Home Spun
An analysis of housing finance in America
Jim Reber
Sponsored by ICBA Securities
AND THE FUTURE OF HOUSING FINANCE IN
SUPPLEMENT OF ICBA INDEPENDENT BANKER
CONTINUES ON. THIS SPECIAL EDITORIAL
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Depression baby
Throughout most of the 1930s the U.S. housing market was in poor shape, as could be expected with unemployment rates over 20 percent and asset values depressed. Home mortgage loans, for those who could afford them, were limited to about half of the value of the property. Also, self-amortizing loans had not yet developed, typical terms were interest-only balloon loans with three- to five-year terms.

To encourage banks to make longer-term, fixed-rate loans in such an environment, Congress created the Federal Housing Administration in 1934. The FHA’s mission then, which continues today, was to provide insurance against default to the lenders. The cost of this insurance was actually born by the borrower, who in most cases wouldn’t qualify without the FHA guaranty. This insurance cleared the way for banks and thrifts to lend money, and for longer terms, as the insurance was required for a relatively long period of time.

Still, the notion of a long-term fixed-rate loan was unsettling for the nation’s lenders. In response to this, the Federal National Mortgage Association, which later became known as “Fannie Mae,” was created by Congress in 1938. Originally Fannie Mae was a direct obligation of the U.S. government.

Fannie Mae was a standing buyer for these loans, thereby providing needed liquidity for the housing industry. It was during this time that the nation was suffering a relapse into recession, even in the midst of the Great Depression. Plenty of evidence suggests that the FHA’s and Fannie Mae’s existence kept the nation’s economic health from being even worse than it was.

New market
Fast forward now to the post-war era in our nation’s housing. Returning veterans who were starting families and going to college on the GI Bill were in need of a place to live, and homebuilding grew at a frenetic pace. The Veterans Administration helped out by guaranteeing FHA loans, which actually bore the risk of default by the borrower, who in most cases wouldn’t qualify without the FHA guaranty. This insurance cleared the way for banks and thrifts to lend money, and for longer terms, as the insurance was required for a relatively long period of time.

Congress took the step of making Fannie Mae a private entity, owned by shareholders but regulated by the Department of Housing and Urban Development (HUD). This was the first government-sponsored enterprise. Fannie Mae was able to finance itself very efficiently thanks to the government sponsorship.

Also in 1968, Congress created the Government National Mortgage Association to administer FHA/VA guaranties. “Ginnie Mae” remains a full faith and credit obligation of the federal government. Two years later saw the creation of “Freddie Mac,” or the Federal Home Loan Mortgage Association. Freddie Mac’s congressional charter, mission and funding were and are very similar to Fannie Mae’s.

Spread the risk
About this time mortgage securities appeared. Ginnie Mae is credited with the first mortgage-backed security (MBS) issuance. Initially MBSs were of the “straight-through” variety. In this structure, an investor will receive a pro-rata distribution of all principal and most interest received from all borrowers whose loans collateralize the pool. The individual loans are very homogenous, in that they have to have similar note rates, remaining terms and credit quality, and be of a conforming loan size.

The benefits of pooling and securitization are numerous. For one, the lender (seller) is able to dispose of an asset that may not meet its cash flow and average maturity criteria. If the seller retains the servicing, which is

common, the sale of the loan is not visible to the borrower. The pooling process both diversifies the prepayment risk over a wide range of loans, and certainly improves the liquidity of the assets. Agency MBSs are very easily purchased and sold in a highly visible market.

An indication of their liquidity is the ease by which they are pledged against FHLBank advances or other borrowings. As Ginnie Mae is a direct instrument of the government, its securities carry a zero percent risk weighting. Guaranteed timely payment of principal and interest makes these securities suitable from a credit risk standpoint for financial institutions. Ginnie Mae securities are collateralized by FHA/VA loans; recall that in this era, most new originations were of this variety.

Conventional mortgages began appearing on the scene in the early 1970s, and these became the collateral for Fannie Mae/ Freddie Mac pools. As Fannie and Freddie were government-sponsored enterprises, with an implied guaranty from the government, their pools are 20-percent risk weighted. Their cash flow, average life, price volatility and liquidity characteristics are very similar to Ginnie Mae’s pools.

However, for many of the same reasons that banks and thrifts wanted to sell the individual loans, these same institutions were reluctant to buy the pass-through securities. The most tangible of these was the long duration. Thirty-year fixed-rate amortizing securities have an average life at the outset of about 10 years.

This also assumes a certain amount of prepayments, which over a wide population of loans tends to average about 6 percent per year, regardless of refinancing opportunities. Even with this assumed prepayment activity, the average lives of these pass-throughs were simply too long for the asset/liability risk profile of depository institutions. The result is that the “take out” for most of these longer-stated final pools were wholesale buyers like life insurance companies or foundations that had longer duration needs.

Call to ARMs
Those in the baby boomer demographic have living memory of the interest rate debacle in the late 1970s, and early 1980s. The year of 1981 gets the most attention for monetary policy gone mad, but in fact rates were high across the entire maturity range.
spectrum for the better part of five years.

The Fed Funds target rate, which hit 20 percent in 1981, was also at that level in early 1980. (See Table 1 on page A5.) The index averaged 12.5 percent in the five years between 1979 and 1983. The 10-year Treasury note, which is the benchmark off of which 10-year fixed-rate mortgage loans are priced, averaged a whopping 11.8 percent during that same period. Veteran bankers recall this era with not so much nostalgia as with fear and loathing.

The significant, and durable, drop in the value of fixed-rate mortgages actually began the reformation of the thrift industry, and a new phase in housing finance. Adjustable rate mortgages (ARMs) were the logical response to this interest rate situation. Thousands of thrifts had their already-margin capital ratios further cut by the huge decline in market values of longer-term loans and pass-through securities.

The thrifts’ primary regulator, FSLIC, logically began making them pay closer attention to interest rate exposure. ARMs emerged as a seemingly win-win: Lenders create shorter-term assets, and borrowers get a lower interest rate than if their loan were fixed, and borrowers get a lower interest rate than if their loan were fixed, and borrowers get a lower interest rate than if their loan were fixed, and borrowers get a lower interest rate than if their loan were fixed.

Mortgage lenders rolled out one new product after another, trying to capture a share of the small but growing market for ARMs. ARM investment pools, as these loans began to be issued, similarly grew in liquidity.

Ginnie Mae ARM pools are very homogeneous in that virtually all of them have the same index, margin, and cap structure, and reset on one of four dates each year: Jan. 1, April 1, July 1, and Oct. 

New mousetrap

While many thousands of banks and thrifts found ARM pools to their liking, there was and have usually been supply limitations. ARM production as a percentage total mortgages never reached even 10 percent until 1991, and more recently has been in the 6 percent range. (See Table 2.) Currently, most ARM borrowers are fully anticipating a sale or refinancing of their homes before the initial low “teaser” rate has a chance to ratchet upwards, so prepayments of seasoned ARMs can be quite fast.

Let us now return to the early 1980s. To satisfy investors’ demands for mortgage securities that did not have 30 years’ worth of monthly payments, financial engineers devised a product that split a pool’s cash flow into different strata. A bank or thrift could now pick and choose between these “tranches” so that average life and price volatility limitations are complied with, and still have investment in the mortgage market. These new products are known as Collateralized Mortgage Obligations or CMOs.

CMOs have received some deserved criticism from examiners over the ensuing 30 years. The term “derivative” spooks many a potential investor. The very creation of a highly predictable mortgage security necessarily requires another one that is equally unpredictable.

However, the vast majority of CMOs that are in the portfolios of community banks are less volatile, and just as liquid, than the pools used as the raw materials in building them. In this manner, more lenders have been able to make and sell fixed-rate loans, and by growing the total lending universe it can be argued that derivatives have helped lower home borrowing costs.

Capitol campaign

Homeownership rates had their 40-year win streak snapped in the early 1980s. The high cost of borrowing and then-recording housing prices on the heels of inflation conspired to cause the homeowners rate to drop, albeit modestly. It was enough of an alarm, however, to set off legislation and mandates for housing. HUD strongly suggested that Fannie Mae and Freddie Mac adopt programs to increase homeownership rates among lower- and middle-income citizens, with the stated goal of a 70 percent homeownership rate for the population as a whole. (This objective remains elusive.) Most presidential administrations in the last 30 years have been solid proponents of growing the number of owner-occupied households.

The government-sponsored enterprises began their participation in the drop in underwriting standards for “conforming” loans. Of course, GSEs were witnessing their shrinkage in market share at the same time. Large national lenders like Countrywide Mortgage were stepping up their marketing to risky borrowers, and were mostly successful in selling these non-conforming credits into an insatiable secondary market. You’ve heard these terms by now: Subprime, Alt-A, liar loans, no- or low-doc loans, and their tawdry brethren.

Toil and trouble

Spurred on by breathtaking hikes in housing prices, private lenders and the GSEs alike continued to churn out mortgage product. Year-over-year housing prices increased by more than 11 percent each year between 2003 and 2006. For a while, most of the questionable product floating around in securitized form behaved pretty well, delinquencies on even subprime loans averaged around 12 percent in this era, which was below historic experience.

The reasonable performance of this substandard product created two unwelcome byproducts: shrinking spreads and delusional investors. Even questionable debtors saw their borrowing rates fall in this era as bond buyers accepted ever-lower risk premia. These bond buyers included Fannie Mae and Freddie Mac. Not only were the housing GSEs purchasing and securitizing trillions of conforming mortgages, and guaranteeing timely payment of principal and interest, they were guilty of mission drift.

For one consequence, the conforming mortgages had lower standandst than had been allowed in the early days of Fannie and Freddie. Since they had to forward principal and interest on loans to their investors, whether received or not, their cash positions began eroding. For another, both agencies were actually buyers of some of the more exotic mortgage product created by the private-label machine. Even if the particular tranches were paying off as predicted, their market values got pampered as liquidity began drying up in mid-2008. Both hurriedly rushed to market to issue more stock at ever-higher rates, simply to stay in compliance with their regulatory minimums.

The final indignity to Fannie Mae, Freddie Mac and the mortgage finance industry in general came on Sept. 7, 2008. The GSEs were placed into conservatorship, all of their common and preferred shareholders lost their investments, and a special class of preferred stock purchased only by the U. S. Treasury was created. This structure remains in place today.

Ironically, for investors in Fannie Mac and Freddie Mac MBSs, this was a positive development. The government-sponsored enterprises, being wholly-owned by Uncle Sam, are viewed as effectively being full faith and credit borrowers. Yield spreads have gradually shrunk in the last three years and are much lower than normal based on absolute yield levels.

After the gold rush

It is not a stretch to say the rise and fall of housing begot the rise and fall of the global economy. As it turns out, there were many complex interconnected financial arrangements between huge multinationals that were...
The housing market, in which hundreds of mortgage lenders had no idea what they were doing, is a classic example of a market failure. The underlying problem was that the market was not price discovery. The government-sponsored enterprises—Fannie Mae and Freddie Mac—were the ones that set the price of mortgage-backed securities (MBSs). The federal government guaranteed these securities, and the market did not care about the underlying risk. In 2006, the Federal Reserve lowered interest rates to near zero, which fueled a housing bubble. When the bubble burst, the mortgage market collapsed, and the government had to bail out Fannie Mae and Freddie Mac.

The government's response to the mortgage meltdown was a series of programs aimed at reducing the burden on borrowers. The Home Affordable Modification Program (HAMP) and the Home Affordable Refinance Program (HARP) were the most notable. These programs allowed borrowers to refinance their mortgages at lower rates, without the need to go through a new underwriting process. However, these programs were not sufficient to prevent the collapse of the housing market.

The government also took a more direct approach to address the problem. The Federal Housing Administration (FHA) was given the power to insure mortgages at a lower cost to borrowers, which helped to stabilize the market. The Federal Reserve also took action by lowering interest rates to near zero, which helped to stimulate the economy.

In the end, the government had to provide a significant amount of bailouts to Fannie Mae and Freddie Mac. In 2009, the government took control of Fannie Mae and Freddie Mac, and in 2013, the companies were sold to private investors. The government's intervention in the mortgage market has had a long-term impact on the housing market. It has led to higher interest rates and lower home prices, and it has also led to a decrease in the supply of new homes.

Days of future past
One day Fannie Mae and Freddie Mac will be fully in the private sector's hands. That is the subject of a report issued by Treasury in February 2011 at the request of Congress. The transfer of ownership will likely be a difficult birthing process as this is a procedure that has never really been attempted. The initial public offering of Fannie Mae in 1968 was of a much smaller scale, and it was met with a collective yawn. The administration's and Congress's best efforts, these programs have been met with a collective yawn. The government-sponsored enterprises to the private sector's hands.

The tale of Fannie Mae and Freddie Mac continues to be spun. The factual record of Fannie Mae and Freddie Mac has been recharacterized, and the numbers are probably not very close to the truth. The size of their spreads is impossible to guess at this point, but based on other Western free-market economies, the numbers are probably not game-changing. This is actually an argument against the existence of the government-sponsored enterprises to begin with.

So the conclusion is that Fannie Mae and Freddie Mac have helped lower the cost of borrowing for millions of U.S. home buyers and have contributed to the increase in homeownership over the last 70 years. The security that they created provided a safe, liquid investment for thousands of community banks. The final accounting of their conservatorship cost to the government and price volatility estimates through the Performance Profile.
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