shareholders." [p.195]

To add context to the next phase of the story, Howard describes the financial reporting problems experienced at Freddie Mac in 2003 that led to the resignation of the long-time chairman, Leland Brendsel and others, including "the most seasoned and experienced risk manager Freddie Mac had." [p.203] Howard felt confident that Freddie Mac's accounting problems would not be found at Fannie Mae. He goes on to state, essentially, that an objective analysis of the company's accounting practices was never contemplated by Armando Falcon. This fact soon became apparent in testimony to the HUD inspector general. Falcon survived these revelations and came back at Fannie Mae with even greater determination to force a restatement of earnings. Accusations of intentional manipulation of earnings to maximize executive compensation brought Frank Raines and Tim Howard to testify before a Congressional committee chaired by long-time critic Richard Baker of Louisiana. Howard provides this quote by Frank Raines:

"There were no facts in the OFHEO report – none. We looked into the facts of what happened six years ago – we found no facts that would support the allegations in the report." [p.211]

Now, the charge against Fannie Mae rested on the accounting treatment for derivatives, governed by the SEC. Fannie Mae's auditors, KPMG, "concurred with the entirely of our submission" to the SEC. Unexpectedly, the SEC ruled against the company and ordered a restatement of the financials. No explanation was provided, not to Fannie Mae officials or to KPMG. Recording the mandated $9 billion loss would, Howard recalled, "push our regulatory capital below our statutory minimum." [p.213] and expose the company to government take-over. The near-term result was the departure of Howard and Raines in December of 2004.

At the end of 2004 I finished my twentieth year at Fannie Mae. At age 57 I decided to leave the corporate world and concentrate my energies on the advocacy of the economic and political reforms I had come to embrace. Most of what I now know about events during and after 2005 until my reading of this book came from newspaper accounts and listening to testimony by the many senior executives who came before various Congressional committees. Several of my former colleagues who remained with the company for a few more years or are there now have provided me with their perspective on the events that followed. What Tim Howard has written is, if more detailed, essentially in agreement with they conveyed to me.

After 1968, Fannie Mae was never contemplated to act as a not-for-profit, grant-making entity. The company was, as Howard describes, a political animal that mastered the tools and methods required to survive in a world where political support could be withdrawn for reasons that had everything to do with changes in political power and the flow of political contributions. One part of the drama Tim Howard did not write about was the short-lived PAC (Political Action Committee) those of us in management were encouraged to support. Among others, (continued on page 14)

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I expressed my opposition to the PAC because although a candidate might support legislation supported by Fannie Mae's business and other interests, that same candidate might embrace ideological positions with which I very deeply opposed. Because of widespread opposition, the PAC was eventually dissolved.

What happened to Fannie Mae, what happened to Tim Howard, to Frank Raines and other senior people at the company is part of a much broader and, I believe, sinister effort participants who strive to maximize profits not by providing the highest level of service at reasonable cost but by securing rent-seeking privileges under law. Tim Howard explains much when we writes:

"The outcomes of the Justice Department inquiry, the SEC investigation, and the OFHEO lawsuit all made clear that OFHEO's allegations against Raines, Spencer and me had no merit at the time they were made. ...But in the greater scheme of things, none of that mattered. In the politicized maelstrom of 2004, OFHEO didn't need merit to achieve their objectives; all they needed was a story. This they certainly had, and it had been enough to decapitate Fannie Mae." [p.227]

In the few years left to Fannie Mae as a major financial company, the pressures to generate business volumes and revenue forced the company into the same sort of high risk decisions that savings institutions made in the late 1980s. Howard provides some details on the decision-making rationale, which I assume were provided to him by other former members of the Fannie Mae management team who survived his departure. His description of what was happening in the market (i.e., the "housing bubble") indicates that even this very astute financial expert and trained economist never realized that the main driver of the rapid rise in property prices was credit-fueled land speculation. The signs were present well before the market for conventional mortgage loans was undermined by the banks and Wall Street moves to build market share on the backs of marginally-qualified or unqualified households. Whether anything could have been done by Fannie Mae to create a "circuit-breaker" to mitigate the eventual market failure is something I have given some thought to.

Over my last four or five years with Fannie Mae, I had been doing all I could to alert my management group to the stresses building in the nation's property markets. Although in his entire book Tim Howard makes no mention of any interaction with the company's team of economists, led by David Bersen, market analysis work I was performing kept me involved with one of our economists and the director of our research group. One of my ideas to help us forecast property trends was to ask members of Congress to introduce legislation to amend the Home Mortgage Disclosure Act to require mortgage originators to add one data element to the information delivered on loans they generated: the land values assigned by appraisers in addition to the total property value. In 2003 or early 2004, I was in discussion with David Bersen about organizing an invitation-only conference on land markets for bank economists. Bersen was one of the few people at Fannie Mae who shared my concerns. The Vice President in charge of our regional group was another. Too late in the game for any real impact, she authorized me to begin speaking to our stakeholder groups in various cities on the role existing tax policies played as an obstacle to community revitalization and the development of affordable housing. Unfortunately, when the attack on Fannie Mae by OFHEA succeeded, concerns for externalities such as the dysfunctional nature of our property markets were short-circuited.

What happened to Fannie Mae in 2008, as Tim Howard details, was a loss of investor confidence, triggered by the abandonment of prudent business practices in the quest for market share and short-term profits:

"Investors and creditors did not want to guess which [companies] would be saved and which would not. They wanted out of all of them, and they fled corporate debt in droves for the safety of short-term Treasuries. Overwhelming demand for these securities pull their yields down to almost zero." [p.5]

"The financial crisis began in the U.S. mortgage market. It had spread so quickly and so intensely because, like a wildfire, it had found so much tinder to burn. That tinder, of course, was the hundreds of billions of dollars in high-risk home mortgages made over the previous five years that were sitting on the balance sheets of virtually every major financial institution in the country. Many of these mortgages were unlikely ever to be repaid, and most of them never should have been made." [p.10]

Desperation, Howard concludes, pulled Fannie Mae into this unstable market environment:

"Fannie Mae had adopted disciplines intended to protect it from credit excesses, but with new management and a radically different risk organization, the company abandoned these disciplines and switched from resisting the lending frenzy to joining it, making the ultimate boom and bust that much more severe." [p.15]

The lesson learned is that even a financial institution run with an unparalleled commitment to ethics in how profits are generated is powerless to overcome systemic flaws in our political structure, flaws that are the fundamental cause of our unstable economic system. My hope in joining Fannie Mae was that in some way I could help to nudge the company in the direction of becoming a change agent. Elsewhere, I have detailed my efforts and quite modest successes achieved. The bottom line was that nothing I did ever attracted the attention of Tim Howard or Frank Raines. Tim Howard's book adds to the growing volume of investigative reporting and analysis concerning the disappearance of ethical corporate governance as well as public governance in our society.

Howard's final words warn us that nothing done since 2007 has addressed the (continued on page 15)

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fundamental causes of the near-collapse of the financial system. "The new system must incorporate the lessons of what really did happen in the 2008 crisis and be based on a hard-nosed understanding of how the financial markets actually work." [p.270] I certainly concur. However, absent measures to tame the nation's land markets, to remove from our economy the rewards to "rent-seeking" and land speculation, we are doomed to experience cycle after boom-to-bust cycle.

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