

November 16, 2011

To the Editor:

I refer to the review by Jeff Madrick and Frank Partnoy of *Reckless Endangerment: How Outsized Ambition, Greed, and Corruption Led to Economic Armageddon* by Gretchen Morgenson and Joshua Rosner, who are two friends and colleagues. I also refer to the earlier article by Partnoy and Madrick, "Why Fannie and Freddie Are Not to Blame for the Crisis," July 13, 2011 <<http://www.nybooks.com/blogs/nyrblog/2011/jul/13/why-fannie-and-freddie-are-not-blame-crisis/>>, as well as other comments supporting these Depression era housing finance agencies.

Partnoy is also a friend and colleague for whom I have great respect. He knows my views on the housing GSEs and their role in enabling the present predicament in the US and around the world. But as I wrote in a review of a new book on this very subject, *Black Box Casino: How Wall Street's Risky Shadow Banking Crashed Global Finance* <<http://www.ritholtz.com/blog/2011/11/72246/>>, the housing GSEs and the Wall Street banks are one and the same. Arguing about which did more harm is a frivolous waste of time by some very smart people.

My view is that Madrick and Partnoy are wrong when they say that Morgenson and Rosner present no evidence that the housing GSEs, which were inspired by the fascist era models seen in 1920s Europe, did not play an essential role in causing the subprime disaster. The government has been essential to creating a homogenous and stable secondary market in home mortgages since the 1930s. None existed prior to that, contrary to the reviewers suggestion that FDR wanted to "revive" the market.

As Galbraith describes in *The Great Crash*, there was no true market for home mortgages in the US prior to the 1930s beyond speculative mania in states such as Florida. The major change was the entry of government into the marketplace. First as I wrote in my 2010 book, *Inflated: How Money and Debt Built the American Dream*, the use of housing to fuel economic growth and support employment goes back 50 years and more as a matter of public policy in the US.

Even before the post-WWII and then Cold War inspired economic growth of the 1960s and 1970s ebbed in the 1980s, costing Gerald Ford and Jimmy Carter successive presidential election losses, housing became the new housing industrial complex. As Morgenson and Rosner describe so well it also became an important cash cow for both major political parties. You cannot credibly say, as the reviewers suggest, that Washington played no role in encouraging the housing boom, especially from the end of the 1980s S&L crisis onward.

A second criticism of both the approach of the reviewers and also, frankly, Morgenson and Rosner too, is not to discuss 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 GSE of all. The authors missed a great opportunity to tie the political

machinations in Washington by former Wall Street bankers such as Jim Johnson to the operational symbiosis between the large banks and federal housing agencies. But to be fair, most Americans including most financial journalists have no idea how to price a mortgage much less understand the inner workings of the government-sponsored secondary market.

When Fannie or Freddie issue pass through securities, it is actually the top four banks that control the creation and sale of the securities. The GSEs rarely purchase loans and now mostly act as a guarantor, at least until a loan defaults. You cannot separate the GSE 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 housing with respect to the GSEs and the Federal Housing Administration. Morgenson and Rosner provide ample documentation of the revolving door between Washington & Wall Street, but the reviewers seem not impressed.

Smaller banks wishing to access government mortgage guarantees for home loan actually must give up more than half the profit or "spread" and the customer relationship by selling their loans to the TBTF banks. Strange that defenders of the New Deal institutions such as Partnoy and Madrick make no comment in any of their writings about the way in which the TBTF banks have essentially taken control of the GSEs, something well documented in *Reckless Endangerment* and other works. In my view, the cartel behavior of the TBTF banks and GSEs is arguably a violation of US anti-trust laws.

Third and again to both the reviewers and authors, there is no recognition of the key role played by all of the GSEs in enabling the bad acts that Partnoy and Madrick have documented so well, namely to first create a new legal template for asset securitizations after WWII. In the landmark 1925 decision by the US Supreme Court in *Benedict v. Ratner*, Luis 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 until after the end of WWII. Then changes to the Uniform Commercial Code in the 1950s and a lot of legal work made possible the revival of the use of home mortgage as collateral for bonds. First the Home Loan Banks, then Fannie in the 1970s and later its hell spawn Freddie, entered the business of mortgage securitizations. How ironic that no one among the friends of Fannie and Freddie notice that the "skin in the game" provisions of the Dodd-Frank legislation arguably violates the basic premise of *Benedict*.

What many people outside the industry do not appreciate is that the banks were running the creation and sale of these securities from the word go. Firms such as Bear, Stearns & Co., where I worked in the 1980s, were trading "whole loans" and pooling mortgages w/o a securitization in that period. By the early 1990s, Citibank was experimenting with mortgage bonds with private or even no default protection at all. And in all of these cases, the legal template created by the lawyers for the Wall Street firms to do these private deals was an imitation of the template used in mortgage deals done for the GSEs.

Finally, let me say to Frank and Jeff Madrick that speaking as an investment banker and conservative Republican, a rare combination on Wall Street where I am again employed after a decade working in the bank ratings field, I feel their pain. Many of my liberal friends in the financial community seem to be apoplectic at the prospect of the down-sizing or elimination of the Depression era GSEs, agencies that were actually created first by Herbert Hoover, the greatest technocrat to ever hold the American presidency.

I think that many American liberals fear that as the public sector in the US is forced to shrink due to fiscal constraints, institutions like Fannie and Freddie will wither away – and along with it the political fortunes of liberalism generally and the Democratic Party in particular. Thus the frantic attempt by the reviewers to shift all of the blame on Wall Street. Even my friend and fishing companion Barry Ritholtz, one of the most astute and disciplined analysts on Wall Street, is displaying signs of cognitive dissonance on this issue. But I think there is plenty of blame for all concerned.

I hope all of my colleagues will take this criticism in the spirit of continuing investigation and think about the operational and legal role played by the GSE to make the subprime crisis possible and, more important, salable to investors. By recklessly using an existing model for issuing government guaranteed securities and perverting it with inferior collateral and worthless private mortgage insurance, Wall Street did commit huge acts of fraud, acts which do rise to the level of criminality, as the reviewers suggest in their latest article, “Should Some Bankers Be Prosecuted?” I applaud them for their analysis. But members of Congress belong in the dock as well.

The bad news for all Americans, however, is that there are tens, perhaps hundreds of billions of dollars of embedded losses inside the housing GSEs, one reason why none of the political candidates seem to want to discuss housing so far in the 2012 election cycle. These losses are matched in magnitude to hidden losses on underwater first and second lien loans festering on the books of the largest banks and inside investor portfolios.

It may give Partnoy, Madrick and the editors of the NYRB some comfort to know that the Republican efforts to downsize the GSEs and allow the “private sector” to pick up the slack in the housing market will “end in tears,” to paraphrase Alan Boyce, a leading mortgage market practitioner and one of my mentors in the housing industry. Until we deal with the fundamental issues arising from the actions of both Washington and Wall Street, the crisis will not end, private credit will continue to contract as it did through the 1930s and 1940s, and employment and business volumes will suffer accordingly.

As Fred Feldkamp, a retired partner of Foley & Lardner LLP in Detroit who is arguably the father of the concept known as “good sale” with respect to mortgage backed securities, wrote in *The Institutional Risk Analyst*:

< <http://us1.irabankratings.com/pub/IRAstory.asp?tag=504>>

“With hindsight, abuses that allowed banks and other instrumentalities of government monetary policy to successfully hide \$30 trillion of financial gambles, whereby managers

enjoyed all the upside and taxpayers/shareholders absorbed all the downside, are shocking. If we are collectively responsible for allowing this folly, perhaps we should not incarcerate the perpetrators, but that cannot mean we will perpetuate the fraud and expect investors to ignore past errors. Instead the capacity of managers of financial institutions to repeat that history must end.”

Yours truly,

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