Our Mortgage Mess – A White Paper

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It is often thought that the seeds of the Housing Bubble were found in the product of the Tech Stock implosion in 2000, and that Alan Greenspan's "easy money" policies were to blame for what we now face as a nation.

In the year 2000 the "Tech Stock" implosion occurred, wiping out hundreds of thousands of investors and thousands of companies.

It, followed by the 9/11 terrorist attacks, threatened to plunge our nation into a deep and lasting recession, or perhaps a deflationary economic collapse.

In fact, the problems go back much further, to the repeal of the last pieces of Glass-Steagall and a willful disregard by The Fed, OCC, OTS, OFHEO and other agencies over the space of more than a dozen years to the principles of sound financial accounting and regulation.

The unfortunate reality is that home prices cannot appreciate, over long periods of time, at a rate that exceeds the growth in income among the population. That this is axiomatic should be obvious to everyone; attempting to "ramp" home prices by any mechanism is always a short-term phenomena, and leads to a highly-destructive housing crash when the limit of debt carrying is exceeded among the population.

The United States, unfortunately, has a history that includes a previous serious housing bubble in the 1920s. During that decade "Interest-only" short-term loans, with a balloon note, were the predominant type of mortgage pushed on buyers – just as "Option ARMs" and "2/28s" were this time around.

When the economy turned these borrowers were destroyed as they were unable to "roll over" those balloon notes into a new mortgage at terms they could afford.

Sound familiar? It should. These "interest only" products were designed with the explicit intention of forcing the borrower to come back into the bank and get a new loan in a couple of years, thereby earning yet another set of fees for the bank.

This was the intent behind the "Option ARM", 2/28, 3/27 and other similar loan products. The borrower is effectively forced to come back to the lender for a "new" mortgage when it either resets or recasts, stripping off their equity and resetting the amortization schedule while transferring their wealth to the lenders and brokers.

But when the economy turns new mortgages are no longer available on the same "easy" terms they were before, and again, those borrowers are destroyed.

Our nation, unfortunately, refused to learn from these mistakes and over the preceding 75 years we have dismantled, piece-by-piece, the protective mechanisms put in place after The Depression intended to prevent a re-enactment of the horrifying conditions of the 1930s.

This housing bubble was created through intentional manipulation of appraisal values, dangerous and even fraudulent mortgage practices and willful blindness and tolerance among regulators that enabled the creation of "off balance sheet" vehicles (SIVs). Dishonest accounting and outright manipulation of credit markets also played a role.

Now the bubble has burst and we are faced with the aftermath.

It is critical that the government address these issues in a prudent and thoughtful fashion. There is a tremendous desire to "bail people out", especially taxpayers who are howling in protest to the government in one form or another.

But doing so, whether those howling are banks, investors (bond or stock), homeowners, builders or anyone else would be a serious – perhaps critical – mistake.

Our nation has, for years, suffered under an excessive amount of intentional misstatement in many areas of our finances. This begins with our own government, and unfortunately has permeated all areas of corporate finance, as there has been no regulatory oversight to prevent it and bring wrongdoers to justice.

As just one example, banks have taken to circumventing reserve requirements through the use of "sweeps", which do not need to be reserved against. This change in their practices has been undertaken precisely to undercut and void a regulatory requirement – that of holding back reserves against deposits – so that leverage can be increased.

But as we have seen, leverage, while good for profits in boom times, is fatal when there is a bust.

In the 1990s there were hundreds of public companies that made materially-misleading statements with regards to their accounting. Yet of those only two – ENRON and MCI/Worldcom – led to indictments and prosecutions.

In 2001 an association of independent appraisers transmitted to Congress[1] thousands of signatures asking for an immediate cessation of unfair and unjust practices, including threats to withhold business if they refused to inflate values or give a predetermined value, ignore deficiencies in the subject property, or simply refusing to pay for an appraisal that does not "hit the desired number."

This petition, at current count, has over 10,000 signatures on it.

It was ignored, and nothing was done – yet clearly, appraisal fraud was a major part of the housing bubble, and coercion of the sort enumerated is just one of the more obvious and outrageous examples.

Incessant “pumping” of home price appreciation and carefully-couched statements that border on predictions have been part and parcel of the Housing Bubble since its inception. Yet it is a mathematical fact that house prices cannot increase, over the long term, at a rate which exceeds growth in wages, as home buyers are, of course, inherently limited by their earnings power.

As prices rise while speculative froth is fanned people are “forced out” of the market on a permanent basis or unsafe lending takes place to continue the charade.

Since it has been and is a goal of the federal government to promote sustainable home ownership, price appreciation at a rate that exceeds income growth is *harmful* to the government’s mandate in this regard.

Belief in such a possibility by Americans is even worse, as that is one of the key “fuels” for a speculative real estate bubble.

The following shows a table of home price and income appreciation “expectations” based on the statement of the National Association of Realtors in 2005, made at their “Midyear Legislative Meetings and Trade Expo” on May 9th of that year.[2] It used claims of 7% home price growth “for that year” and 3.5% income growth (again, “for that year”)

Year	Income	House Price	Price/Income
2000	40000	120000.00	3.00
2001	41400.00	128400.00	3.10
2002	42849.00	137388.00	3.21
2003	44348.72	147005.16	3.31
2004	45900.92	157295.52	3.43
2005	47507.45	168306.21	3.54
2006	49170.21	180087.64	3.66
2007	50891.17	192693.78	3.79
2008	52672.36	206182.34	3.91
2009	54515.89	220615.11	4.05
2010	56423.95	236058.16	4.18
2011	58398.79	252582.23	4.33
2012	60442.75	270262.99	4.47
2013	62558.24	289181.40	4.62
2014	64747.78	309424.10	4.78
2015	67013.95	331083.78	4.94
2016	69359.44	354259.65	5.11
2017	71787.02	379057.83	5.28
2018	74299.57	405591.87	5.46
2019	76900.05	433983.30	5.64
2020	79591.55	464362.14	5.83
2021	82377.26	496867.48	6.03
2022	85260.46	531648.21	6.24
2023	88244.58	568863.58	6.45
2024	91333.14	608684.03	6.66
2025	94529.80	651291.92	6.89
2026	97838.34	696882.35	7.12
2027	101262.68	745664.12	7.36
2028	104806.88	797860.60	7.61
2029	108475.12	853710.85	7.87

Extrapolating that projection out 30 years you can see the multiple is 7.87[3].

Obviously, the owner will not be selling that house to anyone at 7.87x their income, yet these sort of expectations are literally drilled into the heads of Americans with virtually every contact they have with Real Estate professionals. Just as is the case with car dealers, it is never a poor time to consider buying a new automobile.

Never is there a mention of the mathematical certainty that prices must either stall or contract to come into balance with incomes.

Such claims, repeated annually without fail as they were during the bubble years, appear to fit the definition of a "Ponzi Scheme", and there were literally thousands of participants from Realtors to Mortgage Originators to Bankers.

While many individuals involved in the Real Estate trade may not have understood the implications of these projections it is a certainty that the bankers and economists employed by these organizations, who deal with compound interest and earnings every day, did.

These executives crafted bonus plans that took immediate payouts in the billions of dollars rather than the more customary reinvestment and stock or option bonuses that are paid in other industries, and in at least one case, the firm actually shorted mortgage debt that it had bundled up and sold – clear evidence that the firm knew that this Ponzi-style finance had run its course.

Yet none have been charged with an offense and none have been ordered to make fair disclosure of the mathematical certainty that over *long periods of time* home prices will rise only at a rate roughly corresponding to incomes.

The FHA is currently exhibiting a meltdown in its portfolio, with delinquencies advancing rapidly to levels never seen since the data I have available began being tracked in 1990. Here is the historical delinquency rate for FHA loans:

1990: 6.68%
1991: 7.31%
1992: 7.57%
1993: 7.14%
1994: 7.26%
1995: 7.55%
1996: 8.05%
1997: 8.13%
1998: 8.57%
1999: 8.57%
2000: 9.07%
2001: 10.78%
2002: 11.53%
2003: 12.21%
2004: 12.18%
2005: 12.51%
2006: 12.74%
2007: 12.92% (Q3 - Seasonally adjusted)

2008: 16.571% (Q1)

The increase from the 3rd quarter of 2007 to the first quarter of 2008, 28%, is the largest going back to 1986. In addition more than one third of the delinquent loans are 90 or more days late, indicating a very high probability of foreclosure.

The FHA program is broken and on the verge of serving punishing losses upon the taxpayers of America.

Our own government claims that we are $9 trillion in debt, yet the GAO says that Social Security and Medicare, accounted for under GAAP, has $53 trillion in current liabilities on its books. The government ignores this.

Our “Consumer Price Index” is intentionally tampered with using “adjustment factors” that understate price inflation, which causes people on Social Security to receive less than an honest cost of living adjustment year after year.

Banks are currently holding tens of thousands of foreclosed homes on their balance sheets at the full “loan value” even after sending them out for sale with a reserve and having them come back due to the highest bid not meeting that reserve amount. Yet the value of these homes is not adjusted on the bank’s balance sheet to reflect an actual market price – the high bid tendered – irrespective of whether or not the bank accepted it.

Financial institutions are shifting hundreds of billions of dollars from “Level 2” to “Level 3” asset characterization solely because they do not like the market prices being quoted. In addition financial instruments are being shifted from “held for sale” to “held for investment” simply to allow the bank in question to not have to take a mark-to-market on that instrument.

All of these actions overstate the financial strength of firms and, when banks are involved, they result in bloated and inaccurate Tier Capital Ratios, increasing the risk of systemic collapse by preventing bank overseers such as the OCC and OTS from either directing that corrective measures be taken (e.g. suspension of dividends and raising of more capital) or, in extreme cases, closure of the offending institution.

In the immediate future there is a severe risk to our nation’s financial system being posed by the toxic mortgage-backed securities (MBS) that are at the center of the “monoline” insurer storm.

Given what we know about the origination of many of the loans in the 2003-2007 time frame – for instance, that 50% of the stated income loans had incomes overstated by 50% or more (according to HUD), these loan packages are all subject to being torn apart due to fraud at origination.

Fraud has no statute of limitations and has already been alleged by multiple monoline insurers as cause for refusing to pay pending claims. Other investors who have taken large losses will certainly follow.

It is important to note that the losses thus far booked by investment and commercial banks have almost entirely been composed of derivative and "mark to market" losses. Essentially none of the actual credit loss in the underlying securities – that is, the declining price of homes – has been recognized as of this time.

There is somewhere between $2.5 and $3 trillion worth of underlying credit losses that will ultimately be recognized, out of a total wealth destruction (on paper) of approximately $10 trillion.

To the extent that these losses can be blamed on fraud during the origination process, the entity who incurs that loss has the legal right to seek redress for those losses from the party that originated that security, or in the extreme case to "unwind" the purchase event in the first instance and demand the entire face value of the bond be returned to them.

This line of inquiry is certain to lead to these securities being repudiated and "torn apart", landing back on the originating investment bank's balance sheets.

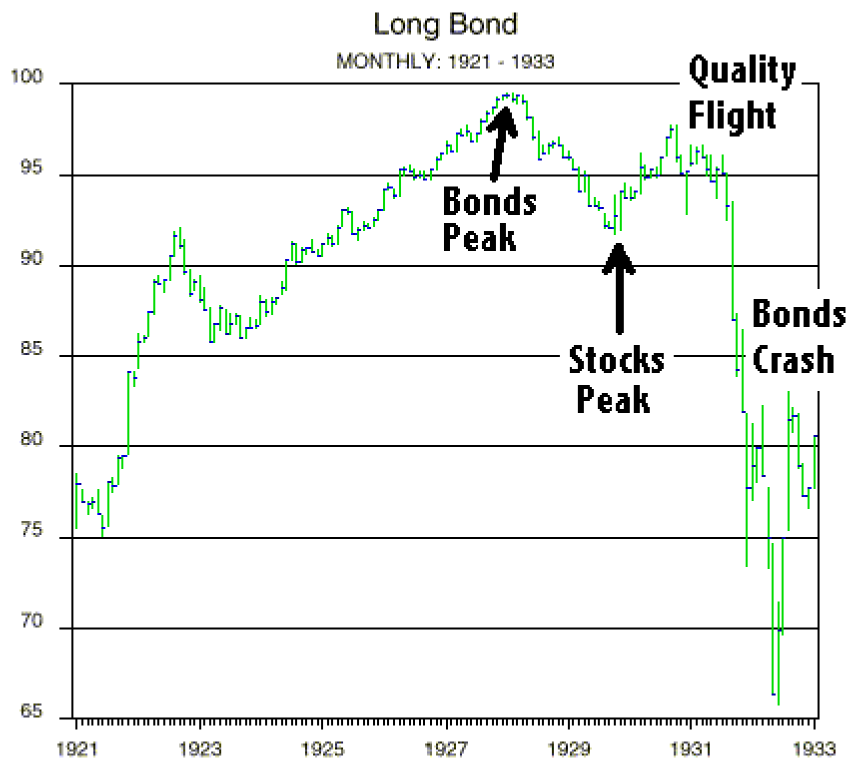
I originally wrote about this on April 20th of 2007[4], and it now appears that my prediction is coming to fruition.

There are currently tens of billions worth of these securities on The Fed's balance sheet via its "TAF" and "TSLF" facilities; as of April 24th this amount is $75 billion dollars, or approximately 1/10th of The Fed's total assets.

This is an extreme amount of risk and is being carried, effectively, by the taxpayer, but not through the obvious path – Treasury would not directly "eat" any defaulted or fraudulently-issued MBSs that are at The Fed.

The risk to the taxpayer, and indeed all Americans, arises because if the market perceives that The Fed's balance sheet has become contaminated with securities issued under fraudulent pretense, it is entirely possible for there to be a broad and disorderly bond market selloff with catastrophic consequence. This would cause yields across the curve to spike higher, and since all credit is priced off some reference to US Treasuries in the United States, it would immediately and radically increase the cost of credit at the worst possible time.

This is effectively what happened in 1931 and transformed what was, up until that point, a deep recession into what we now call The Great Depression.



While the 1931 bond market collapse was not driven by mortgage-backed securities, it was precisely the same general problem – a loss of confidence in both government and private credit markets – that turned the bond market on its ear.

It is critical that this event be avoided and the only way to be certain it will not happen is for The Fed to get all MBS securities off its balance sheet and Treasury to make certain that market participants know that so-called "Agency" bonds are NOT obligations of The Federal Government.

Those entities that wrote "dodgy" paper will then be left exposed to eat the losses from it in due course as this bad, and in many cases fraudulently-originated, debt is unwound over the next several years.

Should we fail to act immediately on this front we run a very real risk of a repeat of the 1930s, and contrary to the claims of Mr. Bernanke and others, The Fed would be powerless to stop it.

We currently require $2 billion a day of foreign investment in our bond market in order to sustain our nation's deficit spending, or about $700 billion a year. Should that support vanish – and it will if we suffer a bond market dislocation – we would be faced with an immediate need to cut nearly 25% of our federal spending, which could not possibly be accomplished without deep cuts into entitlements, the military and domestic discretionary programs.

There is already evidence that the bond market is unimpressed with recent events and the actions of The Fed in this regard, with significant “bid to cover” and “indirect” (foreign government) measures of participation falling in the last few months.

It is certainly true that taking the actions described below will have a short-term negative effect on the equity markets. For example, refusing to bail out the investment banks and forcing the toxic MBS back onto their balance sheets will drive an immediate need for more capital, as will strictly limiting their leverage.

This will in turn require capital raising activities to be instituted immediately on a scale far beyond what has been seen to date, and would likely result in the equity price of the investment and major commercial banks declining by as much as 80% due to the massive dilution that would be involved in such actions.

However, raising capital through this process would lead to a stable economic outcome and remove the risk of systemic failure.

In addition, The Fed’s actions of the last six months have led to a speculative “hot money” bubble in the form of $200 billion in excessive liquidity that has rotated from sector to sector looking for a way to make a “quick killing.” The Fed has injected and maintained this excess “slosh” for the explicit purpose of “tamping down” short-term interest rates to levels far below where they would otherwise be. On April 24th, for example, we saw that bubble of liquidity rotate violently out of commodities and into bank stocks. While this *looks* good (if you’re a bank stock owner) this sort of dynamic instability in our markets, intentionally caused by The Fed in an attempt to force interest rates below their natural level, in fact leads to a greatly increased risk of an outright crash as the level of instability in the marketplace continues to grow. In fact, the violent moves in the stock and credit markets over the last nine months have been almost exclusively caused by this excess liquidity – courtesy of The Fed!

Without contracting the leverage currently in the system and forcing these losses to be taken by those entities who were complicit in the fraudulent activities of the last four years we risk a broad-based disorderly unwind – a market and economic crash – centered in both the bond and stock markets.

There are many who will disagree with the sort of “austerity” steps called for in the following pages. Even more will complain about the provisions that require indictment and prosecution for those who run unlawful Ponzi Schemes that cost our citizens trillions of dollars of real wealth. Certainly, banks and other institutions will complain about limits on their leverage and speculation, even though such limits are very important to protect the security and stability of our financial systems as a whole.

The risks faced by our nation should we fail to take these actions in the immediate future are far worse than the consequences of strong, decisive action.

Our nation's economic future literally hangs in the balance.

We must clean house and return to the "first principles" of honest accounting, reasonable leverage, and entities with a connection to the taxpayer's balance sheet that make loans only based upon sound fundamentals.

In short, legislation must be passed immediately that:

1. Returns to the pre-1982 computation of the Consumer Price Index, and direct that the "Core" index be dropped as a separate measurement, as it is clear that food and energy price changes are neither transitory or particularly volatile – in fact, they have gone in only one direction for the last several years – upward.

2. Causes reporting of our "national debt" to include all accrued and contingent liabilities in accordance with GAAP, precisely as we expect corporations in the United States to do so.

3. Bar the taking of MBS by The Fed, and forces the immediate return of all such securities to those entities who have tendered them to The Fed. In addition Congress must reiterate that agency securities are not obligations, directly or indirectly, of The Federal Government, Treasury or The Federal Reserve. This is of critical importance.

4. Bans the use of all off-balance-sheet financial vehicles such as "SIVs" and "SPEs" by all entities domiciled within the US or listed upon any United States securities exchange.

5. Bans the sale, purchase, or trading of any non-exchange-traded derivative by any entity that has an implicit or explicit Federal Government guarantee. These institutions include all commercial banks, GSEs and, at the present time due to The Fed's PDCF, all investment banks. Hedge funds and other unregulated entities should be free to create and trade such derivatives, so long as they are not sold, purchased, held, or pledged as collateral with or by a regulated entity.

6. Bars all firms, including investment and commercial banks, from recognizing as "revenue" the "decrease" in liabilities from written-down debt. This has been a "feature" of recent quarters, makes firms appear more valuable than they actually are in that they book "earnings" as a consequence of writing down bad paper, and yet these "earnings" are non-cash. Both Lehman and Merrill Lynch booked more than a billion in "revenue" via this path in the last quarter. This gives a tremendously misleading picture to investors of the health and earnings power of these firms.

7. Sets up a CUSIP and published exchange system with an intermediary (such as the OCC for listed options) for exchange trading of credit default swaps and other similar instruments to regularize the terms of such contracts and guarantee that margin

supervision is performed. In addition this provides market participants with the assurance that contracts they purchase will be honored, and that those who sell said contracts will be able to meet their obligations.

8. Requires that all banks and other entities account for all claimed assets and liabilities using market prices on their balance sheet in a fashion that is transparent and accountable. There are many who claim that this is unacceptable. However, in fact not doing so overstates a bank or other firm's financial strength, and it is precisely when an institution is under stress that we cannot afford that to happen. Prudence in lending requires that one know what the collateral one has is worth should it need to be disposed of for some reason. Inventing values is simply unsound.

9. Rescinds FHA "expanded approval limits" along with those applicable to Fannie and Freddie. "High cost areas" are not inherently high cost – they have become so due to rampant speculation, which must be quelled in order to meet the FHA, Fannie and Freddie mandates – affordable and sustainable housing.

10. Provides that all GSEs may underwrite only fully-documented loans, without exception, cap DTI at 36% and the "front end" ratio at 28% (PITI), and require that all mortgages originated by GSEs document a minimum of 15% equity in the property at the time of origination. Today, even with full knowledge of the problems that allowing excessive "debt to income" ratios have caused, FHA's computer systems are permitting DTIs as high as 52%, while VA and conforming DTIs are being accepted by the GSEs into the 60s. It is a time-proven fact that the only effective barrier to foreclosure in difficult markets is the presence of homeowner equity. Allowing near-zero or zero-down loans to be underwritten by GSEs is demonstrably unsafe. (Note that a 15% down payment minimum still provides the homeowner with nearly 7:1 leverage. The risk of a Fannie/Freddie meltdown is very real and must be avoided; S&P is out with a forecast calling for a potential cost to the taxpayer of $1 trillion![5])

11. Bars the issue of unsecured lines of credit by Fannie and Freddie, both of which are now issuing these lines under their "Homesafe" program (see their most recent 10Qs) as a means of shifting non-performing secured loans (mortgages) to unsecured paper, giving the appearance of a lower default rate than actually exists.

12. Bars the appropriation of federal funds by The Federal Reserve or any other entity for bailout activities without the full debate and consent of Congress, as Appropriation is a reserved power under Article I, Section 9 of the Constitution. Acts taken thus far in violation of this separation of powers – including Bear Stearns assumption - must be reversed or ratified by an explicit Act of Congress.

13. Requires strict controls on leverage and bank reserves; as we have seen in a recent report issued by forensic examiners at UBS the bank intentionally ignored risk because of the certainty of being able to take illiquid and possibly worthless CDOs to The Fed Window![6] This sort of "moral hazard" radically increases the risk of systemic failure and must be prevented, both now and in the future. In particular the "sweep" exemption for reserves must be removed, as these are in fact demand deposits and banks have been using this exemption to "game" the regulatory system.

14. Requires that any and all institutions that are subject to Government Support (e.g. those covered under FDIC limits or any "implicit or explicit" assumption of government bailout) must be strictly limited to the leverage afforded by our reserve banking system's guidelines (approximately 8:1 before "risk weighting") with those limits strictly enforced.

15. Bans the use of "VAR" metrics for risk weighting, as such metrics inherently only work in "normal" markets, and yet the risks to our financial system arise from "abnormal" or "disorderly" markets.

16. Bars the bailing out of speculators, homeowners or lenders who find themselves "upside down." It must become the sense of Congress that homes must return to affordable levels, which are known to be an average home price of approximately three times average household income. Attempting to prevent the current correction simply prevents qualified buyers from purchasing homes they can afford and forces loan practices with a high risk of default to the forefront as they are the only way an average family can manage to make their purchase. In addition, and perhaps more importantly, bailouts damage the 80% of homeowners and renters who acted responsibly in a number of ways, including keeping these Americans from purchasing a home on affordable terms.

17. Directs that the Executive shall indict and prosecute those who make projections of "growth" in assets that are mathematically impossible to sustain through a finding that these constitute promotion of an unlawful Ponzi Scheme. As sustainable home ownership is a goal of the government, OFHEO should be directed to publish a document that is required to be given to all persons taking out a mortgage in which it is clearly shown that home price appreciation cannot occur at a sustained rate that exceeds growth in incomes, and that statements to the contrary by Real Estate professionals, whether they be Realtors, Mortgage Brokers or otherwise, constitute fraudulent misrepresentation. A tip line for reporting such events shall be set up, with the firms and individuals against which complaints are lodged, the general character of the complaint and the number of same, shall be made public.

[1] http://appraiserspetition.com
[2] http://findarticles.com/p/articles/mi_m0EIN/is_2005_May_9/ai_n13677745
[3] An earlier revision of this document had an error in both sides of the table and showed a value over 8.x. This has been corrected; there is no material difference in the outcome.
[4] http://ticker-classics.denninger.net/2007/04/i-told-you-so-sorry-i-just-cant-resist.html
[5] http://money.cnn.com/2008/04/21/news/economy/fannie_freddie/index.htm
[6] http://www.reuters.com/article/ousiv/idUSL2159312420080421