A Brief History of the Modern American Mortgage Market & Today’s Financial Crisis

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Presented By:

EMG

Emerging Market Consulting Group

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Alan R. Fowler, CMB
SuSheila Dhillon, CMB
Brian Handal, CMB
The United States mortgage market is undergoing an unprecedented restructuring, forced by a series of painful events to try to reinvent itself into something that can still meet the demands of at least a large portion of the home buying public. The repercussions of the chaos in the mortgage markets have been felt around the world. A surprisingly diverse group, including investors, financial institutions, hedge funds and homeowners worldwide are suffering the effects.

The inevitable question in the time of crisis is “who is to blame?” In this case, there are not enough fingers to point at the complicit partners. Suffice it to say that a perfect storm of events came together at the same time to cause a crisis, the final result of which may not be known for years, and may never be fully understood.

This essay is not an attempt to explain every aspect of the mortgage crisis and its resulting financial impact. There will be no answer to the age old question: “Which came first, the chicken or the egg?” What we will attempt to do is give some historical perspective to the crisis, and perhaps by understanding a few key points to the story, we can avoid some of the costly mistakes made in the past as we restructure the industry, and as other economies around the world look for guidance as they try to build their own mortgage industry.

We will begin with a historical timeline of key events in the modern history of mortgage finance in the United States. From it we will draw some conclusions and attempt to learn some lessons so that the industry can move forward, stronger than it has ever been.

1934 – A severe economic depression hit the United States in 1929 and by 1934 very few Americans were able to buy homes for many reasons, among them: lack of financing. The US Government created the Federal Housing Administration (FHA) to provide guarantees to Banks and Savings institutions in case of borrower default. This insurance encouraged lenders to make mortgage loans because of the protection against losses. Before this, virtually all mortgages were short term loans of five years or less, typically interest-only, with the principal due and payable at the end. If the homeowner could not roll over the loan, the home was foreclosed. As foreclosures skyrocketed, the government invented the modern, long-term, self-amortizing mortgage.

1938 – Banks were still hesitant to make loans because they would be committing too much of their capital into a long term asset (a mortgage), so the government created the Federal National Mortgage Association (later known as Fannie Mae). The purpose of Fannie Mae was to purchase mortgage loans from the banks, freeing up capital for the banks to make new loans. Their mission, therefore, was to ensure liquidity in the mortgage market.
Although Fannie Mae began with just $1 billion in capital, the agency helped usher in a new generation of American home ownership, paving the way for banks to loan money to low- and middle-income buyers who otherwise might not have had the means to buy a home.

Initially, Fannie Mae operated like a national savings and loan, allowing local banks to charge low interest rates on mortgages for the benefit of the home buyer. Fannie Mae would buy the closed loans from the bank and either hold them in their portfolio or sell them to private investors. They would typically hold about 20% of the loans in their own portfolio.

Fannie Mae acted to equalize mortgage supply and demand in capital rich and capital poor areas. For example, funds from well capitalized banks in New York could be used to fund loans in Kansas, where the banks had limited funds. For the first thirty years following its inception, Fannie Mae held a veritable monopoly over the secondary mortgage market.

1946 – The end of World War II and the return of many soldiers to start families ended the housing depression. Seventeen years of pent up demand was unleashed, and the demand for housing and housing finance reached unprecedented levels. Through FHA (which allowed low down payments) the government fulfilled much of the demand for funds by the lenders, and many of the funds were provided by Fannie Mae.

1949 – Fannie Mae began purchasing loans insured by the VA loan Guarantee program, which provided insurance on home loans to military veterans and required no down payment. It was at this point that Fannie Mae received its first criticism that it was encroaching too far on the territory of the private sector.

1954 – The US Congress passed the Federal National Mortgage Association Charter Act which began to transition the ownership of Fannie Mae. Stock was issued to the US Treasury department and to participating banks and lenders, who were required to own stock in order to sell or service loans for Fannie Mae. Fannie Mae continued its purchase of FHA and VA Loans.

1966 – A liquidity crisis began early in the year, and Fannie Mae was called upon to satisfy lenders need for mortgage money. Fannie Mae had to borrow funds at high rates in order to ensure enough funds were available to lenders and their borrowers. The crisis subsided, but appeared again later in the year. It became obvious that, under its current structure, Fannie Mae would not be able to fill the needs of the mortgage market in a protracted credit crisis.

1968 – The 22 year run on housing caused tremendous growth of Fannie Mae, which along with a resource draining war in Vietnam, was putting a strain on the Government balance sheet. The debt of Fannie Mae was the debt of the Federal government. Eager to make things look better, the Administration of US President Lyndon Johnson re-chartered Fannie Mae into a private company with private stockholders and capital sources. However, the company maintained a public mission through its charter that was issued by the federal government. This became the first “Government Sponsored Enterprise” (GSE). Fannie Mae’s Charter describes the company’s purposes, which can be summarized as follows: To provide stability to the secondary
market for residential mortgages and to bring liquidity to all mortgage credit markets. In its new structure, Fannie Mae answered to the US Department of Housing and Urban Development (HUD).

Simultaneously, the government created a new corporation called the Government National Mortgage Association (GNMA or “Ginnie Mae”). Ginnie Mae took many of the “Special Assistance” functions of Fannie Mae and began insuring FHA and VA loans, along with other special government lending programs.

1969 – Countrywide Mortgage was founded by Angelo Mozilo in Calabasas, California.

1970 – The government organized and chartered a second GSE, the Federal Home Loan Mortgage Corporation (“Freddie Mac”). Freddie Mac’s purpose was to offset Fannie Mae’s perceived monopoly of the secondary mortgage market. Their primary function was to purchase loans from the nation’s large number of Savings and Loan associations, while Fannie Mae focused on Banks and other mortgage finance companies.

Fannie Mae formed a new Board of Directors, with 10 members elected by the stockholders and five appointed by the President of the United States.

Also that year, GNMA issued the first ever Mortgage Backed Security (MBS). GNMA pooled similar loans and issued securities on those pools to private investors. GNMA insured that the investors in the securities received their “Pass Through” amount from the security each month.

1972 – Fannie Mae and Freddie Mac began purchasing “conventional” mortgages – mortgages that were not guaranteed by FHA or VA. In order to allow borrowers to put minimum down payments (less than 20%) the loans required insurance from newly formed “Private Mortgage Insurance” (PMI) companies.

1979 – The United States faced an unprecedented period of high inflation and high interest rates. Fannie Mae and Freddie Mac began purchasing Adjustable Rate Mortgages (ARM’s). This benefited themselves, the lenders and the borrowers. Fannie Mae and Freddie Mac were able to add assets to their portfolio that had interest rate changes that mirrored the changes in their cost of funds. The lenders were able to add a new, popular program to their product mix, and borrowers seemingly benefited because the interest rate on the ARM was significantly lower than on fixed rate loans, lowering payments or, more often, allowing them to purchase more expensive homes.

In the years to follow, more innovative products were designed to allow more people to qualify for mortgages. Some examples of these new products include Buy-Downs (where the seller subsidizes the borrower’s payments for a short period of time), Graduated Payment Mortgages (where the payment starts at a lower level and annually increased), Negative Amortization Loans (where the payment is less than the amount needed to amortize the loan, so the difference is added to the balance of the loan each month) and others.
1983 – The first innovation in Pass Through Securities, the “Collateralized Mortgage Obligation” (CMO) was issued by Fannie Mae. A CMO takes a series of mortgage backed assets and divides them into several different classes (or “Tranches”) based on different characteristics such as maturity and cash flows. This allows the instrument to be sold to different classes of investors with different financial objectives and risk tolerances. For example, many investors stayed away from MBS because of “Pre-Payment Risk”. That is, in a falling interest rate environment, borrowers tend to pay off their mortgages at an accelerated pace because they refinance into loans with a lower rate. The investors receive their share of the principal back in a lump sum, requiring them to reinvest those funds in the new, lower rate environment. CMO’s are able to address that issue by issuing classes that are less affected by pre-payment risk.

NOTE: Pass Through Securities
The advent of the Pass Through Security added a dramatic new level of liquidity to the mortgage market. Lenders that wanted to quickly sell their portfolio of loans had limited buyers up to this point. Loans could be sold to large financial institutions, insurance companies and pension funds, but this market was not considered to be very liquid. This presented huge risks to lenders holding the portfolios, especially in regards to the interest rate environment. Lenders, whose capital comes mostly in the form of short term deposits, were forced to hold long term loans. As rates rose, they were forced to pay higher interest to their depositors, but could not raise the rates on their long term mortgages outstanding. Therefore their interest expenses would increase without a corresponding increase in interest income.

The ability to quickly package and sell their loans in the form of a pass through security greatly diminished this risk. Investors liked the securities as well, because there was a liquid market where their interests could be bought and sold quickly and with relatively low cost.

GNMA, as a government agency, receives a benefit (i.e. lower borrowing costs) when raising funds by issuing debt against mortgages because they are backed by the full faith and credit of the US government. Fannie Mae and Freddie Mac have enjoyed a similar advantage. Although they are private companies, the market has assumed that their obligations would also be backed by the government (even though that backing was not explicit). That assumption turned out to be correct in September of 2008. Another benefit Fannie Mae and Freddie Mac received was reduced costs in the form of decreased tax burdens (they paid no Federal income tax) and lighter financial reporting requirements.

1983-1987 – The industry saw an unprecedented boom of refinances. As interest rates declined from 18.5% to 8.5%, a majority of mortgagors refinanced their loans into lower rate mortgages. The results were numerous. Wall Street as well as Fannie Mae and Freddie Mac continued to create more flexible and creative securities to satisfy the exploding demand from the industry.

During this time, the mortgage industry exploded with new companies, new structures and new employees. We saw the rise of mortgage lenders who strictly originated loans and then sold the loans and their servicing rights to another lender, who would then package the loans for sale into the secondary market (Correspondent Lending). Also, there was a huge increase in the number of Mortgage Brokers, who would originate loans on an independent basis for other
lenders (Wholesale Lending). The result was an increase in the number of layers between the borrower and the provider of funds. Many of those layers had little or no incentive to see that the borrower was able to stay in the home and have the ability to repay the loan in a timely manner, nor concern about the performance of the MBS asset being created.

Also during this time, foreign investors increased their appetite for American Mortgage Backed Securities. Asian investors, in particular, invested many of the dollars they had been receiving through their imbalanced trade with the US into the US MBS market, providing ample liquidity for the increased demand for mortgages.

1986-1995 - Savings and Loans, US financial institutions with a history going back to the 1800’s, had a simple mission of holding deposits and lending those deposits in the form of home loans. The 1980’s saw changes in the regulatory environment for S & L’s that allowed them to expand their traditional lines of business. Between a problem with duration miss-match (long term, low fixed rate mortgage interest coming in, rising rates on short term deposits going out), unstable real estate prices and a remarkable increase in fraud, the S&L crisis cost US taxpayers nearly $500 billion and the number of S&L’s in the US dropped from 3,234 to 1,645. (Source: FDIC Banking Review).

April 10, 1987 – Several factors converged, including a sudden decrease in demand by Asian investors, to cause a severe increase in interest rates. In one day, the average rate on a 30 year fixed rate loan went from 8.5% to 10.0%. From the point of view of a lender, this was catastrophic. Over the preceding years, lenders had begun the practice of “locking in” interest rates for borrowers while the loan was in process. The lenders would hold a certain rate for the borrower until closing, and not charge a fee. So, if a lender locked a loan on April 1 that was worth 100% of the loan amount, the value of that loan would have gone down to 90% on April 10, 1987. For every $100,000 in loans that the lender had locked in, they lost $10,000. Many did not survive the impact of that day. The idea of “hedging”, or holding financial instruments that make money when the lender’s mortgages lose money, was relatively new to the industry in 1987, but became much more popular after this lesson was learned. Competitive forces, however, kept lenders from charging for the practice of locking in loans. The need for more and more complex hedging instruments would come into play again in the future.

1987 – Fannie Mae issued the first Real Estate Mortgage Investment Conduit (REMIC), which were created by the Tax Reform act of 1986. REMICs are a flexible form of CMO’s that contain certain tax advantages and could be specifically tailored to attract investors not typically drawn to mortgage related investments. A REMIC is a class of Special Investment Vehicles (SIV’s) that would continue to evolve over the next two decades.

1988 – Fannie Mae stock was added to the Standard & Poor’s 500 index.

1989 – Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act ("FIRREA") of 1989 which made regulation of Fannie Mae and Freddie Mac consistent. Until 1989, Freddie Mac was owned by the Federal Home Loan Bank System and its member thrifts
and governed by the Federal Home Loan Bank Board (later reorganized into the Office of Thrift Supervision). FIRREA severed Freddie Mac's ties to the Federal Home Loan Bank System, created an 18-member board of directors to run Freddie Mac, and subjected it to HUD oversight.

Also, The US government conducted studies of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. These studies laid the foundation for comprehensive regulatory modernization for both Fannie Mae and Freddie Mac in 1992.

1990 – Traditional mortgage powers like Citibank and Countrywide, along with corporate giants like Merrill Lynch and Sears became more active in the secondary market, bypassing the traditional process of Fannie Mae and Freddie Mac and creating what would become known as “Private Label Securities”. These securities were formed by lenders aggregating their loans through intermediaries called “conduits” and packaging the loans into various forms of security vehicles for sale into the secondary market trough Wall Street.

1992 – The US government passed the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (FHEFSSA), which increased government oversight over the GSE's. It created the Office of Federal Housing Enterprise Oversight (“OFHEO”) as a new regulatory office within HUD with the responsibility to "ensure that Fannie Mae and Freddie Mac are adequately capitalized and operating safely." OFHEO was given independent but limited authority over Fannie Mae and Freddie Mac, and was charged with establishing minimum capital standards for each company and verifying that they meet those standards. Additionally, HUD was given authority to mandate goals for the companies to ensure a percentage of their loans to low income borrowers and in disadvantaged areas.

The government was criticized by many people for setting the capital requirements too low, as they were roughly 1/5th of those for other banking institutions. In times of crisis, they say, Fannie Mae and Freddie Mac would not be able to cover any substantial losses, leaving the American taxpayer to cover them, and causing possible worldwide economic instability.

1992-1999 – The US economy exited recession and saw a period of mostly low rates, with the notable exception of a market jolt in 1994. The new mandates imposed by FHEFSSA caused Fannie Mae and Freddie Mac to develop new programs that encouraged lending to those who had been traditionally left out of homeownership. They struggled to develop programs that would encourage homeownership but not raise the risk of losses to their stockholders.

There was a strong push across the country to increase the homeownership rate. After a steady increase in that percentage after World War II, homeownership declined in the 1980's (see Chart 2 in Appendix 1). The new goal was to increase homeownership in the US to 70%. The time seemed right for such a goal. Property values were steadily increasing, interest rates were relatively low, mortgage money was flowing through new and traditional sources, mortgage programs had never been more diverse, and there was a mortgage industry full of people eager to earn a good living by filling the need for homeownership. Lenders derived a
higher and higher percentage of their production through the wholesale and correspondent channels, and the number of mortgage brokers grew at a tremendous rate. Unfortunately, many people also entered the industry that saw it as an easy place to make profits at the expense of others. Their transgressions were often either overlooked or ignored because increasing property values and steady, low interest rates kept problems from becoming too obvious. “Subprime” mortgages, or loans to borrowers with credit that would not allow them to qualify for prime rate mortgage products, increased from $35 Billion to $125 Billion in this period, according to Inside B&C lending.

During this time, many began to worry that the GSE’s had grown too large, were making too many profits at the expense of the rest of the industry, were encroaching into the primary market (which is against their charter) and were posing too great a risk to the American and world economy if they were to fail. There was not a great deal of confidence in OFHEO’s ability to effectively regulate Fannie Mae and Freddie Mac. A group of major lenders and financial services companies began a group called “FM Watch” to shed light on the practices of the 2 GSE’s that they felt were threatening to the industry and the economy.

1998 – The US Budget deficit, which had been running at record levels for much of the last 20 years, shrank and turned into a surplus. With the possibility of reduced government borrowing needs, and therefore a reduction in government bond issuance, discussion began that would have made Fannie Mae and Freddie Mac mortgage securities the new “benchmark” for risk free interest rates. The rationale was that the size of the mortgage securities market would soon be larger than that of the US Treasury market, and the implicit government guarantee behind Fannie Mae and Freddie Mac made the risk their securities similar to those of Treasury securities. The increasing budget deficits and reduction of market share for Fannie Mae and Freddie Mac in the following years quickly put an end to those discussions.

2000 – The US economy slipped into mild recession, but housing prices continued to rise. The Federal Reserve decided to keep the economy growing with a policy to lower short term interest rates from their already low levels. Fannie Mae posted its 14th straight year of significant earnings increases, and 10 straight years of double digit increases in Earnings-Per-Share.

HUD, in a new rule, identified subprime borrowers as a market that could help Fannie Mae and Freddie Mac achieve the affordable housing goals HUD had set for them. The GSE’s continued to stretch their criteria as far as higher LTV’s and lower credit scores, and bought an increasing number of securities backed by sub-prime loans.

September 11, 2001 – The terrorist attacks on the World Trade Center and Pentagon threatened to send the US economy into a severe recession. The Federal Reserve dropped their Discount Rate to .75%. Mortgage rates followed and some 30 year fixed rate loans fell below 5%. The robust housing market was the key to reviving the economy. People continued to spend by using the new equity in their homes.
2002 – HUD sets a goal for the GSE’s to have 50% of their loans be for low and moderate income buyers. Each GSE hit their goal by expanding affordable housing products and purchasing pools of loans rich in low and moderate income borrowers, including sub-prime loans.

2003 – The Federal Reserve lowered the Federal Funds rate to a historic low of 1.0%. Interest rates end their 21 year trend of steady decline and settle in to a very tight range, at very low levels, for the next 5 years. The mortgage industry, which had grown to over 600,000 people, and the secondary market, along with all the players who helped bring the mortgage loans to the market, created industries that must be fed a huge supply of new loans. With the stable interest rates, there was no longer the steady supply of current mortgagors wanting to refinance to lower their rate. Mortgage lenders and Wall Street tried to increase volume in other areas.

Also in 2003, according to OFHEO, Fannie Mae and Freddie Mac issued a record $1.9 Trillion in Mortgage Backed Securities, had $1.5 Trillion of mortgages in their portfolios and had $2.05 Trillion in MBS outstanding. The 1.9 trillion in MBS represented 50% of all mortgage originated that year, according to OFHEO’s 2004 report to Congress. Of the $3.8 trillion in originations, fully 60% were refinances. All together, Fannie and Freddie guaranteed or held over $6 trillion in US mortgage debt. That year OFHEO also enforced action against Freddie Mac, forcing out and filing charges against its executive leaders, over an accounting scandal. In response, OFHEO also requested documents from Fannie Mae to investigate their accounting practices.

2004 – Home prices in the US increased at 11.9%, as home sales and mortgage originations remained at historic levels. HUD’s goals for lending to Low and moderate income borrowers increased to 52%.

OFHEO took administrative action against Fannie Mae, forcing out its executive management over another accounting scandal. Earnings of both GSE’s remained high, but their market share slipped because of the significant growth in the issuance of “Private Label” MBS with loans that would not fit into Fannie or Freddie purchase parameters because of product guidelines.

2004 – 2006 Interest rates remained constant, so the number of refinances to purely reduce interest rates declined dramatically. Making loans to buyers of investment properties as well as the success of the following four products filled the gap left by the lack of pure “Rate/Term” refinances:

1) Subprime loans: The rates on these loans, though higher than rates on prime loans, began to go down and be more attractive to borrowers. Also, qualifying criteria eased. Many borrowers did not have to verify income in order to qualify. Also, Loan-to-Value ratios increased to, in some cases, 100%. This brought millions of new borrowers into homeownership, and allowed many others to refinance their current residences and pull out the equity they had built.
2) Alternative Documentation Loans – These loans were designed for self employed borrowers with complicated financial reports. Traditionally, these loans required borrowers to have excellent credit histories and low loan to value ratios. Those standards relaxed significantly during this period.

3) 80/20 loans. These loans allowed borrowers to avoid buying “Private Mortgage Insurance” (PMI) that was usually required on any conventional loan with an LTV above 80%. In this scheme, borrowers received an 80% first mortgage and a 20% second mortgage.

4) Option ARM loans: these adjustable rate loans contained options to repay that ranged from paying the principal and interest to amortize in a normal period to paying interest only for a period, for example 10 years, to a very low payment that would not even cover the interest due each month. The shortfall in those cases was added to the borrower’s principal so that they owed more at the end of the month than they did at the beginning. Often these loans came with “teaser rates” or rates as low as 1% for a very short period of time.

Volume of these products was extremely high during this period, and their performance to thatpoint was good. Remember, however, that home prices were increasing rapidly, so if any of these borrowers did have trouble paying their mortgage, they were able to sell the home for a profit. Another alternative was for the borrower to obtain second mortgages against the new equity in their homes.

“Predatory Lending,” where a borrower is approved for a mortgage regardless of whether they can afford the payments over the long term, often with rates and terms that are unreasonably high, became prevalent, especially among mortgage brokers. The lenders, in a frenzy to continue their increased profits, continued to buy the loans. Wall Street firms such as Bear Sterns and Lehman Brothers continued to securitize them as the rating agencies like Standard & Poor’s gave the securities good ratings.

The market share of the GSE’s slipped from over 50% to below 33%. The new HUD goal for low and moderate income lending became 55% of units. In order to meet this goal, the GSE’s expand their criteria even further by lowering credit score tolerances and increasing Loan-to-value limits. Also, they actively purchase mortgage portfolios that have loans that help meet their targets. Many of those loans were sub-prime. The GSE’s had also found that the return on the securities backed by sub-prime mortgages brought high returns, helping them increase earnings for their shareholders.

Home prices increased in 2006 by 5.9%, according to OFHEO. During the summer of 2006, most areas saw their home values peak and start to decline.
March, 2007 – As delinquencies in the subprime market began to increase, many of the large sub-prime lenders failed, triggering a loss of confidence in the MBS market.

August, 2007 – Continued losses in subprime loans, as well as fear that troubles could spill over into the prime mortgage markets, triggered a worldwide credit crisis, making it difficult for holders of mortgage portfolios to find buyers, even if the assets were performing.

The market share of Fannie Mae and Freddie Mac began to rise sharply as the alternative sources of mortgage capital dried up. At the same, according to Bloomberg.com, shares of Fannie Mae hit a high of $77 a share.

September 2007 – March 2008 – Credit markets continued in turmoil. The market for private label securities dried up, and many mortgage products were no longer available. Fannie Mae, Freddie Mac and the US government programs for FHA loans became the main outlet for mortgages, and Congress pushed to give each of those agencies more flexibility in dealing with the crisis. Fear that the GSE’s were not well enough capitalized start to grip the market. Fannie Mae stock lost 67% value, falling to the $25 range.

Banks and other financial firms with exposure to mortgages began to see their stock prices fall and they are unable to sell off any of the mortgage assets, even the ones that were performing. The list of mortgage companies that failed grew into the hundreds. The largest mortgage company in the US, Countrywide mortgage, was sold to Bank of America after its stock price plummeted due to its heavy exposure to subprime and option ARM loans.

March 2008 – OFHEO lowered the GSE capital requirements by $200 billion to help them have flexibility to continue pumping liquidity into the mortgage market. According to OFHEO, the GSE’s accounted for over 75% of all new mortgage volume in the US at that time.

July 11, 2008 – Shares of Fannie Mae and Freddie Mac plummeted further as speculation intensified that the Government was preparing to take them over. The fear was that rising delinquencies and foreclosures would cause losses that the GSE’s would not be able to cover with their limited capital.

July 30, 2008 – President Bush signs a housing bill that placed a new regulator, the Federal Housing Finance Agency, which would have broad powers to place restraints on the GSE’s. Speculation that a government bailout was in the works for the GSE’s became prevalent.

September 5, 2008 – Central banks and large commercial investors in China, Russia and other countries consulted with the US Treasury Department informing them that they had lost confidence in the securities backed by Fannie Mae and Freddie Mac and would no longer purchase them. Foreign investors had already lost much of their appetite for the existing securities of the GSE’s. The US government signaled that they would guarantee the debt, and would announce a restructuring by the following Monday.
September 8, 2008 – The US Government placed Fannie Mae and Freddie Mac under government receivership, making the government responsible for the $6 trillion in mortgages that the agencies owned or guaranteed. The $6 trillion figure was over half of the approximately $12 trillion in total mortgages outstanding in the US. The markets rallied for the day, and rates on mortgages in the US dropped significantly due to the renewed willingness from investors to purchase GSE securities. "This euphoria might fade, because Fannie and Freddie are not the problem," said Christopher Low, chief economist at FTN Financial. "Their woes are a symptom of a worldwide contraction in credit that may not be cured by the decision."

September 15, 2008 – Lehman Brothers, a 150 year old Wall Street investment house, filed for bankruptcy after it failed to recapitalize or find a suitable buyer, and the US government declined to step in and bail them out. The losses due to Lehman’s bankruptcy will be huge, but the US government saw that eventuality as something that the financial markets could absorb. Simultaneously, Bank of America agreed to buy Merrill Lynch for $50 billion, much less than its value only days before. Both Lehman and Merrill had significant exposure to real estate loans.

September 16, 2008 - American Insurance Group (AIG), the world’s largest and most diversified insurance company was close to bankruptcy. Ratings agencies lowered AIG’s ratings due mostly to a unit if AIG that had liability for over $400 billion in financial derivatives tied to mortgage loans, triggering the need for billions of dollars in available funds, which AIG did not have. AIG had no lack of assets, but the type of assets they have require time to be sold. The government saw the impact of a default by AIG as potentially crippling to world financial markets. Many world stock exchanges were rumored to be unable to open if such an event occurred. The US government offered a loan to AIG for $85 billion. The loan has a very high rate, so AIG has incentive to quickly sell assets in order to pay it back.

September 19, 2008 – US Treasury Secretary Henry Paulson issue a statement (attached) that acknowledged that the government intervention to date had not had enough impact to ensure the continuance of the world financial system in an orderly fashion. The administration proposed a new entity within the US government that would buy trouble assets of US financial institutions, thereby relieving them from private balance sheets and restoring confidence in the financial system. The plan appropriated $700 billion in order to buy these assets. The government can sell these assets at a later time in order to recoup some of its expenses. The markets, which had experience one of the most tumultuous weeks in history, reacted favorably to the news.
Appendix 1: Charts and Supplemental Information
Interest rates, homeownership rates, home prices and the mortgage market:

Below is a chart of 30 year fixed mortgage rates from 1971 – 2008:

Chart 1

30 Year Fixed Interest Rate Trend
Apr 1971 - Dec 2007

Chart 2

U.S. Homeownership Rates, 1900-2008
The post depression boom in housing caused the rapid increase in homeownership between 1940 and 1970. Rising inflation in the 1970’s and high interest rates in the early 1980’s slowed the increase and caused a short period of decrease in homeownership rates. (Chart 2) Note the peak in mortgage rates at 18.5% in 1982 (Chart 1) and the rapid decent of those rates through 2003. That sustained downward trend in interest rates caused the mortgage industry to, for the first time, create substantial income from refinancing mortgages. As rates dropped, people with higher rates refinanced into lower rates. The short spikes in rates during the 1982-2003 period served to make a market of homeowners who would again need to refinance when rates returned to their downward trend. They were easily able to do this because of the rapidly appreciating property values at that time (Chart 3).

The result was that the mortgage industry grew in size and sophistication. The number of loans that were securitized grew to mammoth proportions. The industry began to heavily rely on the refinance business for much of its profit and Wall Street began to rely on the product to satisfy investor demand.

Once rates leveled off in 2003, the regular refinance business slowed. Lenders and Wall Street came up with new products, or expanded the criteria for existing products, that would replace that volume. Subprime loans began to allow higher Loan-to-Value ratio and offer lower rates relative to prime loans. “Alt-A”, or loans that required little or no asset and income documentation, allowed many people who would not qualify for the inflated property values to obtain financing. Option ARM loans, that had very low initial rates but would allow significant negative amortization, became popular in the highest cost areas of the country, like California.

Falling values, which began in 2006, would expose the flaws in the system: Many people were in homes that they could not afford; they started with little or no equity; once values began to fall, many owed more than their home was worth and; security holders began to see defaults far beyond what they expected based on the risk levels assigned to them. This led to the closing or devaluation of many financial firms and caused a liquidity crisis in financial markets around the world due to the sheer size of the mortgage securities market, and its complexity.
September 19, 2008
hp-1149

Statement by Secretary Henry M. Paulson, Jr. on Comprehensive Approach to Market Developments

Washington, DC—Last night, Federal Reserve Chairman Ben Bermanke, SEC Chairman Chris Cox and I had a lengthy and productive working session with Congressional leaders. We began a substantive discussion on the need for a comprehensive approach to relieving the stresses on our financial institutions and markets.

We have acted on a case-by-case basis in recent weeks, addressing problems at Fannie Mae and Freddie Mac, working with market participants to prepare for the failure of Lehman Brothers, and lending to AIG so it can sell some of its assets in an orderly manner. And this morning we’ve taken a number of powerful tactical steps to increase confidence in the system, including the establishment of a temporary guaranty program for the U.S. money market mutual fund industry.

Despite these steps, more is needed. We must now take further, decisive action to fundamentally and comprehensively address the root cause of our financial system’s stresses.

The underlying weakness in our financial system today is the illiquid mortgage assets that have lost value as the housing correction has proceeded. These illiquid assets are choking off the flow of credit that is so vitally important to our economy. When the financial system works as it should, money and capital flow to and from households and businesses to pay for home loans, school loans and investments that create jobs. As illiquid mortgage assets block the system, the clogging of our financial markets has the potential to have significant effects on our financial system and our economy.

As we all know, lax lending practices earlier this decade led to irresponsible lending and irresponsible borrowing. This simply put too many families into mortgages they could not afford. We are seeing the impact on homeowners and neighborhoods, with 5 million homeowners now delinquent or in foreclosure. What began as a sub-prime lending problem has spread to other, less-risky mortgages, and contributed to excess home inventories that have pushed down home prices for responsible homeowners.

A similar scenario is playing out among the lenders who made those mortgages,
the securitizers who bought, repackaged and resold them, and the investors who bought them. These troubled loans are now parked, or frozen, on the balance sheets of banks and other financial institutions, preventing them from financing productive loans. The inability to determine their worth has fostered uncertainty about mortgage assets, and even about the financial condition of the institutions that own them. The normal buying and selling of nearly all types of mortgage assets has become challenged.

These illiquid assets are clogging up our financial system, and undermining the strength of our otherwise sound financial institutions. As a result, Americans’ personal savings are threatened, and the ability of consumers and businesses to borrow and finance spending, investment, and job creation has been disrupted.

To restore confidence in our markets and our financial institutions, so they can fuel continued growth and prosperity, we must address the underlying problem.

The federal government must implement a program to remove these illiquid assets that are weighing down our financial institutions and threatening our economy. This troubled asset relief program must be properly designed and sufficiently large to have maximum impact, while including features that protect the taxpayer to the maximum extent possible. The ultimate taxpayer protection will be the stability this troubled asset relief program provides to our financial system, even as it will involve a significant investment of taxpayer dollars. I am convinced that this bold approach will cost American families far less than the alternative — a continuing series of financial institution failures and frozen credit markets unable to fund economic expansion.

I believe many Members of Congress share my conviction. I will spend the weekend working with members of Congress of both parties to examine approaches to alleviate the pressure of these bad loans on our system, so credit can flow once again to American consumers and companies. Our economic health requires that we work together for prompt, bipartisan action.

As we work with the Congress to pass this legislation over the next week, other immediate actions will provide relief.

First, to provide critical additional funding to our mortgage markets, the GSEs Fannie Mae and Freddie Mac will increase their purchases of mortgage-backed securities (MBS). These two enterprises must carry out their mission to support the mortgage market.

Second, to increase the availability of capital for new home loans, Treasury will expand the MBS purchase program we announced earlier this month. This will complement the capital provided by the GSEs and will help facilitate mortgage availability and affordability.

These two steps will provide some initial support to mortgage assets, but they are not enough. Many of the illiquid assets clogging our system today do not meet the
regulatory requirements to be eligible for purchase by the GSEs or by the Treasury program.

I look forward to working with Congress to pass necessary legislation to remove these troubled assets from our financial system. When we get through this difficult period, which we will, our next task must be to improve the financial regulatory structure so that these past excesses do not recur. This crisis demonstrates in vivid terms that our financial regulatory structure is sub-optimal, duplicative and outdated. I have put forward my ideas for a modernized financial oversight structure that matches our modern economy, and more closely links the regulatory structure to the reasons why we regulate. That is a critical debate for another day.

Right now, our focus is restoring the strength of our financial system so it can again finance economic growth. The financial security of all Americans — their retirement savings, their home values, their ability to borrow for college, and the opportunities for more and higher-paying jobs — depends on our ability to restore our financial institutions to a sound footing.

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