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The Subprime Crisis -- Cause, Effect and Consequences R. Christopher Whalen

Abstract: Despite the considerable media attention given to the collapse of the market for complex structured assets that contain subprime mortgages, there has been too little discussion of why this crisis occurred. "The Subprime Crisis: Cause, Effect and Consequences" argues that three basic issues are at the root of the problem, the first of which is an odious public policy partnership, spawned in Washington and comprising hundreds of companies, associations and government agencies, to enhance the availability of "affordable housing" via the use of "creative financing techniques." Second, federal regulators have actively encouraged the rapid growth of over-the-counter (OTC) derivatives and securities by all types of financial institutions. And third, also bearing blame for the subprime crisis is the related embrace by the Securities and Exchange Commission (SEC) and the Financial Accounting Standards Board of "fair value accounting." After reviewing the Bush administration's proposed solutions as flawed, this article recommends a strategy for subprime crisis resolution. Job one is to rebuild market confidence in structured assets by going back to "first principles" on issues such as market transparency, standardization of contracts, and accounting treatment. By reducing complexity on the trade of structured assets through simple deal structures and providing investors with the information they need to analyze collateral, for example by requiring SEC registration and public pricing of assets, much of the current liquidity problem is ameliorated.

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The Subprime Crisis -- Cause, Effect and Consequences

R. Christopher Whalen

"The new group at the Fed is not equal to the problem that faces it. They need to speak frankly to the market and acknowledge how bad the problems are, and acknowledge their own failures in letting this happen. This is what is needed to restore confidence. There never would have been a sub-prime mortgage crisis if the Fed had been alert. This is something Alan Greenspan must answer for."

Dr. Anna Schwartz
The Sunday Telegraph
 January 14, 2008

Subprime Crisis: Causes

Despite the considerable media attention given to the collapse of the market for complex structured assets, some of which contain subprime mortgages, there has been precious little discussion of why this crisis in confidence occurred and in particular why some \$3 trillion in private label structured assets are being liquidated, with negative effects on banks, dealers, end investors and the economy. Such a discussion, which is the primary goal of this paper, will hopefully lead members of the financial community to consider how the market for structured assets should change and evolve in future.ⁱ

The failure of Bear, Stearns & Co (NYSE:BSC) last week is just the latest in a series of failures caused by a global process of de-leveraging. The private market for complex structured assets, particularly the \$1 trillion or so of face amount that contained subprime mortgages at the start of 2008, arguably can trace its origins to the market for agency debt, particularly paper issued by government-sponsored entities (GSEs) such as Fannie Mae and Freddie Mac. The collapse of the subprime market is attributable to many factors, but three basic issues seem to be at the root of the problem.

- First, an odious public policy partnership — the National Homeownership Strategy -- spawned in Washington and comprising hundreds of companies, banks, associations and government agencies — to enhance the availability of "affordable housing" via the use of "creative financing techniques."ⁱⁱ
- Second, active encouragement by the SEC and federal bank regulators of the rapid growth of over-the-counter (OTC) derivatives and securities by all types of financial institutions, leading to a breakdown in safety and soundness at banks and securities dealers.

- And third, the related embrace by the Securities and Exchange Commission (SEC) and the Financial Accounting Standards Board (FASB) of “fair value accounting,” an ill-advised change in reporting standards for all public companies that is arguably driving much of the current panic on Wall Street.

Affordable Housing

The partnership for affordable housing was the creation of the real estate, home building and GSEs lobbies, relying upon legal mandates such as the Community Reinvestment Act (“CRA”) to “encourage” the banking industry to target increased home ownership in the U.S.. It began after the real estate collapse of the late 1980s, when the savings and loans (S&L) industry was almost entirely de-capitalized and real estate prices in many parts of the U.S. saw double digit declines. The housing GSEs were effectively insolvent by 1991, but the implicit guarantee by the U.S. Treasury enabled them to survive and expand their activities.

The methods used by the partnership to garner political support were, not surprisingly, similar to those employed by GSEs such as Fannie Mae and Freddie Mac on Capitol Hill. Support for “affordable housing” became a key part of local and national politics, aided by copious “donations” from the GSEs to members of Congress, a fact that lenders and real estate developers used to great advantage.

Banks, for their part, saw the affordable housing push as a way to placate and/or gratify politicians and community activists, and also to meet visibly CRA requirements for making credit available to minorities. CRA loans, let us not forget, have 100% loss rates and are functionally equivalent to political campaign contributions.

By the early part of the 21st century, nearly every mortgage lender in the U.S. incorporated the twin messages of “affordable housing” and “creative financing” into marketing, credit approval and product development efforts. The home builders and realtors were also an important part of the affordable housing push, exerting political influence to gain government support for housing going back three decades to the 1970s. Then as now, boosting home ownership and home building was seen as a way to stimulate a sluggish economy.

Washington consultant Robert Feinberg said in a March 2008 interview: “[In the 1970s] here developed what I call the Homebuilder-Realtor-Mortgage Banker Industrial Complex. They created a mythology that said you could not have enough housing and it was up to the government to make sure that happened. The home builders had a quota of 2 million units that had to be constructed every year. They really didn't care what happened to those homes once they were built.”ⁱⁱⁱ

At a meeting at the Harvard Club this past September, Josh Rosner, a principal of Graham Fisher & Co., noted that the partnership for affordable housing helped push structural changes in the housing industry, which ultimately led to a significant increase in home ownership in the U.S. between the early 1990s (63%) and its peak in 2005 (69%). Said Rosner:

"So what we saw actually was the largest public-private partnership to date, started as the National Partners in Home Ownership in 1994. It was signed onto by the realtors, the home builders, Fannie Mae, Freddie Mac, the mortgage bankers, HUD. It was a massive effort, with more than 1,500 public and private participants, and the state goal was to reach all time home ownership levels by the end of the century. And the stated strategy proposal to reach that goal was, quote: 'to increase creative financing methods for mortgage origination.' Those seeds were sown in 1994. Those policies were put in place in 1994. By 1995 we saw home prices start to rise and home ownership levels also start to rise. How did we do that? There was no private label [mortgage] market at that point. We were really dealing in a world of enterprise [GSE] paper. We saw most of the features [of CDOs and structured assets] that we are now looking at as having been atrocious or irresponsible or poor risk management having started in the enterprise markets. We saw changes in the LTV, changes from manual underwriting to automated underwriting. The approval models used were easy to game. We saw reductions in documentation requirements. We saw changes for mortgage insurance requirements. We saw the perversion of the appraisal process and a move to automated appraisals. All of these features which we now look at and point our fingers at the subprime originators and say 'you bad boys,' all started in the enterprise market. This, by the way, is why I believe there is still significant risk [in the GSEs]." ^{iv}

Regulatory Lapses

The second factor that helped foment the subprime debacle, strangely enough, is not the liberal, easy money monetary policy followed by the Fed under Chairman Alan Greenspan earlier in this decade, but rather errors and omission committed by regulators regarding bank regulatory policy, especially when it comes to bank involvement in securitization. Rosner and others, such as Drexel University professor Joseph Mason, argue that the original model for the subprime market was the GSE market and that most of the features of CDOs and complex structured assets that we now look upon as irresponsible or poor risk management started in the markets for agency paper. ^v

Academic texts are filled with various vies of the utopian dream of an efficient, transparent, private securitization market replacing commercial banks as a means of raising capital. Unfortunately, this vision was simply carried further by Wall Street than anyone in the Congress or the regulatory community anticipated. Whether or not it was reasonable for the Fed or other agencies not to see the danger inherent in the explosive growth in unregulated OTC derivatives and unregistered, opaque complex structured assets markets is another matter. ^{vi}

Mason describes the situation at the OCC in a 2008 interview:

“The subprime crisis results from a growing arbitrage of regulations and accounting rules that got out of hand. Right now the situation is that regulators don't want to acknowledge the problems in the market because to do so is to admit that they missed these same problems, in some cases going back 30 plus years now. They can't admit the problems without admitting malfeasance. On top of that, it's an election year which really throws

things for a loop. And then of course notwithstanding the fact that the regulators have egg of their face, the ratings agencies don't want to make any changes because, for them at least, this world is working just fine.”^{vii}

During the past two decades, the proliferation of off exchange-traded derivatives and the use of off-balance-sheet entities (à la Enron) have been actively encouraged by the Congress, the Federal Reserve Board staff in Washington and other global regulators. The combination of OTC derivatives, risk-based capital requirements authorized by Congress in 1991 and favorable accounting rules blessed by the SEC and the FASB, enabled Wall Street to create a de facto assembly line for purchasing, packaging and selling unregistered securities, such as subprime collateralized debt obligations (CDOs), to a wide variety of institutional investors.^{viii}

European observers aptly describe the literally thousands of CDOs and other types of structured investment vehicles (SIVs) created during the past decade as a “shadow banking system,” but few in the U.S. appreciate that this deliberately opaque pseudo market came into existence and grew with the direct approval and active encouragement of Greenspan, and other senior bank regulators in the U.S. and EU. Moreover, all of this occurred with the encouragement and approval of the academic research community. Regulators even issued cautionary guidance to help the dealer firms manage the quite apparent operational risks from dealing in complex structured assets, but did nothing to stop the financial services industry from creating this huge unregulated securities market.^{ix}

Seen from the perspective of regulatory inaction, the true lesson of the subprime crisis has less to do with the use of subprime mortgages as collateral in the SIVs and much more with how these inferior assets were packaged and sold outside the bounds of established regulatory controls. Not only did regulators allow the creation of new, unregistered assets classes which have caused investors grievous losses, but the use of structured finance by banks for reasons of funding introduced a new element of volatility and instability into the model of many U.S. banking institutions.

The growth in the “markets” for OTC asset classes and related phenomena represents a reversal of nearly a century of regulatory and prudential practices in the U.S.. Following the financial market crises of the 19th and early 20th centuries, the U.S. Congress substituted personal market discipline for regulation.^x The U.S. put in place legal strictures and market guidelines that required virtually all financial instruments to be traded on exchanges, with price discovery and counterparty credit risk issues exposed to the full light of public scrutiny and, thus, market discipline. However, with the “Big Bang” of decimalization in March 2001, the sell-side consensus surrounding the exchange-traded model, which already was under pressure, completely unraveled.^{xi}

While retail investors realized big savings in terms of the cost of execution after decimalization, the Big Bang also ripped the profitability out of institutional trade execution, forcing the major Wall Street firms to strip the services provided to investors down to the bare bones. More than the restrictions of Regulation FD or threats of prosecution by former New York State attorney general Elliot Spitzer, decimalization forced spreads to shrink and gradually compelled many

large sell-side firms to cut back on research and banking coverage for issuers of public securities and to focus new investments on OTC asset classes.

Post-decimalization, trading and sales of stocks and bonds were no longer profitable for many securities firms; thus, the only way to enhance or even maintain profitability was — and remains today — to employ lots of leverage – 30:1 debt to equity or more – and focus on OTC assets. In the shadowy world of OTC structured assets, bid-offer spreads are much wider than on exchanges because of poor transparency and disclosure. It helps if you think of the OTC market for derivative securities as comparable to the market for precious art, where the assets are all unique and pricing is rarely disclosed, except between dealers and clients. Further complicating matters, because OTC assets like CDOs often carried investment-grade ratings purchased from ratings firms, these less liquid assets carry lower risk-based capital requirements than other assets! Again, the operative mission is regulatory arbitrage.^{xii}

Many CDOs are entirely synthetic, with no collateral, supporting the gaming metaphor. Because no contract is comparable to another and because participants can “write” unlimited amounts of default protection without any margin requirements or reserves, pricing for these custom instruments is entirely relative and uncompetitive, and the potential to multiply the basis risk used to define a given transaction is open-ended.

It is no accident, then, that since 2001, the massive growth in the number of hedge funds and the assets these vehicles control also spiked, as broker dealers used their own balance sheets to boost trading volumes and to widen spreads in OTC products. To be fair to Greenspan and the regulators, the major derivative dealer firms share the largest part of the blame for the subprime crisis.

Indeed, as 2008 began, many prime brokers were forcing hedge fund clients to reduce leverage and thereby the amount of assets that the dealers need to finance — assets that the dealers, in fact, own. Once seen as a source of double-digit returns, hedge funds are now viewed by dealers as sources of open-ended liability.

With the failure and sale of Bear, Stearns & Co, the process of deleveraging on Wall Street is likely to accelerate, begging the question as to whether many hedge funds will not be forced to shrink or liquidate entirely in an environment where leverage ratios are well-below the double digit levels seen in the past five years.^{xiii}

Fair Value Accounting

A third significant factor in making the collapse of the market for structured assets containing subprime debt a true catastrophe is the move to fair value accounting, a process that was implemented last year but has been debated for more than a decade. “Fair value” accounting is a new era notion that has developed over the past two decades and was promoted by large segments of the accounting and economics profession, as well as by leaders of the financial services community. It was implemented last year by an arm of the SEC known as FASB or the Financial Accounting Standards Board.

I don't know many people who expect accountants to destroy the world, but the good people at FASB are coming pretty close to doing just that. Fair value accounting is driving and increase investor fears about the solvency of many financial institutions.

Understanding the common intellectual lineage of efficient market theory and fair value accounting is crucially important. Going back decades, economists argued that securitized assets such as those developed by the GSEs would be more transparent, and thus more efficient, than bank assets. It was consequently expected that as the securitization market grew beyond the market for agency paper, the market would be liquid and transparent. The intermediary role of the commercial banking industry would decline and banks would instead focus more and more effort on acting as agent and sponsor for these assets.

As with efficient market theory generally, fair value accounting assumes a high degree of liquidity and stability in all markets. As columnist Allan Sloan said to me last week: "If markets were as efficient as academics suppose, then neither of us could make a living." Watching last weekend as JPMorgan Chase agreed to acquire Bear Stearns for \$236.2 million, or \$2 a share, about 1 percent of the bank's value two weeks before, suggests that perhaps efficient market theory has its limits.

Bert Ely, a Washington-based accountant and banking expert, says that the rapid acceleration of financial technology created classes of assets that neither the Federal Reserve nor the other regulators ever anticipated—or understand even today. Unlike fairly simple GSE obligations or even interest-rate swaps (which are entirely standardized and thus quite liquid), CDOs and other types of OTC derivatives blossomed into hideously complex and opaque permutations, configurations that a smart trial lawyer might successfully argue were deliberately deceptive.

In place of the implicit guarantee of the U.S. Treasury, Wall Street substituted a paid rating from Moody's or S&P, as well as a guarantee from a thinly capitalized bond insurer such as Ambac or MBIA. Whereas the intellectual authors of structured finance anticipated that these new era assets would be highly liquid—for example, qualifying for Level One status under FAS 157—instead Wall Street created an entirely illiquid market of unique assets that qualify only for Level Three treatment under the FASB rules.^{xiv}

Most recently, fair value accounting was pushed by the very same Wall Street firms that wanted to support and nurture the OTC market for structured assets. After all, what better way to validate and protect the wider spreads and profitability of OTC asset classes than to give investors greater comfort when it comes to valuation, especially for assets that carried investment-grade ratings and third-party guarantees from the major bond insurers? The combination of an external rating, third-party guarantees by monoline insurers and fair value accounting provided the necessary ingredients for investors to overlook the obvious liquidity risk defects inherent in CDOs and other complex structured assets.

While Chairman Greenspan initially opposed fair value accounting, it was actively promoted by economists at the Federal Reserve and other global regulatory agencies that were proponents of

the risk-based capital requirements that are embedded in the Basel II capital framework. The “fair value” of assets is now a key part of the capital adequacy analysis of U.S. banks — a fact that has caused many practitioners to complain that Basel II may result in higher capital charges for many assets.

The very same visionaries who believe (mistakenly, in this author’s view) that different types of risk can and should be parsed into separate buckets, measured accurately and then used to support bank safety and soundness have instead created a framework (Basel II) that is arguably ineffective and conflicts with traditional regulator benchmarks, such as leverage ratios. Banks learned very quickly how to game the risk-based capital regime — e.g., the use of SIVs to move assets off balance sheet — and all with the blessing of regulators and the FASB.

It is no small irony, then, that the positive public policy goal of providing a more flexible way of describing the value of different types of assets (i.e., the shift to fair value accounting) has now become a Draconian regime that is forcing banks and some investors to write down CDOs and other types of derivative assets entirely, even though the assets have not yet reached levels of default that would justify even a modest haircut! Two factors — the near-zero liquidity in structured assets and the severe legal strictures of Sarbanes-Oxley — have forced banks to take total losses on assets that were once a source of enormous profitability but lacked organized and defined markets to ensure liquidity.

Part of the reason that companies for centuries used “book value” (e.g., historical cost accounting) to describe the value of assets is that book value accurately reports the cost of the investment. Once an investment is made, the only way truly to determine, on an arm’s length basis, the value of an asset is to sell it to a third party. Unfortunately, since there currently is no market for CDOs and other structured assets, banks have no choice, under the fair value accounting rules, but to take a near total loss — even though the economic value of the assets in terms of cash flow may be closer to par!

Ely and other observers believe that banks and other investors are overreacting to the subprime debacle and that many investors will not know the true economic cost of the crisis in the market for complex structured assets for more than a year. But what is clear is that the change to fair value accounting has turned the subprime crisis into a frightening debacle that threatens the safety and soundness of some of the largest U.S. commercial banks – perhaps needlessly.

At a meeting of nearly three dozen chief investment officers from the insurance sector last week, one CIO described spending 10x as much time and internal resources on the investment section of his firm's audit vs. 2006, in large part because auditors are forcing a "fair value" review of all illiquid assets.

Another CIO describes how investment decisions increasingly are being driven by accounting rather than economic concerns. "We have assets that are not impaired, that are still paying, but our auditor made us write off the full value," notes the CIO, who adds that his auditor has been attempting - unsuccessfully - to get brokers to attest in writing as to the pricing of illiquid assets.

Early in 2008, Citigroup reported an \$18 billion write down from structured assets, and was desperately seeking to raise new capital as further credit and valuation losses loom in 2008. In the absence of fair value accounting, the tens of billions of dollars in trading book losses reported by Citigroup, Merrill Lynch and other global investment firms might have been greatly reduced or avoided entirely.

Sylvain Raines, a lecturer at Baruch College in New York, told a meeting of the Professional Risk Managers International Association last September: "The Chicago School of Economics has been telling us for a century that price and value are identical, i.e. that they are the same number . . . If we do not recognize the fundamental difference that exists between price and value, then we are doomed."^{xv}

While the subprime fiasco may cause the insolvency of a large commercial bank during 2008, the survivors may be able to report extraordinary gains on these same written-down assets once the current investor hysteria passes. As and when the dealer community and their patrons in Washington make adjustments to the structured asset business model, much of the paper now viewed today as toxic waste may actually be quite valuable.

Subprime Effects

U.S.-based credit watchdog S&P said last week that total losses to be booked by the global financial sector from subprime asset-backed securities could reach \$285 billion, but opined that the end of write downs was now in sight for large financial institutions.^{xvi} However, the loan default activity of U.S. banks suggests that the bottom in the real estate market is not yet in sight. Let's consider some of the macro effects of the subprime crisis:

The Banking Industry

- Immediate: Subprime crisis tears gaping hole in bank business models, eliminating volume and income while limiting ALM options. Net effect is large % reduction in credit available.
- Long-term: The clock has been wound back decades. Loan origination now implies retention of the asset as default option. Banks have limited funding, revenue options.

Risk Preferences

- The subprime crisis has changed investor and lender preferences dramatically. Structured assets of all ratings grades are being shunned in favor of simpler cash securities. Dealers are walking away from low-risk markets such as Munis due to concerns about capital availability and "fair value" risk.

- As the Bear, Stearns collapse illustrates, there has been a huge reduction in market liquidity overall, and with this a sharp decrease in leverage used by all market participants.

Litigation

- The subprime crisis has made lenders and their advisers extremely vulnerable to a number of different types of claims. Borrowers are bringing claims against lenders for violations in TILA as well as loan suitability rules. End-investors are likewise suing lenders, dealers and rating agencies for fraud, KYC suitability of complex structured assets.

The Economy

- The forced liquidation of some \$3 trillion in private label structured assets is depriving the financial markets and the U.S. economy of a vast amount of liquidity that the banking system simply cannot restore.

Consequences

It is worth noting that housing prices are generally lagging indicators, suggesting that the bottom in the U.S. housing market probably lies in 2009. No amount of Fed interest rate ease can change that fact that reviving the housing market means that affordability must be restored to home valuations; that is, prices must fall substantially in many markets.

Let's take a look at some examples from the banking industry data collected by the FDIC to see where the U.S. banking system is today in the adjustment process and speculate about future levels of loan defaults.

- The first table in the Appendix to this paper shows that the banking industry as a whole has seen a dramatic slowdown in terms of profitability and a rise in non-current assets and other real estate owned or "OREO." The performance numbers for all banks are clearly deteriorating, but the industry is not yet near a crisis.
- Chart 1 in the Appendix shows gross loan charge-offs or defaults for Citibank NA and its large bank peers. Notice that despite almost a year of market turmoil regarding the credit quality of subprime assets, large bank default rates remains quite low. As the rate of bank default experience reverts to and then exceeds the long-term averages, the U.S. banking industry will face its greatest financial challenge since the early 1990s and possibly the 1930s.
- Chart 2 in the Appendix shows gross loan charge-offs or defaults for Washington Mutual Bank FSB and its large bank peers in the mortgage specialization peer group. Notice the sharp increase in the WaMu charge off performance after the close of the 2005 acquisition of the subprime credit card issuer Provident. In 2007, WaMu's credit card portfolio reported 1,000 bp of charge offs to the FDIC.

- Chart 3 in the Appendix show gross loan charge-offs or defaults for FIA Card Services, the \$170 billion asset credit card unit of Bank of America that includes the former MBIA business. Notice the huge spike in peer group default rates in the 2002 period, which was caused by an 8-10% write-down by several other banks.

Given the magnitude and duration of the trough in bank loan default experience in the 1993-2001 period and the 2004-2007 period, and given the magnitude of the increase in real estate prices in the past seven years, it seems reasonable to conclude that the upward swing in loan defaults now underway will test or exceed recent peaks. The 340bp of default realized by Citibank NA in 1991 threatened that bank's solvency, thus a 2008-2009 bank loan default peak of say 2x 1991 levels would create a broad systemic financial and economic crisis.

A Free Market Solution: Extinguish the GSEs

The trouble with all of the actions by the Federal Reserve and the Bush Administration's proposals to date to address the subprime crisis is that they ignore the underlying causes and do nothing to improve investor sentiment regarding structured assets. Fixing the problem is going to take a concerted effort by the major dealer firms and the regulatory community — an effort that so far is missing necessary leadership from Washington and Wall Street.

Federal bank regulators such as Fed Chairman Ben Bernanke show little political appetite for confronting the Congress regarding its infatuation with housing policy as a means of buying votes. And political appointees such as Treasury Secretary Hank Paulson, the former CEO of Goldman Sachs (NYSE:GS), seem strangely detached from events.

During March of 2008, I had an email exchange with several CEOs of bulge bracket firms, essentially asking "Where's the plan?" from the private sector to address investor angst over illiquid securitized assets. The response was uniform and limp: we have to fix the ratings agencies first, a reply that basically suggests that Buy Side investors are mindless idiots incapable of making asset allocation decisions without guidance from Moody's (NYSE:MCO) or S&P, a unit of McGraw Hill (NYSE:MHP).

Such a response is disappointing, but hardly surprising. Corporate CEOs are no more willing to go to bat for free market principles than are members of Congress or the Cabinet. Yet the collapse of the market for private label structured assets presents an opportunity for private issuers and investors who are willing to take advantage of the current market dysfunction. Indeed, the impending insolvency of both Fannie Mae (NYSE:FNM) and Freddie Mac (NYSE:FRE) may present a way to solve a big part of the problem with the U.S. housing finance sector, namely the hegemony of the U.S. government in mortgage securitization.

My friend Bob Feinberg likes to quip that the government-sponsored entity or "GSE" is now the favored model in America's supposedly free market economy, a telling comment for those familiar with European history. After all, FDR's inspiration for using the GSE model during the

Great Depression came from earlier experiments in fascist Italy and Germany, a model clearly antithetical to a democratic, free society, much less a market-based economy.

Professor Joseph Mason suggests the ultimate cause of the subprime mess is the growing government monopoly over the fat middle, low-risk portion of the U.S. housing market. By leaving the least attractive scraps of the mortgage finance sector to the private banks, which mimicked the GSEs securitization template in an effort to compete, Washington actually created the current crisis in subprime securitizations. If true, the failures of entrepreneurial private companies such as Countrywide Financial and Bear, Stearns & Co. may owe their origins to the invisible hand of Washington – a disturbing possibility. In future, it may not be possible for relative outsiders like a Countrywide or Bear to break into the cartel of large banks that control the world of institutional capital finance.

The Street, however, now has a rare opportunity to recast the current market structure, strike a blow for the national interest and make money at the same time. The false promise of private "credit enhancement" has distorted investor behavior, but balance is returning. Now that underlying credit quality of collateral in private label securitizations is the focus of investor analysis efforts, the markets are moving toward clearing, but help is needed in order to give investors the comfort they require to get back into the game.

Somewhere between the fantasy land idea of "AAA" ratings for subprime debt (defined as paper that routinely throws of 20-30% defaults over say three to five years) and default is a price where such deals get done, without credit enhancements or third-party ratings. Incidentally, that's why my firm subjects U.S. banks to a 1,000 basis point or 10% default tolerance threshold in the Economic Capital model in The IRA Bank Monitor. Finding that market clearing price level is the start of a true solution - maybe even a revolution.

When, not if, the wave of defaults and foreclosures in conforming mortgage paper hits the GSEs, the Congress and a new President will confront a huge public sector bailout. But rather than watching Washington further nationalize the housing finance market, the true underlying cause of the subprime crisis, both sides of the Street should organize and be prepared to bid against a re-nationalization of FNM and FRE. If investors could stop worrying about what the Fed is going to do or whining for a bailout from Congress, we might actually solve this problem and then some.

"Do you think Wilbur Ross would pay 5x tangible book for Freddie," asked my friend and colleague Josh Rosner. Ross, for those of you how don't know the name, is an astute vulture investor who has been accumulating real estate assets on the cheap, most recently in the case of the purchase of H&R Block's Option One mortgage servicing portfolio.

Rosner figures that "tangible" book for FRE is \$0.46 per share, so figure \$2.50 per share including the tip, about sharp discount from the current market value. Remember that the bond holders are the true shareholders of both GSEs. GSE equity is just an option. By Election Day, defaults and mounting OREO could see both GSEs trading in single digits - if they are trading at all.

By being prepared to float a private rescue of FNM and FRE, an organized, coherently led consortium of private banks, dealers and investors could be in a position to propose to the Congress a grand concordat, a systemic fix to the current mess that also could help restore free market discipline to America's increasingly managed financial markets. The executive summary of such a plan reads like this:

- Repeal of [fair value accounting treatment for illiquid financial assets](#).^{xvii}
- Standardization of terms and structure of all private label securitizations.
- Registration with the SEC of all securitizations to be sold to banks/pension and/or mutual funds.
- Public disclosure of secondary market prices for all securitization and OTC derivative transactions.

The Street would bid for the assets and guarantee portfolios of FRE and FNM, and use this vast corpus of deeply discounted "conforming" assets as the foundation for a much larger, purely private securitization market that includes all manner of collateral. A new definition of "conforming" paper would be established for all private securitizations, which may or may not carry ratings or enhancements. The Congress would codify the new standard into law, extinguish the corporate charters of FRE and FNM, and refocus public policy on the subprime area via Ginnie Mae where there is arguably a role for direct government assistance.

Why now for such a bold plan? Well, for starts Uncle Sam is broke. Given current Fed interest rate policy, the war in Iraq and a widening recession, the mere suggestion that the Congress is considering a public bailout of the GSEs would send the dollar into a free fall that makes recent market weakness seem leisurely by comparison. Fears of inflation and growing state-intervention in the U.S. economy would turn the dollar's slump into a rout. How does \$3 per Euro strike you?

When the market value of the GSEs begins to approach "tangible book," the Street has a rare opportunity to roll back Washington's intervention in the U.S. mortgage market and eliminate one of the worst socialist excesses of the New Deal. The missing ingredient, at the moment, is leadership and imagination from the captains of Wall Street, who have been far too comfortable with the status quo. Even usually conservative voices like *Barron's* incredibly call the prospect of nationalization of the GSEs "a good thing."

The good news, though, is that there's plenty of private capital on the sidelines waiting for direction. Can the heads of the major Buy and Sell Side houses summon the necessary courage, brain power and attention to suggest a private sector solution to the subprime crisis? Is there enough courage and self interest on Wall Street to challenge the political equation in Washington? Such an audacious course could reduce the role of government in mortgage finance, takes financial pressure off our spendthrift government and may even help the battered dollar. But most important, it will revive a financing mechanism that is vital for U.S. economic growth, namely the market for private label structured assets.

Appendix

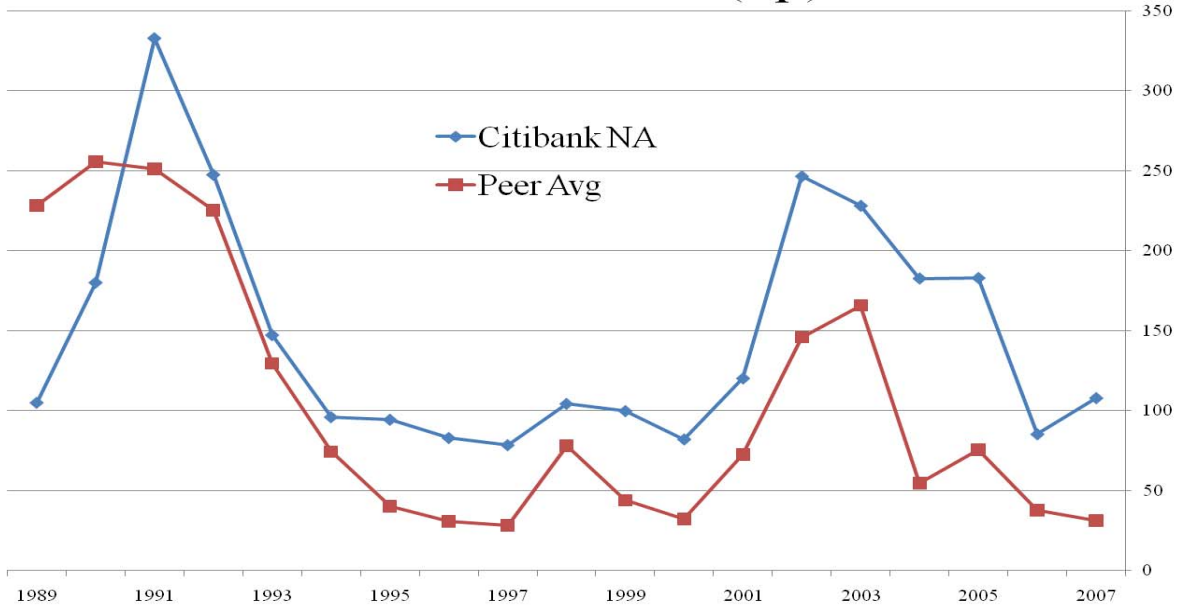
Table 1: Q4 -- US Banking Industry

	2007	2006	2005	2004	2003	2002	2001
Return on assets (%)	0.86	1.28	1.28	1.28	1.38	1.3	1.14
Return on equity (%)	8.17	12.3	12.43	13.2	15.05	14.08	13.02
Core capital (leverage) ratio (%)	7.98	8.22	8.25	8.11	7.88	7.86	7.79
Noncurrent assets plus OREO (%)	0.94	0.54	0.5	0.53	0.75	0.9	0.87
Net charge-offs to loans (%)	0.59	0.39	0.49	0.56	0.78	0.97	0.83
Net operating income growth (%)	-23.72	8.5	11.39	4.02	16.39	17.58	-0.48

Source: FDIC – Quarterly Banking Profile

Chart 1

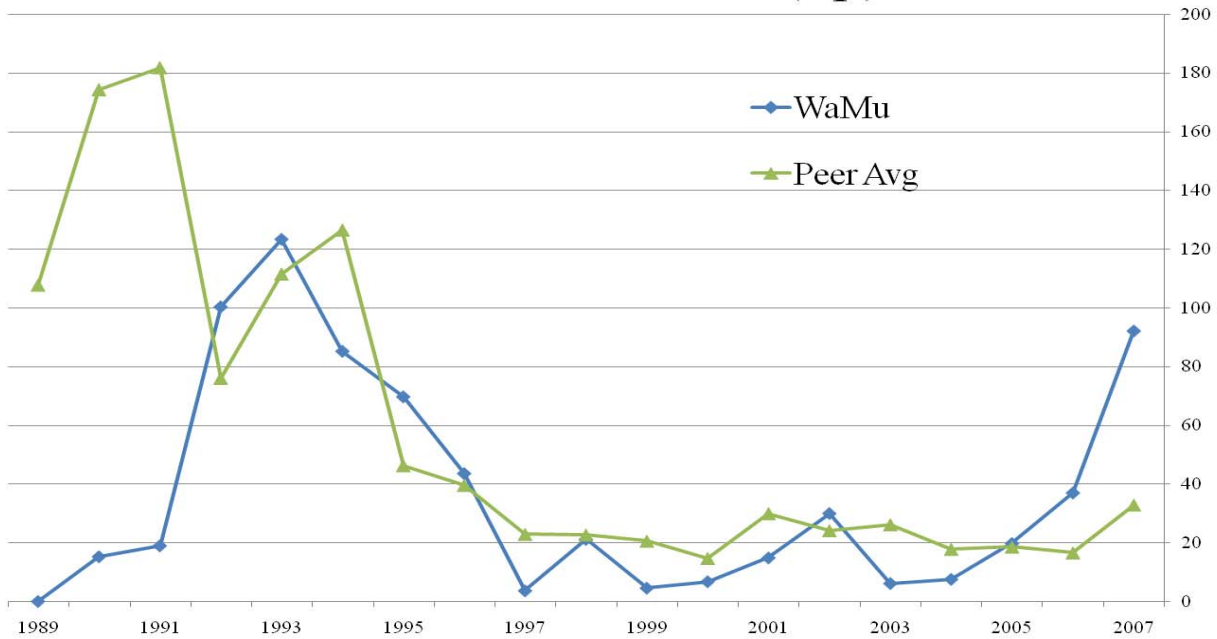
Gross Defaults (bp)



Source: FDIC/IRA Bank Monitor

Chart 2

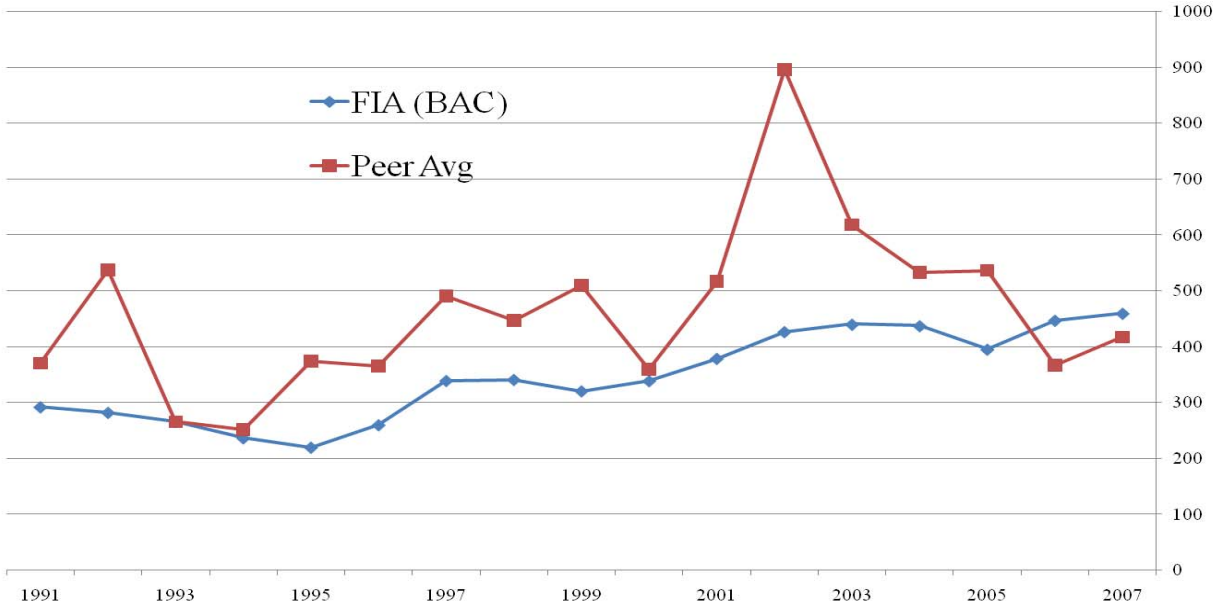
Gross Defaults (bp)



Source: FDIC/IRA Bank Monitor

Chart 3

Gross Defaults (bp)



Source: FDIC/IRA Bank Monitor

Endnotes

ⁱ This paper is based on an earlier article which appeared in the Jan-Feb 2008 issue of *GARP Risk Review* and comments excerpted from *The Institutional Risk Analyst*.

ⁱⁱ See Mason, Joseph, "A National Homeownership Strategy for the New Millenium," *Market Commentary*, February 26, 2008. (See: <http://www.criterioneconomics.com/docs/>)

ⁱⁱⁱ "GSE Nation: Interview with Robert Feinberg," *The Institutional Risk Analyst*, March 17, 2008

^{iv} For a complete summary of Rosner's comments, see "The Subprime Crisis: PRMIA Meeting Notes," *The Institutional Risk Analyst*, September 24, 2007. In 2007, approximately 110.3 million housing units were occupied: 75.2 million by owners and 35.1 million by renters or some 68% owner occupied. This compares with some 63% owner occupied in the early 1990s measured against a smaller population and housing inventory.

^v See Rosner and Mason, "How Resilient Are Mortgage Backed Securities to Collateralized Debt Obligation Market Disruptions?" *The Hudson Institute*, February 15, 2007.

^{vi} See Whalen, Christopher, "New House Rules: How the Feds Are Seeking to Make the World Safe for Derivatives," *The International Economy*, (Summer 2004): 54.

^{vii} See "No True Sale: Interview with Joseph Mason," *The Institutional Risk Analyst*, March 3, 2008

^{viii} The Federal Deposit Insurance Corporation Improvement Act (FDICIA) required banks to use risk-based capital requirements to measure capital adequacy in a prelude to the Basel II framework.

^{ix} See “Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities,” Federal Register (May 19, 2004). The statement has since been amended. Notice that the SEC and federal bank regulator guidance is “suggested” only and has no force of law, either for safety and soundness purposes or to support civil fraud claims.

^x Prior to the 1930s, investors in U.S. banks had double liability for their investments and had to be prepared to invest an additional dollar for each dollar in shares held. With the reforms of the 1930s, however, Washington took explicit responsibility for bank safety and soundness.

^{xi} The SEC issued an order requiring all U.S. exchanges to implement decimalization on June 8, 2000. See <http://www.sec.gov/rules/other/34-42914.htm>.

^{xii} The case of Citigroup’s initial support for its foundering SIVs in mid-2007 is a case in point. Rather than provide direct loans to the SIVs to finance client redemptions, Citigroup reportedly purchased the “AAA” rated paper itself and thereby held an asset with the lowest possible risk weighting! This façade, however, was abandoned later in 2007.

^{xiii} It is typical for hedge funds and broker dealers to run at capital to debt ratios of 30:1. In order for a hedge fund to pay investors a 10% return under the standard 2% of assets invested and 20% share of profits fee structure, most hedge funds must earn 20% annualized returns. As of February 2008, the Credit Suisse/Tremont Hedge Fund Index showed a 1-Year Return of 10.3%.

^{xiv} Level One assets are those for which publicly quoted prices are available. Level Three is for illiquid assets for which there is no public market. See “Summary of Statement No. 157” (<http://www.fasb.org/st/summary/stsum157.shtml>).

^{xv} For a complete summary of Raines comments, see “The Subprime Crisis: PRMIA Meeting Notes,” *The Institutional Risk Analyst*, September 24, 2007.

^{xvi} See Edwards, Andrew, “S&P’s Subprime Report Sees Pain, Hope Ahead,” *The Wall Street Journal*, March 14, 2008

^{xvii} See Whalen, Christopher, “Banks wallow in the muddy waters of ‘fair value’ rules,” *Financial Times*, March 6, 2008.