The Tragedy of the Mortgage Commons:
The Sub-Prime Crisis in the USA: An Insider's View

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Workshop on Housing Finance in South Asia
May 27-29, 2009
Jakarta, Indonesia
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INTRODUCTION: THE SCOPE OF THE CRISIS

As a rational being, each herdsman seeks to maximize his gain. Explicitly or implicitly, more or less consciously, he asks, "What is the utility to me of adding one more animal to my herd?" Garrett Hardin, The Tragedy of the Commons

The United States is now experiencing the greatest economic crisis since the Great Depression. “Between June 2007 and November 2008, Americans lost more than a quarter of their net worth. Total home equity in the United States, which was valued at $13 trillion at its peak in 2006, had dropped to $8.8 trillion by mid-2008” and is still falling. “Housing prices dropped 20% from their 2006 peak, with futures markets signaling a 30-35% potential drop. Total retirement assets, Americans’ second-largest household asset, dropped by 22 percent, from $10.3 trillion in 2006 to $8 trillion in mid-2008. During the same period, savings and investment assets (apart from retirement savings) lost $1.2 trillion and pension assets lost $1.3 trillion. Taken together, these losses total a staggering $8.3 trillion.”

One of every five homeowners with mortgages now owns a home that is worth less than the principal balance. Foreclosures were up 81% in 2008 and 225% since 2006. There were 3.1 million foreclosure filings in 2008—nearly two percent of American households-- and a similar number is expected in 2009. In certain areas, it is even worse. Nearly seven percent of Nevada home owners received a foreclosure notice in 2008.

In addition, widely respected firms, such as Lehman Brothers are now out of business and others, such as Bear Stearns, have been subsumed into other firms. Strong financial institutions, such as Bank of America, have had to rely on the government for financing and now must raise additional capital as well. The U.S. Government now owns 79.9% of the two mortgage titans, Fannie Mae and Freddie Mac.

1 The author would like to thank and acknowledge the following people: Olivier Hassler, Housing Finance Program Coordinator, Financial and Private Sector Development Vice Presidency of the World Bank, for his thoughtful suggestions and guidance; Dr. James Sumners, for his support in the development of this paper; Professor Sharon Oster, Dean of the Yale School of Management, for her lectures in Microeconomics in which The Tragedy of the Commons was taught; and Samantha Taube for her insightful comments and editing.
2 Garret Hardin, The Tragedy of the Commons, Science, Issue 162, 1962
4 CNNMoney.Com, January 23, 2009
5 CNNMoney.Com, January 15, 2009

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As former Deputy Treasury Secretary Roger Altman has noted, “This damage has put the American model of free-market capitalism under a cloud. The financial system is seen as having collapsed.”

This is not just a crisis of numbers. It is a deep personal and community crisis as well. The United States prides itself on being a nation of homeowners, with more than two thirds of Americans owning their own home before this crisis hit. Home equity composes the largest percentage of most families’ assets, and now much of that has been wiped away. Credit is tight, people are losing jobs, and there is general fear for the future. Moreover, this has not only affected the U.S, the financial crisis has spread throughout the world.

**WAS THIS REALLY A “SUB-PRIME CRISIS?”**

The financial crisis has come to be known as the “sub-prime” crisis. Is this terminology accurate and fair? The issue of what the crisis is called and the perception of the cause of the crisis are fundamentally important issues. Since a sub-prime mortgage is one where the mortgagor is a person with less than perfect credit, using the term “sub-prime crisis” implies that it is the borrowers that were the root cause of the crisis. It connotes irresponsibility and implies that the crisis was caused by those whose credit was below “prime” underwriting standards necessary to originate a safe and sound mortgage. This image has the potential to undermine the efforts of countries around the world who are trying to strengthen the affordability of the home buying process, particularly for those with lower incomes.

A sub-prime mortgage, one that is given to persons with little credit history or with less than perfect credit, is not necessarily bad. It can permit those who had been closed out of the housing finance system to enter it, although at a higher cost.

The issue in many cases, was not just about who received the mortgage, it was about what type of mortgage was originated and how it was originated. In fact, many borrowers who received sub-prime mortgages had credit that was good enough qualify for a prime mortgage or, for an ‘Alt-A’ mortgage, which is just one step below prime.

What emerged in the market place were mortgages that combined many risk factors: an adjustable rate mortgage where the mortgagor is qualified only on the initial “teaser” rate, where the monthly payment after the interest rate adjustment becomes unaffordable, where the appraisals are aggressive, where there is no down payment and where there is no mortgage insurance. Oftentimes, the borrower’s income documentation was either not provided or not checked. While the combination of these factors might appear to be a caricature, many of these factors were present in mortgages all across America.

Yet even these types of mortgages were only a portion of the causes of the crisis. The true cause was a broad, system-wide failure; a crisis caused by a lack of responsibility, a lack

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of accountability, a failure to follow standards of prudence, and a regulatory system that was too fragmented to discipline the system. The true cause of the crisis was a combination of many factors:

- A regulatory system that was fragmented, uncoordinated, contradictory, often incompetent, and where key players learned to work outside of the regulated sector

- An aggressive Federal Reserve Bank that was attempting to prevent a recession by lowering interest rates, by encouraging the development of new financial products and by neglecting the warning signs that the housing system could collapse

- A system where many of those in the origination portion of the home-buying process took advantage of the federal government’s desire to increase mortgage finance to those who had historically been closed out of the system, particularly low income, minority and immigrant families

- An “irrational exuberance” on the part of virtually all of the players that the price of housing would continue to rise, and a failure to understand the implications of what an economic downturn could have in communities

- A competitive environment amongst lenders, brokers, builders, financiers, investment bankers and even the Government Sponsored Enterprises (GSE), Fannie Mae and Freddie Mac, became caught up in the cycle of growth

- A time of the development of new financial products in the mortgage markets and in the securities sector, which combined many risk factors

- A chain of players who were compensated on the transaction and who had little if any responsibility in the long term viability of what they were creating

- A system where the proper due diligence was often not done and where each institution trusted that the one before had thoroughly investigated the quality of the financial products

Finally, a government that was unprepared for the scale and scope of the crisis that paid far more attention to large institutions than it did to preventing a continued wave of defaults, foreclosures, and community wide disruption.
THE TRAGEDY OF THE MORTGAGE COMMONS

In the philosophy of Adam Smith who wrote “Wealth of Nations,” individuals acting in their own “rational self-interest in a free-market economy leads to economic well-being.” This book, written in 1776, has been seen as perhaps the best example of the underlying theory of capitalism and free market economics.

In 1968, the scientist Garret Hardin⁸ published an article in the journal, Science, describing the ‘tragedy of the commons’. His article raised questions about whether everyone acting in their own individual, rational self-interest would at the same time be acting in the best interest of the community—and even the long term interests of the individuals.

What Hardin argued was that when a number of individuals each act in their own self-interest, they can destroy the long term good of the community. He discussed the 19th century Oxford economist William Forster, who wondered why cattle on common land looked so much smaller and less healthy than the neighboring cows. The issue was this: some cattle ranchers use land that other farmers use as well. Since each farmer’s income derives from the number of cows raised, it is in his individual self-interest to put as many cows on the commons as possible.

Unfortunately, “the herds exceeded the natural “carrying capacity” of their environment, soil was compacted and eroded, and “weedy” plants, unfit for cattle consumption, replaced good plants. Many cattle died, and so did humans.”⁹ Thus, each farmer acting in his own self-interest hurts not only the good of the community but, ultimately, his own long-term self-interest as well.

Hardin applied this analysis not only to farming, but to the environment more broadly, including acid rain and even, in a later version of his article, to the banking industry.

In the tragedy of the mortgage commons, we will see that while some acted purely out of greed and some acted out of general interest for the polity as a whole – whether ultimately right or wrong—the overall environment became a competitive frenzy of the players acting in their self-interest, causing serious damage to the financial community and, ultimately, to themselves as well.

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⁹ Ibid

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BACK TO THE BASICS: THE MORTGAGE ORIGINATION PROCESS

To understand how this crisis emerged, it is necessary to go back to the basics of prudent mortgage lending. A mortgage loan is a contract between a lender and a borrower. The lender evaluates whether the borrower has the income to service the debt, whether he has a good payment history with other debts, and whether he has enough invested in the property so that there is something at stake to prevent non-payment. The lender must also evaluate the property to see if the selling price is at or below what the market will bear.

For the property, the key issue is about value. If a prospective homeowner has signed a contract to purchase a home and is looking for financing, the lender needs to ensure that the home is worth the contract price. In a mature market, this is done by sending an appraiser to look at the property, to compare it to similar properties that have recently been sold, and to make adjustments based on location, condition and amenities.

To evaluate the borrower’s ability to pay, the lender is supposed to look at the salary and the work history of the applicant. Until recent years, the homebuyer was supposed to have stable employment, which was defined as two years or more with the same company.

The lender is supposed to qualify the potential borrower on the percentage of income that he would be able to spend towards the mortgage, which consists of payments towards the principal, interest, local property taxes and insurance. Other debt payments that are made monthly, such as student loan, alimony, car payments, and credit card debt need to be taken into account as well.

A standard practice is to permit the borrower to have monthly payments of principal, interest, taxes and insurance to a maximum of 33 percent of his income and a maximum of 38 percent of a mortgage payment and other payments. If a borrower has a car payment and consumer debt equal to ten percent of his income, then, under this standard, he could only dedicate 28 percent to mortgage payments.

To judge the buyer’s credit worthiness, the bank would research whether he had any history of bankruptcies or defaults, and would also contract with a service to obtain a “credit score.” Most people, both inside the industry and outside, do not know the specific components of a credit score, but, in general, it is comprised of consumer debt, such as credit cards, student loans, alimony, previous or current mortgages, and other expenses where there is a debt and a minimum fixed payment each month. The buyer’s credit worthiness would not only be a factor in the decision on whether or not to originate a mortgage, but in the pricing at well.

The evaluation of how difficult it would be to walk away was, in general, determined by the down payment, the percentage of the purchase price that the homeowner paid in cash.
towards the purchase. The lender is supposed to verify that this money was not borrowed and that it came from the applicant’s own resources.

Thirty years ago, the standard amount of a down payment was 20 percent, although this could be lower if the homebuyer used a government insured loan, such as FHA or VA, or if he purchased insurance from a private company that would guarantee the loan to the bank if the homeowner defaulted on his payments.

While the process might seem cumbersome, a home is the largest asset most people will ever own and the mortgage the largest debt. The system is about protecting both borrowers and lenders. Ultimately, the system should be in balance. If the standards are too strict, then there will be little market for the mortgages and the only people who could meet the terms and conditions are ones that would likely not need a loan in the first place. If the terms are too loose, then at least one of the parties – if not both—is put at risk.
INSTITUTIONAL HISTORY

Many people compare the crisis today with that of the Great Depression, which occurred 80 years ago. With the nation in both a human and an economic crisis, the federal government under President Franklin Roosevelt embarked on an aggressive plan to turn around the economy. One of the key components of this was to stimulate the banking sector.

“The banking crisis of the 1930’s forced all lenders to retrieve due mortgages....Refinancing was not available, and many borrowers, now unemployed, were unable to make mortgage payments. Consequently, many homes were foreclosed, causing the housing market to plummet. Banks collected the loan collateral (foreclosed homes) but the low property values resulted in a relative lack of assets. Because there was little faith in the backing of the U.S. government, few loans were issued and few new homes were purchased.”

Prior to this time, the type of long-term lending for housing was that we see today as standard was not in existence. The typical borrower would have to put down 50 percent of the loan amount as a down payment and could only borrow for a five year term, putting residential lending out of the reach of most people.

The residential housing and lending sectors were seen as important aspects in the economic recovery. To aid the housing and banking sectors, President Roosevelt supported the National Housing Act of 1934, which created the Federal Housing Administration (FHA). In order to encourage long term housing lending, FHA was given the full authority of the federal government to provide a 100 percent mortgage insurance, which would protect the lenders in the event of a default.

FHA had an enormous impact for banks, for lenders, for homebuilders. Long term lending became the norm, not the exception. The depth of this impact could be seen not just in the 1930s, but in the next decade as returning veterans from World War II were able to obtain low interest, long term mortgages, from FHA and its counterpart in the Veteran’s Administration, thereby creating a housing boom.

The reason this worked so well is that it was not a financial giveaway for either banks or borrowers. Along with the insurance came standards that had to be followed by the lenders and borrowers; standards for the financial institutions, for the underwriting process, for qualifications, for documentation. These standards, while changing somewhat over time, set the norms for the industry for decades.

Mortgage insurance and standards for long-term lending were only one part of what was developed under President Roosevelt. In the wake of the depression, the federal

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government also created the Federal National Mortgage Association (FNMA), the predecessor organization to both Fannie Mae and to the Government National Mortgage Association (Ginnie Mae). It was created to provide the system with liquidity. If the banks had to hold the loans on their books for the long term, then they would not have adequate capital to continue lending. If, however, they could sell these loans, then they would be able to continue the long term lending process. FNMA provided a way for banks to sell the mortgages, creating what has come to be known as a secondary market.

At that time, FNMA could only purchase FHA insured loans “thereby replenishing the supply of lendable money for these government backed loans.” In 1944, the organization’s authority was expanded to the purchase of loans insured by the Department of Veterans Affairs (VA) as well.

A decade later, the structure of the organization’s structure and ownership changed as federal legislation permitted a portion of the organization to be owned by private stockholders. This legislation “removed government backing for borrowings used to fund Fannie Mae's secondary market operations. It stipulated that Fannie Mae be exempt from all local taxes except property taxes, and provided for the Federal Reserve Banks to perform various services for Fannie Mae.” This structure was to remain intact for fourteen years.

THE 1960s: NATIONAL UPHEAVAL AND INSTITUTIONAL CHANGE

The 1960s were a time of tremendous upheaval in America. The U.S. was involved in an unpopular war in Vietnam; there was a general air of protest, against both the war and against racial discrimination. These tensions created enormous for President Lyndon Johnson.

To demonstrate Johnson’s commitment to urban issues, the Department of Housing and Urban Development (HUD) was created as a cabinet level agency in 1965. FHA became part of this new department and was no longer an independent organization.

Given a decision not to raise taxes during the war, the federal government was also under tremendous financial pressure. Due to this, President Johnson and Congress privatized Fannie Mae, which became a self supporting organization. Fannie Mae was also given the authority to issue securities.

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13 The original mission and functions of purchasing and securitizing government insured or guaranteed mortgages was placed in a new organization, the Government National Mortgage Administration or Ginnie Mae, which became part of the federal Department of Housing and Urban Development.

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However, the federal role in Fannie Mae’s oversight did not end. While the federal government no longer owned Fannie Mae, it became a “government sponsored enterprise” and would be regulated by HUD to insure that Fannie Mae still maintained a social mission as part of its core business.\textsuperscript{14} \textsuperscript{15}

The Federal Home Loan Mortgage Corporation (Freddie Mac) was created two years later with an essentially similar charter. Many say that this was primarily to provide competition to Fannie Mae. Two years later, Fannie Mae become a publicly traded company and was also given the authority to purchase conventional loans; loans not insured or guaranteed by the U.S. government.

That the market was also changing during these times. For a number of reasons, including limits on loan amounts, insurance premiums, and documentation requirements, the market share of conventional mortgages was surpassing FHA’s. By 1976, Fannie Mae was purchasing more conventional loans than it was government insured loans.

This history is important to understand because it sets the stage for what was to occur decades later. On the one hand, Fannie Mae was created as a governmental organization with an economic and social purpose and with access to financial benefits, such as the ability to borrow at government rates and an exemption from corporate taxation.

On the other hand, the privatization of the company created a fiduciary responsibility to its shareholders. It could no longer act like a government organization. It entered a competitive marketplace where it had to compete and to grow; to ensure profitability and a high rate of return on investment. While Fannie Mae grew rapidly in the decades to come, this tension became apparent in the current mortgage crisis as it engaged in practices that ultimately caused its takeover by the government.

\textsuperscript{14} Ibid
\textsuperscript{15} When Fannie Mae was privatized, the Government National Mortgage Association (Ginnie Mae) was created as a wholly owned corporation within HUD, to “guarantee investors the timely payment of principal and interest on mortgage backed securities backed by federally insured or guaranteed loans.”

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THE SYSTEM GROWS: BENEFITS AND CHALLENGES

For decades, while the system was not perfect, it worked well. The Government’s intervention in the system in the 1930s created long lasting, sustained changes.

Mortgage insurance and underwriting standards enabled many favorable changes for borrowers. Thirty year mortgages were now standard. Down payment requirements were not only lowered to 20 percent, they could be lowered even further with mortgage insurance, particularly FHA’s. New programs were developed by Fannie Mae and Freddie Mac. Homeownership rates soared, especially after World War II, although minority homeownership rates still lagged.

Banks were able to originate mortgages efficiently because of the secondary market. Lenders knew they could sell the mortgages to institutions such as Fannie Mae or Freddie Mac.

This financing system had another benefit: quality control. Controls were put on the system because in order for the loan to be insured by FHA or purchased by the GSEs, certain standards had to be met. According to Lewis Ranieri, the former Salomon Brothers Vice-Chairman, when these institutions were the key players “they played the role of gatekeeper; the government sponsored enterprises (GSEs) had loan underwriting standards—things like minimum down payments, two-inch-thick loan documents, and mortgage insurance that covered potential losses.”

THE SYSTEM BREAKS DOWN

If the system had created so much good, then how did it go so terribly wrong? How did a system that created so much opportunity, so much wealth and so much growth in the economy turn into one that caused so much damage, not just in the United States, but around the world?

There is no one answer. There was a combination of factors that collided in a tsunami of economic distress. Most importantly, an environment was created that undermined the system of standards, and of checks and balances, which had been in place since the 1930s.

These factors included:

- The development of new financial products that eliminated the need for both a down payment and mortgage insurance
- A competitive environment that put pressure on easy, fast transactions even at a higher cost

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16 Muolo and Padilla

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• The growth of many types of non-traditional mortgages with risk factors, such as “stated income” mortgages, “piggy-back” mortgages, negative amortization mortgages, adjustable rate mortgages, sub-prime, higher interest rate mortgages, and a combination of several mortgages with several risk factors
• Investment bankers and others were aggressively pursuing mortgage purchases at high prices and without detailed information
• Rating agencies that did not perform the proper due diligence on the securities
• A government regulatory system that was fragmented and ineffective
• A central bank that was trying to prevent a recession by lowering interest rates and that also encouraged the development of “financial innovations” that proved to be much of the system’s undoing

The early part of this decade saw explosive growth in the mortgage industry not just from one of these factors, but from them all. Companies that had been in the traditional mortgage business and companies that had been in the personal loan and second mortgage business saw tremendous growth potential in new products and in new markets.

As interest rates declined, as new financial products were introduced, as new opportunities were created because of the internet, and as the market boomed, the driving force amongst lenders and mortgage brokers became volume. “Lenders let their standards slip because if they didn’t make a loan, their competitor would…the net effect was a competitive frenzy, with lenders furiously undercutting each other to gain customers.17”

This could be extremely lucrative, not just to the owners and senior managers of mortgage companies, but to originators, processors and other employees. “The best salespeople earned $1 million to $3 million a year. Loan processors who never graduated from college and did little more than check paperwork on loan files earned up to $100,000.18” Brokers who sold loans to the mortgage companies were also compensated extremely well. Not only that, top outside brokers were rewarded monetarily and with dinners, trips, golfing outings.

What happened to the underwriting standards? They disappeared. As one broker stated, “We would do everything we could to get the deals done. Sales had the final say on everything…There weren’t any bad loans.19”

Moreover, new players were continually entering the market: mortgage brokers, lenders who had heretofore only originated consumer loans, investment banks, real estate investment trusts, homebuilders and others.

Mortgage brokers and loan originators were compensated on volume. The greater the volume, the more income that they earned. Some originators were not only compensated on the volume, but on the type of loan, the interest rate and the fees that were paid. If a

18 Chain of Blame, Paul Muolo and Mathew Padila, John Wiley and Sons, 2008, p167
19 Ibid

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sub-prime loan was originated at a higher than normal interest rate (regardless of whether the borrower could qualify as a prime borrower), the originator often received greater compensation, as did the wholesaler selling the loans to the investment banks, and as did the securities issuer.

**MORTGAGE PRODUCT “INNOVATIONS”**

The explosive growth of the mortgage market was heavily dependent on products that were different than the traditional 30 year fixed rate, 20 percent down payment mortgage.

**“Piggy-back Loans”**

In traditional mortgage lending, the borrower had to contribute 20 percent of the sales price as a down payment. If that was not possible than he either had to qualify, be approved for and receive an FHA insured loan, or he had to purchase private mortgage insurance. In fact, not only did the borrower have to make the down payment, he had to produce several months of bank statements to prove that the funds were not borrowed. Ensuring that the borrower had a strong enough financial commitment to the property and/or that there was insurance to protect the lender in the event of a default was one of the bedrocks of the mortgage finance system.

The “piggy-back” or “80/20” mortgage undermined one of the most important lending standards. The borrower would take out a first mortgage of 80 percent and then a second mortgage of 20 percent, which generally carried a higher interest rate than the first. Since the first mortgage was not greater than 80 percent, no mortgage insurance was required.

This had a number of implications. First, the borrower entered the property with no equity invested. Second, it violated the spirit of mortgage qualifications. The reason for a down payment is to assure the lender and investor that the borrower had something at stake. In an 80/20 mortgage, while the first mortgage might have technically met the lender’s criteria, in actuality, it put the lender or investor at risk.

Third, it permitted the borrower to work around the standards of mortgage insurance, both for financial reasons and for reasons of access. In an FHA mortgage, while the down payment is small, the borrower must uphold certain standards, including income documentation and verification. Moreover, he must pay both an upfront and monthly insurance premiums.

In the case of private mortgage insurance, while there was generally no upfront fee, the borrower had to pay a monthly premium. So while the borrower saved money, the mortgage holder (or holders since mortgages were often broken down in tranches and sold to different investors) was left uncovered in the event of a default.
While FHA helped to stimulate the mortgage lending and banking sectors in the mid 20th century by providing mortgage insurance, the new wave of growth was caused, in part, by precisely the opposite reason – avoiding the expense and underwriting criteria of a loan with mortgage insurance.

It also had an implication that was not understood until recently. The first mortgage holder has payment rights before that of the second mortgage holder. If a borrower is delinquent, the lender or servicer will sometimes try to restructure the mortgage. However, if this results in a financial loss to the second lien holder, which it generally will, he can block the overall restructuring. In essence, the second mortgage holder can hold the restructuring process hostage, forcing the loan into default and the home into foreclosure. In business contracts, this is known as a “hold-up problem.” While this might simply be a negotiating position, it is a strong one.

**Adjustable Rate Mortgages (ARMs)**

The same period also saw rapid growth in adjustable rate mortgages (ARMs) and a decline in the market share of the fixed rate, 30 year mortgage. ARMs, in and of themselves, can have a positive purpose. It is a way of making housing more affordable since the initial rates on the ARMs are lower than for the longer term mortgage. Since most homeowners only stay in their houses for seven years, the logic is that there was no need to pay the extra interest rate costs for a 30 year amortizing loan. It also has the benefit of being more attractive to investors.

In an ARM, the buyer pays a set interest rate for a designated period of time, after which the loan would “balloon,” and have to be paid off, or where the interest rate could adjust, generally up to a predetermined limit. For instance, a 5/25 mortgage would be one where the amortization term is thirty years, the first five of which are locked into a fixed interest rate and the latter 25 would be adjustable. A common limit on the rate adjustment is two percent per year and six percent total over the life of the mortgage.

The issue with ARMs was not the product themselves; it was in the type of adjustable rate mortgage: in how borrowers were qualified, in how the mortgages adjusted, and in combination with other risk factors.

Many lower income borrowers received mortgages where the interest rate lock was only for two years. Oftentimes, the initial rates were “teaser rates,” ones that were lower than the prevailing market rates, but which had higher than market rates for the remaining 28 years to compensate for the first two years. When the rates adjusted, borrowers could be put in financial peril.

What made these mortgages even more dangerous was that the buyer could be qualified on the basis of the teaser rate without any sensitivity analysis of the interest rate.

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adjustment on affordability. When this happened, a second tenet of prudent mortgage lending was violated. A mortgage is supposed to be affordable, and that affordability is defined as having the borrower pay no more than a certain percentage of his income to the mortgage and to other debt. If the borrower is qualified only on the initial rate, an increase to the market interest rate could easily push him well outside the affordable ratio.

“Liar’s Loans”

This decade saw the growth of another financial product, the “stated income” loan. Here, the borrower simply stated his income to the broker or lender, without any documentation, without any verification. Betsy Bayer, First Vice President of Countrywide Mortgage, the largest (and now failed) originator of sub-prime loans, said that the company’s compliance staff termed “liar loans.” The New York Times reported said that at least 40 percent of those applying for a no or low documentation mortgages did so because they did not believe that could qualify for the loan they needed to buy their house. Imagine this conversation between a mortgage broker and a borrower. “Oh, you are buying a $600,000 house and you say you have a $200,000 year annual income from cutting lawns in your neighborhood— but don’t have any proof of your income. No problem.”

Other “Innovative” Mortgages

In addition to these types of loans, other “innovative” products were offered. These included “interest only” loans where the homebuyer did not pay down any principal. These also included “negative amortization” loans where “the outstanding principal balance of the loan increases, rather than amortizing, because the scheduled monthly payments do not cover the full amount required to amortize the loan. The unpaid interest is added to the outstanding principal, to be repaid later.”
RISK LAYERING EXPLODES

What we can see from this was that there were mortgages where the homebuyer had no equity at stake, where their income was likely not what they stated it was, where the lender or investor did not have the benefit of mortgage insurance, and where interest rates could increase to the point of being unaffordable. These and other risk factors combined into one mortgage meant that many of the key principles underlying prudent lending standards were being violated – and violated at the same time: rules regarding down payments and mortgage insurance, rules regarding affordability, and rules regarding documentation.

Federal Reserve Chairman Ben S. Bernanke has stated that it was the combination of various forms of risk that caused many of the problems. “Some lenders evidently loosened underwriting standards. So called risk-layering—combining weak borrower credit histories with other risk factors, such as incomplete income documentation or very high cumulative loan-to-value ratios—became more common. These looser standards were likely an important source of the pronounced rise in early payment defaults…amongst sub-prime ARMs.”

While Chairman Bernanke is correct that layering many risks into one loan was a cause of the crisis, this did not just happen to people with “sub-prime” credit, they were also made to those considered “Alt-A,” which means their credit was considered to have the grade of A-, and to ones with prime credit as well. These loans were made to lower income people, to moderate income people, and even to those with incomes that were higher. Without proper documentation, it is difficult to know whether a loan classified as sub-prime could qualify as prime and vice versa. We know now that there were many people that could have qualified for a prime mortgage, but were sold one with higher fees, higher rates, higher risks – for higher profits.

Mark Zandi, Chief Economist for Moody’s Economy.Com argues that “These factors combined to create an extraordinarily risky housing finance sector. The quality of lenders’ underwriting inexorable eroded. At its most craze point at the apex of the housing bubble, disingenuous, predatory, and even fraudulent lending corrupted parts of the mortgage market. The mortgage industry’s dramatic transformation from a staid business to a financial Wild West created the fodder for the subprime financial shock.”

THE PRESSURE ON VALUATION

While these changes took place on the qualification end of mortgage origination, there was pressure to be aggressive on the valuation of the properties as well. Lenders, after

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22 Federal Reserve Chairman Ben S. Bernanke, Speech to the 43rd Annual Conference on Bank Structure and Competition, Chicago IL, May 17, 2007

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all, hire appraisers. If an appraiser was not aggressive enough and it resulted in the loss of transactions, it was likely that that appraiser would see his business from that lender decline or be eliminated. According to one report, “In one office, a salesman whacked the top of an appraiser’s desk with a baseball bat and screamed at her for killing his deal.” While this example is certainly extreme, it does point to the competitive nature of the origination process and the pressure placed on appraisers to value the property so that the deal could be closed.

Much of the industry also changed in a way that encouraged aggressive appraisals. Fannie Mae and Freddie Mac began to encourage automated appraisals. This was both to reduce costs and increase speed, both of which were competitive factors. A licensed appraiser did not have to physically visit the property, saving both time and money. While an automated appraisal could produce an accurate valuation, it was one more step in the flow of events that placed an emphasis on speed and volume, rather than an emphasis on quality.

23 Ibid
24 In 1998, FHA moved in a different direction. It began to require that a qualified, licensed appraiser visit the property and note any major conditions that could limit its habitability. This could not be performed by a unlicensed appraisers under the signature of the appraiser. This was done to protect both the homeowner and the FHA portfolio. I was involved with this decision, which was changed a few years later due to industry pressure.

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A HISTORY OF DISCRIMINATION MEETS THE BORROWERS

There are a number of obvious questions that can be asked. Were some buyers and investors taking advantage of the system? Indeed some were, particularly those that were interesting in “flipping” the home; only owning a short time before selling it to make a quick profit. Should the borrowers have known that they were potentially placing themselves in jeopardy? Here again, some were indeed and took out mortgages that they knowingly could not afford, but the majority did not do that.

Perhaps most importantly, why did the borrowers not go to a lending institution where the terms might have been better? The answer has to do with the intimidation of the mortgage process overall, and with the relationship between lending institutions and minority communities in particular.

The traditional mortgage lending process is very overwhelming, confusing and intrusive. Borrowers are asked to sign form after form, often written in legal language that is hard to understand. They are asked to provide tax records, proof of savings for the down payment, verification of their employment and income, and explanations of any potential issues in their credit evaluation. Then there is the waiting period to see if they will be approved or not. The traditional lending model also requires a fair amount of available cash: for the down payment, for the origination fees, and for other costs. All these factors encourage borrowers to seek means for obtaining a loan outside traditional lending institutions.

Another reason had to do with who many of the new borrowers were: low income persons, minorities, immigrants. Many of these persons were in groups that historically had been the victims of discrimination. In fact, minority borrowers were far more likely to receive a sub-prime mortgage than majority borrowers. Black households making more than $68,000 a year (were) almost five times as likely to hold high-interest subprime mortgages as are whites of similar — or even lower — incomes.25

The effect of this is significant, on a $350,000 mortgage, “a difference of three percentage points — a typical spread between conventional and subprime loans — tacks on $272,000 in additional interest over the life of a 30-year loan.26”

What makes matters worse is that many borrowers that received a sub-prime mortgage were not sub-prime borrowers; they had excellent credit. Shaun Donovan, a long time housing professional who is the new Secretary of the Department of Housing and Urban Development noted that approximately “33 percent of the subprime mortgages given out in New York City in 2007, Mr. Donovan said, went to borrowers with credit scores that should have qualified them for conventional prevailing-rate loans.27”

26 Ibid
27 Ibid

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The history of discrimination by financial institutions provides a significant explanation of why many members of minority groups went outside the traditional mortgage lending challenges. In the words of Colvin Grannum, who grew up in a black neighborhood in Brooklyn and became president of the Bedford-Stuyvesant Restoration Corporation, a nonprofit organization that builds and renovates housing, “I don’t want to say it’s in the cultural DNA, but a lot of us who are older than 30 have some memory of disappointment or humiliation related to banks. The white guy in the suit with the same income gets a loan and you don’t? So you turn to local brokers, even if they don’t offer the best rates.”

If a mortgage broker approaches them or that a friend or relative has worked with, if they are referred to a lender by a realtor they know, if there is a storefront mortgage office in their neighborhood, it makes the process much easier. This is particularly true if there is a language barrier. If they are also told that the amount of cash for the down payment will be minimal, if they do not have to pay the additional cost of mortgage insurance, if the initial interest rate is lower (especially if they are approaching the maximum debt to income ratio), and if they are told that they will be approved and approved quickly, then the decision is an easy one for many people. Even if it more expensive in the long run.

For the brokers and originators, selling a sub-prime mortgage to someone who could have qualified for a conventional mortgage often meant higher compensation. In the chain that followed afterwards, the lender or wholesaler who sold the loan to the investment banks received a higher fee as well due to the higher interests rates (and sometimes prepayment penalties), as did the investment banker who packaged the loan and sold it to investors.

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28 Ibid

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THE NEW SECONDARY MARKET

One of the ways that a tragedy of the commons could be prevented would be if there was a financial incentive for each individual to act both in the good of the whole and in their long-term individual best interests. For decades, standards were generally upheld in the mortgage market because of the incentives—to insure the mortgages, to sell the mortgages, and to keep originating and selling more.

The cause of this financial crisis was not only the types of loans that were originated; it was the incentives that were provided to those selling, buying and packaging the mortgages. This could not have happened without money; money that came without the types of requirements that had heretofore been necessary; money that worked outside of the normal, regulated channels. This could only happen with the active involvement of the secondary market players: investment banks and other financial institutions, rating agencies, Fannie Mae and Freddie Mac – and a powerful, central bank that was both providing low cost capital to the mortgage market and was applauding the development of new financial products.

Before the advent of the secondary market, mortgages that were originated by a particular lender were held on the books of that particular lender as whole loans. With the creation of the secondary market, this changed. Lenders could originate the loans, sell them, and have capital to originate more loans. In the 1980s, the majority of loans were either insured by the FHA or VA, or sold to and guaranteed by Fannie Mae or Freddie Mac. However, for the most part, these loans met reasonable underwriting standards29.

As competitively as brokers and lenders pursued potential homeowners as clients, the investment banks pursued the lenders. They did so with competitive aggressiveness, with lowered standards – and with lots of money. They actively worked to build relationships with those that could sell the loans.

If Fannie Mae and Freddie Mac were gatekeepers to the secondary market, how did they let this occur? The answer is the market moved around them. This became even more the case after 2003 as Fannie Mae and Freddie Mac were dealing with accounting scandals, opening the door even more for others who could package mortgages into securities.

The opportunity for the investment banks was tremendous—and they began to pursue mortgage lenders and wholesalers with fervor. Sub-prime, Alt-A and other non-traditional mortgages were highly prized because they carried higher interest rates and, when packaged into securities, would mean higher yields.

When Stanley O’Neal became CEO of Merrill Lynch he saw that “residential mortgages represented the largest debt market not only in the United States, but in the entire world.

29 The crisis in the Savings and Loan Industry demonstrates that this was not always the case.

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Americans owed $8 trillion on their homes—even more than the federal government owed on all its Treasury bonds.\(^{30}\) Mr. O’Neal’s “message to Merrill’s mortgage department was clear. Go after the sub-prime business. Be number one.\(^{31}\)"

The market became so heated that investment bankers sometimes paid even more than the par value of the loans, paying a premium for the right to purchase the mortgages. This, of course, was then more than made up by the fees that could be earned in selling the mortgages to investors.

Making the markets even more competitive was that the lines between the different types of organizations became crossed and new organizations were entering the market. As an example, Countrywide moved from being a direct lender, to a wholesaler of loans from mortgage brokers, to actually issuing securities. In 2004 the company “blew away the competition,” and securitized $72 billion in sub-prime and non-prime loans.\(^{32}\)"

Investment banks, such as Merrill Lynch went in the other direction by purchasing First Franklin Corporation, the fourth largest sub-prime lender in the United States. When Angelo Mozilo, the former Chairman of Countrywide was asked about the investment banks now competing on the lending side as well, he commented, “They did not want to come to us for loans…They thought they could manufacture it themselves.\(^{33}\)"

So not only were mortgage lenders competing against other lenders to sell their product, and not only were investment banks competing against other investment banks to purchase the mortgages, but investment banks competed against mortgage lenders and mortgage lenders competed against investment banks. The competition had become multi-dimensional.

When the loans were packaged and sold to investors, they were rarely sold as whole loans. They were broken up into different pieces, packaged into securities, and sold to different investors.

The parts or “tranches” that were senior, that were considered most secure and which were highly rated by rating agencies, such as Standard and Poor’s, Moody’s and Fitch, were sold to investors that were the most risk averse. These were the vast majority of the securities sold. The more risky tranches, those that were junior carried higher interest rates and were sold to a different class of investor. There was such demand that more than one trillion dollars were issued in mortgage securities in 2005 and 2006. Even with the markets beginning to decline, nearly one trillion dollars were issued in 2007. It was a gold rush.

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30 Zandi, p. 188  
31 Zandi, p. 189  
32 Zandi, p. 189  
33 Zandi, p. 195  

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THE RESPONSIBILITY OF THE RATING AGENCIES

Another question is why investors purchased loans when, in hindsight, there was clearly so much risk in the underlying portfolio. Much of the reason for this can be attributed to the rating agencies. According to Lewis Ranieri, the former Vice-Chairman of Salomon Brothers, “Investors…were used to getting data on the securities they were buying, but not in this new market. ‘The rating agencies are playing the role of quasi-regulator; they’ve been cast into this role.’ It was their job to look at the loans backing the subprime bonds to make sure the investor was getting a quality product. It was up to the rating agencies to grade the bonds; that’s what the securities underwriter paid them for.”

There has not been any adequate explanation for why the rating agencies failed to analyze what was in the portfolios. The rating agencies gave many of these bonds their top rating, at least the senior tranches, even though the underlying mortgages were weak.

The role of leverage also played an enormous role in the crisis. The issue of homeowners putting down very little money, if any, and using the leverage that mortgages give them was certainly part of the cause of the crisis. However, the scale of the destruction could not have occurred without the investment banks, REITs and others leveraging their portfolios and doing so without sufficient reserves. Some tried to hedge their risk through credit default swaps and other derivatives. Those that provided this “insurance,” such as AIG, did not have sufficient capital to protect against losses either. AIG was one of the first firms to be bailed out of the government in this crisis.

Mark Zandi, the Moody’s economist noted that “the rating agencies badly misjudged the risks. Poor quality data and information led to serious miscalculations. The agencies were not required to check what the originators or servicers of the mortgage loans told them, and this information was increasingly misleading. The agencies also had the difficult task of developing models to evaluate the risk of newfangled loan schemes that had never been through a housing slump or economic recession. Without that experience, the models were not up to the task they were asked to perform.34”

How did this situation occur? The lenders relied on information from the originators, including mortgage brokers, the investment banks relied on the information from the lenders and wholesalers, and the investors relied on information from the investment bankers and from the rating agencies. In the end, who knew what documents were in the loan files? Who cared?

Everyone made money: the realtors, the appraisers, the mortgage brokers, the loan originators, the investment banks, the investors and others. All were compensated on the transactions; many compensated even more if it was a sub-prime or Alt-A loan with a higher interested, or an adjustable rate mortgage which lessened the long term financial risk of the investor. None had a vested financial interest in the long term performance of

34 Zandi, p. 19

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the loans. You did your job, received excellent financial compensation and passed the risk to the next person in the chain.

FANNIE MAE AND FREDDIE MAC: PART II

If Fannie Mae and Freddie Mac had been such critical parts in developing the secondary mortgage markets, and if they had been such powerful financial players, then what occurred to bring both of these established institutions into conservatorship such a short time later?

The first the answer is that both were trying to recover from accounting scandals that occurred in 2003. Second, they attempted to meet or exceed the government’s mission standards, which President Clinton was committed to and which were increased under President Bush. Third, they sought to be a strong, competitive player in an environment where the market was moving around them.

In this environment, where the players in each sector were competing with one another, and where they were even developing products to compete in different sectors, even Fannie Mae and Freddie Mac became enveloped. Executives of Fannie Mae, which had begun as a government agency, become partially privatized, and ultimately became a company traded on the New York Stock Exchange felt that they had a responsibility to compete or they would lose market share and, therefore, potentially lose the confidence of their stockholders.

Daniel Mudd, a former executive of GE Capital,\(^{35}\) became the CEO of Fannie Mae in December 2004. Part of his responsibility was to rebuild the organization after the accounting difficulties and another part was to grow the business and increase market share. And that growth was in the sub-prime and Alt-A business.

According to a report in the New York Times, Mr. Mudd saw that the company made a decision as non-prime loans became an increasing sector of the market. “We face two stark choices: one, stay the course; two, meet the market where the market is.\(^{36}\)”

Fannie Mae’s original charge was to purchase, guarantee and ultimately securitize mortgages. Yet it was limited in the types of mortgages it could purchase, even after it was permitted to purchase conventional mortgages.

However, as its portfolio grew it had a second—and more powerful—way to earn money: through its portfolio investments. Here, too, it was limited in the quality of the investments in which it could invest.

\(^{35}\) The author of this paper worked for GE Capital from 1997 to 1998, although not in the same area as Mr. Mudd.


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This is where the paths of the Government Sponsored Enterprises, Fannie Mae and Freddie Mac, crossed with the investment banking community and created a back door way to compete in this market. With lenders originating non-prime loans and having these loans packaged into securities composed of different tranches with different ratings, Fannie Mae and Freddie Mac were ultimately able to invest in mortgages that they could not purchase directly. By buying the senior tranches of the non-prime mortgage securities, they were investing in high quality, triple A rated securities, which were permitted investments.

This was a “four for one.” First, Fannie Mae and Freddie Mac could invest capital in securities of the very firms that had become their competitors; in essence co-opting the competition. Second, the GSEs could say to the government, to their Boards, and to their stockholders that their investments were safe and secure. Third, they could earn a higher yield on investment by investing in these securities than they could in their traditional in their traditional lines of business.

Finally, the government permitted the GSEs to count many of these investments towards their affordable goals since the mortgages underlying them were going to low income and minority borrowers. So even if these mortgages were not ones that federal regulators would permit them to purchase, they not only did so this way, but received the regulator’s blessing and encouragement.

According to former Chief Credit Officer Edward J. Pinto, by 2008, Fannie Mae and its counterpart, Freddie Mac, held or guaranteed 10.5 million non-prime loans worth $1.6 trillion, one in three of all sub-prime loans, and nearly two in three of all so called Alt-A loans, often called “liar loans,” which, according to experts were due to accounting practices “that masked their sub-prime and Alt-A lending.”

To demonstrate how their choices affected their portfolios, 68 percent of the private level securities Fannie Mae and Freddie Mac are holding are now considered “below investment grade.”

There is an obvious question here? Why did someone not see this and try to prevent it from happening? What if a person in the chain became concerned about the long-term good of these mortgages, performed more thorough due diligence and rejected the riskier loans? The answer is simple: you were left behind. If you did not grow, then others would compete against you for the business. Having a responsibility to the shareholders, owners or investors in the business, you would likely not have been perceived as being aggressive enough in the business. That, in and of itself, could put your job, your reputation, and your personal financial position at risk.

37 Ibid
38 Ibid

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To understand the dynamic at work, we can see this environment through Hardin’s lens. “Even when herdsmen understand the long-run consequences of their actions, they generally are powerless to prevent such damage without some coercive means of controlling the actions of each individual. Idealists may appeal to individuals caught in such a system, asking them to let the long-term effects govern their actions. But each individual must first survive in the short run…The non-angel gains from his “competitive advantage” (pursuing his own interest at the expense of others) over the angels. Then, as the once noble angels realize that they are losing out, some of them renounce their angelic behavior.
THE REGULATORY FRAMEWORK

While the financial elements of the mortgage system became stronger and more sophisticated, the regulatory aspects never caught up with the times. Different organizations had responsibility over different aspects of the housing finance system. Some of these organizations regulated securities. Others regulated different aspects of the banking industry. Several regulated the housing sector; in particular the mission goals. Another regulated the safety and soundness of Fannie Mae and Freddie Mac. Each had a hand on a different part of the elephant. In this environment, there was simply no way to gain a clear view of the whole – until the system collapsed.

These organizations include:

- The Securities and Exchange Commission (SEC), another organization created in the wake of the Great Depression, which “oversees the key participants in the securities world, including securities exchanges, securities brokers and dealers, investment advisors, and mutual funds.”
- The Federal Deposit Insurance Corporation (FDIC), which insures bank deposits, protects against bank failures and “directly examines and supervises about 5,300 banks and savings banks, more than half of the institutions in the banking system.” The FDIC’s regulatory authority is for both “safety and soundness and consumer protection.”
- The Federal Reserve Board, one of the most powerful institutions in the United States, which not only controls monetary policy and credit conditions, but which is also supposed to supervise and regulate banking institutions to ensure safety and soundness, maintain the stability of the financial system, and provide financial services “to depository institutions, the U.S. government, and foreign official institutions, including playing a major role in operating the nation's payments system.”
- The Office of Thrift Supervision (OTS), an office within the U.S. Department of the Treasury. Its mission is to supervise charter and regulate the thrift industry. The OTS is supposed to examine “each savings association every 12-to-18 months to assess the institution’s safety and soundness, and compliance with consumer protection laws and regulations.” The OTS is a relatively new organization and was established as a response to the savings and loan crisis of the 1980s. In 1989, the U.S. Congress created OTS, moving deposit insurance to the FDIC and establishing the OTS to regulate the thrift industry.

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42 FDIC website, FDIC.gov
• The Federal Housing Finance Board\(^{45}\) (FHFB), the regulator of 12 Federal Home Banks that provide capital to its 8,100 member banks (thrifts) that, in turn, primarily provide capital for home mortgages. This Board, which is an independent regulatory agency in the U.S. Government, is suppose to ensure “that the Federal Home Loan Banks, operate in a safe and sound manner, carry out their housing and community development finance mission, and remain adequately capitalized and able to raise funds in the capital markets.”\(^{46}\)

• The Office of the Comptroller of the Currency (OCC), also housed within the Treasury Department. It is one of the oldest organizations, having been established in 1863 as a bureau in the Treasury. The OCC “charters, regulates, and supervises all national banks. It also supervises the federal branches and agencies of foreign banks.”\(^{47}\) Its mission is to ensure “a stable and competitive national banking system.”

• The Department of Housing and Urban Development (HUD), which specializes in assistance to lower income people and communities, and the department in which FHA had been housed since 1965 had a number of organizations under its umbrella: the Office of Federal Housing Enterprise Oversight (OFHEO), which was the financial “safety and soundness” regulator of the GSEs; the Housing Office for GSE Oversight, a part of FHA; and the Office of Fair Housing, which had the responsibility for reviewing FHA insured loans and lenders and for enforcing whether there were fair, non-discriminatory standards and practices in mortgage lending.

The follow sections explore two of these organizations: the Federal Reserve and the Department of Housing and Urban Development.

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\(^{45}\) Along with OFHEO, this organization became part of the Federal Housing Finance Agency in 2008.

\(^{46}\) Federal Housing Finance Board website, [www.fhfb.gov](http://www.fhfb.gov). This website remains despite the fact that the Board has merged into FHFA.

\(^{47}\) Office of the Comptroller of the Currency website, [www.occ.gov](http://www.occ.gov)

The Tragedy of the Mortgage Commons, Ira G. Peppercorn, May 27, 2009
HUD’s REGULATORY ORGANIZATIONS: FRAGMENTATION AND THE LACK OF RESOURCES

While HUD housed several of the key housing regulators, the statutory fragmentation of these organizations, the lack of budgetary resources, the reputation of HUD and FHA in both the Congress and in communities and the fact that HUD could only regulate parts of the mortgage markets, all contributed to its inability to prevent the mortgage crisis from emerging.

In the early 1990s, Members of the U.S. Congress believed the federal government “had not been effective in ensuring that the enterprises’ activities benefited specific targeted groups, including low and moderate income Americans, and those who live in the underserved areas, such as central cities and rural communities.”

Therefore, in 1992, the U.S. Congress passed the Federal Housing Enterprises Financial Safety and Soundness Act. “Among other provisions, the 1992 act directed HUD to set numeric housing goals, which required the enterprises to meet specific criteria each year for the purchase of mortgages serving targeted groups.48” Within HUD, this responsibility was given to FHA, which created the Housing Office for GSE Oversight, a small office within FHA.

Yet while FHA had the mission oversight of Fannie Mae and Freddie Mac, it was not the financial regulatory authority of these organizations. That responsibility was given to a new office, the Office of Federal Housing Enterprise Oversight (OFHEO). “As the safety and soundness regulator, OFHEO oversees the GSEs' capital requirements and conducts regulatory examinations of the GSEs' business operations and practices to identify those that pose a risk to their financial viability, and, thus, potentially, to the taxpayer.49”

Six years later, HUD was still being criticized for not doing enough to ensure that Fannie Mae and Freddie Mac aggressively pursued the government’s mission goals. This was certainly not easy given that the office was composed of less than 20 people. OFHEO was also criticized as being ineffective.

In 1998, Congress asked the General Accounting Office (GAO), to investigate whether HUD was regulating Fannie Mae and Freddie Mac effectively. The GAO and HUD were then asked to testify before Congress. An investigation by the GAO and testimony before Congress are considered serious events. A member of Congress must request that GAO investigate some area that a Senator or Congressman is concerned about. A GAO

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49 Ibid

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report followed by a request to testify before Congress demonstrates even a more serious concern.

The General Accounting Office noted that to effectively accomplish its oversight, “HUD has a basic responsibility to ensure that the enterprises’ mortgage purchase activities serve the credit needs of all Americans and that the enterprises' financial activities are consistent with their housing mission. 50”

In its evaluation, the GAO concluded that HUD was not being tough enough to push Fannie Mae and Freddie Mac. It was also concerned that it did not have an independent way of verifying the GSEs’ data. “Specifically, HUD has not yet implemented a program to assess the accuracy of the enterprises' housing goal compliance data.”

HUD was in a difficult position. Its budget for mission regulation of the GSEs was less than $3 million per year and the number of full time staff was less than 20. OFHEO was larger, with a budget of $16 million and 72 people on staff. 51 This was in comparison to two of the largest corporations in America, ones with very powerful lobbying arms, with community support all across American and with many allies in both the administration and in Congress.

Moreover, the fragmentation in this structure—not to mention the fragmentation in America’s housing finance regulatory system in general—contributed to a lack of effectiveness. In a statement that would prove to be prescient, that GAO commented, “The current regulatory structure results in a fragmented approach to regulation that may not adequately consider potential tradeoffs between financial safety and soundness and the housing mission. 52”

According to Joe Lockhart, OFHEO’s director during the Bush Presidency, the Agency was only given weak powers and questioned if Congress really wanted Fannie and Freddie regulated. 53 The U.S. Congress gave mixed messages to the regulators saying, on the one hand, “regulate more forcefully and more fully,” and, on the other hand “don’t regulate them too much.”

50 Ibid
52 Kingsbury testimony; emphasis added
53 Joe Lockhart, Distressed Asset Roundtable and Exchange (DARE) conference, May 12, 2009
PREDATORY LENDING AND THE PERCEPTION OF FHA

Another reason why it would have been difficult for FHA to regulate Fannie Mae and Freddie Mac more strongly had to do with the reputation that FHA had at that time. In the late 1990s, the criticism of predatory lending was not aimed at Fannie Mae and Freddie Mac, it was aimed at FHA. At that point, FHA was facing tremendous pressure from Members of Congress, from the press, and from community groups across America, in both its core, single family insurance, and in its housing rehabilitation programs.

Some of this pressure came from organizations such as the National Training and Information Center (NTIC), a “national organizing, policy, research, and training center for grassroots community organizations dedicated to building power to reclaim our democracy and advance a far-reaching racial and economic justice agenda.54” The organization and the National’s People’s Action, a project of the NTIC, are organizations that used unusual types of protests to attract media action and force policy action on behalf of low income people. At that time, it was led by the late Gale Cincotta, a tough community activist who was not intimidated by power.

In one example, three busloads of protestors arrived at then Secretary Andrew Cuomo’s house on a Sunday afternoon as he was planting flowers with his children to protest the way in which FHA was hurting communities.

The criticism of FHA then was that, in some cases, it was destroying communities, not helping them. People were financing homes that were in poor condition with FHA insured mortgages, where the borrower did not have the funds to rehabilitate or even maintain the house. Its key home rehabilitation program was fraught with fraud. Its programs for handling foreclosed properties were took too long, were ineffective and hurt entire neighborhoods.

In Syracuse, New York, block after block of foreclosed houses that FHA had taken back into its portfolio were empty, uncared for and vandalized. Making matters worse was that many of the foreclosed homes were concentrated in small areas. This caused crime problems, and hurt the property values of those remaining in these working class neighborhoods.

Another problem was that FHA insurance was used to finance properties that were unsafe and in poor physical condition. In Chicago, Illinois, a Minister said that when his daughter was on the first floor in the kitchen, the bathtub on the second floor fell through the floor into the kitchen just a few feet from where his daughter was standing.

In Baltimore, Maryland, realtors, appraisers, and lenders were working together to sell an overvalued home. When the person defaulted, the house would be “flipped,” then purchased in foreclosure, and then sold again to another unsuspecting borrower.

54 National Training and Information Center’s website, www.NTIC-US.Org

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While some of these problems were due to corruption, the cause was more systemic than that. FHA had a system where, if a lender met certain standards, it was given the “direct endorsement” authority to underwrite the loan and to have an endorsement of FHA insurance placed on it. As a quality control check, FHA was supposed to examine the files of 10 percent of the loans.

In reality, the percentage reviewed was far less than that was required. Moreover, when reviews were taking place, it was often just to see if the correct paperwork was in the files. Lenders were routinely overriding FHA’s basic underwriting criteria and were doing so with a minimum of justification. HUD simply did not have the systems in place to monitor the lenders.

Lenders who violated the system were rarely sanctioned. FHA did have a tool to discipline lenders, the Mortgagee Review Board, but it was understaffed, underutilized and could only be used for lenders originating FHA insured loans. Unless the lender’s actions were particularly egregious, it was difficult to prove. Even then, there were few cases brought before the MRB. In the rare cases were a lender was investigated and faced the possibility of disciplinary action, such as having its ability to directly endorse FHA insurance removed, the lender could bring in its attorneys to fight it, find any flaws in FHA’s case and argue for much lighter disciplinary action, or none at all.
FHA AND FANNIE MAE: VILLIANS AND HEROES

If FHA was the villain, then Fannie Mae was the hero. It made a commitment to provide a trillion dollars towards affordable housing and was actively pursuing that commitment. It established a division, headed by a former community activist, focusing specifically on community lending and on specialized services to cities and states across America. Fannie Mae was also very savvy politically.

It established partnership offices in many cities, usually headed by a person with strong political connections there. It created a foundation to provide grants to community based organizations—sometimes the same ones that were criticizing FHA. It hired top officials from both Republican and Democratic administrations, as well as former Congressional staff members. Its CEO through most of the 1990s, Jim Johnson, had been a top aide to former Vice President Walter Mondale. Its next CEO, Frank Raines, was the Director of the Office of Management and Budget under President Clinton.

It had strong support from both parties in Congress. It demonstrated its willingness to act on some key social issues. It had political connections. It was a financial powerhouse. It was rare to find sharp criticism of the company and, when it did—such as from Republican Congressman Richard Baker, the criticism was perceived as ineffective. It was a successful company, not a government agency, so it had the support of Republicans. It reached out and provided grants, loans and investments for low income communities across America, so it had the support of the Democrats.

It also appeared much more competent than the government agencies. After all, it was FHA that was hurting the local communities, not Fannie Mae. Why create a strong regulator inside of government bureaucracy that could not even keep its own house in order, when Fannie Mae appeared to do so many things right?

This perception is one of the reasons that, in the late 1990s, it was extremely difficult to challenge Fannie Mae and Freddie Mac. If FHA could not effectively manage and monitor its own operations, how would it have the capability and the credibility to manage Fannie Mae and Freddie Mac? It was only when the accounting scandals broke a few years later that the criticisms of the GSEs began to emerge.

CONSUMER PROTECTION AND THE DECLINE OF MARKET SHARE

An additional challenge is that when FHA tried to put regulatory procedures in place, not only did it receive industry criticism, but it also helped the organization lose market share. A good example of this is what happened when FHA created stronger consumer
The Tragedy of the Mortgage Commons, Ira G. Peppercorn, May 27, 2009

protection to prevent the types of problems we saw in Chicago and other cities. At the time, Fannie Mae and Freddie Mac were moving towards “automated appraisals,” where the appraiser did not have to physically go into the properties, in order to reduce costs and reduce the time to approve a mortgage.

FHA went in the opposite direction and created stronger appraisal procedures that required a licensed appraiser physically visit the property to be financed and note any major material conditions that would affect the habitability, safety and durability of the home. This changed caused an outcry from industry and was one factor amongst several that helped to cause a decline in market share of FHA.

What ultimately happened was that when changes such as this were put in place, it was not seen as helping consumers; it simply gave more credence to the perception that FHA was bureaucratic and behind the times. When that perception was combined with other issues such as insurance fees, down payment requirements, and documentation standards, it became even more negative. When new financial products that did not have these restrictions grew, fewer and fewer customers used FHA and moved to the non-regulated sector.

Between 1996 an 2005, a GAO study noted that “FHA’s share of the market for home purchase mortgages in terms of numbers of loans declined 13 percentage points (from 19 to 6 percent), while the prime and subprime shares grew 3 and 13 percentage points, respectively. The agency experienced a sharp decrease among populations where it traditionally has had a strong presence. For example, FHA’s market share dropped 25 percentage points (from 32 to 7 percent) among minority borrowers and 16 percentage points (from 26 to 10 percent) among low- and moderate-income borrowers. At the same time, subprime market share among these groups rose dramatically.55"

The GAO noted the reasons for this: “FHA's product restrictions and lack of process improvements relative to the conventional market and product innovations and expanded loan origination and funding channels in the conventional market--coupled with interest rate and house price changes--provided conditions that favored conventional over FHA-insured mortgages.56"

Yet, as the GAO also noted, that while homebuyers who were moving away from FHA did so because of less bureaucracy and lower initial costs, in the end they were placing themselves at risk since low initial interest rates could rise “substantially in a short period of time.57"

The answer to the question of why the government did not step in to prevent the crisis, or at least why HUD did not step in, the answers are clear. Its regulatory authority was

56 Ibid
57 Ibid

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fragmented, underfunded and relied on the regulated entities for much of its information. Its reputation—much of which was deserved—was that its own actions were hurting communities hurt its credibility in its power to regulate Fannie Mae and Freddie Mac. And when put consumer oriented regulations and procedures in place, it contributed to the move from FHA to the non-regulated sector.
THE FEDERAL RESERVE AND CHAIRMAN ALAN GREENSPAN

If HUD did not have the resources or credibility in the financial community to effectively regulate the mortgage markets, there was another that did: the Federal Reserve. The Federal Reserve affected the housing market in two ways: through monetary policy and through regulation.

Many people, such as Steve Forbes, are highly critical of Chairman Greenspan’s monetary policy. They believe that this fostered an atmosphere of easy credit that was ultimately one of the greatest contributors to the current economic crisis.

While there is some merit to the criticism, it is important to understand the environment America was in and the challenges we faced at the time. Having watched the consequences of the financial crisis in Japan in the 1990s and having witnessed the human tragedy of September 11, 2001 and its ensuing economic impact, deflation became the key fear of the Federal Reserve Chairman.

Moreover, Greenspan was concerned that the same situation that occurred in Japan in the 1990s could happen in America. “With the story of most major economies in the postwar period being the emergence of, and then battle against inflation, concerns about deflation, one of the banes of an earlier century, seldom surfaced. The recent experience of Japan has certainly refocused attention on the possibility that an unanticipated fall in the general price level would convert the otherwise relatively manageable level of nominal debt held by households and businesses into a corrosive rising level of real debt and real debt service costs.58”

To prevent the possibility of deflation, or of a recession, Greenspan aggressively tried to stimulate the economy. The Federal Reserve’s Open Market Committee dropped the interest rate, in steps, from 3.5 percent to one percent. While the Fed’s actions only directly affected the short term interest rates, they can and did have a powerful symbolic effect on long term interest rates as well. Part of this is the comfort given to the financial community that the Federal Reserve would intervene to prevent a financial crisis.

For the financial community, stock prices remained low. It was the housing market that prevented the American economy from falling into a recession. “When monetary policy finally did get traction, it was through the housing market. The fed was barely able to pull the economy out if it post-stock-bubble slump, and even then it was able to do so only because it was lucky enough to have another bubble come along at the right time. 59”

The Federal Reserve faced another challenge that could threaten the growth. Fannie Mae and Freddie Mac were beset by accounting scandals. Since they were the market leaders

58 Chairman Alan Greenspan, Issues for Monetary Policy, The Economic Club, New York, December 19, 2002
59 Krugman, p.152

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in mortgage securities, the fear was that the one bright area in America’s economy would be tarnished as well.

It was rare for both political parties to agree on a policy, and for that policy to have the support of the business community. The goal of continuing to increase homeownership was one shared by Republicans and Democrats alike, as well as by some of the strongest trade associations in the country: the National Association of Home Builders, the National Association of Realtors, and the Mortgage Bankers Association of America.

Moreover, since there was a large gap between low income and minority and majority homeownership rates, the biggest growth area was for those who had traditionally been closed out of the market. The Clinton administration and the U.S. Congress both agreed with this, which the Bush administration did even more aggressively in its pursuit of a policy to create a nation of homeowners. While the Federal Reserve is not directed by a U.S. President, this was clearly something Alan Greenspan agreed with as well.

Here is where Chairman Greenspan’s monetary policies, his desire to have the housing sector serve as a enabler of economic growth, and his philosophy on regulation dovetailed.

His regulatory philosophy was “simple and clear: the private sector was more competent and able to police itself than the government was in policing financial markets.” When combined with the stimulus that low interest rates could provide, Greenspan’s strategy appeared to be effective. “As interest rates fell, the housing market took off and lifted the economy into a self-sustaining economic expansion. By 2004, home sales, housing starts, and housing prices were surging. Thousands of jobs were being created in housing related industries and other industries were adding to payrolls as well.”

His skepticism of government regulators was matched by his enthusiasm for alternative financial products. He applauded the growth of non-traditional mortgage products, including ARMs. For instance, “Federal Reserve Chairman Alan Greenspan said…that Americans’ preference for long-term, fixed-rate mortgages means many are paying more than necessary for their homes and suggested consumers would benefit if lenders offered more alternatives.”

“American consumers might benefit if lenders provided greater mortgage product alternatives to the traditional fixed-rate mortgage. To the degree that households are driven by fears of payment shocks but are willing to manage their own interest rate risks, the traditional fixed-rate mortgage may be an expensive method of financing a home.”

He noted specifically “that ‘option-adjusted spread’ on mortgages suggest that the cost of these benefits conferred by fixed-rate mortgages can range from 0.5 percent to 1.2

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60 Zandi, p.152
61 Zandi, p. 72
62 USA Today, February 23, 2004

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percent, raising homeowners' annual after-tax mortgage payments by several thousand dollars, \(^{63}\) in comparison to adjustable rate mortgages.

Greenspan received some criticism at the time. “Anyone who takes out an ARM essentially assumes interest-rate risk. If interest rates rise over time, your mortgage payments rise, too. In Greenspan's ARM-ed world, homeowners would have to watch interest rates every day, make judgments as to whether they think rates are going to rise or fall, and hedge accordingly.\(^{64}\)”

Chairman Greenspan’s theory was not necessarily wrong. Adjustable rate mortgages can be a useful tool in mortgage lending that can save many homeowners money. This is particularly true in a time of rapidly escalating housing prices. However, there was no way to see if the ARM would cause borrowers to be subjected to interest rate shock at the adjustment period, particularly if the homeowners were only able to qualify on the initial interest rate, if it was a “piggyback” (80/20) loan, if it was a “liars loan” (little or no documentation), if the appraisal was too aggressive or if these and other factors were combined in layers of risk.

So while ARMs in and of themselves can be beneficial, Greenspan was not sending a cautionary signal about the effect that the multiplicity of risks could have. Nor did he send a cautionary note about the high degree of leverage in the securities industry. In fact, his optimism about innovations, not just in mortgage lending, but in securities as well, combined with low interest rates, contributed, both financially and symbolically, to the crisis that emerged.

It opened the door to a wave of new investments in the housing finance sector. With the stock market in a slump and interest rates at very low levels, housing was the strongest sector of the economy. Therefore, housing finance became a very attractive investment. Capital flowed into this sector not only from the United States, but from international sources as well. Investors saw that they could increase their yield safely by moving from Treasuries to Fannie Mae and Freddie Mac. Many believed that even though these were not public entities, they had the implicit guarantee of the U.S. Government.

It was an easy next step from GSE securities, to those issued outside of government or government sponsored channels. Housing was a strong and vibrant sector of the American economy, mortgage finance was backed by hard assets, some of the most respected names in the American financial community, such as Goldman Sachs, Lehman Brothers and Merrill Lynch were actively involved in this area, and Moody’s, Standard and Poor’s and Fitch were rating the senior tranches of the mortgage securities their highest ratings. They could have all of this and at higher yields than at the traditional “safe” financial vehicles. Not to mention the fact that these innovations had the blessing of the Chairman of the Federal Reserve.

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\(^{63}\) Daniel Gross, Slate, February 27, 2004

\(^{64}\) Ibid

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Housing finance was, therefore, pulled by one side and pushed by the other. Capital flowing into the system helped to drive the investment banks for more and more mortgage finance opportunities. This created an environment where mortgage originators and wholesalers knew they had a valuable product and could continue to sell as much as they had.

On the other side was the wish by renters to own their home, by homeowners who wanted to move up, and by mortgage brokers and lenders to grow their business. The development of new financial products created innumerable opportunities. With housing prices continually increasing, and with a lender to originate a loan and sell it, meant that they had no risk.

The message from the President and from the Federal Reserve Chairman only strengthened this. Homeownership was good, it helps the economy, it gives people the pride of ownership, it creates opportunities in the construction and financial sectors, and it makes us strong. New financial products help achieve these goals and the private sector should be free of regulatory constraints so that it could pursue continued innovation.

The mortgage market did not hear any concerns about the erosion of standards in mortgage lending. And the securities industry certainly did not hear concerns from the person in the most important economic position in the American government.
RESPONSE TO THE CRISIS

The potential for a crisis had been known for some time. Foreclosures were greatly increasing in some markets, such as Nevada, Florida, Ohio, parts of California and other areas. Yet the roots of this crisis were so deep that, by the time it was apparent that something was very wrong, it would have been almost impossible to prevent it.

According to Peter Swagel, a former Treasury Department official “By early 2007, we were all aware of the looming problems in housing, especially among sub-prime borrowers as foreclosure rates increased and subprime mortgage originators such as New Century went out of business.”

The initial focus of the government was saving large financial institutions in order to prevent what could have been a full-scale economic collapse. It bailed out AIG a company with $1 trillion in assets, since it provided insurance and other financial products that were to act as insurance to many institutions—not just for banks and investment banks, but for retirement funds, property insurers and others. This was even though AIG had acted irresponsibly by not protecting against losses.

Ironically, it let Lehman Brothers collapse since it had such a large percentage of its portfolio invested in housing and, therefore, it was believed, would not have nearly as broad of an impact if it collapsed. It helped to arrange for the purchase of Bear Stearns by J.P. Morgan. It took over Fannie Mae and Freddie Mac, ensuring that the payment streams would continue, thus realizing the thought that many had all along—that before the government would allow the GSEs to fail, it would step in.

With Fannie Mae and Freddie Mac, the “Treasury committed to inject up to $100 billion of capital each into Fannie and Freddie as needed to ensure that they had positive net worth; a Treasury lending facility if needed; and a program under which Treasury would purchase GSE mortgage backed securities in the open market…The U.S. government ended up as 79.9 percent owner of the GSEs…(this figure) was chosen in light of accounting rules that would have brought GSE assets and liabilities into the government balance sheet at 80 percent ownership.”

The federal government vacillated on the policy approach it would take. Would it provide liquidity to the financial institutions? Would it fully or partially nationalize them? Would it purchase the troubled assets or provide financial incentives to the private sector for their purchase?

In the fall of 2008, one of the main components of the government’s policy appeared to be in the purchase of troubled assets. In September 2008, the Treasury Department requested the authority from Congress for a “Legislative Proposal for Treasury Authority

66 Swagel, p. 28

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to Purchase Mortgage-Related Assets (TARP). The proposal requested $700 billion, asked Congress to give the Treasury Secretary maximum flexibility to determine the pricing and other conditions for the purchases – and was a total of three pages. Legislation creating the TARP was passed by Congress and signed by President Bush, but only gave the Secretary the authority for half that amount unless additional authority was given.

However, the Treasury programs became more of one that was injecting capital into the troubled institutions rather than directly purchasing assets. The majority of the capital that has actually been spent went to Bear Stearns ($29 spent of $29 billion committed) to facilitate its sale to JP Morgan Chase; Fannie Mae and Freddie Mac ($60 of $400 billion) to cover their losses; AIG ($42 of $53 billion) to provide “seed money to create investment vehicles to buy, hold and possibly dispose of bad securities held or insured by A.I.G.,” and $645 of $700 billion for the Troubled Asset Relief Program (TARP). Of the TARP funds, an additional $70 billion went to AID, $45 billion to Bank of America, and $45 billion plus an additional $5 billion for loan guarantees went to Citigroup.

The actual spending was only a small percentage of the larger commitment. According to the New York Times, the U.S. Government made $12.2 trillion in commitments in the various aspects of the bailouts through April 30, 2009: $9.0 trillion as an investor, $1.7 trillion as an insurer and $1.4 trillion as a lender. Of this, $2.5 trillion had been spent and $10 billion recouped through dividends and fees. Much of the investor funds has and will be for the purchase of commercial paper, securities from the Government Sponsored Enterprises, and mutual fund assets.

TARP received a great deal of criticism – for its lack of details, for giving the Treasury Secretary too much authority, for a lack of transparency, and for a failure to detail what the bailout funds had actually accomplished.

Part was also due to the fact that it appeared that precious little was going to the victims of the crisis, while much was going to firms that were believed to be a great part of the cause of the crisis. This criticism turned to outrage when the reports of multi-million dollar compensation packages and excessive spending were reported.

AIG turned into a “money pit” for federal funds, first with a direct agreement and, subsequently, with the use of TARP funds, its executives still did not understand (or care about) the ramifications of using public money. “Less than a week after the federal government had to bail out American International Group Inc., the company sent executives on a $440,000 retreat to a posh California resort, lawmakers investigating the company's meltdown said Tuesday. The tab included $23,380 worth of spa treatments for AIG employees at the coastal St. Regis resort south of Los Angeles even as the

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67 Swagel p.34
68 Adding Up the Government’s Total Bailout Tab, New York Times, February 4, 2009. (It is assumed that the commitments noted were those pledged as of April 30, 2009, but the spending noted was as of the date of the article.)
company tapped into an $85 billion loan from the government it needed to stave off bankruptcy. 69

**HOPE FOR HOMEOWNERS?**

In a January 2009 draft report issued by a five person bi-partisan panel headed by Elizabeth Warren, a Harvard Law School professor, reviewed the implementation of the bailout and found that the effort of the U.S. Treasury were faulted on a variety of fronts: “having no ability to ensure banks lend the money they have received from the government; having no standards for measuring the success of the program; and for ignoring or offering incomplete answers to panel questions.”

“The panel reserved its most strident criticism for Treasury's approach to dealing with the foreclosure crisis at the root of the economic turmoil…The draft report noted that Treasury hasn't used any of TARP's $700 billion to help borrowers refinance or deal with mortgages that are worth more than the market value of the homes they are tied to. 70

Within the administration there were some such as the Federal Deposit Insurance Corporation who argued for more direct financial incentives to homeowners. However, all governments have turf wars and the Chairman of the FDIC is not considered nearly as powerful as the Secretary of the Treasury—particularly when the Secretary’s position is in line with that of the administration overall. This resulted in the FDIC largely being ignored until recently when the FDIC’s position has been given more credence in the new administration.

While the federal government understood that defaults and foreclosures were causing severe economic, personal and community distressed, its reaction was one of ambivalence. On the one hand, it encouraged such efforts as the Hope Now Alliance, which was an effort to work with borrowers and lender-servicers on mortgage medications, which was able to aid several hundred thousand families. This, however, was a voluntary effort on the part of the lenders.

On the other hand, for both policy and budgetary reasons, the government did not want to provide financial incentives to prevent a home from going into foreclosure. “Within the administration…there was no desire to put public money on the line to prevent additional foreclosures. This is because any such government program would inevitably involve a bailout of some ‘irresponsible’ homeowners. 71

This ambivalence played out in the administration’s willingness to support the Economic Recovery Act passed by Congress into law in 2008 72. However, here again there were no

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69 Reported in the Kansas City Star website, October 8, 2009  http://primebuzz.kcstar.com/?q=node/14879
70 Ibid
71 Swagel, p. 15

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direct federal dollars. The government would use FHA insurance if a lender was willing to write down a mortgage to 87 percent of its current market value.

This was the impetus behind a program at FHA, Hope for Homeowners. This program “was created by Congress to help those at risk of default and foreclosure refinance into more affordable, sustainable loans.”

Hope for Homeowners was designed to help 400,000 homeowners. It has helped almost no one. One industry expert specializing in foreclosure prevention said that the program had helped 25 homeowners. The program was poorly designed as can be seen in the fact that it required a 3.5 percent up front insurance premium. This was from borrowers that were in so much financial trouble that they were facing default and foreclosure.

Lenders were either reluctant or unable to use this program as well. Writing down a mortgage is significantly more difficult than reducing the interest rate, since unless the servicer is given the authority in advance it needs lender or investor approval. This is difficult if the loan pool it is in has been divided into tranches, packaged into different securities, and sold to different investors. It also did not deal with the fact that many homeowners in distress had second mortgages.

Was the reason for not wanting to provide foreclosure assistance to borrowers in danger of default simply a policy of wanting to assist “irresponsible” borrowers? Clearly, it was more than that. Part was likely due to fears that if some owners were helped, others who were not in trouble might want a share in the funds as well.

The approach the Bush administration took in part clearly had to do with the prevention of economic collapse, given the size, scope and impact on the economy that the failing firms had. Those who were involved in the structuring of the Treasury programs noted that if they did not intervene, they feared the economic collapse would have been far worse.

It is also easier—though not necessarily better—to create a program that deals with a few large firms than it is one that would have to deal with millions of borrowers across America. So the intellectual default, particularly in time of crisis, goes back to programs that could quickly provide economic stabilization.

There is another possible reason—simply not knowing how to deal with the situation or whether it would even be possible to develop such a program at all. It is interesting that even Mr. Swagel, who provides a thoughtful, insider’s analysis of the decisions that were made during the crisis and who clearly understands the impact of this crisis on families across America, does not have any recommendation regarding foreclosure prevention and assistance to homeowners in his conclusions. His recommendations only center on the

73 FHA Website, http://portal.hud.gov/portal/page?_pageid=73,7601299&_dad=portal&_schema=PORTAL
74 Swagel, p. 16

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banking sector: Winnowing the banking system; recapitalizing the surviving banks, and resolving uncertainty about the viability of surviving banks.\textsuperscript{75}

The Obama administration has begun addressing direct aid to homeowners. Under their new proposed plan, $75 billion of funding would be provided from the Troubled Asset Relief Program. This plan is supposed to provide relief to borrowers who took out loans backed by Fannie Mae or Freddie Mac. The program allows incentives to investors and servicers to modify the terms of the borrowers’ loans. To be eligible, the new mortgage payment would have to be less than 38 percent of the borrower’s income. For every dollar that it is reduced to between 31 percent and 38 percent, the government would then provide a one to one match.

To do this, the interest rate can be adjusted to a minimum of two percent and the loan term can be extended to 40 years. The mortgage rate will stay constant until the fifth year at which time in can be adjusted one percentage point per year until it either reaches the prevailing market rate or the original interest rate, whichever is lower. The loan can only be adjusted once under this program.

In order to be eligible, borrowers cannot owe more than 105 percent of the current market value and the borrower must be current on his payments.

Mortgage servicers and inventors will receive financial incentives. Servicers will receive $1000 for each loan they modify under the program and investors will receive $1500 per loan. There are additional incentives provided if the mortgagor remains current. Homeowners themselves will receive up to $1000 per year in principal reduction for up to five years, if they remain current on their mortgages.

There will also be financial incentives for the servicers and holders of second mortgages. Servicers will receive $250 for each second mortgage restructured. Investors will be able to receive a percentage of the mortgage, although the precise amount has not been announced. Industry experts estimate that it will be 12 percent at maximum. Since second lien holders can block the restructuring of the first mortgage, an effective program is very important.

These programs, while necessary first steps, show the difficulty in creating a method to help so many borrowers in trouble. First, the eligibility requirements will close off many of the borrowers most in need. Second, they are voluntary programs. An investor does not have to participate in the restructuring. In particular, second mortgage holders may still believe that they have greater leverage by continuing to block the mortgage restructuring than by accepting the percentage that they will be offered. Third, unless servicers develop an aggressive program to reach out borrowers, it will be up to the borrower to learn about the program and contact their servicers.

When the new criteria for the program are announced, one of the key factors will be the underwriting standards and documentation requirements. According to one industry

\textsuperscript{75} Swagel, p. 47

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expert, under an initial iteration of the program, servicers were not only being asked to underwrite the loan under current market conditions and with the borrower’s current income, but were being asked to re-underwrite the loan based on the borrower’s initial income at the time of origination. This was to make sure that the borrower did not make any false statements during the origination process, which would certainly be difficult to verify in a stated income loan.

There is also the issue of the scale and scope of the program. $75 billion, although not a small amount, is only about one tenth of the financial commitment made to the Trouble Assets program in general, not to mention the funds for Bear Stearns, Fannie Mae, Freddie Mac, Bank of America, AIG, and the purchase of commercial paper, securities, and mutual fund assets.

Moreover, from an administrative point of view, it is far more challenging to modify mortgages one by one than it is to handle large transactions going to a few companies. There is no efficient way of handling this. So while these appear to be better steps than the first Help for Homeowners program, it is too early to see whether these programs will actually work in the scale that they need to.

What role FHA will play—and whether it can effectively play that role – is another critical issue. Many are putting their hopes in the hands this government insurance program, which has seen its market share dramatically increase. Some point to the fact that its default and foreclosure numbers are better than the sub-prime market overall as an indicator that it can effectively handle this increase. Yet are FHA’s numbers better because it has been well managed? Or is the real reason that many of the riskier borrowers found alternative channels causing both the decline in FHA’s market share and more positive numbers in its portfolio? If more and more loans are insured by the government through FHA, how will we judge the additional risks and how can these risks be minimized?

One issue that has received very little attention is what will happen to the properties that are already in foreclosure. The federal government announced a $4 billion Neighborhood Stabilization Program (NSP) to assist communities with this problem. The program has not seen much usage and a newer version was recently announced.

Unless the financial bleeding stops; unless there is some way of effectively preventing foreclosures as well as properties that are already in foreclosure, the housing market will continue to decline, more homeowners will be imperiled, more communities will see their property tax base erode, and the economic spiral will continue.
CONCLUSION: A SYSTEMIC TRAGEDY

While many call the current economic situation, the “sub-prime crisis,” in reality, that terminology blames the victims and ignores causes far deeper and far wider than sub-prime borrowers.

Moreover, many of the factors individually would not have been enough to cause the crisis. In fact, many of these factors have positive aspects. It was only the combination of many events that caused a broad, systemic failure.

- Sub-prime mortgages target to borrowers with less than perfect credit can be beneficial for both lenders and homeowners. However, it became irresponsible when the loan originator knew that the borrower could qualify for a mortgage with better terms, but sold the borrower a mortgage with higher interest rates and higher fees. It was even more irresponsible when the loan had many layers of risk.
- Adjustable rate mortgages can also be beneficial by providing low interest rates, particularly if a borrower’s income is expected to grow. However, if the underwriting that qualifies the borrower is based on the initial interest rate without a sensitivity analysis on the effect of the rate adjustments, then this endangers both the borrowers and the investors.
- Fannie Mae and Freddie Mac made great contributions to the mortgage industry by providing liquidity to financial institutions that were originating mortgages, by increasing access to mortgages, and by making contributions to many American communities. Yet those benefits were undermined by carelessness in the types of securities they purchased and in the desire to compete even when warning signals arose.
- Performance based compensation can be an effective management tool. However, if the compensation is only based on the transactions, and there is no attention paid to quality and to performance over the long term, then this type of circumstance will almost certainly emerge.
- Lowering interest rates to prevent a recession is certainly an understandable goal, especially in light of the nation trauma America suffered in the wake of September 11, 2001; in the fear that an economic downturn similar to what occurred in Japan in the 1990s could occur here, in the goal to increase homeownership, and in the lack of alternative investments. What was not responsible was the encouraging of new financial products without a thorough analysis of what could go wrong, even when many of these implications were being raised publicly.
- Encouraging homeownership amongst groups that have been closed out of the system for decades is both a noble goal and a smart business decision. Yet if no one was looking at how this was occurring, looking at the quality of the mortgages and at the risks embedded in the system, then the very people that should have been helped were hurt.
In the end, the system failed us in that it failed to follow the basic standards that had made mortgage loans safe investments for decades. If a house is no stronger than its foundation, there are areas that simply cannot be justified: a failure to seek information, a lack of willingness to perform the proper due diligence and an unquestioning willingness to pass the risk to someone else. Lenders and brokers made loans without the proper information. Investment bankers sought deal after deal without verifying the lenders’ portfolios. The rating agencies failed to evaluate the mortgage portfolios and to certify they were of the highest quality without that investigation. Investors’ also showed a willingness to trust the word of others without investigating themselves.

In tragedy of this mortgage commons each player acting individually created short term gains at the expense of the long-term health of the whole—and of the individual players as well. One could argue that the only way that this could have been prevented is if there was a body that could look at the emerging situation in its totality and have the authority to enforce a change.

Yet, our regulatory authorities were fragmented and uncoordinated. Some, such as HUD, did not have the information, the capability or the reputation to regulate effectively. Others, such as the FDIC, raised concerns at points, but were not listened to. The most powerful regulator, the Federal Reserve, focused so hard on the benefits of the financial innovations, that it not only did not see the risks, it encouraged continued risky behavior.

Now we face a situation where thousands and thousands of families have lost their homes; where communities all across America are having to cut back valuable services; where the two most powerful mortgage finance corporations are in a government conservatorship; where some of the most respected banks and investment banks are out of business; where international and domestic investors have experienced tremendous losses; where the crisis has spread to countries and institutions all over the world; and where there has been tremendous loss to jobs, to people and their families.

Just as the causes of the crisis were systemic, the solutions must be systemic as well. If we do not assist the large, financial institutions, then we run the risk of economic collapse. Yet if we only help them, particularly with the lack of accountability and transparency we have seen to date, and do not develop a comprehensive system to prevent further foreclosures, then the system will continue to decline – causing more economic losses, more hardship, and more pain.

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The Tragedy of the Mortgage Commons, Ira G. Peppercorn, May 27, 2009