

The Tragedy of the Mortgage Commons

Ira G. PEPPERCORN

President

IRA PEPPERCORN INTERNATIONAL, LLC

WORLD BANK-IFC

WORKSHOP ON HOUSING FINANCE IN SOUTH ASIA

JAKARTA INDONESIA MAY 28, 2009

U.S. Mortgage System

- Formerly mortgage market leader
- Homeownership rates over two-thirds
- Mortgage system collapsed
- U.S. economy in recession
- World-wide impact

Mortgage Crisis 2006-2008

Loss of \$8.3 Trillion

- Americans lost 25%+ net worth (2007-2008)
- Total home equity dropped \$13 trillion to \$8.8 trillion
- Housing prices dropped 20% from peak, with futures markets signaling a 30-35% potential drop
- Foreclosures increased by 225%
- Nearly 2% households in foreclosure; 7% in Nevada

“Sub-Prime” Crisis Misleading

- Sub-prime mortgage for a borrower with less than A credit
- Negative implications for low income and minority borrowers
- 33% Sub-prime borrowers in New York could have qualified for prime mortgage
- Crisis not just about “who,” but “what” and “how”
- Mortgages with multi-layered risks

Comparative Understandings

- Adam Smith: “Individuals acting in their own rational self-interest in a free-market economy leads to economic well-being.”
- Garret Hardin: “An unmanaged commons in a world of limited material wealth and unlimited desires inevitably ends in ruin.”

True Causes

- Competitive “gold rush” environment
- New, risky financial products
- Irrational exuberance and capital flow
- Lack of responsibility and accountability
- Lack of information and documentation
- Federal Reserve: Prevent deflation
- Fragmented regulatory system
- Products outside of regulated sector
- Government unprepared

Prudent Mortgage Lending

- Employment and salary history
- Monthly debt to income ratio (mortgage and total)
- Credit worthiness
- Down payment source and availability
- Documentation and verification
- Property valuation

Institutional History

- Response to Great Depression & banking crisis
 - Creation of FHA: mortgage insurance (1934)
 - Establishment of FNMA: liquidity (1938)
- Fannie partially privatized (1954)
- Institutional change (1960s)
 - HUD, Ginnie Mae, Freddie Mac created
 - Fannie privatized: enters conventional market
- Growth 1970s-1990s)
 - Conventional purchases more than government (1976)
 - Financial safety and soundness oversight (1992)
 - Fannie & Freddie 40% of U.S. mortgage market (1990s)

System Benefits

- Tremendous growth of mortgage market: 68% homeowners
- Development of mortgage standards and discipline
- Down-payment requirements reduced
- Secondary market partnering with governments
- Liquidity for financial institutions
- Not perfect: minority and low income lending

Breakdown of System

- New financial products
- Competitive environment
- Investment bankers and others: market opportunity
- Rating agencies role
- Government regulatory system that was fragmented and ineffective
- Central bank prevent recession
- Capital flowing into system
- Government encouragement

Lending Explodes

- Tremendous opportunities
- Non-traditional mortgages and layering
- Decline of mortgage standards
- Broker and originator frenzy
- Aggressive valuation
- Competition and Compensation

Mortgage Product Innovations

- Piggy back loans (80/20)
- Adjustable rate mortgages
- Stated income loans (Liar's Loans)
- Interest only loans
- Negative amortization mortgages
- Multi-layered risks

Discrimination and Targeting

- Minority borrowers victims of lending institutions
- Mortgage application process intimidating
- Broker and originator less intimidating & mortgage process easier
- Many borrowers had prime or Alt-A credit yet paid 3% more
- Broker, lender, wholesaler incentives for these mortgages

Money Talks

- Americans owed \$8 trillion in mortgages, more than Treasury debt,
- Sub-prime, stated income, Alt-A debt higher yield, higher fees
- Investment banks aggressively pursuing lenders
- Securities issued in tranches
- Asset backed securities in 2007 greater than top 5 banks
- Lenders & investment bankers differences blur

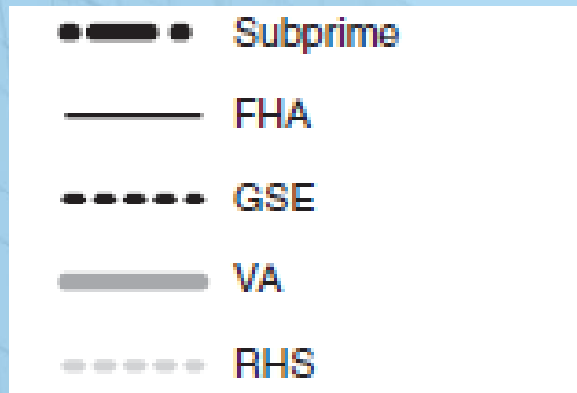
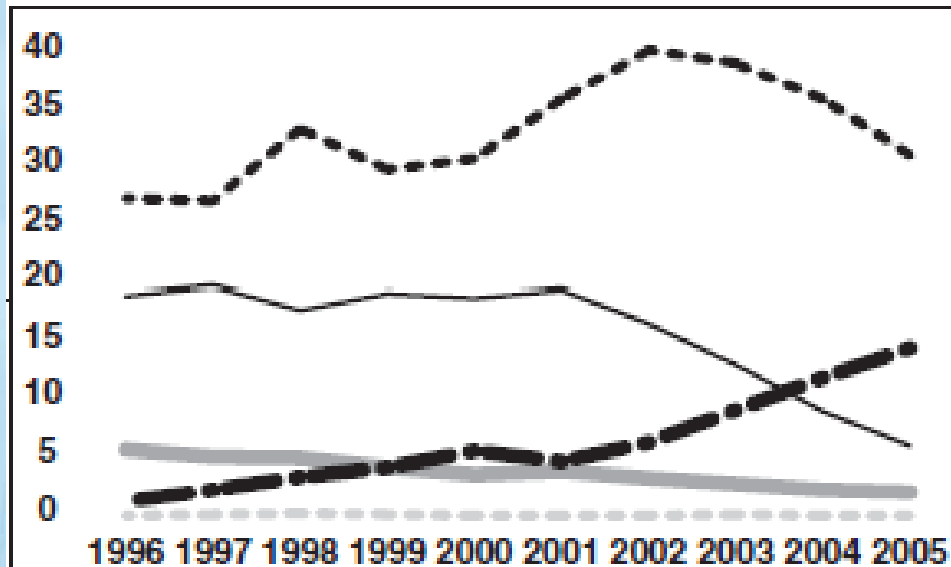
Rating the Rating Agencies

- Rating agencies should perform thorough due diligence
- Gave senior tranches top ratings
- Agencies not required to check information from originators or servicers
- Financial models built on older mortgage models
- Disconnect between value of securities and value of underlying assets
- Who investigated the mortgage portfolios?

Fannie Mae, Freddie Mac Compete

- Accounting scandals 2003-4 hurt reputation
- Other financial organizations gain market share
- Inherent contradiction in government structure
- Fannie Freddie restricted on types of mortgages purchased and guaranteed
- Fannie Mae CEO: “We face two stark choices: one, stay the course; two, meet the market where the market is.”

FHA and GSE Decrease, Sub-Prime Grows



In the Back Door

- Greater spread on investments than purchases
- Sub-prime senior tranche AAA; permitted investment
- Government increases mission goals & relaxes sub-prime standards in 2004
- By 2008, 1/3 sub-prime; 2/3 stated income loans
- Now 68% “private label” securities purchases below investment grade

The Market Overheats

- Intense competition: Compete or die
- Borrowers sold mortgages easier and less upfront, but with long term consequences
- Lack of responsibility; lack of accountability throughout the process
- In a rush, due diligence not thoroughly performed
- Risked passed to next player in the chain
- Compensation not tied to medium or long term performance

Where were the Regulators? Fragmented Regulatory System

- Federal Housing Administration
- Office of Federal Housing Enterprise Oversight
- Office of Thrift Supervision
- Federal Housing Finance Board
- Federal Reserve
- Federal Deposit Insurance Corporation
- Comptroller of the Currency
- Securities and Exchange Commission
- State & local regulators

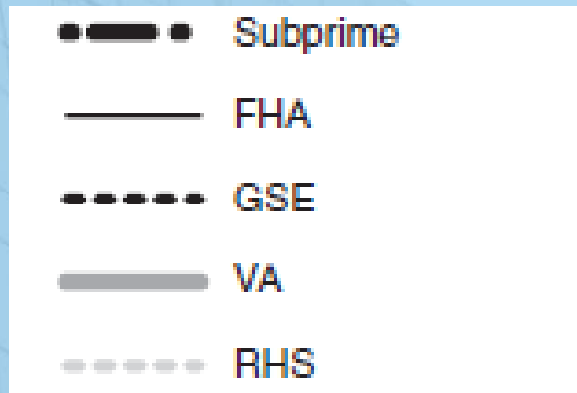
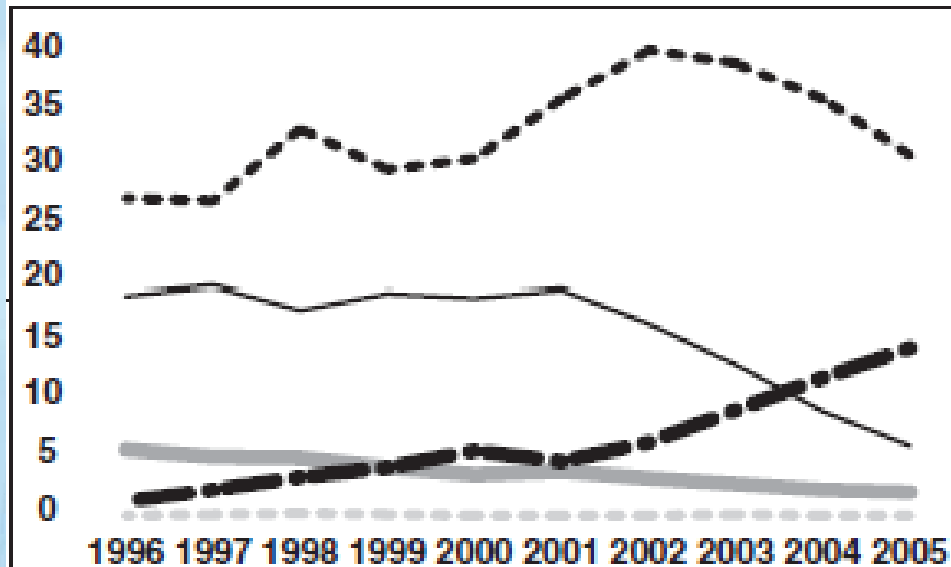
HUD Challenges: Fragmentation, Funding, Credibility

- Regulatory functions split between mission & finance
 - Mission: decrease gap minorities and majority
 - Finance: Safety and soundness
- Lack of funding and staff
- FHA destabilizing communities, not sub-prime loans
- Fannie Mae
 - Community contributions
 - Trillion dollar affordable housing commitment
 - Strong relationships with Congress

Regulation's Catch 22

- Consumer protection causes loss of market share
- Stronger appraisals cause negative reaction
- Prevention of predatory lending (2000) cause more loss of market.
- Anti-predatory lending reversed (2004); helps cause mortgage crisis.

FHA and GSE Decrease, Sub-Prime Grows (Reprise)



GAO Analysis of FHA Market Share Loss

- Product restrictions and lack of process improvements relative to the conventional market
- Product innovations, expanded loan origination and funding channels in the conventional market, interest rate and house price changes
- Less bureaucracy and lower initial costs
- Risk: low initial interest rates could rise substantially in a short period of time

Central Bank: Prevent a Recession

- Federal Reserve powerful; affected monetary policy and market regulation
- Chairman Alan Greenspan had tremendous credibility
- September 11, 2001 caused national trauma & economic tension
- Greenspan feared deflation similar to Asia in 1990s
- Lowered prime interest rate from 3.5% to 1%

Greenspan: Growth, Housing and Regulation

- Housing growth supported by public & private; Democrats and Republicans
- Challenged by Fannie & Freddie accounting scandals & declining customer base
- Greenspan's philosophy: market self discipline better than government bureaucrats
- Housing market rises further, contributing to economic growth
- Supports alternative mortgage, securities and other financial products

Capital Floods In

- Treasury rates low, stock market low, housing sector strong and growing
- International & domestic investors see opportunity
- Move from Treasuries to Fannie & Freddie paper; believe implicit federal guarantee
- Step to non-governmental or GSE securities; AAA, higher yields and market blessing of Fed Chairman
- Capital pushes investment banks, REITs, pushes lenders
- Competitive process becomes circular

2007: The Fix Did not Fix

- Delinquency, default and foreclosure rates increase
- Worse in certain areas: Nevada, Florida, California, Ohio
- Trouble with sub-prime lenders, such as New Century
- Federal government begins to deal, but it is too late

2008: Markets Collapse and Initial Response

- Name firms in trouble: Lehman, Bear Stearns, AIG, Merrill Lynch
- Fannie Mae, Freddie Mac federal conservatorship
- Government policy aims to large organizations to prevent economic collapse
- Policy changes from trouble assets to capital provision

Government Commitments: \$12.2 Trillion

- \$9.0 trillion as an investor
- \$1.7 trillion as an insurer
- \$1.4 trillion as a lender.
- \$2.5 trillion spent through April 30, 2009
- \$10 billion recouped through dividends and fees.

Commitments and Spending (Billions)

FIRM	SPENT	COMMITTED
• Bear Stearns	\$ 29	\$ 29
• Fannie and Freddie	\$ 60	\$400
• AIG	\$ 42	\$ 53
• TARP	\$645	\$700 TARP funds, (TARP funds include AIG (\$70) BofA (\$45) Citigroup (\$50))

Solutions for Homeowners and Communities?

- TARP criticized for lack of transparency and for failure to help homeowners
- Government believed direct aid for homeowners not appropriate
- Help for Homeowners, voluntary lender restructurings: 25 out of projected 400,000
- New \$75 billion program to help four million homeowners, helped 10-55,000 families
- Efforts to assist communities with vacant housing below expectations

Where We Stand Now

- Growth rate in prime now higher than sub-prime 11/08 -2/09
 - Number of prime troubled loans increased 473,00,
 - Subprime mortgages increased 14,000
 - Alt-A loans rose 159,000
- Unemployment: job loss 650,000 jobs per month
- Continued decline of housing prices

Lessons: Individual Actions Understandable

- Closing the gap between minority and majority is right morally and from business perspective
- Sub-prime loans can aid people that could not get prime credit
- ARMs can be useful to enter market & affordability
- Secondary market can spur growth in market
- Performance based compensation can encourage meeting and exceeding goals
- Low interest rates can prevent recession
- New investors can create opportunities

Some Factors Irresponsible

- Pushing loans not in borrowers best interest
- Higher rates, terms to minority borrowers
- Products to avoid borrowers' stake and insurance
- Second mortgages blocking restructurings
- Lack of due diligence on the part of all parties
- Passing along risk without accountability
- Compensation not tied to long term performance
- Encouraging “back door” channels from GSEs
- Failure to follow prudent lending practices

Improve Current Response

- Transparent, accountable aid to large organizations
- Create possibility of public gain
- Strong, coordinated effort to aid troubled borrowers
- Government, Lender, Investor
- Prevent continued decline of neighborhoods
- Coordinated oversight and monitoring

Long Term Musts

- Proper underwriting and verification
- Fairness in lending and consumer disclosure
- Due diligence on the part of all parties: trust, but verify
- Minimization of multiple risk factors
- Mortgage insurance unless significant down payment
- Investment policies consistent with social goals
- Effective, coordinate regulatory system
- Continued efforts to reach out to those closed out
- Do not forget the importance of rental housing


Angels and Devils

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.

Garrett Hardin

Prevent the Next Tragedy

- Provide incentive to act like angels
- Decisive disciplinary actions to prevent devils
- Ensure foundation is strong and firm
- Establish system for financial disaster prevention



Thank You
Terima Kasih

For More Information:
IraPeppercorn@Earthlink.net
+1 (703) 329-2233
New Blog Announced Soon!