PRESERVATION OF AFFORDABLE HOUSING

POAH

The future of the housing market, Fannie Mae, Freddie Mac and more

excerpts from a conversation with Bart Harvey

Bart Harvey is the retired Chair of the Board and CEO of Enterprise Community Partners. As a board member at Fannie Mae, he is involved in the organization's strategic planning even as it faces calls in Congress for its elimination. He recently led a brown bag discussion with the staff of POAH and shared his views of the financial crisis and the future of the housing market, the mortgage interest deduction, and government sponsored enterprises Fannie Mae and Freddie Mac.

Policy makers are considering decisions around the budget, tax policy and housing investments that will affect each and every American. Ultimately what works for lower and middle income people is to have a job and regular income. Very little is being proposed by those who were most hurt by the financial crisis, and the community that represents these constituents needs to be more forceful in their proposed solutions.

— Bart Harvey

"What Goldman never lost sight of was Dick Pratt's old warning: the mortgage was the most dangerous financial product ever created. It's what Goldman forgot that caused all its problems. It wasn't just dealing with a financial product. It was dealing with people's homes."

from All the Devils Are Here – the Hidden History of the Financial Crisis
by Bethany McLean and Joe Nocera

The beginning of the end

For many years Fannie Mae and Freddie Mac built up dominance in the mortgage underwriting market because they were implied government backed entities and could borrow at lower costs. Wall Street – wanting a larger part of the action – eventually went around Fannie and Freddie's underwriting duopoly with looser underwriting, riskier credits and higher yields. Even though it had no direct financial interest in the conduits it set up, Wall Street had the ability to slice and dice people's homes into ever more risky tranches and sell them through conduits and securities around the world. The more they sold, the more money they made. The more subprime originators generated, the more Wall Street wanted – more mortgages faster. Goldman Sachs, Morgan Stanley and others even put money into originators and said "get us product".

Early on, as things were breaking down in the underwriting and early defaults were coming in, financial institutions could still take over their defaults and sell their asset for more money – never being forced to default on it - or put it back to Fannie and Freddie if they owned it.

There are $1.1 trillion of private label securities out there – mostly generated by Wall Street and those are the worst performing of all the collateral debt obligations (CDOs) issued and sold.

Fannie Mae's share went from 40% of market to 20% in originations from 2005-2007 and they were irrelevant because Wall Street had set up conduits and looser standards. Fannie's fatal mistake was that they chased it - taking the bad stuff along with the good. Fannie and Freddie have been important to our field of affordable housing and have been a big force in multifamily housing and low income housing tax credits so it matters what happens to them in the longer run.

Looking at the guilty parties, several factors come into play. Wall Street created the way of selling this product around the world and since they suffered no repercussions stemming from losses, they didn't really care about the weak nature of the product until they finally got caught with product as the game of musical chairs ended.

Years earlier, the SEC had passed a regulation that said any investment bank with $5 billion or more of capital could leverage itself almost 40 to 1 and self regulate. Lehman, Bear Stearns, Goldman, Merrill Lynch and Morgan Stanley did just that and disguised their actual leverage with accounting sleight of hand. They all were overstretched and yet competed with one another by making use of that leverage. They were so creative they even generated product that didn't exist; they created virtual CDOs or "synthetic" CDOs. When you're making synthetic CDOs, you're not manufacturing anything - you're gambling – having turned the world market into a casino.

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Meanwhile AIG, the largest and soundest insurance company in the world, was the counter party for most of these poorly underwritten bonds – CDOs etc. When Wall Street wanted to lay off its risk, AIG was on the other end of all these bad debts and AIG had to pay up because it had lost on them. The government came in to take over AIG (one part of the company had guaranteed more than $200 billion of CDOs) because its default would have taken down the entire financial system. It offered AIG's counter parties less than a dollar on the dollar. The three largest counterparties, including Goldman Sachs, refused the offer, taking the risk that the whole financial system would go down including their own institutions.

They gambled and won getting dollar for dollar because they knew the government wouldn't let that happen.

The taxpayers saved the major firms from bankruptcy, but who is helping the middle class and lower income taxpayers?* The only ones who benefit are the financial people who take a piece of each side of the action leaving taxpayers, in this casino-like atmosphere, in the role of "the House." Taxpayers end up backing a system that generates fortunes for some players - who get to keep the money whether they win or lose. Ultimately taxpayers have the responsibility of paying to bail out others like AIG if there is large failure.

At this point in our history, we are a huge debtor nation and confidence in the dollar and our country will not continue unless we begin to deal with our structural deficits, which are huge. We are finally getting a hearing in Congress of our budget, our debt and our long term commitments to social security, Medicare/ Medicaid and Defense.

While we cannot balance our budget solely with cuts to discretionary spending, it will be cut and housing subsidies and affordability is going to get hurt in this process. Compounding the political problems is the influence of lobbyists and campaign contributions. Ironically, when government TARP funds were repaid by financial institutions which they had stabilized, the very same financial institutions greatly increased their lobbying and campaign contributions and they have outsized influence as a result. Advocates need a voice in the proceedings.

Housing market

The housing market is soft and will continue to be for a while. It is predicted there will be 8-9 million defaults by the end of it.

The housing market is totally supported by Fannie, Freddie and FHA right now, which collectively are 90% plus of the market; banks and financial institutions are not a major factor in this market. The feds, by keeping rates low, gave the banks low cost money to work with to build their capital accounts back up through fixed income trading, the carry trade, and large margins.

This was all part of a national policy – and it may be good for the rest of the country – to replenish financial institutions and their capital so they can lend again. But why is it portrayed that the financial institutions are doing us a favor? Why don't those who were most hurt by the actions of the large financial institutions, low and middle income people, propose some other policies and not leave it to the well paid lobbyists of the financial institutions?

Dispelling Myths

Despite the negative perception, Fannie's book of business in single family homes, beginning in 2009, is the best book of business they've ever seen by all the early indicators of default such as LTV, credit scores, etc.. While you will see Fannie losing money each year, this comes from their old book of business from 2005-2007, and disproportionately from the high unemployment that came out of this crisis and the subprime they took down, yet even in subprime, their experience is significantly better than the private label securities (issued by Wall Street) that are out there.

It will take a while until you see the new book of business dwarf the old but the country is not losing more money by keeping Fannie and Freddie the way they are now. In fact, the phase out proposal of 5-7 years came because to do anything less than that would be to crater the housing market. The truth is that Fannie and Freddie are repaying taxpayers, not accruing additional losses. Looking at the actions of Fannie from 2009 on, we will see a much healthier book of business and a repayment to taxpayers. The truth is Fannie is supporting the market and is making an effort to keep people in their homes which also is cost effective given the severity of defaults.

The future of GSEs

The "white paper" that came out earlier this year on the future of Fannie and Freddie resulted from a call for getting rid of Fannie and Freddie from both political parties. In the atmosphere of these calls, Republicans put 90% of the blame on the two institutions and ascribed maybe 10% of the blame to the private market in spite of significant facts to the contrary.

Among the more ridiculous congressional legislative proposals, the Republicans proposed eliminating Fannie Mae and Freddie Mac in two years, notwithstanding the fact that they carry most of the market. They proposed government pay scales for Fannie and Freddie employees that would cause a mass exodus leaving $5 trillion worth of untended assets that you'd have to transfer within two years. It would be better to reconstitute Fannie and Freddie to their previous way of operating or at least to give a similar entity the ability to compete with the major banks on mortgages execution and servicing.

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The worst option is that the big four banks, among those who visited the plague on low and middle class families, will control and price the entire $11 trillion housing market — the primary proposal today.

However, through implicit or explicit government guarantees, Fannie and Freddie bring pots of money from China and elsewhere into our mortgage markets, which lower the cost to that market to single family and multifamily low and middle income housing seekers. The 30 year fixed rate mortgage exists only in this country because of Fannie and Freddie and further lowers those costs.

Other potential victims of a recast financial system are small community banks, credit unions, and regional banks up to several billion dollars in size. The Federal Home Loan Bank system (for these banks) gives collateral and liquidity to small and regional banks. Eliminating Fannie and Freddie would limit their option for off loading their mortgages and potentially put them out of business — a further consolidation of power among the few remaining big banks.

Options

- The first option is a purely private market which would turn over an $11 trillion market primarily to four banks that are still too big to fail and will only get larger.
- The second option calls for a private market — that is until they get in trouble — at which point a government mechanism like Fannie would step in. I am uncertain how this bail out mechanism would work but it does conjure up a sense of déjà vu!
- The third option splits up Fannie and Freddie into mini-GSEs and require 5% cash retention so they have some money in the game, and establishes a transparently priced direct governmental guarantee for losses resulting from catastrophes.

Under any of these three options, single family housing costs would go much higher. If you leave it totally to the private market, it's the end of the 30 year mortgage creating an exclusively adjustable rate market instead – a potentially disastrous situation for low income people who can't handle the jump in rates.**

Where from here?

Underwriting is harder now, down payments are higher, and costs are up causing home ownership rates to decline from 69% to 67%. They will probably fall into the low 60s. Each percent drop represents 1.2 million households no longer owning a home, so rentals are the only place for people to go.

A more balanced housing policy with more rental housing will be the future and it is coming your way. The need for middle and low income people to have affordable rental housing will be essential. Vacancy rates are down which will cause rents to go up; meanwhile policy people have not addressed how we can expect to create more affordable rental housing.

The mortgage interest deduction (MID)

The MID should be available for getting people into houses but it's being misapplied, benefiting those who least need it. A large majority of the mortgage interest deduction is going to those making over $250,000 per year (and most of that for the largest houses and even for yachts) with the rest spread among the rest of the country's homeowners. Senator Connie Mack, co chair of the bipartisan budget deficit reduction committee under President Bush said the mortgage interest deduction is "indefensible". There should be means testing or something else.

It is a fallacy that it will depress home ownership if you eliminate it. Countries where they have done that have not seen a decline in home ownership. In its place we might have an extended workforce housing tax credit. If you invested part of the savings from a reduced MID into rental housing, you would have $50-100 billion per year as a new potential revenue source.

Fannie or Freddie assured lending in all parts of the country – they didn't discriminate by geography and nothing in the new proposals suggest similar rules. Also, without 30 year amortization, it will be even harder for first time buyers. This is balanced somewhat by lower housing prices but financing is much harder and will continue to be.

Policy makers are considering decisions around the budget, tax policy and housing investments that will affect each and every American. Ultimately what works for lower and middle income people is to have a job and regular income. Very little is being proposed by those who were most hurt by the financial crisis, and the community that represents these constituents needs to be more forceful in their proposed solutions.

**Harvey singled out former Federal Reserve Bank Chair Paul Volcker, an early Obama advisor, as one of the few economic experts who opposed the "casino" atmosphere of derivatives.*

***Canada has an adjustable rate market that resets at 10 years and has heavily regulated banks that were not into subprime mortgages even though the Canadian government is the ultimate insurer for most of the market.*