# THE HOUSING CRISIS, THE MORTGAGE CRISIS,
# THE "YOU NAME IT" CRISIS
# and THE "BAILOUT" or "RESCUE PLAN"

**By Stephen L. Bakke, October 2008**

## *The Finger*

We have a severe financial, credit, and liquidity crisis, caused by our housing and mortgage crisis. As I write this we are in the midst of ridiculous political maneuvering to gain the most advantage out of supporting, opposing, passing, defeating, delaying, spinning, posturing, blaming, …………. regarding appropriate government intervention and about what happened and when. So I would like to choose a large finger and do some pointing of my own. Some of this is of my manufacture. Many of the concepts and specifics can be found on legitimate on-line news services and similar sites "from whence" I lifted them.

## *The Crisis*

Let's go back in time. In spite of protests and assurances to the contrary, the housing bubble and excesses in mortgage lending has its roots in the 1970s with the passage of the now much discussed "Community Reinvestment Act of 1977" (CRA). The CRA, which was subsequently strengthened in the Clinton and Bush administrations, is a federal law that mandates lenders to offer credit throughout their entire market to borrowers they would not otherwise lend to, and discourages them from restricting their credit services to higher income markets. The application of the legislation really hit its stride in the early 1990s in reaction to moral outrage which was ringing throughout the media because lenders were reluctant to lend in certain neighborhoods. The restricted practices are referred to as "redlining" – or limiting lending into higher risk areas and to higher risk borrowers.

Creating a crisis was certainly not intended, and an "easy out" is to state that creating bad loans was never the intent. But be careful what you wish for; you may get it. Be careful what you give people incentive to do; they will do it in spades. While well intentioned, this legislation led to many unintended consequences. It led to rampant lending foolishness and many abuses. Lenders were pressured to be creative developing ways that would put home ownership into the hands of lower income citizens. I was personally present at a meeting which included discussion of the need to be more creative finding ways to put homes into the hands of more Americans.

CRA encouraged banks and thrifts to make simplified "desktop" loans, "100% of equity" loans, and the so called "low dock" and "no doc" loans to customers who (as it turns out) had no realistic ability to repay the loan. The expansion of issuing adjustable rate mortgages (ARMs) also probably exacerbated the problem. Of course, the new and growing artificial demand further expanded the "housing bubble" and encouraged these "loosy goosy" lending practices by giving false security as to housing (collateral) values. That's really how the crisis all began. And then values inevitably softened, often dramatically, and hence the crisis began.

The problem started with government intervention into the financial markets, and it is now government which is denying its role in the problem and which wants to save the situation – and regrettably will have to.

### *It Takes a Wizard (Maybe)*

"Lions and Tigers and Bears! Oh My!" as Dorothy exclaimed long ago, has now become: "Freddie and Fannie and Bear Stearns! Oh S___!" exclaimed by all of us modern day Dorothys. Fannie and Freddie ("F&F") exploded and many bystanders were injured in the blast – some fatally. After the events described above regarding CRA, the housing crisis, and the attending credit crises, it is clear F&F had become a key enabler of the mortgage crisis. They fueled Wall Street's efforts to securitize sub-prime loans by becoming the primary customer of sub-prime-mortgage pools. In addition, they held an enormous portfolio of mortgages. When F&F couldn't make the market, they became the market. They provided the wild market liquidity within which even mortgage-backed securities assembled by others could find a ready home. Take away F&F, or regulate them more wisely, and it's hard to imagine how these highly liquid markets would ever have emerged and the whole mess would never have happened. But it did!

### *The Warning (And this is important)*

But we were warned! In "W's" first year in office he explicitly called for more oversight and reform of F&F. I have found information on several congressional hearings about the problem – in 2003, 2004, and 2005 for sure. And yes, regulators did blow the horn. Remember the scandal surrounding the accounting procedures of the agencies during that time? And the accusations of impropriety about the huge salaries and bonuses paid to the agencies' top officials? The SEC has taken a lot of "flack" for their culpability (probably deservedly), but to be fair, in 2004, the SEC's chief accountant told Fannie's chief Franklin Raines that Fannie's position on the relevant accounting issue was not even " on the page" of allowable interpretations. After this there seemed to be some momentum to create much more effective regulators to handle these agencies which had escaped regulations.

At a 2004 Subcommittee hearing the Republican Chairman Baker predicted the collapse of Fannie if nothing was done. He called for more regulation, something Democrats claim Republicans never wanted.

In 2005 Alan Greenspan told Congress how urgent it was for it to act in the clearest possible terms: If F&F "continue to grow, continue to have the low capital that they have, continue to engage in the dynamic hedging of their portfolios, which they need to do for interest rate risk aversion, they potentially create ever-growing potential systemic risk down the road…..We are placing the total financial system of the future at a substantial risk". So said the Fed Chairman – in 2005. Yes, we were warned!

***The "Loyal Opposition"***

Barney Frank, a man saturated with guilt for this crisis, has spent the last few years ridiculing Alan Greenspan, John McCain and others who sought more regulation for Fannie's market-distorting schemes. He and his Senate counterpart Senator Dodd claim that this mess is the result of poor oversight – but Senator Dodd is in charge of the oversight of banks.

Representative Maxine Waters stated in the 2003 hearing on Financial Services that "We do not have a crisis at Fannie Mae and in particular Freddie Mac under the outstanding leadership of Frank Raines". In the 2004 hearing, Representative William Lacy Clay called the investigation that found illegal activity at Fannie a "lynching". This was very incendiary language considering both Clay and Raines are African American.

There is so much more available from these hearings.

***They Tried – They Really Did!***

What happened next? For the first time in history, a serious F&F reform bill was passed by the Senate Banking Committee which gave a regulator power to crack down and ultimately improve the quality of the loans being made. But the bill didn't become law because Democrats opposed it on a party-line vote in the committee. Republicans were "tied up" by the absolute and tight Democratic opposition, and couldn't even get the Senate to vote on the matter! A reporter wrote at the time: "It is a classic case of socializing the risk while privatizing the profit. The Democrats and the few Republicans who oppose portfolio limitations could not possibly do so if their constituents understood what they were doing." The roadblock built by the Senate Democrats was done, I am sure, for what some of them thought were honorable reasons.

If we are talking about our current candidates and pointing the finger, we need to keep in mind that Senator John McCain was one of the three co-sponsors of "S.90", the bill that was intended to avert this mess. To be fair, and on the other hand, Senator McCain's standard recent response has been to talk about wiping out earmarks and eliminating waste, fraud and abuse. And firing the SEC Commissioner, and so on. OK. But a cynic's response to the Senator's would be: Respectfully, Mr. McCain, waste, fraud and abuse may be the only things holding the system together at this point – but I didn't say that – and that's a discussion for when the tsunami has passed.

***Recently***

Former President Bill Clinton, who many conservatives long for as a reasonable Democratic opponent, stated in September on ABC TV, regarding his party's reluctance to place more restrictions on F&F: "I think the responsibility that the Democrats have may rest more in resisting any efforts by Republicans in the Congress, or by me when I was president, to put some standards and tighten up a little on Fannie Mae and Freddie Mac." WOW!

Also in September, the Wall Street Journal stated in an editorial: "(Barney Frank's) record is close to perfect as a stalwart opponent of reforming the two companies, going back more than a decade. The first concerted push to rein in F&F in Congress came as far back as 1992, and Mr. Frank was right there, standing athwart. But things really picked up this decade, and Barney was there at every turn".

Now, having been presented with a proposed solution or rescue, it's almost as if the Democratic leaders want to rush through a bill to "bailout" those who made wrong decisions and now want to escape accountability.

***Crap Sandwich***

Our candidate for President, Senator McCain has been criticized for describing our economy as have "sound fundamentals". What in the hell is wrong with that comment? Isn't that a perfectly "leaderly" thing for a candidate to say? Would you propose our leaders say "We really suck and need to start all over again"? Of course not! Our attitude must be realistic but positive!

We have been presented with a solution which Senator McCain reluctantly supports. Use a huge amount of our resources to add liquidity to the market by buying existing unmarketable loans or loan portfolios in order to once again give confidence that there is a market for legitimate transactions involving loans and collateral.

Too make a long story short, I am philosophically aligned with those opposing the House and Senate proposals for solutions. But I have been in the finance community too long to look at this as the ideologue that I often am. If we don't act, the implications are too huge in terms of our credit system. I think the home mortgage market is only a small part of the real concern now. Much more important is our basic commerce – commercial loans as well as individual loans.

This crisis has gone beyond just a bank having made some bad loans. More important in the larger scheme of things is that our entire credit markets are "constipated". No bank can trust another bank in terms of meeting their mutual agreements. And sooooo! much of our commerce depends on commercial finance in the form of commercial term loans, working capital loans, commercial paper, and the like. These have been caught like a "deer in the headlight" of the current crises. Banks are skeptical of their commercial syndication partners' willingness (or ability) to honor their commitments. I understand there is limited liquidity available in the "overnight lending/borrowing" activities of our banking system. And "nobody trusts nobody" in conducting business as usual in the fast moving economy we now have. So something has to be done now or the damage will be greater than any $700 billion or $1 trillion price tag you want to attach to it. And we have an international economy which will give us a "double wammy" if we don't do anything fairly soon.

Some sincere ideologues would just let things take care of themselves. Let bankruptcies occur if necessary, let losers be losers, etc. and things will work out and we won't have violated the strict free enterprise philosophy so embedded in our conservative souls. The implications are so much deeper than just one company suffering for their sins – perhaps appropriately. But I believe we lost that opportunity when we didn't take the steps necessary proposed by our leaders in the administration and Congress 3, 4, and 5 years ago.

***I Agree***

As the House Minority Leader Boehner said this week in reference to the proposed Rescue Plan: It's a "crap sandwich", but he was going to eat it. I guess I'm willing to as well. Let the "ideologues" make sure we don't get too ridiculous in our task.