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## FEELING THE PAIN

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# NEVADA'S AG PICKS A FIGHT

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By Christopher Whalen

## On GSE reform: Be careful what you wish for

Ending government control of Fannie and Freddie too soon could 'end in tears'



### KEY CONCEPTS

You cannot separate the GSEs from JPMorgan Chase, Citigroup, Wells Fargo and Bank of America — the four horsemen of the financial apocalypse that hold control over the secondary mortgage market.

There are risks to ending government involvement in housing too soon.

*Since the collapse of the housing market began in 2007, a debate has raged as to whether Washington or Wall Street bears the greatest part of the responsibility for the disaster. On one hand, Joe Nocera of The New York Times, Frank Partnoy writing in The New York Review of Books, and Barry Ritholtz in The Big Picture, among others, take the view that the Depression era housing institutions such as the Federal Housing Administration and Fannie Mae were not the primary culprits. Rather, Wall Street greed was the main cause of the housing fiasco.*

On the other hand, Peter Wallison of American Enterprise Institute, Gretchen Morgenson of The New York Times and her co-author Josh Rosner (“Reckless Endangerment: How Outsized Ambition, Greed, and Corruption Led to Economic Armageddon”) take the view that Washington’s corrupt political class and government sponsored enterprises like Fannie Mae and Freddie Mac were the enablers of the financial boom. Wall Street’s stupidity was merely imitating and enlarging the template created by the GSEs.

Inflation and debt are part of the American dream, an idea I explored in my 2010 book “Inflated.” No surprise then that the components of the “housing industrial complex” — the GSEs, banks, private insurers, builders, Realtors and bond brokers — are all guilty and all complicit in pursuing the dream. And the GSEs and big banks are one and the same in a grand celebration of the benevolent corporate state.

The U.S. government has been essential to creating a homogenous and stable secondary market for home mortgages since the 1930s. Without President Herbert Hoover

creating the Federal Home Loan Banks (1932) and President Franklin Roosevelt’s expansion of federal support for sales of mortgages with the Federal Housing Administration (1934) and Fannie Mae (1938), there would be no secondary mortgage market, period.

A second issue is the close operational integration of the top four banks and the GSEs, including Fannie, Freddie and the Federal Home Loan Banks, which are the largest GSEs of all. You cannot separate the GSEs from JPMorgan Chase, Citigroup, Wells Fargo and Bank of America — the four horsemen of the financial apocalypse that exercise illegal cartel control over the secondary market for residential mortgages. The big four zombie banks run the GSEs in the same way that they exercise control over special purposes entities and the private mortgage insurers.

Third is the key role played by all of the GSEs in enabling the new business and legal template for asset securitizations after World War II. In the landmark 1925 decision *Benedict v. Ratner*, Justice Louis Brandeis wrote that retention of rights inconsistent

with sale — what we call today skin in the game — “imputes fraud conclusively.” The Brandeis thunderbolt closed the Wall Street sausage factory for structured securities from 1925 until after the end of the 1950s. Changes to the Uniform Commercial Code and a lot of legal work slowly revived the use of home mortgage as collateral for bonds. First the Federal Home Loan Banks, then Fannie in the 1970s and later Freddie Mac, entered the business of mortgage securitizations.

How ironic that none of the friends of Fannie and Freddie notice that the skin in the game provisions of the Dodd-Frank legislation arguably violate the basic premise of *Benedict*. Neither does Joe Nocera, my pal Ritholtz nor the writers at *The New York Review* notice that the GSEs are now run by and for the largest banks, which control all aspects of agency mortgage securitizations. “Bend over” is the operative message from the big bank-GSE cartel to the American public.

Mark Calabria of the CATO Institute notes: “By focusing on ‘the role of government’ in housing, (Nocera) moves the debate away from the reckless immoral behavior of Fannie and Freddie. He can claim this is about social policy and paint himself as a caring progressive, despite the massive regressive theft that Fannie and Freddie have actually been.” Amen. When you look at how Fannie and Freddie cherry picked high spread loans to low-income families for their portfolios before the crisis, then since 2008 actively denied these same low-income families their legal right to refinance, it is hard to describe the GSEs as anything but predatory.

As the sparring continues in the media, there is a similar debate on Capitol Hill about how these insolvent housing agencies will be resolved. As with the savings and loan crisis of the 1980s, there is a slow political process under way to address the problems related to the GSEs and the top-four banks. The political progress is glacial, about as fast

Rethink Symposium



MARCH  
21-23

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as the process of resolving foreclosed real estate inside the GSEs and the big banks. And in every case, the slow pace of resolution is all about concealing a vast problem. In the case of both the too-big-to-fail banks and the GSEs, extending the process of resolving residential properties taken over as the result of foreclosure has the salubrious effect of pushing the public day of reckoning for the total losses into the future.

In the case of the GSEs, the loss on a bad loan is not recognized until the underlying collateral is sold — meaning that there are tens if not hundreds of billions of losses embedded on the balance sheets of Fannie Mae and Freddie Mac in the form of bad loans. When Fannie Mae or Freddie Mac make good on a guarantee and purchase a defaulted loan back from a residential mortgage-backed securitization trust, the busted loan is put onto the books of the GSE at “cost.” In some cases homes are not foreclosed for years after the loan goes bad.

The Obama administration has made no accurate disclosure to Congress as to the likely losses to the Treasury for continued support for the GSEs after the 2012 election — one reason why no candidate of any political coloration wants to talk about housing in the presidential debates, so far. Indeed, the \$36 billion, two-month extension of the employer payroll tax holiday was paid for by Congress with a 10-basis-point increase in the guarantee fees for Fannie and Freddie, but this tax assumes that these agencies will be writing a certain volume of new loan guarantee business in the future.

Gretchen Morgenson writes in The New York Times: “Using Fannie and Freddie as a money spigot sent a powerful message: Never mind that losses at these mortgage giants have cost taxpayers \$150 billion so far. Or that many Americans would prefer these toxic twins to go out of business sooner rather than later. As long as Fannie and Freddie are viewed as piggy banks, there

is little chance that Congress will dissolve them. It looks as if these taxpayer-owned zombies, which did so much damage to our economy, are poised to live on and on.”

Unfortunately, the GSEs now see declining business volumes in favor of the FHA, which wrote 90% of new government guarantees for residential loans originated by U.S. banks in 2011. These deals mostly refinanced existing loans. The opponents of Fannie and Freddie in Congress may not need to try very hard to shrink these two entities given current trends, with a single-digit runoff rate for guarantees and double digits for the investment book.

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Despite valiant efforts by liberals to defend Fannie and Freddie, most reform proposals envision an eventual wind down of these two GSEs, leaving FHA as the only public housing guarantee agency.

“Sen. Johnny Isakson, R-Ga., a thought leader in Congress on mortgages and housing policy, introduced the Mortgage Finance Act of 2011,” reports Chuck Gabriel of Capital Alpha Partners, one of Washington’s leading research firms focused on housing policy.

“The Isakson bill would authorize the most aggressive schedule for housing GSE wind down proposed to date, putting Fannie Mae and Freddie Mac into receivership no later than 18 months after enactment,” Gabriel reported.

The payment schedule in the proposal from Isakson, of note, means holders of the GSE preferred securities likely will get nothing. Zero. Nada.

The Isakson proposal replaces Fannie and Freddie with a transitional vehicle that would be fully privatized in year 10, maybe. Taxpayers would still need to make investors in Fannie and Freddie debt whole.

“Similar to Rep. Scott Garrett’s, R-N.J., evolving Private Mortgage Market Investment Act,” Gabriel notes, “the proposal would compel adoption of a less onerous QRM (qualified residential mortgage) standard, allowing 5% down payments instead of the 20% proposed by regulators last March.”

The common element between Garrett and Isakson is the 95 loan-to-value ratio

standard for QRM, which frankly tells it all for 2012 when it comes to a real estate market “recovery.” With the number of households focused on owning a home shrinking and the government withdrawing financing from the secondary market, effective borrowing rates to consumers for home mortgages must rise even as home prices remain flat to down on many markets.

The pro-reform forces ought to be careful what they wish for. CATO’s Calabria last year celebrated the fact that homes sales rose after the Obama administration decided not to retain a higher cap for loans guaranteed by Fannie and Freddie, only for the more stringent FHA limits.

But as Alan Boyce, a mortgage finance expert, told me in December, ending the government’s role too quickly will “end in tears” in terms of home prices, labor mobility and the U.S. economy. ■