9

ALL IN

CONTENTS

In 2003, the Bakersfield, California, homebuilder Warren Peterson was paying as little as $35,000 for a 10,000-square-foot lot, about the size of three tennis courts. The next year the cost more than tripled to $120,000, as real estate boomed. Over the previous quarter century, Peterson had built between 3 and 10 custom and semi-custom homes a year. For a while, he was building as many as 30. And then came the crash.

"I have built exactly one new home since late 2005," he told the FCIC five years later.[1]

In 2003, the average price was $155,000 for a new house in Bakersfield, at the southern end of California's agricultural center, the San Joaquin Valley. That jumped to almost $300,000 by June 2006.[2] "By 2004, money seemed to be coming in very fast and from everywhere," said Lloyd Plank, a Bakersfield real estate broker. "They would purchase a house in Bakersfield, keep it for a short period and resell it. Sometimes they would flip the house while it was still in escrow, and would still make 20% to 30%."[3]

Nationally, housing prices jumped 152% between 1997 and their peak in 2006,[4] more than in any decade since at least 1920.[5] It would be catastrophically downhill from there—yet the mortgage machine kept churning well into 2007, apparently indifferent to the fact that housing prices were starting to fall and lending standards to deteriorate. Newspaper stories highlighted the weakness in the housing market—even suggesting this was a bubble that could burst anytime. Checks were in place, but they were failing. Loan purchasers and securitizers ignored their own due diligence on what they were buying. The Federal Reserve and the other regulators increasingly recognized the impending troubles in housing but thought their impact would be contained. Increased securitization, lower underwriting standards, and easier access to credit were common in other markets, too. For example, credit was flowing into commercial real estate and corporate loans. How to react to what increasingly appeared to be a credit bubble? Many enterprises, such as Lehman Brothers and Fannie Mae, pushed deeper.

All along the assembly line, from the origination of the mortgages to the creation and marketing of the mortgage-backed securities and collateralized debt obligations (CDOs), many understood and the regulators at least suspected that every cog was reliant on the mortgages themselves, which would not perform as advertised.

THE BUBBLE: "A CREDIT-INDUCED BOOM"

Irvine, California–based New Century—once the nation's second-largest subprime lender—ignored early warnings that its own loan quality was deteriorating and stripped power from two risk-control departments that had noted the evidence. In a June 2004 presentation, the Quality Assurance staff reported they had found severe underwriting errors, including evidence of predatory lending, legal and state violations, and credit issues, in 25% of the loans they audited in November and December 2003. In 2004, Chief Operating Officer and later CEO Brad Morrice recommended these results be removed from the statistical tools used to track loan performance, and in 2005, the department was dissolved and its personnel terminated. The same year, the Internal Audit department identified numerous deficiencies in loan files; out of nine reviews it conducted in 2005, it gave the company's loan production department "unsatisfactory" ratings seven times. Patrick Flanagan, president of New Century's mortgage-originating subsidiary, cut the department's budget, saying in a memo that the "group was out of control and tries to dictate business practices instead of audit."[6]

This happened as the company struggled with increasing requests that it buy back soured loans from investors. By December 2006, almost 17% of its loans were going into default within the first three months after origination. "New Century had a brazen obsession with increasing loan originations, without due regard to the risks associated with that business strategy," New Century's bankruptcy examiner reported.[7]

In September 2005—seven months before the housing market peaked—thousands of originators, securitizers, and investors met at the ABS East 2005 conference in Boca Raton, Florida, to play golf, do deals, and talk about the market. The asset-backed security business was still good, but even the most optimistic could read the signs. Panelists had three concerns: Were housing prices overheated, or just driven by "fundamentals" such as increased demand? Would rising interest rates halt the market? And was the CDO, because of its ratings-driven investors, distorting the mortgage market?[8]

The numbers were stark. Nationwide, house prices had never risen so far, so fast. And national indices masked important variations. House prices in the four sand states, especially California, had dramatically larger spikes—and subsequent declines—than did the nation. If there was a bubble, perhaps, as Fed Chairman Alan Greenspan said, it was only in certain regions. He told a congressional committee in June 2005 that growth in nonprime mortgages was helping to push home prices in some markets to unsustainable levels, "although a 'bubble' in home prices for the nation as a whole does not appear likely."[9]

Globally, prices jumped in many countries around the world during the 2000s. As Christopher Mayer, an economist from Columbia Business School, noted to the Commission, "What really sticks out is how unremarkable the United States house price experience is relative to our European peers."[10] From 1997 to 2007, price increases in the United Kingdom and Spain were above those in the United States, while price increases in Ireland and France were just below. In an International Monetary Fund study from 2009, more than one half of the 21 developed countries analyzed had greater home price appreciation than the United States from late 2001 through the third quarter of 2006, and yet some of these countries did not suffer sharp price declines.[11] Notably, Canada had strong home price increases followed by a modest and temporary decline in 2009. Researchers at the Federal Reserve Bank of Cleveland attributed Canada's experience to tighter lending standards than in the United States as well as regulatory and structural differences in the financial system.[12] Other countries, such as the United Kingdom, Ireland, and Spain, saw steep house price declines.

American economists and policy makers struggled to explain the house price increases. The good news was the economy was growing and unemployment was low. But, a Federal Reserve study in May 2005 presented evidence that the cost of owning rather than renting was much higher than had been the case historically: home prices had risen from 20 times the annual cost of renting to 25 times.[13] In some cities, the change was particularly dramatic. From 1997 to 2006, the ratio of house prices to rents rose in Los Angeles, Miami, and New York City by 147%, 121%, and 98%, respectively.[14] In 2006, the National Association of Realtors' affordability index—which measures whether a typical family could qualify for a mortgage on a typical home—had reached a record low.[15] But that was based on the cost of a traditional mortgage with a 20% down payment,[16] which was no longer required. Perhaps such measures were no longer relevant, when Americans could make lower down payments and obtain loans such as payment-option adjustable-rate mortgages and interest-only mortgages, with reduced initial mortgage payments. Or perhaps buying a home continued to make financial sense, given homeowners' expectations of further price gains.

During a June meeting, the Federal Open Market Committee (FOMC), composed of Federal Reserve governors, four regional Federal Reserve Bank presidents, and the Federal Reserve Bank of New York president, heard five presentations on mortgage risks and the housing market. Members and staff had difficulty developing a consensus on whether housing prices were overvalued and "it was hard for many FOMC participants . . . to ascribe substantial conviction to the proposition that overvaluation in the housing market posed the major systemic risks that we now know it did," according to a letter from Fed Chairman Ben Bernanke to the FCIC. "The national mortgage system might bend but will likely not break," and "neither borrowers nor lenders appeared particularly shaky," one presentation argued, according to the letter. In discussions about nontraditional mortgage products, the argument was made that "interest-only mortgages are not an especially sinister development," and their risks "could be cushioned by large down payments." The presentation also noted that while loan-to-value ratios were rising on a portion of interest-only loans, the ratios for most remained around 80%. Another presentation suggested that housing market activity could be the result of "solid fundamentals." Yet another presentation concluded that the impact of changes in household wealth on spending would be "perhaps only half as large as that of the 1990s stock bubble." Most FOMC participants agreed "the probability of spillovers to financial institutions seemed moderate."[17]

As one recent study argues, many economists were "agnostics" on housing, unwilling to risk their reputations or spook markets by alleging a bubble without finding support in economic theory.[18] Fed Vice Chairman Donald Kohn was one. "Identification [of a bubble] is a tricky proposition because not all the fundamental factors driving asset prices are directly observable," Kohn said in a 2006 speech, citing research by the European Central Bank. "For this reason, any judgment by a central bank that stocks or homes are overpriced is inherently highly uncertain."[19]

But not all economists hesitated to sound a louder alarm. "The situation is beginning to look like a credit-induced boom in housing that could very well result in a systemic bust if credit conditions or economic conditions should deteriorate," Federal Deposit Insurance Corporation Chief Economist Richard Brown wrote in a March 2005 report. "During the past five years, the average U.S. home has risen in value by 50%, while homes in the fastest-growing markets have approximately doubled in value." While this increase might have been explained by strong market fundamentals, "the dramatic broadening of the housing boom in 2004 strongly suggests the influence of systemic factors, including the low cost and wide availability of mortgage credit."[20]

A couple of months later, Fed economists in an internal memo acknowledged the possibility that housing prices were overvalued, but downplayed the potential impacts of a downturn. Even in the face of a large price decline, they argued, defaults would not be widespread, given the large equity that many borrowers still had in their homes. Structural changes in the mortgage market made a crisis less likely, and the financial system seemed well capitalized. "Even historically large declines in house prices would be small relative to the recent decline in household wealth owing to the stock market," the economists concluded. "From a wealth-effects perspective, this seems unlikely to create substantial macroeconomic problems."[21]

MORTGAGE FRAUD: "CRIME-FACILITATIVE ENVIRONMENTS"

New Century—where 40% of the mortgages were loans with little or no documentation[22]—was not the only company that ignored concerns about poor loan quality. Across the mortgage industry, with the bubble at its peak, standards had declined, documentation was no longer verified, and warnings from internal audit departments and concerned employees were ignored. These conditions created an environment ripe for fraud. William Black, a former banking regulator who analyzed criminal patterns during the savings and loan crisis, told the Commission that by one estimate, in the mid-2000s, at least 1.5 million loans annually contained "some sort of fraud," in part because of the large percentage of no-doc loans originated then.[23]

Fraud for housing can entail a borrower's lying or intentionally omitting information on a loan application. Fraud for profit typically involves a deception to gain financially from the sale of a house. Illinois Attorney General Lisa Madigan defines fraud more broadly to include lenders' "sale of unaffordable or structurally unfair mortgage products to borrowers."[24]

In 80% of cases, according to the FBI, fraud involves industry insiders.[25] For example, property flipping can involve buyers, real estate agents, appraisers, and complicit closing agents. In a "silent second," the buyer, with the collusion of a loan officer and without the knowledge of the first mortgage lender, disguises the existence of a second mortgage to hide the fact that no down payment has been made. "Straw buyers" allow their names and credit scores to be used, for a fee, by buyers who want to conceal their ownership.[26]

In one instance, two women in South Florida were indicted in 2010 for placing ads between 2004 and 2007 in Haitian community newspapers offering assistance with immigration problems; they were accused of then stealing the identities of hundreds of people who came for help and using the information to buy properties, take title in their names, and resell at a profit. U.S. Attorney Wilfredo A. Ferrer told the Commission it was "one of the cruelest schemes" he had seen.[27]

Estimates vary on the extent of fraud, as it is seldom investigated unless properties go into foreclosure. Ann Fulmer, vice president of business relations at Interthinx, a fraud detection service, told the FCIC that her firm analyzed a large sample of all loans from 2005 to 2007 and found 13% contained lies or omissions significant enough to rescind the loan or demand a buyback if it had been securitized. The firm's analysis indicated that about $1 trillion of the loans made during the period were fraudulent. Fulmer further estimated $160 billion worth of fraudulent loans from 2005 to 2007 resulted in foreclosures, leading to losses of $112 billion for the holders. According to Fulmer, experts in the field—lenders' quality assurance officers, attorneys who specialize in loan loss mitigation, and white-collar criminologists—say the percentage of transactions involving less significant forms of fraud, such as relatively minor misrepresentations of fact, could reach 60% of originations.[28] Such loans could stay comfortably under the radar, because many borrowers made payments on time.

Ed Parker, the head of mortgage fraud investigation at Ameriquest, the largest subprime lender in 2003, 2004, and 2005, told the FCIC that fraudulent loans were very common at the company. "No one was watching. The volume was up and now you see the fallout behind the loan origination process," he told the FCIC.[29] David Gussmann, the former vice president of Enterprise Management Capital Markets at Fannie Mae, told the Commission that in one package of 50 securitized loans his analysts found one purchaser who had bought 19 properties, falsely identifying himself each time as the owner of only one property, while another had bought five properties.[30] Fannie Mae's detection of fraud increased steadily during the housing bubble and accelerated in late 2006, according to William Brewster, the current director of the company's mortgage fraud program. He said that, seeing evidence of fraud, Fannie demanded that lenders such as Bank of America, Countrywide, Citigroup, and JP Morgan Chase repurchase about $550 million in mortgages in 2008 and $650 million in 2009.[31] "Lax or practically non-existent government oversight created what criminologists have labeled 'crime-facilitative environments,' where crime could thrive," said Henry N. Pontell, a professor of criminology at the University of California, Irvine, in testimony to the Commission.[32]

The responsibility to investigate and prosecute mortgage fraud violations falls to local, state and federal law enforcement officials. On the federal level, the Federal Bureau of Investigation investigates and refers cases for prosecution to U.S. Attorneys, who are part of the Department of Justice. Cases may also involve other agencies, including the U.S. Postal Inspection Service, the Department of Housing and Urban Development, and the Internal Revenue Service. The FBI, which has the broadest jurisdiction of any federal law enforcement agency, was aware of the extent of the fraudulent mortgage problem.[33] FBI Assistant Director Chris Swecker began noticing a rise in mortgage fraud while he was the special agent in charge of the Charlotte, North Carolina, office from 1999 to 2004. In 2002, that office investigated First Beneficial Mortgage for selling fraudulent loans to Fannie Mae, leading to the successful criminal prosecution of the company's owner, James Edward McLean Jr., and others. First Beneficial repurchased the mortgages after Fannie discovered evidence of fraud, but then—without any interference from Fannie—resold them to Ginnie Mae.[34] For not alerting Ginnie, Fannie paid $7.5 million of restitution to the government. McLean came to the attention of the FBI after buying a luxury yacht for $800,000 in cash.[35] Soon after Swecker was promoted to assistant FBI director for investigations in 2004, he turned a spotlight on mortgage fraud. "The potential impact of mortgage fraud is clear," Swecker told a congressional committee in 2004. "If fraudulent practices become systemic within the mortgage industry and mortgage fraud is allowed to become unrestrained, it will ultimately place financial institutions at risk and have adverse effects on the stock market."[36]

In that testimony, Swecker pointed out the inadequacies of data regarding fraud and recommended that Congress mandate a reporting system and other remedies and require all lenders to participate, whether federally regulated or not. For example, suspicious activity reports, also known as SARs, are reports filed by FDIC-insured banks and their affiliates to the Financial Crimes Enforcement Network

(FinCEN), a bureau within the Treasury Department that administers money-laundering laws and works closely with law enforcement to combat financial crimes. SARs are filed by financial institutions when they suspect criminal activity in a financial transaction. But many mortgage originators, such as Ameriquest, New Century, and Option One, were outside FinCEN's jurisdiction—and thus the loans they generated, which were then placed into securitized pools by larger lenders or investment banks, were not subject to FinCEN review. William Black testified to the Commission that an estimated 80% of nonprime mortgage loans were made by noninsured lenders not required to file SARs. And as for those institutions required to do so, he believed he saw evidence of underreporting in that, he said, only about 10% of federally insured mortgage lenders filed even a single criminal referral for alleged mortgage fraud in the first half of 2009.[37]

Countrywide, the nation's largest mortgage lender at the time, had about 5,000 internal referrals of potentially fraudulent activity in its mortgage business in 2005, 10,000 in 2006, and 20,000 in 2007, according to Francisco San Pedro, the former senior vice president of special investigations at the company.[38] But it filed only 855 SARs in 2005, 2,895 in 2006, and 2,621 in 2007.[39]

Similarly, in examining Bank of America in 2007, its lead bank regulator, the Office of the Comptroller of the Currency (OCC), sampled 50 mortgages and found 16 with "quality assurance referrals" for suspicious activity for which no report had been filed with FinCEN. All 16 met the legal requirement for a filing. The OCC consequently required management to refine its processes to ensure that SARs were consistently filed.[40]

Darcy Parmer, a former quality assurance and fraud analyst at Wells Fargo, the second largest mortgage lender from 2004 through 2007 and the largest in 2008, told the Commission that "hundreds and hundreds and hundreds of fraud cases" that she knew were identified within Wells Fargo's home equity loan division were not reported to FinCEN. And, she added, at least half the loans she flagged for fraud were nevertheless funded, over her objections.[41]

Despite the underreporting, the jump in mortgage fraud drew attention. FinCEN in November 2006 reported a 20-fold increase in SARs related to mortgage fraud between 1996 and 2005. It noted that two-thirds of the loans being created were originated by mortgage brokers who were not subject to any federal standard or oversight.[42] Swecker unsuccessfully asked legislators to compel all lenders to forward information about criminal fraud to regulators and law enforcement agencies.[43]

Swecker attempted to gain more funding to combat mortgage fraud but was resisted. Swecker told the FCIC his funding requests were cut at either the director level at the FBI, at the Justice Department, or at the Office of Management and Budget. He called his struggle for more resources an "uphill slog."[44]

In 2005, 25,988 SARs related to mortgage fraud were filed; in 2006 there were 37,457. The number kept climbing, to 52,862 in 2007, 65,004 in 2008, and 67,507 in 2009.[45] At the same time, top FBI officials, focusing on terrorist threats, reduced the agents assigned to white-collar crime from 2,342 in the 2004 fiscal year to fewer than 2,000 by 2007. That year, its mortgage fraud program had only 120 agents at any one time to review more than 50,000 SARs filed with FinCEN. In response to inquiries from the FCIC, the FBI said that to compensate for a lack of manpower, it had developed "new and innovative methods to detect and combat mortgage fraud," such as a computer application, created in 2006, to detect property flipping.[46]

Robert Mueller, the FBI's director since 2001, said mortgage fraud needed to be considered "in context of other priorities," such as terrorism. He told the Commission that he hired additional resources to fight fraud, but that "we didn't get what we had requested" during the budget process. He also said that the FBI allocated additional resources to reflect the growth in mortgage fraud, but acknowledged that those resources may have been insufficient. "I am not going to tell you that that is adequate for what is out there," he said. In the wake of the crisis, the FBI is continuing to investigate fraud, and Mueller suggested that some prosecutions may be still to come.[47]

Alberto Gonzales, the nation's attorney general from February 2005 to September 2007, told the Commission that while he might have done more on mortgage fraud, in hindsight he believed that other issues were more pressing: "I don't think anyone can credibly argue that [mortgage fraud] is more important than the war on terror. Mortgage fraud doesn't involve taking loss of life so it doesn't rank above the priority of protecting neighborhoods from dangerous gangs or predators attacking our children."[48]

In 2008, the Office of Federal Housing Enterprise Oversight, the regulator of the GSEs, released a report showing a "significant rise in the incidence of fraud in mortgage lending in 2006 and the first half of 2007." OFHEO stated it had been working closely with law enforcement and was an active member of the Department of Justice Mortgage Fraud Working Group.[49] "The concern about mortgage fraud and fraud in general was an issue," Richard Spillenkothen, head of banking supervision and regulation at the Fed from 1991 to 2006, told the FCIC. "And we understood there was an increasing incidence of [mortgage fraud]."[50]

Michael B. Mukasey, who served as U.S. attorney general from November 2007 to the end of 2008, told the Commission that he recalled "receiving reports of mortgage failures and of there being fraudulent activity in connection with flipping houses, overvaluation, and the like. . . . I have a dim recollection of outside people commenting that additional resources should be devoted, and there being speculation about whether resources that were being diverted to national security investigations, and in particular the terrorism investigations were somehow impeding fraud investigations, which I thought was a bogus issue." He said that the department had other pressing priorities, such as terrorism, gang violence, and southwestern border issues.[51]

In letters to the FCIC, the Department of Justice outlined actions it undertook along with the FBI to combat mortgage fraud. For example, in 2004, the FBI launched Operation Continued Action, targeting a variety of financial crimes, including mortgage fraud. In that same year, the agency started to publish an annual mortgage fraud report. The following year, the FBI and other federal agencies announced a joint effort combating mortgage fraud. From July to October 2005, this program, Operation Quick Flip, produced 156 indictments, 81 arrests, and 89 convictions for mortgage fraud. In 2007, the FBI started specifically tracking mortgage fraud cases and increased personnel dedicated to those efforts. And in 2008, Operation Malicious Mortgage resulted in 144 mortgage fraud cases in which 406 defendants were charged by U.S. Attorneys offices throughout the country.[52]

William Black told the Commission that Washington essentially ignored the issue and allowed it to worsen. "The FBI did have severe limits," because of the need to respond to the 9/11 attacks, Black said, and the problem was compounded by the lack of cooperation: "The terrible thing that happened was that the FBI got virtually no assistance from the regulators, the banking regulators and the thrift regulators."[53] Swecker, the former FBI official, told the Commission he had no contact with banking regulators during his tenure.[54]

As mortgage fraud grew, state agencies took action. In Florida, Ellen Wilcox, a special agent with the state Department of Law Enforcement, teamed with the Tampa police department and Hillsborough County Consumer Protection Agency to bring down a criminal ring scamming homeowners in the Tampa area. Its key member was Orson Benn, a New York–based vice president of Argent Mortgage Company, a unit of Ameriquest. Beginning in 2004, 10 investigators and two prosecutors worked for years to unravel a network of alliances between real estate brokers, appraisers, home repair contractors, title companies, notaries, and a convicted felon in a case that involved some 130 loans.[55]

According to charging documents in the case, the perpetrators would walk through neighborhoods, looking for elderly homeowners they thought were likely to have substantial equity in their homes. They would suggest repairs or improvements to the homes. The homeowners would fill out paperwork, and insiders would use the information to apply for loans in their names. Members of the ring would prepare fraudulent loan documents, including false W-2 forms, filled with information about invented employment and falsified salaries, and take out home equity loans in the homeowners' names. Each person involved in the transaction would receive a fee for his or her role; Benn, at Argent, received a $3,000 kickback for each loan he helped secure. When the loan was funded, the checks were frequently made out to the bogus home construction company that had proposed the work, which would then disappear with the proceeds. Some of the homeowners never received a penny from the refinancing on their homes. Hillsborough County officials learned of the scam when homeowners approached them to say that scheduled repairs had never been made to their homes, and then sometimes learned that they had lost years' worth of equity as well. Sixteen of 18 defendants, including Benn, have been convicted or have pled guilty.[56]

Wilcox told the Commission that the "cost and length of these investigations make them less attractive to most investigative agencies and prosecutors trying to justify their budgets based on investigative statistics."[57] She said it has been hard to follow up on other cases because so many of the subprime lenders have gone out of business, making it difficult to track down perpetrators and witnesses. Ameriquest, for example, collapsed in 2007, although Argent, and the company's loan-servicing arm, were bought by Citigroup that same year.

DISCLOSURE AND DUE DILIGENCE: "A QUALITY CONTROL ISSUE IN THE FACTORY"

In addition to the rising fraud and egregious lending practices, lending standards deteriorated in the final years of the bubble. After growing for years, Alt-A lending increased another 5% from 2005 to 2006. In particular, option ARMs grew 7% during that period, interest-only mortgages grew 9%, and no-documentation or low-documentation loans (measured for borrowers with fixed-rate mortgages) grew 14%. Overall, by 2006 no-doc or low-doc loans made up 27% of all mortgages originated. Many of these products would perform only if prices continued to rise and the borrower could refinance at a low rate.[58]

In theory, every participant along the securitization pipeline should have had an interest in the quality of every underlying mortgage. In practice, their interests were often not aligned. Two New York Fed economists have pointed out the "seven deadly frictions" in mortgage securitization—places along the pipeline where one party knew more than the other, creating opportunities to take advantage.[59] For example, the lender who originated the mortgage for sale, earning a commission, knew a great deal about the loan and the borrower but had no long-term stake in whether the mortgage was paid, beyond the lender's own business reputation. The securitizer who packaged mortgages into mortgage-backed securities, similarly, was less likely to retain a stake in those securities.

In theory, the rating agencies were important watchdogs over the securitization process. They described their role as being "an umpire in the market."[60] But they did not review the quality of individual mortgages in a mortgage-backed security, nor did they check to see that the mortgages were what the securitizers said they were.

So the integrity of the market depended on two critical checks. First, firms purchasing and securitizing the mortgages would conduct due diligence reviews of the mortgage pools, either using third-party firms or doing the reviews in-house. Second, following Securities and Exchange Commission rules, parties in the securitization process were expected to disclose what they were selling to investors. Neither of these checks performed as they should have.

Due diligence firms: "Waived in"

As subprime mortgage securitization took off, securitizers undertook due diligence on their own or through third parties on the mortgage pools that originators were selling them. The originator and the securitizer negotiated the extent of the due diligence investigation. While the percentage of the pool examined could be as high as 30%, it was often much lower; according to some observers, as the market grew and originators became more concentrated, they had more bargaining power over the mortgage purchasers, and samples were sometimes as low as 2% to 3%.[61] Some securitizers requested that the due diligence firm analyze a random sample of mortgages from the pool; others asked for a sampling of those most likely to be deficient in some way, in an effort to efficiently detect more of the problem loans.

Clayton Holdings, a Connecticut-based firm, was a major provider of third-party due diligence services. [62] As Clayton Vice President Vicki Beal explained to the FCIC, firms like hers were "not retained by [their] clients to provide an opinion as to whether a loan is a good loan or a bad loan." Rather, they were hired to identify, among other things, whether the loans met the originator's stated underwriting guidelines and, in some measure, to enable clients to negotiate better prices on pools of loans.[63]

The review fell into three general areas: credit, compliance, and valuation. Did the loans meet the underwriting guidelines (generally the originator's standards, sometimes with overlays or additional guidelines provided by the financial institutions purchasing the loans)? Did the loans comply with federal and state laws, notably predatory-lending laws and truth-in-lending requirements? Were the reported property values accurate?[64] And, critically: to the degree that a loan was deficient, did it have any "compensating factors" that offset these deficiencies? For example, if a loan had a higher loan-to-value ratio than guidelines called for, did another characteristic such as the borrower's higher income mitigate that weakness? The due diligence firm would then grade the loan sample and forward the data to its client. Report in hand, the securitizer would negotiate a price for the pool and could "kick out" loans that did not meet the stated guidelines.

Because of the volume of loans examined by Clayton during the housing boom, the firm had a unique inside view of the underwriting standards that originators were actually applying—and that securitizers were willing to accept. Loans were classified into three groups: loans that met guidelines (a Grade 1 Event), those that failed to meet guidelines but were approved because of compensating factors (a Grade 2 Event), and those that failed to meet guidelines and were not approved (a Grade 3 Event). Overall, for the 18 months that ended June 30, 2007, Clayton rated 54% of the 911,039 loans it analyzed as Grade 1, and another 18% as Grade 2—for a total of 72% that met the guidelines outright or with compensating factors. The remaining 28% of the loans were Grade 3.[65] In theory, the banks could have refused to buy a loan pool, or, indeed, they could have used the findings of the due diligence firm to probe the loans' quality more deeply. Over the 18-month period, 39% of the loans that Clayton found to be deficient—Grade 3—were "waived in" by the banks. Thus 11% of the loans sampled by Clayton were accepted even though the company had found a basis for rejecting them (see figure 9.1).

Referring to the data, Keith Johnson, the president of Clayton from May 2006 to May 2009, told the Commission, "That 54% to me says there [was] a quality control issue in the factory" for mortgage-backed securities.[66] Johnson concluded that his clients often waived in loans to preserve their business relationship with the loan originator—a high number of rejections might lead the originator to sell the loans to a competitor. Simply put, it was a sellers' market. "Probably the seller had more power than the Wall Street issuer," Johnson told the FCIC.[67]

The high rate of waivers following rejections may not itself be evidence of something wrong in the process, Beal testified. She said that as originators' lending guidelines were declining, she saw the securitizing firms introduce additional credit

Rejected Loans Waived in by Selected Banks

From January 2006 through June 2007, Clayton rejected 28% of the mortgages it reviewed. Of these, 39% were waived in anyway.

Financial Institution	A ACCEPTED LOANS *(Event 1 & 2)/ Total pool of loans*	B REJECTED LOANS *(Event 3)/ Total pool of loans*	C REJECTED LOANS WAIVED IN BY FINANCIAL INSTITUTIONS	D REJECTED LOANS AFTER WAIVERS *(B–C)*	E FINANCIAL INSTITUTION WAIVER RATE *(C/B)*
Citigroup	58%	42%	13%	29%	31%
Credit Suisse	68	32	11	21	33
Deutsche	65	35	17	17	50
Goldman	77	23	7	16	29
JP Morgan	73	27	14	13	51
Lehman	74	26	10	16	37
Merrill	77	23	7	16	32
UBS	80	20	6	13	33
WaMu	73	27	8	19	29
Total Bank Sample	**72%**	**28%**	**11%**	**17%**	**39%**

NOTES: From Clayton Trending Reports. Numbers may not add due to rounding.
SOURCE: Clayton Holdings

Figure 9.1

guidelines. "As you know, there was stated income, they were telling us look for reasonableness of that income, things like that."[68] With stricter guidelines, one would expect more rejections, and, after the securitizer looks more closely at the rejected loans, possibly more waivers. As Moody's Investors Service explained in a letter to the FCIC, "A high rate of waivers from an institution with extremely tight underwriting standards could result in a pool that is less risky than a pool with no waivers from an institution with extremely loose underwriting standards."[69] Nonetheless, many prospectuses indicated that the loans in the pools either met guidelines outright or had compensating factors, even though Clayton's records show that only a portion of the loans were sampled, and that of those that were sampled, a substantial percentage of Grade 3 Event loans were waived in.

Johnson said he approached the rating agencies in 2006 and 2007 to gauge their interest in the exception-tracking product that Clayton was developing. He said he shared some of their company's results, attempting to convince the agencies that the data would benefit the ratings process. "We went to the rating agencies and said, 'Wouldn't this information be great for you to have as you assign tranche levels of risk?'" Johnson recalled. The agencies thought the due diligence firm's data were "great," but they did not want the information, Johnson said, because it would presumably produce lower ratings for the securitizations and cost the agency business—even in 2007, as the private securitization market was winding down.[70]

When securitizers did kick loans out of the pools, some originators simply put them into new pools, presumably in hopes that those loans would not be captured in the next pool's sampling. The examiner's report for New Century Financial's bankruptcy describes such a practice.[71] Similarly, Fremont Investment & Loan had a policy of putting loans into subsequent pools until they were kicked out three times, the company's former regulatory compliance and risk manager, Roger Ehrnman, told the FCIC. As Johnson described the practice to the FCIC, this was the "three strikes, you're out rule."[72]

Some mortgage securitizers did their own due diligence, but seemed to devote only limited resources to it. At Morgan Stanley, the head of due diligence was based not in New York but rather in Boca Raton, Florida. He had, at any one time, two to five individuals reporting to him directly—and they were actually employees of a personnel consultant, Equinox.[73] Deutsche Bank and JP Morgan likewise also had only small due diligence teams.[74]

Banks did not necessarily have better processes for monitoring the mortgages that they purchased. At an FCIC hearing on the mortgage business, Richard Bowen, a whistleblower who had been a senior vice president at CitiFinancial Mortgage in charge of a staff of 200-plus professional underwriters, testified that his team conducted quality assurance checks on the loans bought by Citigroup from a network of lenders, including both subprime mortgages that Citigroup intended to hold and prime mortgages that it intended to sell to Fannie Mae and Freddie Mac.

For subprime purchases, Bowen's team would review the physical credit file of the loans they were purchasing. "During 2006 and 2007, I witnessed many changes to the way the credit risk was being evaluated for these pools during the purchase processes," Bowen said. For example, he said, the chief risk officer in Citigroup's Consumer Lending business reversed large numbers of underwriting decisions from "turn down" to "approved."[75]

Another part of Bowen's charge was to supervise the purchase of roughly $50 billion annually in prime loan pools, a high percentage of which were sold to Fannie Mae and Freddie Mac for securitization. The sampling provided to Bowen's staff for quality control was supposed to include at least 5% of the loan pool for a given securitization, but "this corporate mandate was usually ignored." Samples of 2% were more likely, and the loan samples that Bowen's group did examine showed extremely high rates of noncompliance. "At the time that I became involved, which was early to mid-2006, we identified that 40 to 60 percent of the files either had a 'disagree' decision, or they were missing critical documents."[76]

Bowen repeatedly expressed concerns to his direct supervisor and company executives about the quality and underwriting of mortgages that CitiMortgage purchased and then sold to the GSEs. As discussed in a later chapter, the GSEs would later require Citigroup to buy back $1.5 billion in loans as of November 2010, finding that the loans Citigroup had sold them did not conform to GSE standards.

SEC: "The elephant in the room is that we didn't review the prospectus supplements"

By the time the financial crisis hit, investors held more than $2 trillion of non-GSE mortgage-backed securities and close to $700 billion of CDOs that held mortgage-backed securities.[77] These securities were issued with practically no SEC oversight. And only a minority were subject to the SEC's ongoing public reporting requirements. The SEC's mandate is to protect investors—generally not by reviewing the quality of securities, but simply by ensuring adequate disclosures so that investors can make up their own minds. In the case of initial public offerings of a company's shares, the work has historically involved a lengthy review of the issuer's prospectus and other "offering materials" prior to sale.[78]

However, with the advent of "shelf registration," a method of registering securities on an ongoing basis, the process became much quicker for mortgage-backed securities ranked in the highest grades by the rating agencies. The process allowed issuers to file a base prospectus with the SEC, giving investors notice that the issuer intended to offer securities in the future. The issuer then filed a supplemental prospectus describing each offering's terms. "The elephant in the room is that we didn't review the prospectus supplements," the SEC's deputy director for disclosure in corporation finance, Shelley Parratt, told the FCIC.[79] To improve disclosures pertaining to mortgage-backed securities and other asset-backed securities, the SEC issued Regulation AB in late 2004. The regulation required that every prospectus include "a description of the solicitation, credit-granting or underwriting criteria used to originate or purchase the pool assets, including, to the extent known, any changes in such criteria and the extent to which such policies and criteria are or could be overridden."[80]

With essentially no review or oversight, how good were disclosures about mortgage-backed securities? Prospectuses usually included disclaimers to the effect that not all mortgages would comply with the lending policies of the originator: "On a case-by-case basis [the originator] may determine that, based upon compensating factors, a prospective mortgage not strictly qualifying under the underwriting risk category or other guidelines described below warrants an underwriting exception."[81] The disclosure typically had a sentence stating that "a substantial number" or perhaps "a substantial portion of the Mortgage Loans will represent these exceptions."[82] Citigroup's Bowen criticized the extent of information provided on loan pools: "There was no disclosure made to the investors with regard to the quality of the files they were purchasing."[83]

Such disclosures were insufficient for investors to know what criteria the mortgages they were buying actually did meet. Only a small portion—as little as 2% to 3%—of the loans in any deal were sampled, and evidence from Clayton shows that a significant number did not meet stated guidelines or have compensating factors.[84] On the loans in the remainder of the mortgage pool that were not sampled (as much as 97%), Clayton and the securitizers had no information, but one could reasonably expect them to have many of the same deficiencies, and at the same rate, as the sampled loans. Prospectuses for the ultimate investors in the mortgage-backed securities did not contain this information, or information on how few loans were reviewed, raising the question of whether the disclosures were materially misleading, in violation of the securities laws.

CDOs were issued under a different regulatory framework from the one that applied to many mortgage-backed securities, and were not subject even to the minimal shelf registration rules. Underwriters typically issued CDOs under the SEC's Rule 144A, which allows the unregistered resale of certain securities to so-called qualified institutional buyers (QIBs); these included investors as diverse as insurance companies like MetLife, pension funds like the California State Teachers' Retirement System, and investment banks like Goldman Sachs.[85]

The SEC created Rule 144A in 1990, making securities markets more attractive to borrowers and U.S. investment banks more competitive with their foreign counterparts; at the time, market participants viewed U.S. disclosure requirements as more onerous than those in other countries. The new rule significantly expanded the market for these securities by declaring that distributions which complied with the rule would no longer be considered "public offerings" and therefore would not be subject to the SEC's registration requirements. In 1996, Congress reinforced this exemption with the National Securities Markets Improvements Act, legislation that Denise Voigt Crawford, a commissioner on the Texas Securities Board, characterized to the Commission "as prohibit[ing] the states from taking preventative actions in areas that we now know have been substantial contributing factors to the current crisis."[86] Under this legislation, state securities regulators were preempted from overseeing private placements such as CDOs. In the absence of registration requirements, a new debt market developed quickly under Rule 144A. This market was liquid, since qualified investors could freely trade Rule 144A debt securities. But debt securities when Rule 144A was enacted were mostly corporate bonds, very different from the CDOs that dominated the private placement market more than a decade later.[87]

After the crisis unfolded, investors, arguing that disclosure hadn't been adequate, filed numerous lawsuits under federal and state securities laws. As we will see, some have already resulted in substantial settlements.

REGULATORS: "MARKETS WILL ALWAYS SELF-CORRECT"

Where were the regulators? Declining underwriting standards and new mortgage products had been on regulators' radar screens in the years before the crisis, but disagreements among the agencies and their traditional preference for minimal interference delayed action.

Supervisors had, since the 1990s, followed a "risk-focused" approach that relied extensively on banks' own internal risk management systems.[88] "As internal systems improve, the basic thrust of the examination process should shift from largely duplicating many activities already conducted within the bank to providing constructive feedback that the bank can use to enhance further the quality of its risk-management systems," Chairman Greenspan had said in 1999.[89] Across agencies, there was a "historic vision, historic approach, that a lighter hand at regulation was the appropriate way to regulate," Eugene Ludwig, comptroller of the currency from 1993 to 1998, told the FCIC, referring to the Gramm-Leach-Bliley Act in 1999.[90] The New York Fed, in a "lessons-learned" analysis after the crisis, pointed to the mistaken belief that "markets will always self-correct." "A deference to the self-correcting property of markets inhibited supervisors from imposing prescriptive views on banks," the report concluded.[91]

The reliance on banks' own risk management would extend to capital standards. Banks had complained for years that the original 1988 Basel standards did not allow them sufficient latitude to base their capital on the riskiness of particular assets. After years of negotiations, international regulators, with strong support from the Fed, introduced the Basel II capital regime in June 2004, which would allow banks to lower their capital charges if they could show they had sophisticated internal models for estimating the riskiness of their assets. While no U.S. bank fully implemented the more sophisticated approaches that it allowed, Basel II reflected and reinforced the supervisors' risk-focused approach. Spillenkothen said that one of the regulators' biggest mistakes was their "acceptance of Basel II premises," which he described as displaying "an excessive faith in internal bank risk models, an infatuation with the specious accuracy of complex quantitative risk measurement techniques, and a willingness (at least in the early days of Basel II) to tolerate a reduction in regulatory capital in return for the prospect of better risk management and greater risk-sensitivity."[92]

Regulators had been taking notice of the mortgage market for several years before the crisis. As early as 2004, they recognized that mortgage products and borrowers had changed during and following the refinancing boom of the previous year, and they began work on providing guidance to banks and thrifts. But too little was done, and too late, because of interagency discord, industry pushback, and a widely held view that market participants had the situation well in hand.

"Within the board, people understood that many of these loan types had gotten to an extreme," Susan Bies, then a Fed governor and chair of the Federal Reserve Board's subcommittees on both safety and soundness supervision and consumer protection supervision, told the FCIC. "So the main debate within the board was how tightly [should we] rein in the abuses that we were seeing. So it was more of 'to a degree.'"[93]

Indeed, in the same June 2005 Federal Open Market Committee meeting described earlier, one FOMC member noted that "some of the newer, more intricate and untested credit default instruments had caused some market turmoil." Another participant was concerned "that subprime lending was an accident waiting to happen." A third participant noted the risks in mortgage securities, the rapid growth of subprime lending, and the fact that many lenders had "inadequate information on borrowers," adding, however, that record profits and high capital levels allayed those concerns. A fourth participant said that "we could be seeing the final gasps of house price appreciation." The participant expressed concern about "creative financing" and was "worried that piggybacks and other non-traditional loans," whose risk of default could be higher than suggested by the securities they backed, "could be making the books of GSEs look better than they really were." Fed staff replied that the GSEs were not large purchasers of private label securities.[94]

In the spring of 2006, the FOMC would again discuss risks in the housing and mortgage markets and express nervousness about the growing "ingenuity" of the mortgage sector. One participant noted that negative amortization loans had the pernicious effect of stripping equity and wealth from homeowners and raised concerns about nontraditional lending practices that seemed based on the presumption of continued increases in home prices.

John Snow, then treasury secretary, told the FCIC that he called a meeting in late 2004 or early 2005 to urge regulators to address the proliferation of poor lending practices. He said he was struck that regulators tended not to see a problem at their own institutions. "Nobody had a full 360-degree view. The basic reaction from financial regulators was, 'Well, there may be a problem. But it's not in my field of view,'" Snow told the FCIC. Regulators responded to Snow's questions by saying, "Our default rates are very low. Our institutions are very well capitalized. Our institutions [have] very low delinquencies. So we don't see any real big problem."[95]

In May 2005, the banking agencies did issue guidance on the risks of home equity lines of credit and home equity loans. It cautioned financial institutions about credit risk management practices, pointing to interest-only features, low- or no-documentation loans, high loan-to-value and debt-to-income ratios, lower credit scores, greater use of automated valuation models, and the increase in transactions generated through a loan broker or other third party. While this guidance identified many of the problematic lending practices engaged in by bank lenders, it was limited to home equity loans. It did not apply to first mortgages.[96]

In 2005, examiners from the Fed and other agencies conducted a confidential "peer group" study of mortgage practices at six companies that together had originated $1.3 trillion in mortgages in 2005, almost half the national total. In the group were five banks whose holding companies were under the Fed's supervisory purview—Bank of America, Citigroup, Countrywide, National City, and Wells Fargo—as well as the largest thrift, Washington Mutual.[97] The study "showed a very rapid increase in the volume of these irresponsible loans, very risky loans," Sabeth Siddique, then head of credit risk at the Federal Reserve Board's Division of Banking Supervision and Regulation, told the FCIC.[98] A large percentage of their loans issued were subprime and Alt-A mortgages, and the underwriting standards for these products had deteriorated.[99]

Once the Fed and other supervisors had identified the mortgage problems, they agreed to express those concerns to the industry in the form of nonbinding guidance. "There was among the Board of Governors folks, you know, some who felt that if we just put out guidance, the banks would get the message," Bies said.[100]

The federal agencies therefore drafted guidance on nontraditional mortgages such as option ARMs, issuing it for public comment in late 2005. The draft guidance directed lenders to consider a borrower's ability to make the loan payment when rates adjusted, rather than just the lower starting rate. It warned lenders that low-documentation loans should be "used with caution."[101]

Immediately, the industry was up in arms. The American Bankers Association said the guidance "overstate[d] the risk of non-traditional mortgages."[102] Other market participants complained that the guidance required them to assume "a worst case scenario," that is, the scenario in which borrowers would have to make the full payment when rates adjusted.[103] They disputed the warning on low-documentation loans, maintaining that "almost any form of documentation can be appropriate."[104] They denied that better disclosures were required to protect borrowers from the risks of nontraditional mortgages, arguing that they were "not aware of any empirical evidence that supports the need for further consumer protection standards."[105]

The need for guidance was controversial within the agencies, too. "We got tremendous pushback from the industry as well as Congress as well as, you know, internally," the Fed's Siddique told the FCIC. "Because it was stifling innovation, potentially, and it was denying the American dream to many people."[106]

The pressures to weaken and delay the guidance were strong and came from many sources. Opposition by the Office of Thrift Supervision helped delay the mortgage guidance for almost a year.[107] Bies said, "There was some real concern about if the Fed tightened down on [the banks it regulated], whether that would create an unlevel playing field . . . [for] stand-alone mortgage lenders whom the [Fed] did not regulate." Another challenge to regulating the mortgage market was Congress. She recalled an occasion when she testified about a proposed rule and "members of Congress [said] that we were going to deny the dream of homeownership to Americans if we put this new stronger standard in place."[108]

When guidance was put in place in 2006, regulators policed their guidance through bank examinations and informal measures such as "voluntary agreements" with supervised institutions.

It also appeared some institutions switched regulators in search of more lenient treatment. In December 2006, Countrywide applied to switch regulators from the Fed and OCC to the OTS. Countrywide's move came after several months of evaluation within the company about the benefits of OTS regulation, many of which were promoted by the OTS itself over the course of an "outreach effort" initiated in mid-2005 after John Reich became director of the agency. Publicly, Countrywide stated that the decision to switch to the OTS was driven by the desire to have one, housing-focused regulator, rather than separate regulators for the bank and the holding company.[109]

However, other factors came into play as well. The OCC's top Countrywide examiner told the FCIC that Countrywide CEO Angelo Mozilo and President and COO David Sambol thought the OCC's position on property appraisals would be "killing the business."[110] An internal July 2006 Countrywide briefing paper noted, "The OTS regulation of holding companies is not as intrusive as that of the Federal Reserve. In particular, the OTS rarely conducts extensive onsite examinations and when they do conduct an onsite examination they are generally not considered intrusive to the holding company." The briefing paper also noted, "The OTS generally is considered a less sophisticated regulator than the Federal Reserve."[111] In August 2006, Mozilo wrote to members of his executive team, "It appears that the Fed is now troubled by pay options while the OTS is not. Since pay options are a major component of both our volumes and profitability the Fed may force us into a decision faster than we would like." Countrywide Chief Risk Officer John McMurray responded that "based on my meetings with the FRB and OTS, the OTS appears to be both more familiar and more comfortable with Option ARMs."[112]

The OTS approved Countrywide's application for a thrift charter on March 5, 2007.

LEVERAGED LOANS AND COMMERCIAL REAL ESTATE: "YOU'VE GOT TO GET UP AND DANCE"

The credit bubble was not confined to the residential mortgage market. The markets for commercial real estate and leveraged loans (typically loans to below-investment-grade companies to aid their business or to finance buyouts) also experienced similar bubble-and-bust dynamics, although the effects were not as large and damaging as in residential real estate. From 2000 to 2007, these other two markets grew tremendously, spurred by structured finance products—commercial mortgage–backed securities and collateralized loan obligations (CLOs), respectively—which were in many ways similar to residential mortgage-backed securities and CDOs. And just as in the residential mortgage market, underwriting standards loosened, even as the cost of borrowing decreased,[113] and trading in these securities was bolstered by the development of new credit derivatives products.[114]

Historically, leveraged loans had been made by commercial banks; but a market for institutional investors developed and grew in the mid- to late 1990s.[115] An "agent" bank would originate a package of loans to only one company and then sell or syndicate the loans in the package to other banks and large nonbank investors. The package generally included loans with different maturities. Some were short-term lines of credit, which would be syndicated to banks; the rest were longer-term loans syndicated to nonbank, institutional investors. Leveraged loan issuance more than doubled from 2000 to 2007, but the rapid growth was in the longer-term institutional loans rather than in short-term lending. By 2007, the longer-term leveraged loans rose to $387 billion, up from $46 billion in 2000.[116]

Starting in 1998, the longer-term leveraged loans were packaged in CLOs, which were rated according to methodologies similar to those the rating agencies used for CDOs. Like CDOs, CLOs had tranches, underwriters, and collateral managers. The market was less than $5 billion annually from 1998 to 2002, but then it started growing dramatically. Annual issuance exceeded $40 billion in 2005 and peaked above $80 billion in 2007. From 2000 through the third quarter of 2007, more than 60% of leveraged loans were packaged into CLOs.[117]

As the market for leveraged loans grew, credit became looser and leverage increased as well. The deals became larger and costs of borrowing declined. Loans that in 2003 had paid interest of 4 percentage points over an interbank lending rate were refinanced in early 2007 into loans paying just 2 percentage points over that same rate. During the peak of the recent leveraged buyout boom, leveraged loans were frequently issued with interest-only, "payment-in-kind," and "covenant-lite" terms.[118] Payment-in-kind loans allowed borrowers to defer paying interest by issuing new debt to cover accrued interest. Covenant-lite loans exempted borrowers from standard loan covenants that usually require corporate firms to limit their other debts and to maintain minimum levels of cash. Private equity firms, those that specialized in investing directly in companies, found it easier and cheaper to finance their leveraged buyouts. Just as home prices rose, so too did the prices of the target companies.

One of the largest deals ever made involving leveraged loans was announced on April 2, 2007, by KKR, a private equity firm. KKR said it intended to purchase First Data Corporation, a processor of electronic data including credit and debit card payments, for about $29 billion. As part of this transaction, KKR would issue $8 billion in junk bonds and take out another $15 billion in leveraged loans from a consortium of banks including Citigroup, Deutsche Bank, Goldman Sachs, HSBC Securities, Lehman Brothers, and Merrill Lynch.[119]

As late as July 2007, Citigroup and others were still increasing their leveraged loan business.[120] Citigroup CEO Charles Prince then said of the business, "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing." Prince later explained to the FCIC, "At that point in time, because interest rates had been so low for so long, the private equity firms were driving very hard bargains with the banks. And at that point in time the banks individually had no credibility to stop participating in this lending business. It was not credible for one institution to unilaterally back away from this leveraged lending business. It was in that context that I suggested that all of us, we were all regulated entities, that the regulators had an interest in tightening up lending standards in the leveraged lending area."[121]

The CLO market would seize up in the summer of 2007 during the financial crisis, just as the much-larger mortgage-related CDO market seized. At the time this would be roughly $300 billion in outstanding commitments for new loans; as demand in the secondary market dried up, these loans ended up on the banks' balance sheets.[122]

Commercial real estate—multifamily apartment buildings, office buildings, hotels, retail establishments, and industrial properties—went through a bubble similar to that in the housing market. Investment banks created commercial mortgage–backed securities and even CDOs out of commercial real estate loans, just as they did with residential mortgages. And, just as houses appreciated from 2000 on, so too did commercial real estate values. Office prices rose by nearly 60% between 2003 and 2008 in the central business districts of the 32 markets for which data are available. The increase was 193% in Phoenix, 153% in Tampa, 147% in Manhattan, and 146% in Los Angeles.[123]

Issuance of commercial mortgage–backed securities rose from $47 billion in 2000 to $169 billion in 2005, reaching $230 billion in 2007. When securitization markets contracted, issuance fell to $12 billion in 2008 and $3 billion in 2009. When about one-fourth of commercial real estate mortgages were securitized in 2007, securitizers issued $41 billion of commercial mortgage CDOs, a number that again dropped precipitously in 2008.[124]

Leveraged loans and the commercial real estate sector came together on July 3, 2007, when the Blackstone Group announced its plan to buy Hilton—a hotel chain with 2,900 properties—for $26 billion, a 40% premium over the share price. A year later, one author described this deal as "the apogee of the early-millennial megabuyout frenzy, where cheap and readily available credit, coupled with a relentless one-upmanship, spurred private equity firms to buy out companies at often absurd overvaluations, saddle them with massive debt, and then pay themselves hefty fees for the trouble."[125] Twenty billion dollars in financing came from the top five investment banks and large commercial banks such as Bank of America and Deutsche Bank.[126]

Bear Stearns was increasingly active in these markets. While Bear topped the 2006 market in residential securitizations, it ranked in the bottom half in commercial securitizations.[127] But it was racing to catch up, and in a 2007 presentation boasted: "In 2006, we firmly established Bear Stearns as a global presence in commercial real estate finance." The firm's commercial real estate mortgage originations more than doubled between 2004 and 2006.[128]

And then the market came crashing to a halt. Although the commercial real estate mortgage market was much smaller than the residential real estate market—in 2008, commercial real estate debt was less than $4 trillion, compared to $12 trillion for residential mortgages[129]—it declined even more steeply. From its peak, commercial real estate fell roughly 45% in value, and prices have remained close to their lows. Losses on commercial real estate would be an issue across Wall Street, particularly for Lehman and Bear. And potentially for the taxpayer. When the Federal Reserve would assume $30 billion of Bear's illiquid assets in 2008, that would include roughly $4 billion in loans from the unsold portion of the Hilton financing package.[130] And the commercial real estate market would continue to decline long after the housing market had begun to stabilize.

LEHMAN: FROM "MOVING" TO "STORAGE"

Even as the market was nearing its peak, Lehman took on more risk.

On October 5, 2007, when commercial real estate already made up 6.3% of its assets, Lehman Brothers acquired a major stake in Archstone Smith, a publicly traded real estate investment trust, for $5.4 billion. Archstone owned more than 88,000 apartments, including units still under construction, in over 340 communities in the United States. It was the bank's largest commercial real estate investment.[131]

Lehman initially projected that Archstone would generate more than $1.3 billion in profits over 10 years—projections based on optimistic assumptions, given the state of the market at that point. Both Lehman and Archstone were highly leveraged: Archstone had little cushion if its rent receipts should go down, and Lehman had little cushion if investments such as Archstone should lose value.[132] Although the firm had proclaimed that "Risk Management is at the very core of Lehman's business model," the Executive Committee simply left its risk officer, Madelyn Antoncic, out of the loop when it made this investment.[133]

Since the late 1990s, Lehman had also built a large mortgage origination arm, a formidable securities issuance business, and a powerful underwriting division as well. Then, in its March 2006 "Global Strategy Offsite," CEO Richard Fuld and other executives explained to their colleagues a new move toward an aggressive growth strategy, including greater risk and more leverage. They described the change as a shift from a "moving" or securitization business to a "storage" business, in which Lehman would make and hold longer-term investments.[134]

By summer 2006, the housing market faced ballooning inventories, sharply reduced sales volumes, and wavering prices. Senior management regularly disregarded the firm's risk policies and limits—and warnings from risk managers—and pursued its "countercyclical growth strategy." It had worked well during prior market dislocations, and Lehman's management assumed that it would work again.[135] Lehman's Aurora unit continued to originate Alt-A loans after the housing market had begun to show signs of weakening.[136] Lehman also continued to securitize mortgage assets for sale but was now holding more of them as investments. Across both the commercial and residential real estate sectors, the mortgage-related assets on Lehman's books increased from $67 billion in 2006 to $111 billion in 2007. This increase would be part of Lehman's undoing a year later.

Lehman's regulators did not restrain its rapid growth. The SEC, Lehman's main regulator, knew of the firm's disregard of risk management. The SEC knew that Lehman continued to increase its holding of mortgage securities, and that it had increased and exceeded risk limits—facts noted almost monthly in official SEC reports obtained by the FCIC.[137] Nonetheless, Erik Sirri, who led the SEC's supervision program, told the FCIC that it would not have mattered if the agency had fully recognized the risks associated with commercial real estate. To avoid serious losses, Sirri maintained, Lehman would have had to start selling real estate assets in 2006.[138] Instead, it kept buying, well into the first quarter of 2008.

In addition, according to the bankruptcy examiner, Lehman understated its leverage through "Repo 105" transactions—an accounting maneuver to temporarily remove assets from the balance sheet before each reporting period. Martin Kelly, Lehman's global financial controller, stated that the transactions had "no substance"—their "only purpose or motive . . . was reduction in the balance sheet." Other Lehman executives described Repo 105 transactions as an "accounting gimmick" and a "lazy way of managing the balance sheet as opposed to legitimately meeting balance sheet targets at quarter-end." Bart McDade, who became Lehman's president and chief operating officer in June 2008, in an email called Repo 105 transactions "another drug we R on."[139]

Ernst & Young (E&Y), Lehman's auditor, was aware of the Repo 105 practice but did not question Lehman's failure to publicly disclose it, despite being informed in May 2008 by Lehman Senior Vice President Matthew Lee that the practice was improper. The Lehman bankruptcy examiner concluded that E&Y took "virtually no action to investigate the Repo 105 allegations, . . . took no steps to question or challenge the non-disclosure by Lehman," and that "colorable claims exist that E&Y did not meet professional standards, both in investigating Lee's allegations and in connection with its audit and review of Lehman's financial statements."[140] New York Attorney General Andrew Cuomo sued E&Y in December 2010, accusing the firm of facilitating a "massive accounting fraud" by helping Lehman to deceive the public about its financial condition.[141]

The Office of Thrift Supervision had also regulated Lehman since 1999 through its jurisdiction over Lehman's thrift subsidiary. Although "the SEC was regarded as the primary regulator," the OTS examiner told the FCIC, "we in no way just assumed that [the SEC] would do the right thing, so we regulated and supervised the holding company."[142] Still, not until July 2008—just a few months before Lehman failed—would the OTS issue a report warning that Lehman had made an "outsized bet" on commercial real estate—larger than that by its peer firms, despite Lehman's smaller size; that Lehman was "materially overexposed" to the commercial real estate sector; and that Lehman had "major failings in its risk management process."[143]

FANNIE MAE AND FREDDIE MAC: "TWO STARK CHOICES"

In 2005, while Countrywide, Citigroup, Lehman, and many others in the mortgage and CDO businesses were going into overdrive, executives at the two behemoth GSEs, Fannie and Freddie, worried they were being left behind. One sign of the times: Fannie's biggest source of mortgages, Countrywide, expanded—that is, loosened—its underwriting criteria, and Fannie would not buy the new mortgages, Countrywide President and COO Sambol told the FCIC.[144] Typical of the market as a whole, Countrywide sold 72% of its loans to Fannie in 2003 but only 45% in 2004 and 32% in 2005.[145]

"The risk in the environment has accelerated dramatically," Thomas Lund, Fannie's head of single-family lending, told fellow senior officers at a strategic planning meeting on June 27, 2005. In a bulleted list, he ticked off changes in the market: the "proliferation of higher risk alternative mortgage products, growing concern about housing bubbles, growing concerns about borrowers taking on increased risks and higher debt, [and] aggressive risk layering."[146]

"We face two stark choices: stay the course [or] meet the market where the market is," Lund said. If Fannie Mae stayed the course, it would maintain its credit discipline, protect the quality of its book, preserve capital, and intensify the company's public voice on concerns. However, it would also face lower volumes and revenues, continued declines in market share, lower earnings, and a weakening of key customer relationships.[147] It was simply a matter of relevance, former CEO Dan Mudd told the FCIC: "If you're not relevant, you're unprofitable, and you're not serving the mission. And there was danger to profitability. I'm speaking more long term than in any given quarter or any given year. So this was a real strategic rethinking."[148]

Lund saw significant obstacles to meeting the market. He noted Fannie's lack of capability and infrastructure to structure the types of riskier mortgage-backed securities offered by Wall Street, its unfamiliarity with the new credit risks, worries that the price of the mortgages wouldn't be worth the risk, and regulatory concerns surrounding certain products.[149] At this and other meetings, Lund recommended studying whether the current market changes were cyclical or more permanent, but he also recommended that Fannie "dedicate significant resources to develop capabilities to compete in any mortgage environment."[150] Citibank executives also made a presentation to Fannie's board in July 2005, warning that Fannie was increasingly at risk of being marginalized, and that "stay the course" was not an option. Citibank proposed that Fannie expand its guarantee business to cover nontraditional products such as Alt-A and subprime mortgages.[151] Of course, as the second-largest seller of mortgages to Fannie, Citibank would benefit from such a move. Over the next two years, Citibank would increase its sales to Fannie by more than a quarter, to $56 billion in the 2007 fiscal year, while more than tripling its sales of interest-only mortgages, to $4 billion.[152]

Lund told the FCIC that in 2005, the board would adopt his recommendation: for the time being, Fannie would "stay the course," while developing capabilities to compete with Wall Street in nonprime mortgages.[153] In fact, however, internal reports show that by September 2005, the company had already begun to increase its acquisitions of riskier loans. By the end of 2005, its Alt-A loans were $181 billion, up from $147 billion in 2004 and $138 billion in 2003; its loans without full documentation were $278 billion, up from $200 billion in 2003; and its interest-only mortgages were $75 billion in 2005, up from $12 billion in 2003. (Note that these categories can overlap. For example, Alt-A loans may also lack full documentation.) To cover potential losses from all of its business activities, Fannie had a total of $40 billion in capital at the end of 2005. "Plans to meet market share targets resulted in strategies to increase purchases of higher risk products, creating a conflict between prudent credit risk management and corporate business objectives," the Federal Housing Finance Agency (the successor to the Office of Federal Housing Enterprise Oversight) would write in September 2008 on the eve of the government takeover of Fannie Mae. "Since 2005, Fannie Mae has grown its Alt-A portfolio and other higher risk products rapidly without adequate controls in place."[154]

In its financial statements, Fannie Mae's disclosures about key loan characteristics changed over time, making it difficult to discern the company's exposure to subprime and Alt-A mortgages. For example, from 2005 until 2007, the company's definition of a "subprime" loan was one originated by a company or a part of a company that specialized in subprime loans. Using that definition, Fannie Mae stated that subprime loans accounted for less than 1% of its business volume during those years even while it reported that 5% of its conventional, single-family loans in 2005, 2006 and 2007 loans were to borrowers with FICO scores less than 620.[155]

Similarly, Freddie had enlarged its portfolios quickly with limited capital.[156] In 2005, CEO Richard Syron fired David Andrukonis, Freddie's longtime chief risk officer. Syron said one of the reasons that Andrukonis was fired was that Andrukonis was concerned about relaxing underwriting standards to meet mission goals. He told the FCIC, "I had a legitimate difference of opinion on how dangerous it was. Now, as it turns out . . . he was able to foresee the market better than a lot of the rest of us could."[157] The new risk officer, Anurag Saksena, recounted to the FCIC staff that he repeatedly made the case for increasing capital to compensate for the increasing risk,[158] although Donald Bisenius, Freddie's executive vice president for single-family housing, told FCIC staff that he did not recall such discussions.[159] Syron never made Saksena part of the senior management team.[160]

OFHEO, the GSEs' regulator, noted their increasing purchases of riskier loans and securities in every examination report. But OFHEO never told the GSEs to stop. Rather, year after year, the regulator said that both companies had adequate capital, strong asset quality, prudent credit risk management, and qualified and active officers and directors.

In May 2006, at the same time as it paid a $400 million penalty related to deficiencies in its accounting practices, Fannie agreed to limit its on-balance-sheet mortgage portfolio to $728 billion, the level on December 31, 2005.[161] Two months later, Freddie agreed to limit the growth of its portfolio to 2% per year.[162] In examination reports for the year 2005, issued to both companies in May 2006, OFHEO noted the growth in purchases of risky loans and non-GSE securities but concluded that each GSE had "strong" asset quality and was adequately capitalized. OFHEO reported that management at Freddie was committed to resolving weaknesses and its Board was "qualified and active." The 2005 examination of Fannie was limited in scope—focusing primarily on the company's efforts to fix accounting and internal control deficiencies—because of the extensive resources needed to complete a three-year special examination initiated in the wake of Fannie's accounting scandal.[163]

In that special examination, OFHEO pinned many of the GSEs' problems on their corporate cultures. Its May 2006 special examination report on Fannie Mae detailed the "arrogant and unethical corporate culture where Fannie Mae employees manipulated accounting and earnings to trigger bonuses for senior executives from 1998 to 2004."[164] OFHEO Director James Lockhart (who had assumed that position the month the report was issued) recalled discovering during the special examination an email from Mudd, then Fannie's chief operating officer, to CEO Franklin Raines. Mudd wrote, "The old political reality [at Fannie] was that we always won, we took no prisoners . . . we used to . . . be able to write, or have written rules that worked for us."[165]

Soon after his arrival, Lockhart began advocating for reform. "The need for legislation was obvious as OFHEO was regulating two of the largest and most systematically important US financial institutions," he told the FCIC.[166] But no reform legislation would be passed until July 30, 2008, and by then it would be too late.

2006: "Increase our penetration into subprime"

After several years during which Fannie Mae purchased riskier loans and securities, then-Chief Financial Officer Robert Levin proposed a strategic initiative to "increase our penetration into subprime" at Fannie's January 2006 board meeting.[167] In the next month the board gave its approval.[168] Fannie would become more and more aggressive in its purchases. During a summer retreat for Fannie's senior officers, as

Stephen Ashley, the chairman of the board, introduced Fannie's new chief risk officer, Enrico Dallavecchia, he declared that the new CRO would not stand in the way of risk taking: "We have to think differently and creatively about risk, about compliance, and about controls. Historically these have not been strong suits of Fannie Mae. . . . Today's thinking requires that these areas become active partners with the business units and be viewed as tools that enable us to develop product and address market needs. Enrico Dallavecchia was not brought on-board to be a business dampener."[169]

In 2006, Fannie acquired $516 billion of loans; of those (including some overlap), $65 billion, or about 13%, had combined loan-to-value ratios above 95%; 15% were interest-only; and 28% did not have full documentation.[170] Fannie also purchased $36 billion of subprime and $12 billion of Alt-A non-GSE mortgage-backed securities.[171] The total amount of riskier loans represented larger multiples of capital than before.

At least initially, while house prices were still increasing, the strategic plan to increase risk and market share appeared to be successful. Fannie reported net income of $6 billion in 2005 and then $4 billion in 2006. In those two years, CEO Mudd's compensation totaled $24.4 million and Levin, who was interim CFO and then chief business officer, received $15.5 million.[172]

In 2006, Freddie Mac also continued to increase risk, "expand[ing] the purchase and guarantee of higher-risk mortgages . . . to increase market share, meet mission goals, stay competitive, and be responsive to sellers' needs."[173] It lowered its underwriting standards, increasing the use of credit policy waivers and exceptions. Newer alternative products, offered to a broader range of customers than ever before, accounted for about 24% of that year's purchases. Freddie Mac's plan also seemed to be successful. The company increased risk and market share while maintaining the same net income for 2005 and 2006, $2 billion.[174] CEO Richard Syron's compensation totaled $23.2 million for 2005 and 2006 combined,[175] while Chief Operating Officer Eugene McQuade received $13.4 million.[176]

Again, OFHEO was aware of these developments. Its March 2007 report noted that Fannie's new initiative to purchase higher-risk products included a plan to capture 20% of the subprime market by 2011. And OFHEO reported that credit risk increased "slightly" because of growth in subprime and other nontraditional products. But overall asset quality in its single-family business was found to be "strong," and the board members were "qualified and active." And, of course, Fannie was "adequately capitalized."[177]

Similarly, OFHEO told Freddie in 2007 that it had weaknesses that raised some possibility of failure, but that overall, Freddie's strength and financial capacity made failure unlikely.[178] Freddie did remain a "significant supervisory concern,"[179] and OFHEO noted the significant shift toward higher-risk mortgages.[180] But again, as in previous years, the regulator concluded that Freddie had "adequate capital," and its asset quality and credit risk management were "strong."[181]

The GSEs charged a fee for guaranteeing payments on GSE mortgage–backed securities, and OFHEO was silent about Fannie's practice of charging less to guarantee securities than their models indicated was appropriate. Mark Winer, the head of Fannie's Business, Analysis and Decisions Group since May 2006 and the person responsible for modeling pricing fees, raised concerns that Fannie Mae was not charging fees for Alt-A mortgages that adequately compensated for the risk. Winer recalled that Levin was critical of his models, asking, "Can you show me why you think you're right and everyone else is wrong?"[182] Undercharging for the guarantee fees was intended to increase market share, according to Todd Hempstead, the senior vice president at Fannie in charge of the western region.[183] Mudd acknowledged the difference between the model fee and the fee actually charged and also told the FCIC that the scarcity of historical data for many loans caused the model fee to be unreliable.[184]

In the September 6, 2008, memo that would recommend that Fannie be placed into conservatorship, OFHEO would expressly cite this practice as unsafe and unsound: "During 2006 and 2007, modeled loan fees were higher than actual fees charged, due to an emphasis on growing market share and competing with Wall Street and the other GSE."[185]

2007: "Moving deeper into the credit pool"

By the time housing prices had peaked in the second quarter of 2006, delinquencies had started to rise. During the board meeting held in April 2007, Lund said that dislocation in the housing market was an opportunity for Fannie to reclaim market share. At the same time, Fannie would support the housing market by increasing liquidity.[186] At the next month's meeting, Lund reported that Fannie's market share could increase to 60% from about 37% in 2006.[187] Indeed, in 2007 Fannie Mae forged ahead, purchasing more high-risk loans.[188] Fannie also purchased $16 billion of subprime non-GSE securities, and $5 billion of Alt-A.[189]

In June, Fannie prepared its 2007 five-year strategic plan, titled "Deepen Segments—Develop Breadth." The plan, which mentioned Fannie's "tough new challenges—a weakening housing market" and "slower-growing mortgage debt market"—included taking and managing "more mortgage credit risk, moving deeper into the credit pool to serve a large and growing part of the mortgage market." Overall, revenues and earnings were projected to increase in each of the following five years.[190]

Management told the board that Fannie's risk management function had all the necessary means and budget to act on the plan. Chief Risk Officer Dallavecchia did not agree, especially in light of a planned 16% cut in his budget. In a July 16, 2007, email to CEO Mudd, Dallavecchia wrote that he was very upset that he had to hear at the board meeting that Fannie had the "will and the money to change our culture and support taking more credit risk," given the proposed budget cut for his department in 2008 after a 25% reduction in headcount in 2007.[191] In an earlier email, Dallavecchia had written to Chief Operating Officer Michael Williams that Fannie had "one of the weakest control processes" that he "ever witnessed in [his] career, . . . was not even close to having proper control processes for credit, market and operational risk," and was "already back to the old days of scraping on controls . . . to reduce expenses." These deficiencies indicated that "people don't care about the [risk] function or they don't get it."[192]

Mudd responded, "My experience is that email is not a very good venue for conversation, venting or negotiating." If Dallavecchia felt that he had been dealt with in bad faith, he should "address it man to man," unless he wanted Mudd "to be the one to carry messages for you to your peers." Mudd concluded, "Please come and see me today face to face."[193] Dallavecchia told the FCIC that when he wrote this email he was tired and upset, and that the view it expressed was more extreme than what he thought at the time.[194] Fannie, after continuing to purchase and guarantee higher-risk mortgages in 2007, would report a $2.1 billion net loss for the year, caused by credit losses. In 2007, Mudd's compensation totaled $11.6 million and Levin's totaled $7 million.

In 2007, Freddie Mac also persisted in increasing purchases of riskier loans. A strategic plan from March highlighted "pressure on the franchise" and the "risk of falling below our return aspirations."[195] The company would try to improve earnings by entering adjacent markets: "Freddie Mac has competitive advantages over non-GSE participants in nonprime," the strategy document explained. "We have an opportunity to expand into markets we have missed—Subprime and Alt-A."[196] It took that opportunity. As OFHEO would note in its 2007 examination report, Freddie purchased and guaranteed loans originated in 2006 and 2007 with higher-risk characteristics, including interest-only loans, loans with FICO scores less than 620, loans with higher loan-to-value ratios, loans with high debt-to-income ratios, and loans without full documentation. Financial results in 2007 were poor: a $3.1 billion net loss driven by credit losses. The value of the $152 billion subprime and Alt-A private-label securities book suffered a $13 billion decline in market value.[197] In 2007, Syron's compensation totaled $18.3 million and McQuade's totaled $3.8 million.

Affordable housing goals: "GSEs cried bloody murder forever"

As discussed earlier, beginning in 1978, the Department of Housing and Urban Development (HUD) periodically set goals for the GSEs related to increasing homeownership among low- and moderate-income borrowers and borrowers in underserved areas. Until 2005, these goals were based on the fraction of the total mortgage market made up of low- and moderate-income families. The goals were intended to be only a modest reach beyond the mortgages that the GSEs would normally purchase.[198]

From 1997 to 2000, 42% of GSE purchases were required to meet goals for low- and moderate-income borrowers. In 2001, the goal was raised to 50%.[199] Mudd said that as long as the goals remained below half of the GSEs' lending, loans made in the normal course of business would satisfy the goals: "What comes in the door through the natural course of business will tend to match the market, and therefore will tend to meet the goals."[200] Levin told the FCIC that "there was a great deal of business that came through normal channels that met goals" and that most of the loans that satisfied the goals "would have been made anyway."[201]

In 2004 HUD announced that starting in 2005, 52% of the GSEs' purchases would need to satisfy the low- and moderate-income goals. The targets would reach 55% in 2007 and 56% in 2008.[202] Given the dramatic growth in the number of riskier loans originated in the market, the new goals were closer to where the market really was. But, as Mudd noted, "When 50% became 57[%] ultimately, then you have to work harder, pay more attention, and create a preference for those loans."[203] Targeted goals loans (loans made specifically to meet the targets), while always a small share of the GSEs' purchases, rose in importance.

Mudd testified that by 2008, when the housing market was in turmoil, Fannie Mae could no longer balance its obligations to shareholders with its affordable housing goals and other mission-related demands: "There may have been no way to satisfy 100% of the myriad demands for Fannie Mae to support all manner of projects [or] housing goals which were set above the origination levels in the marketplace."[204] As the combined size of the GSEs rose steadily from $3.6 trillion in 2003 to $4.9 trillion in 2007,[205] the number of mortgage borrowers that the GSEs needed to serve in order to fulfill the affordable housing goals also rose. By 2005, Fannie and Freddie were stretching to meet the higher goals, according to a number of GSE executives, OFHEO officials, and market observers.

Yet all but two of the dozens of current and former Fannie Mae employees and regulators interviewed on the subject told the FCIC that reaching the goals was not the primary driver of the GSEs' purchases of riskier mortgages and of subprime and Alt-A non-GSE mortgage–backed securities. Executives from Fannie, including Mudd, pointed to a "mix" of reasons for the purchases, such as reversing the declines in market share, responding to originators' demands, and responding to shareholder demands to increase market share and profits, in addition to fulfilling the mission of meeting affordable housing goals and providing liquidity to the market.

For example, Levin told the FCIC that while Fannie, to meet its housing goals, did purchase some subprime mortgages and mortgage-backed securities it would otherwise have passed up, Fannie was driven to "meet the market" and to reverse declining market share. On the other hand, he said that most Alt-A loans were high-income-oriented and would not have counted toward the goals, so those were purchased solely to increase profits.[206] Similarly, Lund told the FCIC that the desire for market share was the main driver behind Fannie's strategy in 2006. Housing goals had been a factor, but not the primary one.[207] And Dallavecchia likewise told the FCIC that Fannie increased its purchases of Alt-A loans to regain relevance in the market and meet customer needs.[208]

Hempstead, Fannie's principal contact with Countrywide, told the FCIC that while housing goals were one reason for Fannie's strategy, the main reason Fannie entered the riskier mortgage market was that those were the types of loans being originated in the primary market.[209] If Fannie wanted to continue purchasing large quantities of loans, the company would need to buy riskier loans. Kenneth Bacon, Fannie's executive vice president of multifamily lending, said much the same thing, and added that shareholders also wanted to see market share and returns rise.[210] Former Fannie chairman Stephen Ashley told the FCIC that the change in strategy in 2005 and 2006 was owed to a "mix of reasons," including the desire to regain market share and the need to respond to pressures from originators as well as to pressures from real estate industry advocates to be more engaged in the marketplace.[211]

To ensure an adequate supply of mortgages in case the goals were not met in the normal course of business, Fannie and Freddie instituted outreach programs in underserved geographic areas and conducted educational programs for originators and brokers.[212] In addition, as explained by Mike Quinn, the Fannie executive responsible for the goals, Fannie set lower fees on loans that met the goals, although it would not purchase mortgages that fell outside its predetermined risk targets.[213] Ashley also maintained that Fannie did not shift eligibility or underwriting standards to meet goals but instead directed its resources to marketing and promotional efforts, housing fairs, and outreach programs run by the company's partnership offices. "The effort was really in the outreach as opposed to reduced or diminished or loosened standards," Ashley told the FCIC.[214]

Former OFHEO Director Armando Falcon Jr. testified that the GSEs invested in subprime and Alt-A mortgages in order to increase profits and regain market share and that any impact on meeting affordable housing goals was simply a by-product of this activity.[215] Lockhart, a subsequent OFHEO director, attributed the GSEs' change in strategy to their drive for profit and market share, as well as the need to meet housing goals. Noting that the affordable housing goals increased markedly in 2005,[216] he said in an FCIC interview that the "goals were just one reason, certainly not the exclusive reason" for the change.[217] These views were corroborated by numerous other officials from the agency.[218]

The former HUD official Mike Price told the FCIC that while the "GSEs cried bloody murder forever" when it came to the goals, they touted their contribution to increasing homeownership. In addition, Price and other HUD officials told the FCIC that the GSEs never claimed that meeting the goals would leave them in an unsafe or unsound condition.[219]

Indeed, the law allowed both Fannie Mae and Freddie Mac to fall short of meeting housing goals that were "infeasible" or that would affect the companies' safety and soundness.[220] And while the GSEs often exceeded the goals, in some cases those targets were adjusted downward by HUD or, in rare cases, were simply missed by the GSEs.[221] For example, on December 12, 2007, Mudd wrote to HUD: "Fannie Mae believes that the low- and moderate-income and special affordable subgoals are infeasible for 2007."[222] Fannie Mae's 2007 strategic plan had already anticipated such a communication, stating, "In the event we reach a viewpoint that achieving the goals this year is 'infeasible,' we will determine how best to address the matter with HUD and will continue to keep the Board apprised accordingly."[223] In fact, both Fannie and Freddie appealed to HUD to lower two components of the goals for affordable housing. HUD complied and allowed the GSEs to fall short without any consequences.[224]

The impact of the goals

At least until HUD set new affordable housing goals for 2005, the GSEs only supplemented their routine purchases with a small volume of loans and non-GSE mortgage–backed securities needed to meet their requirements. The GSEs knew that they might not earn as much on these targeted goal loans as they would earn on both goal-qualifying and non-goal-qualifying loans purchased in the usual course of business; on some of these loans, they might even lose money. The organizations also had administrative and other costs related to the housing goals.

In June 2009 Freddie Mac staff made a presentation to the Business and Risk Committee of the Board of Directors on the costs of meeting its goals. From 2000 to 2003, the cost of the targeted goal loans was effectively zero, as the goals were reached through "profitable expansion" of the company's multifamily business. During the refinance boom, the goals became more challenging and cost Freddie money in the multifamily business; thus, only after 2004 did meeting the multifamily and single-family goals cost the GSE money. Still, only about 4% of all loans purchased by Freddie between 2005 and 2008 were bought "specifically because they contribute to the goals"—loans it labeled as "targeted affordable." These loans did have higher than average expected default rates, although Freddie also charged a higher fee to guarantee them. From 2003 through 2008, Freddie's costs of complying with the housing goals averaged $200 million annually. The costs of complying with these goals took into account three components: expected revenues, expected defaults, and foregone revenues (based on an assumption of what they might have earned elsewhere). These costs were only computed on the narrow set of loans specifically purchased to achieve the goals, as opposed to goal-qualifying loans purchased in the normal course of business.[225] For comparison, the company's net earnings averaged just under $3 billion per year from 2003 to 2006.[226]

In 2004, Fannie Mae retained McKinsey and Citigroup to determine whether it would be worthwhile to give up the company's charter as a GSE, which—while affording the company enormous benefits—imposed regulations and put constraints on business practices, including its mission goals. The final report to Fannie Mae's top management, called Project Phineas, found that the explicit cost of compliance with the goals from 2000 to 2003 was close to zero: "it is hard to discern a fundamental marginal cost to meeting the housing goals on the single family business side."[227] The report came to this conclusion despite the slightly greater difficulty of meeting the goals in the 2003 refinancing boom: the large numbers of homeowners refinancing, in particular those who were middle and upper income, necessarily reduced the percentage of the pool that would qualify for the goals.

In calculating these costs, the consultants computed the difference between fees charged on goal-qualifying loans and the higher fees suggested by Fannie's own models. But this cost was not unique to goal qualifying loans. Across its portfolio, Fannie charged lower fees than its models computed for goals loans as well as for non-goals loans. As a result, goals loans, even targeted goals loans, were not solely responsible for this cost. In fact, Fannie's discount was actually smaller for many goal-qualifying loans than for the others from 2000 to 2004.

Facing more aggressive goals in 2006 and 2007, Fannie Mae expanded initiatives to purchase targeted goals loans. These included mortgages acquired under the My Community Mortgage program, mortgages underwritten with looser standards, and manufactured housing loans. For these loans, Fannie explicitly calculated the opportunity cost (foregone revenues based on an assumption of what they might have earned elsewhere) along with the so-called cash flow cost, or the difference between their expected losses and expected revenue on these loans. For 2006, as the market was peaking, Fannie Mae estimated the cash flow cost of the loans to be $115 million and the opportunity cost of the targeted goals loans $390 million, compared to net income that year to Fannie of $4.1 billion—a figure that includes returns on the goal-qualifying loans made during the normal course of business.[228] The targeted goals loans amounted to $18 billion, or 3.4%, of Fannie Mae's $524 billion of single-family mortgage purchases in 2006.[229] As the markets tightened in the middle of 2007, the opportunity cost for that year was forecast to be roughly $1 billion.[230]

Looking back at how the targeted affordable portfolio performed in comparison with overall losses, the 2009 presentation at Freddie Mac took the analysis of the goals' costs one step further. While the outstanding $60 billion of these targeted affordable loans was only 4% of the total portfolio, these were relatively high-risk loans and were expected to account for 19% of total projected losses. In fact, as of late 2008, they had accounted for only 8% of losses—meaning that they had performed better than expected in relation to the whole portfolio. The company's major losses came from loans acquired in the normal course of business. The presentation noted that many of these defaulted loans were Alt-A.[231]

COMMISSION CONCLUSIONS ON CHAPTER 9

The Commission concludes that firms securitizing mortgages failed to perform adequate due diligence on the mortgages they purchased and at times knowingly waived compliance with underwriting standards. Potential investors were not fully informed or were misled about the poor quality of the mortgages contained in some mortgage-related securities. These problems appear to have been significant. The Securities and Exchange Commission failed to adequately enforce its disclosure requirements governing mortgage securities, exempted some sales of such securities from its review, and preempted states from applying state law to them, thereby failing in its core mission to protect investors.

The Federal Reserve failed to recognize the cataclysmic danger posed by the housing bubble to the financial system and refused to take timely action to constrain its growth, believing that it could contain the damage from the bubble's collapse.

Lax mortgage regulation and collapsing mortgage-lending standards and practices created conditions that were ripe for mortgage fraud.