CENTER FOR RESPONSIBLE LENDING

Wall Street, Not Fannie Mae & Freddie Mac, Created & Led the Toxic Mortgage Market

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QUICK TAKE

What Did Cause the Crisis – and What's Most Urgent Now?
It used to be that all parties involved in the mortgage market had an interest in sustainable loans. During the subprime boom, misaligned incentives allowed mortgage brokers, lenders, and investors to profit greatly from reckless and predatory lending and toxic financial products.

This does not change the reality that millions of American families now face potential foreclosure because of the inherently risky lending that took place during the subprime boom.

Instead of focusing on false causes of the crisis, Congress needs to give its full attention to economic recovery—which will remain out of reach as long as we continue to have 300,000 foreclosure filings every month.

Too many preventable foreclosures are occurring, and too often by loan companies using fraudulent or slip-shod methods. We need to stem the tide and make sure we stop unnecessary and illegal evictions.

Alan Greenspan, Christopher Cox and. John Snow, when questioned by House Oversight in 2008, all agreed that Fannie Mae and Freddie Mac were not the primary cause of the subprime meltdown. http://thinkprogress.org/2008/10/23/mica-waxman/

Wall Street Led the Toxic Market

It's well known that toxic subprime loans started the foreclosure crisis, and the disaster spread to other mortgages approved without properly qualifying borrowers. The facts show that Fannie Mae and Freddie Mac (the government-sponsored enterprises, "GSEs") were followers, not leaders, in the events leading up to today's foreclosure epidemic.

During the 2000s, subprime mortgage lending grew rapidly as Wall Street seized on the opportunity to invest in riskier, higher-interest mortgages. "Securitization"—the process of gathering thousands of mortgage loans into investment pools and selling pieces to investors—made it possible for loosely-regulated lenders to make loans and then immediately sell them to private firms that created mortgage-backed securities.

Fact: The GSEs were prohibited from buying subprime mortgages. Fannie and Freddie had no role at all in this. Fannie and Freddie could not buy, guarantee or "securitize" subprime mortgages because subprime loans were outside the prescribed GSE guidelines.[1] *Thus, all subprime mortgage-backed securities were created by Wall Street firms—not the GSEs*. For this reason, as the subprime market rapidly expanded, Fannie Mae and Freddie Mac actually lost market share.

Fact: Although the GSEs did purchase subprime mortgage-backed securities as investments, they never did so in a volume that matched Wall Street's. In 2004, under heavy pressure to join the rest of the market, the GSEs followed the big banks and other firms in investing in subprime mortgage-backed securities, all of which were created by Wall Street firms.[1] The GSEs' investment in subprime mortgage-backed securities was far less than Wall Street's.

Fact: The GSEs eventually guaranteed and created investments with "Alt-A" loans—which were not affordable housing loans. Alt-A loans went to relatively wealthier borrowers with higher credit scores, though often these loans had risky features such as limited documentation. These investments are the primary reason that the GSEs were placed into conservatorship. This market would have existed with or without support from Fannie Mae and Freddie Mac. They and the private market share responsibility for supporting these loans, but the GSEs' investments were generally less risky than Wall Street's.

<u>Fact</u>: Mortgage loans purchased by Fannie Mae and Freddie Mac—including loans to lower-income borrowers—are performing better than the private market. As of June 2010, 13.35% of GSE loans to borrowers with credit scores under 660 were 90+ days delinquent or in foreclosure. By comparison, the Mortgage Bankers Association reports that the serious delinquency rate for subprime loans was *over 28%*.

<u>Fact</u>: Affordable housing loans were not the problem. The GSEs' losses were caused by risky loans that generally went to borrowers with higher incomes.

- The GSEs' financial losses stem primarily from Alt-A mortgages, which are not connected to affordable housing, since Alt-A loans generally go to wealthier borrowers. In fact, the GSEs' support of the Alt-A market weakened their performance on meeting affordable housing goals. It was not "goals pressure," but rather the drive for profit and market share, that motivated Alt-A investments.

- Similarly, the vast majority of subprime loans were made by lenders who were not subject to the Community Reinvestment Act. CRA covers banks and thrifts, which didn't make many subprime loans. <u>In fact, fully 94% of subprime mortgage loans were made by institutions not covered by CRA</u>.

- Abusive loan terms, rather than risky borrowers, bear the greatest responsibility for the foreclosure crisis. Recent studies have shown that, comparing borrowers of similar risk characteristics, loans with sensible terms had significantly lower foreclosure rates than explosive subprime loans made by non-bank lenders.

<u>Notes</u>

<u>CRA coverage</u>**:** Staff Analysis of the Relationship between the CRA and the Subprime Crisis, Board of Governors of the Federal Reserve -- Division of Research and Statistics (November 21, 2008) www.federalreserve.gov/newsevents/speech/20081203_analysis.pdf.

<u>GSEs loans less risky than Wall Street's:</u> Inside the GSEs, January 3, 2007, p. 4. These securities are divided into tranches, with the AAA tranches being the least risky, and for this reason the easiest to sell to investors. Fannie Mae and Freddie Mac purchased only AAA tranches. It was the ability of private companies to fund the riskiest portion of subprime mortgage loans that made possible the explosive growth of subprime lending. See Pershing Square Capital Management, L.P., "Who's Holding the Bag," presentation, May 2007, available at www.designs.valueinvestorinsight.com/bonus/pdf/IraSohnFinal.pdf.

<u>Alt-A primary source of losses</u>: Fannie Mae investor presentation, "Fannie Mae 2008 Q2 10-Q Investor Summary," (Aug. 6, 2008), p. 36, available at www.fanniemae.com/media/pdf/webcast/080808transcript.pdf. By the middle of 2008, Alt-A loans accounted for roughly 10% of the GSEs' risk exposure, but 50% of their combined losses. Federal National Mortgage Association, U.S. SEC Form 10-Q, for quarterly period ended June 30, 2008, p.6, available at www.fanniemae.com/ir/pdf/earnings/2008/q22008.pdf; Federal Home Loan Mortgage Corporation, United States SEC 10-Q, for the quarterly period ended June 30, 2008, p.71, available at www.freddiemac.com/investors/.

<u>Serious delinquency rate over 28%</u>: Kevin Park, "Fannie, Freddie and the Foreclosure Crisis," University of North Carolina Center for Community Capital (Sept. 2010) www.ccc.unc.edu/documents/FannieFreddieForeclosure.pdf at 4.

<u>Weaker performance on housing goals</u>: See Kevin Park, "Fannie, Freddie and the Foreclosure Crisis" at 4.

<u>Loan terms vs. risky borrowers</u>. L. Ding, R. Quercia, W. Li and J. Ratcliffe, "Risky Borrowers or Risky Mortgages?: Disaggregating Effects Using Propensity Score Models," (Revised May 17, 2010), [1] at http://aux.zicklin.baruch.cuny.edu/jrer/papers/pdf/forth/accepted/Risky%20Borrowers%20or%20Risky%20Mortgages.pdf at 3 (finding that for borrowers with similar risk characteristics, the estimated default risk with a CRA-covered loan through a special lending program through Self-Help is about 70 percent lower than with a subprime mortgage); see also See E. Laderman and C. Reid, "CRA Lending During the Subprime Meltdown," at 118, available at www.frbsf.org/publications/community/cra/cra_lending_during_subprime_meltdown.pdf.