Chapter 8: Post Year's Events:
The Paulson Proposal, Congressional Action, and HHI Chairman's Essays

While the September 15 meeting was in progress the stock market took its biggest drop since the 9/11/01 catastrophe. The Treasury Secretary Henry Paulson proposal presented to Congress, a so-called bailout proposal, met with cool reception. After going through compromises it was rejected by the House on September 29. The market started down before the vote, following an announcement that Citigroup took over Wachovia, but upon defeat of the proposed legislation it went down sharply setting a new record for declines since the market reopened after the 9/11/01 catastrophe. It recovered somewhat the following day, but the debt market, the scene of greatest stress, remains in trouble. The liquidity crisis is exacerbated by banks not willing to lend in many creditworthy situations as an overreaction, or prudent measure, take your pick.

The HHI Chairman, in his capacity as an individual, continued to write essays for HHI and SCRC leadership, with some distribution to the media. The next essay was later that week.

Draft of September 19, 2008

Wealth Destruction

By Maury Seldin[1]

The plan under discussion by the Federal Reserve and Treasury along with Congress is a variation of the Resolution Trust Corporation approach to the bailout of S & L's in the debacle of the 1990's. The biggest difference will be that the RTC acquired real estate assets while the bailout under discussion will acquire monetary assets in the form of derivatives based on underlying residential mortgages. That is significant in that it does not go to the root of the wealth destruction that is plaguing the economy.

The Treasury, under the leadership of Secretary Paulson, takes a perspective of Wall Street in viewing the problems from the perspective of a capital market issue. Secretary Paulson, on September 15 in an interview on the public television News Hour, said the following, "The root of the problem lies in this housing correction. And until we stem the housing correction, until the biggest part of that is behind us and we have more stability in housing prices, we're going to continue to have turmoil in the financial markets." That is a big step in the right direction for Treasury, but it falls short of being placed in a comprehensive strategy for dealing with the crisis.

The NY Times on September 19, 2008 quotes Paulson as follows: "What we are working on now is an approach to deal with systemic risks and stresses in our capital markets,' said…Paulson…It would be 'a comprehensive approach that would require legislation to deal with illiquid assets on financial institutions' balance sheets,' he added." It is comprehensive only from the point of capital markets as viewed on Wall Street. It fails to come to grips with the wealth destruction on Main Street, the decline in the value of the houses that are the underlying security behind the mortgages which have in turn been

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securitized and re-securitized to where the aggregate debt far exceeds the value of the underlying value of the real estate.[2]

A truly comprehensive approach would deal with abating the freefall in house prices that is destroying wealth; a cascading on Main Street that has reverberated to Wall Street through the capital market. The approach that seemingly would be taken by the Feds is to form a corporation that would buy distressed securities from the financial institutions in order to provide them with some liquidity. The problem is being defined as a systemic problem in which there is insufficient liquidly. It is treating the symptoms in a very expensive way.

If the Feds bought, through the new entity, whole mortgages at discounts deep enough to be able to workout a restructuring of the mortgage debt with a borrower in order to avoid foreclosure, that would be superb. The mortgage investor would realize the loss, not a bailout, and the agency would save the house from being added to an already flooded market. That would provide liquidity and would be similar to the RTC although instead of reselling the mortgage right away it would convert a defaulted mortgage into one in good standing that could be sold in the capital market when the credit crunch had subsided.

The big difference is that the whole mortgages were bundled and sliced into tranches with different claims on the cash flow from the underlying mortgages, and the tranches may have been re-bundled and again sliced into tranches. These derivatives are what would be acquired in order to provide liquidity and then presumably would be resold in a market that was less disorderly. The taxpayers would take a great big loss.

It would make a lot more sense to look through the opaque structure back to the underlying mortgage and work out a viable restructuring of the debt. There are some legal impediments that would require substantial changes in the rights of defaulting borrowers. Part of the problem is that the securitized mortgages have investors with different priorities of claims and their servicers have limited authority to restructure the debt. In the case of bankruptcies, courts have the authority for a cram down, a forced restructuring of debt. That is not the case in when it comes to foreclosure. Thus, under the current arrangements there are foreclosures taking place because there is no way to get agreement among investors with different priorities of claims. As a result the foreclosure provides proceeds that are less than could be obtained by restructuring the debt, and the added house on the market contributes to more foreclosures.

The Homer Hoyt Institute, along with other funders, has been funding research on the contagion effect of the foreclosures and the development of a comprehensive strategy to deal with the subprime crisis. The program was launched with a research roundtable last October and the encore research roundtable "The Subprime Mortgage Crisis: What Next?" was held September 15 at the Hudson Institute, which along with University of Pennsylvania's Wharton School and the Homer Hoyt Institute provided sponsorship. It

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[2] This is discussed by Charles R. Morris in his book, *The Trillion Dollar Meltdown: Easy Monet, High Rollers, and the Great Credit Crash."* See pages 76, 135, and 163.

was a program of the Subprime Crisis Research Council, an informal organization that brings together leading academics on the issues with industry, government and consumer representative organizations.

The opening presentation was by Jack Guttentag, Professor of Finance Emeritus of Wharton, one of the nations leading authority on the topic. His presentation is available on audio through the web on the Hudson Institute site. He came up with a recommendation built upon the distinction between the cash flow issues on mortgages and the capital value issues. Building on his perceptions, it seems that the United State's taxpayers could save a lot of money if the focus of a new bailout organization was on guaranteeing up to five years of mortgage payments on restructured mortgages. The exposure would be substantially reduced because instead of the new RTC type organization buying securities for which there was no really good resale market and suffering great losses because the foreclosure process would keep driving prices down, it would buy securities at prices that reflect current values, but at prices that could actually produce a profit.

The key to preserving or enhancing the values of the derivatives is twofold. First, the distributions to these financial assets are based upon payment of interest and principle on the underlying mortgages. The Feds should include in their program that which is necessary to stop the downward spiral in house prices that erodes the values of the mortgages and the derivatives which represent partial interests in the form of claims on the payments. By shoring up these payments, the Feds would be dealing with the second part of preserving or enhancing the value of the derivatives.

This second part would produce mortgages that have a payment guarantee for long enough to let time and the market absorb the excess supply of housing created by the excessive lending of the last eight years. Once that supply is absorbed, and housing production has already fallen to some historic lows, the value of the existing stock will resume its growth and the value of the mortgages and the derivatives will be enhanced.

The way to look at these financial assets is to look at the likely income streams and the capitalization rates that are required to induce buyers to invest in them. At origination an interest rate is set, possibly with some adjustments in points paid, that reflects the capitalization rate the investor expects to earn. That capitalization rate reflects expectations of prepayments as well as defaults. The resale market of these financial assets may be at prices above or below the stated interest rate reflecting the risk assessments. In today's market, the derivatives would bring very low prices, heavy discounts, because the capitalization rates are very high. Through a program along the lines just outlined, the risks of foreclosure are reduced, especially because of the federal guarantee of payments for a period of time; thus the capitalization rates are reduced and the value of the assets increased.

The concept is that federal authority would permit borrowers who are in default and threatened by foreclosure, to sue in federal court for an adjudication of their situation, which may include alleged fraud or misrepresentation, and have the court order a cram down. That cram down would affect the tranch investors in accord with their priority of claim. It would obviate a mutual consent of all tranch holders to the restructuring of the loan and would override the holder in due course provisions that protect investors from responsibility of crimes of the mortgage originators. The investors would need to seek redress by proceeding against the alleged criminals who defrauded the borrowers, and would have the evidence of the federal court in pursuing the claim.

The idea is to stabilize the housing market before it goes much further in destroying wealth; a destruction that is exacerbating the recession. A new RTC type bailout may well be necessary, but it is not sufficient. Thus far, federal policy has been reactive to crises in the capital markets without adequate attention to the housing markets. It is time for a comprehensive strategy on the part of the federal government. Furthermore, the strategy should be dovetailed with the strategies of the states; and it is important to note that the states' strategies differ substantially, not only because the nature of their problems differ, but also because their underlying values differ, and they are reflected in their policies.

At this time, the plan by the Administration has not been finalized; it needs the cooperation of Congress. The Congress is in favor of intervention, and bipartisan action is expected. But Congress sees the broader picture more realistically because it looks to the housing market stabilization as well as to the provision of liquidity to the holders of the toxic debt. An Associated Press story by Devlin Barrett reports that on September 18 Senator Schumer on the floor of the Senate said the following: "Without a comprehensive solution that helps keep people in their homes, no amount of money advanced by Uncle Sam will restore the fundamental strengths of the American economy…Unless we also solve our financial problem the economy will not recover and the housing problem will get worse, so we need to do both."

The AP report continues with "Under Schumer's model, the government would give capital infusions or loans to banks in return for an equity stake, similar to the deal struck with insurance giant American International Group, Inc. earlier this week. In return, the banks would lift objections to legislation allowing loan modification for homeowners in bankruptcy. Currently, a person in bankruptcy cannot renegotiate the terms of their mortgage, unlike other kinds of debt." This is in the direction of what I just put on the table as intervention. It needs to go farther.

The AP story also reports, in paragraphs that I have combined into a single paragraph, that "By offering his plan, Schumer is specifically opposing another proposal being eyed by powerful members of Congress. House Financial Services Committee Chairman Barney Frank, D-Mass., said Wednesday such an entity might be needed in coming months to stabilize markets and prevent more implosions at major financial institutions. 'There have been a series of ad hoc interventions that have not worked, 'Frank said. 'Has the private market made so many mistakes and burdened itself with so much bad paper that there needs to be some public intervention?' The idea has also won fresh support from Republican presidential candidate John McCain, who on Thursday called for a

RTC-type entity that could 'provide an orderly process through which to identify bad loans and eventually sell them."

Senator McCain's comment overlooks the fact that it is derivatives that are the toxic paper that is contemplated and that these derivatives have tranches not whole loans. The problem is to get control of the bad loans so as get workouts rather than foreclosures.

The differences between the House and the Senate should be easier to resolve that between the Congress and the Administration because Congress is looking to the housing market as well as the capital market while the Administration is not giving the root causes in the housing market the attention that it is due.

The developments of the week appeared to be approached from a perspective of politics rather than government in that it appears that the depths of analysis are shallow. The character of the problem was identified in a series of essays published by the newsletter of the Maury Seldin Advanced Studies Institute of Real Estate and Land Economics and of the Homer Hoyt Fellows. That led to the research program launched by the Homer Hoyt Institute to deal with improving the forecasting of outcomes through research.

The research that is supported by the Homer Hoyt Institute, and the organizations that supplemented that support, is provided in conjunction with a Subprime Crisis Research Council (SCRC). Information about SCRC is available on the Hoyt website, www.hoyt.org. The centerpiece of the research supported is blended into the Task Force on the Subprime Crisis of the SCRC. That study, in progress, was reported on at the research roundtable encore held on September 15 at the Hudson Institute. The Power Point Presentation is on the web, as is the recording of it and the discussion, on the Hudson Institute web site.

The Homer Hoyt Institute is in the process of redesigning its website in order to accommodate a library of research in which the authors may directly update their reports. That would enable the White Paper to be updated by its authors as they progress. Additionally, the Institute is exploring the feasibility of installing a hierarchically threaded discussion capability so that researchers and others could comment on specific aspects of a comprehensive program outlined in the White Paper, which I see titled as "Policy Analyses for a Strategic Approach to Deal with the Subprime Crisis." That study is not yet posted on the HHI site, but it will be when it gets farther along. In the meantime more information on of the SCRC and the Homer Hoyt Subprime Crisis Research Program is available on the Hoyt site and the draft in progress on the Institute's report of the first year activities is available on a selective basis to potential participants in the team effort to deal with the mess.

The Institute's funding for the program will run out along about the end of the calendar year. Worthwhile additional research is there to be supported, and the website capability to be expanded. Cooperative efforts in any dimension are welcome, but in any event, the Institute hopes to be able to continue to facilitate the most relevant research by others even after its funding runs out.

It was followed by another a few days later.

September 22, 2008

**Marketing Toxic Tranches:
Include the Other Parts of the Mortgage Derivatives
Underlying the Subprime Crisis**

By Maury Seldin[3]

Toxic tranches are the parts of the mortgage derivatives that while containing value based on priority of claim on the cash flows to a bundle of tranches has the potential of reducing the value of other tranches in the pool and cascading to other pools. If one does not understand that sentence then it is not possible to reach a well reasoned decision with regard to the legislation being discussed in which the federal government would acquire mortgage based assets from distressed financial institutions.

The situation is incredibly complex, but here is an explanation that should enable the reader to understand the opening sentence. A tranch is a slice of a mortgage based asset that has a priority of claim on the cash flows generated by the payments of principal and interest due to the owners of the asset. The word toxic, derived from the poison used for arrows, can refer to the poison itself, meaning that the tranch is poisoned; or, it can refer to something which will poison something else, that is, a tranch is toxic if it can poison (reduce the value of) other tranches.

These interests in mortgages are marketed to investors under an agreement with a mortgage servicer who collects the mortgage payments and distributes them in accordance with the contract. There are variations in the authority of the servicers in dealing with a borrowers who are in default, but the ultimate power is in foreclosing. The difficulty is that foreclosure may not be the best remedy. The best remedy may be a "cram down." The cram down is a reduction of liability ordered by a court in a bankruptcy proceeding. It is not available under current law to mortgage foreclosure situations.

A court ordered process would not be necessary if the mortgage servicer, or other authority, had the power to renegotiate the mortgage, and write off, or otherwise deal with, the amount of principle by which the mortgage debt exceeds the value of house that would be realized in a market sale. Related to this is the adjustment of the interest rate and/or payments called for in the mortgage agreement. Without such adjustments it may not be feasible or worthwhile for the borrower to continue to make payments.

The result of this contractual and institutional structure is that mortgages are being foreclosed upon that under more sensible arrangements could be "worked out." The

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impact on the investor is that less proceeds are realized from the foreclosure than would be realized by a workout. The cascading refers to the impact on other mortgages in the same local market. The foreclosures reduce the value of other properties in the locality and some of them go to foreclosure further reducing values in the neighborhood and breeding more foreclosures.

Ordinarily the process stops when speculators pick up assets to hold for a better market, but the psychological impact may be so great that the price declines overshoot the long term price trend by so much that the collateral damage excessively destroys wealth and the would be recovery times are lengthened because the recession that is caused or exacerbated further lengthened recovery time.

This is amazingly written without footnotes and documentation; but it is done so because of the timing issue. When the Homer Hoyt Institute website www.hoyt.org is revamped it will have linked references for this essay. In the meantime, researchers and others who have significant interest in the back-up may contact the author at mseldin@mchsi.com with specific requests and receive complimentary guidance to the literature that will be useful in understanding the validity of the statements.

But, now on to marketing toxic assets; there are two problems. One is getting rid of the toxicity. The other is getting transparency in knowing the values of assets through knowing more about the underlying assets, the mortgages and the local housing market.

The market for the derivatives, the assets composed of bundles of tranches, would be enhanced if there was better information on the value of the assets. That is a massive project, but certainly a lot less costly that the losses occasioned by buying the distressed assets as part of a bailout of the distressed financial institutions and holding them for a better market while the market deteriorates because of the toxicity and cascading. The nature of that information system is the subject for a different essay since it is really great effort to keep this one short.

The point here is twofold; first, stop the toxic effects one way or another, and second, develop an information system that facilitates a market for the derivatives. The upside is that if a new government sponsored entity acquires the derivatives at distressed prices and takes action to stop the freefall in house prices and provides an information system that facilitates a market for the derivatives, it can make a profit. The way it is going now, it will be at a huge loss.

Accompanying this essay is Friday's essay, "Wealth Destruction." It places this essay in context.

The next essay, sent September 24, was as follows:

Taking Advantage of the American Public

By Maury Seldin[4]

The American Public has been taken advantage of in the creation of the subprime crisis. Is the American Public going to be taken advantage of in the process of cleaning up the mess?

The answer depends on the quality of analyses used by those who are governing the nation; but unfortunately, politics may deter the development and use of the most well reasoned analyses that might be brought to bear, responding to forceful pressures based upon fear of the debacle getting worse.

Developing well reasoned analyses leading to a way out of the mess starts with understanding the way the American Public was taken advantage of in the process of the nation getting into the mess. Simply looking to find the guilty parties does not do it. There is lots of guilt to go around. The line of reasoning is to follow the money; the creation and destruction of wealth and the change in liquidity, all the time bearing justice in mind.

Wealth was created through the rise in house prices to unsustainable levels using predatory lending and other mortgage loans that should never have been made. It was transferred to sellers who got out early enough, and was accompanied by a substantial set of buyer/borrower paid fees going to the mortgage originators and the packagers of the partial interests, tranches, sold to investors who were led to believe that the investments were high quality. The collapse of the housing market and the liquidity crisis in the capital market are the visible aspects of the debacle.

The Administration, led by the Treasury Secretary, is pressing for purchase of illiquid assets held by institutions on the basis of providing liquidity to the capital market to keep the institutions in business; using taxpayer money. Congress, led by committee leadership is pressing to include provisions that would deal with the housing market sector as well.

There are numerous provisions under discussion. The focus here is on the taxpayer interests. The scariest aspect is the potential of a collapse of the financial system that would reverberate to depress the rest of economy. Obviously, a top consideration is to keep a flow of funds in the credit markets necessary to facilitate a healthy economy; the issues are built upon the alternatives for so doing.

A candidate for the worst provision from the standpoint of the American taxpayer is to pay more than the lowest price available for whatever assets are acquired. The premium,

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it is argued, would help the institution stay in business. The argument sometimes includes the point that by paying the higher price the selling institution could mark up the values on the remaining mortgage derivatives in its portfolio. While those arguments are correct, they take advantage of the American taxpayer because it is not necessary to subsidize the profitability of the institutions that made horrendous mistakes.

The institutions may survive with lesser assets by simply transferring more of the toxic derivatives in order to get the infusion of cash. The values according to general accepted accounting principles are interesting for a variety of purposes, but the application of those principles do not necessarily represent reality. The reality is the institutions have a going concern value which has been diminished by the poor decisions made in holding the toxic investments. If there is enough to make it worth continuing after selling off the illiquid assets at distressed prices, then it can stay in business. If not, it is a candidate for acquisition by another institution, which by its nature can provide liquidity and managerial oversight. If that is not feasible then bankruptcy of some sort is the option. These are the options that have been used to deal with various institutions.

Buying the assets through a newly created government sponsored enterprise can prove to be profitable for the American taxpayer if (1) only assets that have value are bought, (2) the prices are cheap enough, (3) action is taken to stop the decline in value of the derivatives, and (4) the assets are held while they increase in value and the creation of a resale market is fostered.

The plan proposed for advancing the funds for acquisition of the mortgage based assets does not have the level of detail that deals with the recovery of the investment. No prudent investor would make such an investment without some plan of how to get out. The Treasury Secretary is urging quick action, but it is not apparent which institutions are the potential sellers, the extent of their difficulty, the nature of the assets to be acquired, and the price. Some of the assets are worthless.

The system of bundling the tranches and reselling partial interest is not transparent with a listing of the mortgage assets underlying the investment sold. As a result, the investor, who has been told that the assets are diversified, generally knows a risk rating that is erroneous and that there is a geographical diversification. But, the strengths of the underlying debt are unknown. Transparency and market information would add to the marketability and the value of the asset.

The institutions that are in trouble did not bother to go to the trouble to develop that information system, although some entrepreneurs have developed detailed mortgage specific data. But it is not clear that that has been utilized in valuing the derivatives. If a government sponsored enterprise is going to invest a huge amount of money in acquiring the assets, it would be wise to invest in an information system that would value it. Furthermore, that information system would be useful in intervening in the housing market to prevent excessive foreclosures.

Preventing excessive foreclosures is the most important thing that could be done to protect the American taxpayer. The cram downs available in general bankruptcies are not available in foreclosures on owner occupied residences. Such owners, even if defrauded, have no recourse to the investor who is a holder in due course. Governmental intervention is essential in stopping the freefall in housing prices.

The arguments against many of these provisions are that it will adversely affect the long term flow of capital to mortgage investment. If those making those arguments are so concerned, where were they when the mess was being created? Besides, doing emergency measures in the short run does not necessarily mean that they need to endure. Some of the changes need sunset provisions.

American taxpayers deserve better, or maybe not – they elected the government that was supposed to regulate the industry.

It was followed by another a few days later.

Draft of September 27, 2008

Crises Extrication:

The Housing Debacle, Credit Crunch, and Government Mismanagement

By Maury Seldin[5]

"I am mad as hell, and I won't take it anymore!!" is a quote from a 1976 movie, *Network.*[i] That is getting to be the attitude of the American public judging by the opposition from the phone calls to congressmen about the current effort to fund a $700 billion bailout to Wall Street.

The situation is complex, and there is a lot of blame to go around. But, many in congress are slow to grasp enough of the complexity to come up with a well reasoned consensus. The intent here is to provide a line of reasoning that will shed sufficient light on the issues that would enable the provision of a better path out of the crises; and there is more than one crisis, but all related.

The readership, such as it is, would like the text to be short, simple, and easily understood. Well, that is not going to happen. There is a lot of the complexity; some of it can be relegated to endnotes, and some will be provided. But in the interest of getting this distributed some of the endnotes will be incomplete. As to being easily understood, that is more difficult. Each reader has her or his own paradigm and selects points to ponder, and processes them in a way well established in one's own brain circuitry. Thus the predispositions significantly affect what is understood. So, the reader is urged to put

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aside the conclusions already reached, probably heavily imbedded in one's own underlying values, and view the issues from what may be a fresh perspective.

We are not putting values aside. To the contrary, the focus is on justice. In fact, that is the philosophical base for this analysis; and here is one of my favorite quotes from Plato's *Republic*: "Isn't there another alternative? said I; we might convince you that you must let us go. ¶ How will you convince us if we refuse to listen? ¶ We cannot, said Glaucon."[ii] Just listening will not be enough! It will take some perseverance to get a holistic view of the situation and grasp enough of the detail to see the line of reasoning. Let's start with an analysis of the government mismanagement crisis, then go to the underlying housing crisis, and finally return to the credit crunch crisis which will be alluded to in the discussion of the other situations.

The Government Mismanagement

While there is plenty of blame to go around, not even limited to organization in the mortgage origination and packaging industries, rating agencies, and borrowers who should have known better, this is not about distributing blame. Rather it is about getting better management out of government – and there is a crisis in that process.

As this is being drafted (September 27, 2008) congressional representative as administration representatives are trying to hammer out a compromise on the administration's $700 million bailout program, currently called a rescue plan.

The big initial issue within congress was inclusion of Main Street as well as Wall Street in the plan, and some progress has been made on that point. The latest holdout for a bi-partisan approach is some conservative Republicans in the House who want to use an insurance program that appears to provide a put option to the investors without the government advancing the cash now. That is likely to go the way of their other idea of reducing capital gains taxes.

The Treasury Secretary's approach has been to use fear of catastrophe in urging funding of the whole $700 million dollars now, in part to allay fears of further worsening of the crisis. Since the absence of detail would provide a blank check without an acceptable program, congress, some Republicans as well as Democrats, has rejected the proposal. A compromise is being worked on with great uncertainty.

There is some probability that something will be agreed on fairly soon. But this morning's bridge column by Frank Stewart made a relevant point quoting from a book by Kit Woolsey, *Partnership Defense.* The quote is "Base a signal on what you think is the best defense at the point you signal, not on what the best defense could have been."

As I have written in another essay,[iii] "But, it is essential that there be a blending of the strategies of the various players in or[der] to arrive at a grand national strategy. ¶ "During World War II there was such a blend because of the common concern for survival of our free society," The relevance is that a common defense against further deterioration of the economy is bringing together a bi-partisan program based on the signals that the two major parties have from each other. They will probably come up with something, but it will not be the best defense government could provide, although it will probably be the best that politics could do.

Coming up with a comprehensive national strategy goes beyond the current legislative discussion.[iv] The discussion here is focusing on federal legislation.

What follows is a discussion of a best defense of the economy, "with justice for all," on the part of the federal government. It may be timely enough to be of use in the contemplated legislation, but it certainly is timely enough to improve a follow-up program. The follow-up program needs to go to the root of the crises, the housing debacle.

There is a role for state and local government and for organizations representing industry and consumer interests. Those have been discussed as part of a year long program that is about to conclude.[v]

The Housing Debacle

One of my other essays, "The Culprits of the Subprime Crisis," provides a perspective of the roots of the debacle. Here is an excerpt, ¶ "Temporary wealth in the form of rising home equity was created because home loans that should have never been made fed an unsustainable rise in house prices. It was just a question of time and circumstances until the excessive prices would adjust. The extent of the adjustments is exacerbated by excessive construction of new homes; construction that will take some time to absorb, varying with local economic growth. It is further exacerbated by foreclosures that flood the market. Part of the impact is the downward pressure on prices, but part is the costs of the process. The wealth destruction includes losses from market prices typically overshooting the longer term trend. At some point it pays to buy and hold unused inventory on the expectation of recovery; but that expectation has an interdependence with economic reaction and the emotion involved. ¶The ability of the market to move house prices is heavily dependent on the cost and availability of mortgage credit. The mismatch of risks and rewards in the mortgage lending process and the resulting derivatives fueled the housing boom. It also created wealth; much of which was drained from the mortgage finance system, **but it also moved wealth into financial instruments that had no chance of preserving value.** [Emphasis added.] The process developed a capital structure in a fractional reserve system which created additional wealth. The WSJ of 8/27/08 contains several stories of difficulties resulting from the contraction of the capital market; **a contraction attributable in substantial degree to the destruction of wealth triggered by default on the derivatives that are based on mortgage loans that should never have been made.** [Emphasis added.] ¶Regulation that permits the market to do its job is complex. But the paradigm in use by regulators and other players falls short of understanding how reflexivity[vi] can accelerate wealth creation and destruction. The biggest problem is that the side effects of the subprime disaster are affecting millions of Americans through the recessionary process triggered or aggravated by the subprime crisis."

The point is that the wealth creation and destruction in the housing market generated the destruction of wealth in the capital market and now the administration wants to buy the derivatives of dubious value without a program for stopping the wealth destruction in the housing market.[vii] Fortunately, the Democratic leadership has set the condition of doing something for Main Street. That program is in the right direction, but has not reached a detailed stage that says that indicates adequacy.

There are various approaches that might be used to stop the downward spiral in house prices. The basic economic principle of use here is to stop adding to the supply of houses on the market through excessive foreclosures that flood an already flooded market. Aside from the excessive destruction of wealth in the form of losses realized by holders of the interests in the debt instruments attributable to foreclosure, the further depression of prices obtainable in the market generates a loss in proceeds to other mortgage interest holders. For some they simply get less proceeds of sale. For others, houses that would not otherwise go into foreclosure are reduced in market value by enough to cause some owners to let the house go to foreclosure.

The worst is not over. There are many mortgage resets due in the next few years and other mortgage loan terms that when enforced by the lenders through their mortgage servicers will lead to more foreclosures.

The alignment of interests has been a problem from the very beginning of the debacle. Loan agents were paid incentive fees to produce more profitable origination fees even when the mortgage created was not in the best interest of the borrower or the ultimate investor. Now, the compensation of the servicers is typically paid upfront with a foreclosure and there is not an incentive to rework the loan. Even with such an incentive, the contractual arrangement with the investors who have different priorities of claim on the proceeds prohibits the servicer from making some workouts.

There may be no practical way in getting a voluntary agreement among tranch holders with different priorities of claim. In typical bankruptcy proceedings not involving foreclosed owner occupied residences the courts may order cram downs. The cram down simply allocates proceeds among diverse claimants having reduced and/or restructured the debt. Such a process might be used to avert finalizing a foreclosure by forcing a reduction in debt and/or change in interest rate or payments or other terms that would make it feasible for the owner to stay in the house. There are variations of such proposals that would provide some recompense to mortgage interest holders when the property later sold at a price above the cram down value but less than the would be debt.[viii]

Another consideration is the "holder in due course" legal provisions which protect third parties from liability to borrowers for fraudulent actions in the creation of the debt by the originating party. This leaves defrauded borrowers without remedy except if they can find the originator, who may be out of business, or who may not have the resources necessary for a remedy. Thus, as a practical matter, victims are likely prospects for foreclosure especially since there power using a legal process is likely to be ineffectual.

In some cases foreclosure could be avoided if the mortgage terms were renegotiated. One possibility is to suspend "holder in due course" restraints in localities where predatory lending destroyed the viability of a local housing market. Court ordered relief from the holders of derivatives, distributed pro rata rather than priority, could be a strong incentive for quasi-voluntary reworking of the mortgage debt.

If any of these ideas are viable they could be implemented by federal courts overriding state court provisions which vary widely on foreclosure issues. Some state and local governments have provided intervention and more can reasonably be expected. It is important to treat these extraordinary measures as temporary relief, possibly limited to local areas designated as catastrophic housing market areas. There is great concern about institutional changes adversely affecting the future flow of mortgage funds for hope ownership. That concern is justified. The issue may be to keep some states from being excluded because they have tougher laws; that could be done with national legislation that used local criteria for application.

The intent here is not to come up with a specific proposal. Rather, the intent is to light the way to better decisions by providing a better understanding of the sate and identifying issues that are worthy of exploration. What is critical now is that whatever legislation is passed be a well reasoned step to a comprehensive program that may be adjusted from time to time. My series of essays point to development of strategies and avoiding panic. Panic has a poor cost benefit relationship.[ix]

Credit Crunch

The credit crunch is a capital market phenomenon that reduces the availability of credit adversely affecting economic growth and stability and placing undue hardships on the public. The opening quote, "I am mad as hell, and I won't take it anymore!!" is the ground swell that is happening.

Politics and government are not the same. I see politics and the quest for power, which may be for the right to govern but may be for other objectives. I see government as the institutional arrangement for collective action to reflect national interests.

The quote from the Declaration of Independence that I like best is "We hold these Truths to be self-evident, that all Men are created equal, that they are endowed by their Creator with certain inalienable Rights, that among these are Life, Liberty, and the Pursuit of Happiness." And, from the pledge of allegiance, "with liberty and justice for all." The point is that while there is a constitution and there is legislation, the mismanagement of government has not done well in pursuing these goals.

Liberty requires justice and justice should be for all. That needs to be considered in correcting the difficulties in the capital market. I have footnoted my latest essay.[x] It is from the draft and without footnotes. Final copy, with footnotes is on the web.

My latest essay outlined some points that would in essence comprise alternative plan, but some could be included in the proposal currently being considered by congress. Here is an excerpt from the essay.

1. Create three new government sponsored enterprises (GSEs) for the express purpose of acquiring distressed mortgage based assets at the lowest available prices from financial institutions deemed to be in danger of survival because of the lack of liquidity attributable in large measure to the acquisition of the toxic mortgage derivatives. Provide an initial equity base of $75 billion each with one or more additional $75 billion after the first $50 billion is actually used to acquire the distressed assets not marketable to others. This approach deals with a number of subsidiary issues. Here are some subsidiary issues.

a. It is grossly unfair to the American taxpayers to have the federal government spend any more for the acquisition of monetary assets of dubious value than is necessary in a market.
b. The talk of paying a price based on value held to maturity simply does not make sense because very few of the assets are going to be held to maturity. The assets are bundles of tranches with various priorities of claim with many of the tranches being paid off or written off as worthless after a foreclosure. The aggregate debt on most of the underlying mortgages used in the recent securitized process is greater than the market price obtainable for the residences. Furthermore, many of the mortgage notes have resets of interest rate after two or three years and the higher rates and mortgage payments make it impractical for the homeowner to continue to make payments, or selling or refinancing may also not be feasible.
c. There is no legal provision for cram downs on owner occupied residences under foreclosure so that an excessive number of foreclosures will occur because the there is no method to adjudicate differences among the interests of the tranch holders other than to apply the priority of claims on cash generated from payments and foreclosure.
d. The use of three competing entities will provide some competition is setting a market price. More, such as five, could be used. The best way to value the assets is to value the individual tranches based on expectations of payments by the borrower. The values will be higher if cram downs are available because it will bypass the costs of foreclosure and reverberations from contagion effects. In the absence of information on individual tranches a competitive bid will reflect individual judgments, the best available under the circumstances.
e. Set up a regulatory agency for oversight to the operations and with ability to discharge management. Furthermore, Treasury will retain ownership with the option of selling off assets when market conditions improve, merging the GSEs and or selling them off. The values of the assets will be enhanced if there is stabilization in the housing markets and if better information systems are available for valuing the assets. Indeed, the process should lead to an exchange based trading system.

f. Exempt selling institutions from having to write down remaining derivatives based on fire sale prices received for sales of assets in temporally weak markets.
2. Have the appropriate regulatory agency design the qualifications for potential selling financial institutions to be permitted to offer the mortgage derivative for sale to the newly created GSEs.
a. The applicant organizations would need to show that the mortgage derivative assets were a substantial portion of their illiquid investments and that some government assistance as a buyer of last resort was warranted.
b. The organization would also need to agree to limitations on golden parachutes and other executive compensation for an appropriate period of time.
c. The organization would also need to provide an acceptable strategic plan for restoring an acceptable equity base and limitations on leverage in future operations and accept governance of the regulatory authority
3. If these or similar terms are not acceptable to the organizations then they have other options.
a. They can use other assets for liquidity.
b. They can merge or be acquired.
c. They can go through bankruptcy. The government's interest is in having a viable capital market worth responsible institutions. The bailout is to be designed to save a sufficient number of institutions and to provide a viable regulatory framework bearing in mind that sunset provisions should be used where appropriate.
4. Intervene in the housing markets to stop the downward spiral of house prices.
a. Set up federal cram down courts that have the authority for intervening in foreclosures, whether in deed of trust or court foreclosure states, on the basis of fair value of the house as security (thus assuring the lender/investor of greater proceeds than foreclosure.
b. Identify locations where predatory lending and other excessive terms were foisted on borrowers and develop voluntary cooperation among servicers representing the dominant mortgage and derivative holders to initiate recasting mortgages before defaults. Use suspension of holder in due course protections where fraud and/or misrepresentation is alleged as an inducement to gain protection from senior tranch holders as well as lesser claims. The application of the suspension would leave the investor with recourse to the originators, some of whom are still in business.
c. Establish additional counsel agencies to assist the homeowners in seeking redress of grievances and provision of financial assistance in the event of temporary loss of income from unemployment. These social programs can be funded from the profits made by the GSEs.
d. Consider establishing a mortgage payment insurance program that would cover up to five years of mortgage payments to be used as an inducement of lenders to defer foreclosure allowing time for market recovery.

These ideas are not meant to be definitive. They include some thoughts presented by other academics, references available on request. Also, some of the ideas are expanded on in other essays, available on request.

Conclusion

Extricating ourselves from the current crises is not a simple process. There is no silver bullet. The best that we can do is to get a blending of strategies of the different interests. One critical aspect of that is to improve forecasts of outcomes. That has taken over my life this last year and the progress is noted in a draft of a report to the Homer Hoyt Institute that, along with others, funded a research program alluded to in references. These are my personal views based upon over half a century (actually 57 years) of industry and academic work, so there is some professional competence in the analyses. My concluding comment is a repeat of a sentence in the opening section of this missive, "So, the reader is urged to put aside the conclusions already reached, probably heavily imbedded in one's own underlying values, and view the issues from what may be a fresh perspective."

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Then, two days later.

September 29, 2008

Insuring Toxic Mortgage Derivatives:
What the Proposed Legislation is Calling "Troubled Assets"
By Maury Seldin[6]

Insuring toxic mortgage derivatives may be hazardous to your health. Dealing with the hazards requires dealing with the risks. Aside from understanding the nature of toxicity in mortgage derivatives, and the basics of any insurance, it is essential to have a workable strategy assuming there is concern with the potential returns from underwriting the risks, and the draft legislation say that there is such concern, "(1) MINIMIZING NEGATIVE IMPACT.—The Secretary shall use the authority under this Act in a manner that will minimize any potential long-term negative impact on the taxpayer, taking into account the direct outlays, potential long-term returns on as sets purchased, and the overall economic benefits of the program…"

Toxicity is a term loosely used but a rigorous analysis requires detailed understanding of what is meant by the term. As I wrote in an essay last week, "Toxic tranches are the parts of the mortgage derivatives that while containing value based on priority of claim on the cash flows to a bundle of tranches has the potential of reducing the value of other tranches in the pool and cascading to other pools.[xi]

I also wrote, "If one does not understand that sentence then it is not possible to reach a well reasoned decision with regard to the legislation being discussed in which the federal government would acquire mortgage based assets from distressed financial institutions. ¶

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[6] Dr. Seldin is Washington D.C.'s American University Realtor Chair Professor Emeritus. He also happens to be Chairman of the Board of the Homer Hoyt Institute (HHI), but the views presented by Dr. Seldin are his personal and professional views. HHI is a granting foundation dedicated to developing and disseminating the body of knowledge in real estate and land economics and closely related areas. HHI does not take positions on specific legislation.

The situation is incredibly complex, but here is an explanation that should enable the reader to understand the opening sentence [of that essay]. A tranch is a slice of a mortgage based asset that has a priority of claim on the cash flows generated by the payments of principal and interest due to the owners of the asset. The word toxic, derived from the poison used for arrows, can refer to the poison itself, meaning that the tranch is poisoned; or, it can refer to something which will poison something else, that is, a tranch is toxic if it can poison (reduce the value of) other tranches. ¶ These interests in mortgages are marketed to investors under an agreement with a mortgage servicer who collects the mortgage payments and distributes them in accordance with the contract. There are variations in the authority of the servicers in dealing with borrowers who are in default, but the ultimate power is in foreclosing. The difficulty is that foreclosure may not be the best remedy. The best remedy may be a "cram down." The cram down is a reduction of liability ordered by a court in a bankruptcy proceeding. It is not available under current law to mortgage foreclosure situations."

The insurance component, under discussion of the draft of the EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 as this is written, presumably would permit a financial institution to buy an insurance policy against loss on a mortgage derivative containing a bundle of tranches. The wording as I understand it is " **Section 102. Insurance of Troubled Assets.** If the Secretary establishes the TARP program, the Secretary is required to establish a program to guarantee troubled assets of financial institutions. ¶ The Secretary is required to establish risk-based premiums for such guarantees sufficient to cover anticipated claims. The Secretary must report to Congress on the establishment of the guarantee program."

Some detail from the draft, without line number is as follows: "The Secretary shall collect premiums from any financial institution participating in the program established under subsection (a). Such premiums shall be in an amount that the Secretary determines necessary to meet the purposes of this Act and to provide sufficient reserves pursuant to paragraph (3)… AUTHORITY TO BASE PREMIUMS ON PRODUCT RISK.—In establishing any premium under paragraph (1), the Secretary may provide for variations in such rates according to the credit risk associated with the particular troubled asset that is being guaranteed. The Secretary shall publish the methodology for setting the premium for a class of troubled assets together with an explanation of the appropriateness of the class of assets for participation in the program established under this section. The methodology shall ensure that the premium is consistent with paragraph (3). (3) MINIMUM LEVEL.—The premiums referred to in paragraph (1) shall be set by the Secretary at a level necessary to create reserves sufficient to meet anticipated claims, based on an actuarial analysis, and to ensure that taxpayers are fully protected."

Setting a premium to reflect the risk on an insured set of tranches should be based upon the chance of loss, an actuarial analysis. Insurance is used for diversifiable risk, the idea being that the total premiums paid will cover all losses plus costs of administration, adjusted for returns on premiums paid but not spent. The most critical variable is forecasting payments to be received by the pool of tranches.

Ideally, the forecast would be based on tranch by tranch forecasts in each pool and diversification among pools. It is doubtful that Treasury will have a data base sufficient to make such forecasts. Alternatively, Treasury could start with a collection of pools and make forecasts for the collections, and then diversify among collections. Even then it is doubtful that Treasury could come up with a good estimate of losses.

The process is further complicated by adverse selection. The holders of the derivatives are the ones who select what will be submitted for insurance. The selection is likely to based on the assets deemed by them to be the most troubled. In essence, they are buying a put option.

It would be good to know how the objectives of the insurance program will be achieved; and Congress might do well to have the legislation reflect a constraint on the issuance of insurance (payments on guarantees of principal and interest) until it, or a designated authority, has an acceptable plan on pricing the risk and determining premiums.

Fortunately, the proposed legislation includes some provision for reducing foreclosures. Here is the quotation, "**Section 110. Assistance to Homeowners.** Requires federal entities that hold mortgages and mortgage-backed securities, including the Federal Housing Finance Agency, the FDIC, and the Federal Reserve to develop plans to minimize foreclosures. [It] Requires federal entities to work with servicers to encourage loan modifications, considering net present value to the taxpayer."

Unfortunately, that effort to reduce foreclosures does not go far enough. From an insurance point of view, it is prudent to encourage actions that would reduce losses. That is the thinking that insurance companies use in promoting worker safety.

That thinking as applied to toxic derivatives calls for dealing with the situation in which there are diverse interests among different tranch holders created out of common underlying mortgages. The servicers may not have the authority to modify the loans and with defaults the most senior tranch holders would opt for foreclosure. Some of junior tranch holders would be wiped out by foreclosure and would do better with a reworking of the loan.

As noted in my previous essay, "The best remedy may be a 'cram down.' The cram down is a reduction of liability ordered by a court in a bankruptcy proceeding. It is not available under current law to mortgage foreclosure situations. A court ordered process would not be necessary if the mortgage servicer, or other authority, had the power to renegotiate the mortgage, and write off, or otherwise deal with, the amount of principle by which the mortgage debt exceeds the value of house that would be realized in a market sale. Related to this is the adjustment of the interest rate and/or payments called for in the mortgage agreement. Without such adjustments it may not be feasible or worthwhile for the borrower to continue to make payments."

I further wrote, "The result of this contractual and institutional structure [difficulty in avoiding foreclosure because of authority distribution] is that mortgages are being foreclosed upon that under more sensible arrangements could be 'worked out.' The impact on the investor is that less proceeds are realized from the foreclosure than would be realized by a workout. The cascading refers to the impact on other mortgages in the same local market. The foreclosures reduce the value of other properties in the locality and some of them go to foreclosure further reducing values in the neighborhood and breeding more foreclosures."

If Congress passes the emergency legislation, and some legislation at this point would be wise, it should find a way to deal with these issues; otherwise it will be very expensive for the taxpayers. Governmental dealing with toxic mortgages can be injurious to the taxpayers' health. Protection for the taxpayer in the form of significant reductions in foreclosures is necessary, and that may require collateral legislation such as I have alluded to in other essays. A comprehensive strategy would do better than a piecemeal approach.

The next day, just preceding the House resuming session, the following was sent:

September 30, 2008

A More Palatable Emergency Economic Stabilization Act of 2008

By Maury Seldin[7]

A more palatable Emergency Economic Stabilization Act of 2008, the so-called bailout legislation that Congress did not pass on September 29, 2008, is feasible. The outcry from the voters who did not want to subsidize Wall Street can be dealt with by making the legislation profitable. The conservative Republicans who did not want government action replacing market discipline can be brought on board by including a market discipline. The Democrats that opposed the legislation also on ideology can also be brought on board by strengthening the direct benefits to homeowners in distress and those endangered by further declines in house prices and deterioration of the economy.

The two main amendments would focus on (1) creating at least a few government sponsored enterprises (GSEs) to be the purchasers of the distressed assets, that have their value based on underlying mortgages, at distressed prices using a competitive bid to qualified sellers, and (2) authorizing strong temporary measures that would stop the increasing rate of foreclosures that is driving house prices down with a result of more foreclosures and adverse effects on the rest of the economy. The net result would be profitable operation for government as a byproduct of relieving the credit crunch of the capital market that is endangering the rest of the economy.

The Administration's focus has been on the Wall Street problem with the attention to the Main Street coming from the Democrats. The proposed legislation moved towards Main Street with consideration for homeowners, but fell short of dealing with the economics of the housing market by not considering strong measures that would reduce the increasing supply of houses on the market occasioned by foreclosure.

[7] Dr. Seldin is Washington D.C.'s American University Realtor Chair Professor Emeritus. He also happens to be Chairman of the Board of the Homer Hoyt Institute (HHI), but the views presented by Dr. Seldin are his personal and professional views. HHI is a granting foundation dedicated to developing and disseminating the body of knowledge in real estate and land economics and closely related areas. HHI does not take positions on specific legislation

The underlying problem is the creation of a temporary wealth in the form of unsustainable house prices. Some of the wealth went to sellers, but some went to owners who refinanced. The process generated great profits for the originators and the subsequent packagers of the mortgages who securitized them. The investors got stuck with the derivatives, some of which are of dubious value. There was a value transfer with investor money going into derivatives resulting in the current liquidity crunch of some of the financial institutions that now own the derivatives.

The bailout of these institutions is the Wall Street issue. The amendment that would bring on more support would be one that created institutions that would buy these illiquid assets. The assets are illiquid because there is no good way to know what they are worth, and their value keeps dropping as house prices keep dropping. An additional complication is that generally accepted accounting procedures call for marking to market what is tradable in the portfolio, and presumably the sale of some of the assets at distressed prices would adversely affect the valuation of the remaining similar assets and thereby put pressure on equity capital requirements. In many of the institutions the leverage is excessive. A more realistic way to treat the accounting for the remaining assets is on almost anything other than the last sale – the last sale speaks to only part of the volume; the volume affects price and so selling some under extreme pressure does not reflect what the rest would be offered for sale at. Some progress is being made on that front with the accounting professionals.

Another consideration is limitations on golden parachutes and executive compensation. Such concessions might be required to permit sellers to participate in the program. Additional restrictions could be included dealing with issues such as limiting leverage.

Returning to the main issue, the financial institutions made some bad deals and it is not out of sympathy for them that the government is providing liquidity, it is out of national interest. So if they don't want to sell, then don't sell. Some of the institutions have already filed for bankruptcy and some have been acquired at seemingly bargain prices. That is how markets operate and as long as we have enough institutions for competition let those that made the poor judgments pay the price.

The problem is the absence of a market for these derivatives of dubious value. By creating a few GSEs, using Treasury funds, there will be some semblance of a market. This gets the Treasury out of direct operation of the business and permits providing an incentive structure for some Wall Street types to operate the enterprise and buy as cheaply as possible. The institutions can hold as long as necessary and may contribute to developing a serious ongoing market for derivatives with a transparency to the system.

While this is going on the government should legislate and adjudicate so as to stop the downward spiral in house prices through excessive foreclosure. The byproduct of that would be an enhancement of value of the assets acquired with substantial potential benefit to taxpayers.

The kind of legislation required would be permitting federal courts to cram down mortgages under foreclosure or imminent threat of foreclosure. This is necessary because the disparate interests of tranch holders preclude voluntary cram downs and such cram downs may be beyond the authority of the mortgage servicers.

Implementation might be coordinated with states electing to adopt procedures for designating mortgage/foreclosure disaster areas in which such actions were applicable. Much of the distressed mortgages are concentrated in areas of predatory lending and other areas reasonably identifiable. The use of these extraordinary measures may be selective and temporary. As with cancer, you do what you have to do, but the measures are temporary.

Some voluntary compliance on the part of derivative holders may be induced if the "holder in due course" limitations on victims' remedies are relaxed. Borrowers who were victims of fraud or misrepresentation currently have no recourse the third party holders of the debt, which includes tranch holders of different priorities of claim. By allowing courts to get such remedies for non compliant tranch holders in a voluntary cram down effort, the senior tranch holders suddenly get liability from foreclosure not previously held; the result may be cooperation in a cram down that avoids the foreclosure that usually brings a lot less proceeds than reworking a loan.

This is complex and this is the simplified version. But it is doable. It just takes some effort to understand on the part of the legislators and to explain to the taxpaying public.

The thrust of these essays is finding a way to deal with the underlying problem of falling house prices as a means to contributing to whatever compromise is worked out for the capital markets. Whatever the resolution, assuming something passes, it will only be a step in the right direction. We still have to deal with the housing market, and that may require state and local action.

Our next step, as of October 3, is to see what is feasible with state and local government. At this stage we could allocate another $20,000 and still retain sufficient reserves. There was talk of getting a $10,000 proposal from NGA's Center for Best Practices that would indicate some things that work at state and local level to reduce foreclosures. Also there was discussion of a conference at Penn that would relate to these issues; both of these to tie into the White Paper.

Also, the participation of the Federal Government is not over. We will see some legislation, sooner or later, probably today The next chapter picks up on unfolding events.

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[i] The text of the speech is as follows "Beale: I don't have to tell you things are bad. Everybody knows things are bad. It's a depression. Everybody's out of work or scared of losing their job. The dollar buys a nickel's worth; banks are going bust; shopkeepers keep a gun under the counter; punks are running wild in the street, and there's nobody anywhere who seems to know what to do, and there's no end to it. ¶We know the air is unfit to breathe and our food is unfit to eat. And we sit watching our TVs while some local newscaster tells us that today we had fifteen homicides and sixty-three violent crimes, as if that's the way it's supposed to be! ¶ We all know things are bad -- worse than bad -- they're crazy. ¶It's like everything

everywhere is going crazy, so we don't go out any more. We sit in the house, and slowly the world we're living in is getting smaller, and all we say is, "Please, at least leave us alone in our living rooms. Let me have my toaster and my TV and my steel-belted radials, and I won't say anything. Just leave us alone." ¶Well, I'm not going to leave you alone. ¶I want you to get mad! ¶I don't want you to protest. I don't want you to riot. I don't want you to write to your Congressman, because I wouldn't know what to tell you to write. I don't know what to do about the depression and the inflation and the Russians and the crime in the street. ¶ All I know is that first, you've got to get mad. ¶You've gotta say, "I'm a human being, goddammit! My life has value!" ¶So, I want you to get up now. I want all of you to get up out of your chairs. I want you to get up right now and go to the window, open it, and stick your head out and yell, ¶"I'm as mad as hell, and I'm not going to take this anymore!!" See the website, thttp://www.americanrhetoric.com/MovieSpeeches/moviespeechnetwork2.html

[ii] This quote is from *The Republic of Plato* translated by Francis MacDonald Cornford, Oxford University press, page 4. Other translations do not necessarily correspond. The discussion is when a group that outnumbers the Socrates group wants them to join in going to a torch-race on horseback; but Glaucon, a member of the Socrates group, refuses on behalf of his group.
[iii] The essay is titled, "Intervention" was written shortly after the takeover of Fannie Mae and Freddie Mac that was in the week that preceded the presentation of the $700 million proposal. Her is the essay, with emphasis added:

Intervention
By Maury Seldin

The takeover of Fannie Mae and Freddie Mac by the federal government is the latest of a series of interventions by the Federal Government[iii] in dealing with what has become known as the subprime crisis. This may be viewed as a de facto nationalization, although a temporary one. The greatest danger with such interventions is that short term solutions if left to endure as long term institutional changes may create even greater problems. The market is a wonderful tool, if appropriately regulated. What is appropriate depends on the situation.[iii]

The problem in the capital markets was built upon the easy monetary policy of the last decade, fed by mortgage loans that should never have been made, resulting in unsustainable increases in housing prices. The mortgages (that financed the purchase of housing at excessive prices and the construction of houses too early for a stable market) that were securitized were sliced into tranches with varying priority of claims. Some of those tranches were then bundled and again securitized. Leverage for investors got as high as 33:1 making for great profit, if there was a profit, but rapid loss for even modest declines. The debt created in the process far exceeded the value of the underlying security, houses that were excessively priced.

When house prices started to adjust, the increase in foreclosures fed further price declines that began a downward price spiral that will overshoot what would be a normal trend line in housing prices. The problems in the capital markets exacerbated the decline in house prices because the availability of mortgage money was unduly constrained. That constraint was in part as a result of destruction of wealth, but in part because of a change in perception of risk.

Appropriate intervention to reduce the overshooting of the price trends by the downward spiral is the challenge facing the regulators, but also the other participants in the market. Some states and local governments have already intervened.[iii] What would make the most sense is a coordinated effort among state and local governments, along with the federal government; furthermore, the lenders and the servicers would do well to provide voluntary cooperation rather than being coerced by some new legislation. Additionally, the borrowers need to be more responsive in dealing with their default. It is amazing that many do not try to work out their problems.

Ideally, the regulators would have good forecasts of turning points in the local markets as the staring point for the decision to intervene. The great difference in the intervention decisions for the capital markets and the housing markets is that the scale is different. The capital markets are national and international and have homogonous institutions as players. Failure of such institutions, given their links to other institutions, could be disastrous. Thus, it makes sense to intervene to avoid disaster. It would help if their scale of institutions were reduced, which is the plan for Fannie and Freddie. But the critical decision is to be sure that the intervention is temporary. Such interventions, if permanent, would sacrifice the use of market mechanisms for market discipline. But, market discipline is a necessary condition, but not sufficient. The proper regulatory environment must be present. A great cause of the debacle has been the mismatch of risks and rewards in the securitization of mortgages. It was a failure in regulation.

The housing market situation is of an entirely different scale. The markets for the housing are predominantly local. The lenders, through the securitization, are fractionated and represented by servicers who have fiduciary responsibility to holders of different priorities of claims. The borrowers, even if defrauded, have no recourse to holders in due course of the tranches created by securitization. Thus, reworking the mortgage loans become exceptionally complex. Furthermore, the incentives for the servicers may be counterproductive in reaching the solution.

Some of the intervention may require overriding private contract. That is a scary step, especially when one considers that precedents of such intervention could adversely affect the future flow of funds to the mortgage market.

There are no simple solutions. This is a complex situation dealing with the strategies pursued by different players. These strategies are developed by the parties in pursuit of their own interests with their forecasts of outcomes.

The thrust of the research supported by the Homer Hoyt Institute, with additional funding from industry, is to improve the forecast of outcomes. Hopefully, by the players having better forecasts they will have better strategies. **But, it is essential that there be a blending of the strategies of the various players in or to arrive at a grand national strategy.** [Emphasis added.]

During World War II there was such a blend because of the common concern for survival of our free society. [Emphasis added.] Mustering a coalition of diverse interests for a common goal is no small matter. We do not know how great the danger is of a catastrophic result from the debacle. But what we do know is that the closer we get to really knowing, the more difficult it is to avert. Given what is at stake, it makes sense to treat the cancer before it spreads further. This can be done, but we need to improver the quality of our decisions, and that means improving the forecasts of outcomes. That is what we do at the Homer Hoyt Institute, and that is what we are doing in the current situation through the development of the Subprime Crisis Research Council, which has leading academics in the field and has reached out to industry, government, and consumer representatives. The September 15 meeting is an interim report of the centerpiece research project, a white paper on "Policy Analyses for a Strategic Approach to Deal with the Subprime Crisis."

The output of that meeting will be some guidance in developing the final report of the Task Force of the Subprime Crisis Research Council and a prioritization of research to be funded with the small amount of unallocated funds, but hopefully supplemented by additional external support. It may also generate research by other organizations, including governmental organizations.

[iv] The Homer Hoyt Institute has funded a White Paper to approach a comprehensive strategy. Information aout that is on the web. add references

[v] Add reference to SCRC and SCRP

[vi] Reflexivity – insert explanation

[vii] I identified the nature of the problem that was emerging in the initial of ther series of essays published as inserts in the newsletter of the Maury Seldin Advanced Studies Institute and the Hoyt Fellows, see www.hoyt.org.

[viii] Reference some of the proposals.

[ix] Reference substantial additional material.

[x] Here, without footnotes, is the essay "Developing Policy for Dealing with the Subprime Crisis: A Matter of Justice" available on the web at http://www.hoyt.org/asi/

Developing policy for dealing with the subprime crisis may be viewed as a matter of justice. There are different views of justice with differences in underlying values. And, the concept of justice is complex. Yet, considering the issues as a matter of justice provides an opportunity for a comprehensive analysis that considers the conflicts of incommensurability.

Dealing with incommensurability is critical because politically based pronouncements may focus on one value and scuttle a policy that would override a lesser value with one that is rated higher for the current situation. There are no simple answers that do justice to the situation. So, let us explore the complexity on the basis of a philosophical foundation built through the ages utilizing the basic principles of our American heritage.

The Borrowers

The borrowers include some who were defrauded, some who were misled, some who were uninformed, and some who were greedy. Many were refinancing to take out cash for consumption expenditures. Others were buying beyond their means. And others were speculators who hoped to be bailed out with a profit from rising prices, either as a homeowner or investor.

All of these borrowers participated in absorbing a supply of mortgage money that was abundant because of a combination of easy monetary policy and a boom in derivative financing that created debt far greater than the value of underlying assets. That was possible because the asset behind the last of the debt was based on an earlier round of debt based on an asset based on the mortgage based on the presumed value of the housing. Translated that means that a pool of mortgages was created and sold off in tranches (slices) with tiered claims on payments; the tranches of different pools were pooled and sold off in another set of tranches. Some of these were heavily financed. Final investors could be leveraged as high as 33:1 meaning that a 3% decline wipes out equity.

Among the results of this process are the following: a rise in house prices averaging about 50% in about eight years followed by a decline in prices of varying magnitudes (some great and generally not yet abated), more housing built than will be needed for some time (varying greatly by location), borrowers with debt beyond the value of the housing they own, and more mortgage based debt (including derivatives) than cannot possibly be paid out of proceeds from sales of the financed real estate.
It would be unrealistic to assume that the borrowers as a group had any idea of the scale and complexity of the debacle in which they participated. Yet, prudent decisions on the part of the borrowers would have mitigated the extent of the fiasco.

There are numerous policy prescriptions and programs aimed at borrower education and lender disclosure, as well as regulation designed to counter the incentive payment to mortgage brokers that caused them to steer borrowers to mortgages less favorable to the borrowers but more favorable to the mortgage bankers. Some of these are discussed in the Subprime Crisis Research Council White Paper being written that was funded by the Homer Hoyt Institute and its co-funders (Freddie Mac, Mortgage Bankers Association, and National Association of Realtors). An appendix containing a National Governors Association Best Practices report, to also be funded as funds become available, will also discuss specific options relating to improved borrower decisions.

The difficulty of these programs should not be underestimated. A large proportion of defaulting borrowers do not even contact lenders' servicing representatives; this behavior indicates that many defaulting borrowers have a paucity of financial skills. It is a noble effort to improve the situation, and it will require great resources and time; all worthwhile. But, it will be overshadowed by the institutional changes necessary to avert a recurrence of such debacles.

In the meantime, there is the matter of justice for the borrowers that are engulfed in the debacle. There are some who argue for a bailout of borrowers since they say that there was a bailout of lenders. Actually, the Federal Reserve's action of providing liquidity to the capital market was to abate the chaos that was emerging, not to save the derivative investors. More on that later. But, the issue here is, what is justice for the borrowers?

At one end of the spectrum are borrowers who were defrauded. The courts are an appropriate vehicle for remedial action. However, there is a serious problem in getting corrective action when the mortgage has been securitized and is held in pieces as part of a pool by third parties who are "holders in due course." Holders in due course are generally exempt from claims against the originators. Furthermore, many of the originators are no longer in business. It is a conundrum. If the protection to the investor is overridden, what will happen when one looks for more investors? If it not overridden, how is the injured party going to get justice? The conflict is because there is incommensurability, justice and justice or justice and equity.

The lender obeyed the law and expects the borrower to, so his cause is just. The borrower deserves to have the situation corrected because she or he was defrauded, but that justice is estopped by the law. If you move toward the middle ground the borrower is entitled to relief, but you don't want to choke off future flow of funds. But, the middle ground might be reached by overriding the highest risk tranches claim to payment under the theory that they accepted the greatest risk. True, that the fraud was not among the risks engendered, but that is the closest place at which to place the override, and the least damage to the future flow of funds.

If you don't like that solution, come up with another. The other may help future borrowers, but it may just leave the current defrauded borrower out in the cold. That may be a reasonable alternative and the legislatures and courts may be "the deciders."

At the other end of the spectrum is the set of borrowers who were speculators that knew the risks, but counted on rising prices. If anyone has sympathy for them, we just haven't heard about it. So justice would have it that they made their bet and lost; so no relief! However, there may be an exception in the case of the houses being located in a local economic disaster area of the housing debacle. Such areas, if designated by governmental authority, may have intervention programs designed to stop price cascading leading to additional foreclosures that destroy the neighborhood. In that case, then maybe speculators will get a windfall, much as derivative investors did with the Fed intervention to avoid chaos.

The spectrum in the middle requires a more detailed classification by borrower situation and location. The borrower situation relates not only to mortgage terms and property valuation, but also to buyer characteristics including ability to continue to own or possibly rent. Displacement from one's home can be a traumatic experience, and that is worthy of consideration as well as impact on the neighborhood. Lender/investor cooperation is another consideration in that there may be countervailing pressures in which some hard choices; justice to whom becomes the issue. It is the old cost/benefit situation where those that bear the costs may not be the people as those that bear the benefit.

<u>The Lenders</u>

You have heard it said, "Be careful what you wish for, you might get it." Well, the lenders wanted little regulation, and they got it. The investors wanted outlets for their funds, and they got it. The problem is that what may have made sense for individual firms did not make sense for the industry.

The story goes that the head of one firm did not approve of what was going on with subprime lending, but succumbed to pressure from staff and the sales force because everyone else was doing it. He went along with it, to his regret.

There was no justice in the compensation programs that induced mortgage brokers to steer borrowers to less desirable (but more profitable for the firm and salesman) options. There was no justice in the lack of disclosure that was rampant. But, industry did not regulate itself and governmental regulation was too weak to be of significance in averting the shady practices. Justice requires consumer protection, and the American system fell short.

The American system, in contradistinction to the European system, views the market as free to operate unless regulation is indicated. By way of contrast, the European system, based on Napoleonic premises, views regulation as the starting point with markets granted permission. This is not advocating changing the American view to European; rather only to improve on the operation of the American system.

The American view of "liberty and justice for all" is rooted in "the inalienable right to life, liberty, and the pursuit of happiness," which was derived from John Locke's "life, liberty, and property." The property meant person as well as real and personal property. The philosophical base is on the individual rights.

Freedom, or liberty, is an element in justice and is manifested in individual decisions in partaking in market activity. But, there is a wide misunderstanding about markets. Markets are tools, not idols for worshipping. As tools, they are best used to achieve objectives, but sometimes need to be regulated in order to avoid, or minimize, or mitigate, misuse.

We now turn to looking at justice as it relates to those performing the functions of the market on the supply side of the flow of funds to the mortgage sector of the capital market. There are originators, lenders, servicers, packagers, and investors.

In an earlier era much of the home mortgage finance was provided by savings and loan associations that originated, serviced and held the mortgages as investors. When the strong demand of the growing western states required more funds that were locally generated and the savings banks in the northeast were getting more local savings that were needed by local borrowers the savings and loan associations worked out an arrangement to sell 90% of some of their loans to savings banks, retaining the 10% and servicing rights. This worked well because the alignment of interests, while not the same, was close enough to provide prudence in mortgage lending.

But the industry wanted access to the larger capital market, and it got it. Fannie Mae, Ginnie Mae, and Freddie Mac led the securitization. The problem emerged as the alignment of interests was destroyed. If the originator does not have an alignment of interests with the investor, some system of justice needs to be provided.

The Subprime Crisis Research Council White Paper, and its appendix of best practices as summarized by the Best Practices unit of the National Governors Association deals with, or will when published, specific options. The concern here is with the underlying principles.

The incentive structure of the originators was counter productive for justice, and thus is a candidate for regulation. Some people may simply hope that individuals do the right thing because it is just. Maybe that would work in a perfect world, and maybe we ought to at least move closer in instilling the values in the formative years. In the meantime, the options are based upon the carrot and the stick, incentives and regulation, and probably a combination. The lender, frequently a mortgage banker, may make the loan to be sold, probably in a package, and maybe sliced (cut into tranches), or the purchaser will slice it up and sell off tranches, probably diversified by location.

Markets work best for society when they operate with a level playing field. Asymmetric information tilts the field in favor of those with superior information. Thus disclosure requirements are reasonable regulations, frequently considered as part of transparency. But the disclosure in origination is one thing, and transparency in the chain of securitization goes well beyond it. That transparency becomes critical in investors knowing what they get and borrowers knowing to whom the debt is owed, even though the servicer is the one with whom the borrow deals.

There are two sides with different problems. On the investor side there is the disclosure that includes the rating system, another mess. On the borrower side there is the renegotiation problem because the tranch system leaves investors with diverse interests. The issues may be viewed as institutional arrangements.

Markets as Institutional Arrangements

Markets are institutional arrangements so common that each of us probably feels that we understand them well. Maybe most of us do, but maybe some of us don't really get it right. And, as the old saying goes, it is not what you don't know that gets you in big trouble, it is what you believe you know that turns out not to be so.

Well at the risk of being the victim of knowing what is not really so, here is a view of markets built on the concepts of justice.

A lone individual on earth could simply deal with the relationship between himself and nature. But, when others are involved, some organizational structure emerges. The nature of that structure varies widely by culture. As an exercise in polemics we could take the Islamic view of all governmental authority is from God, and it is written in the Koran, and justice is based on that authority. At the other extreme we could take the American view that all governmental authority arises from the individual and that the governmental authority derives from the people through a democratic process.

Both those views are rooted in Abrahamic religious heritage. The American view is rooted in the Judaic view of the value of the individual. If you want a polemic not religiously based, then one is present in communism as compared to democracy. The source of authority in communism is the state as compared with the source of authority in democracy being the individuals as politically represented.

The American view of markets may be seen as potential and actual transactions resulting from individual actions or potential actions. The key is in the concept of a commercial transaction based on individual choices of buyers and sellers. If there is only one seller, it is a monopoly. If there is only one buyer it is a monopsony. If there are a few sellers it is an oligopoly. If there are only a few buyers it it's a oligopsony**.**

Monopolies are illegal in the United States unless regulated. That is done because of the unequal power in the market. Similarly, oligopolies may be regulated in order to level the playing field. Interestingly enough, cartels are international arrangements for exploiting the market with a heavily tilted playing field, and are not regulated by a single government, but rather dependent on the conspirators' unified action and minimal impact of non-participating competitive suppliers.

We will leave dealing with cartels aside. Rather, our focus is on justice as sought domestically in the regulation of markets. That justice is social justice and it includes distributive justice and commutative justice. Distributive justice relates to allocational systems while commutative justice refers to individual participation.

We see our society as just in an allocational system when we resolve the incommensurability of equality and liberty. Liberty may positive or negative. Negative freedom is the absence of limitation as with regulation. Positive freedom is the presence of ability. Thus, one may not be restricted from an activity by regulation, but may not have the resources.

Equality may be in opportunity or in resources. The quote from the Declaration of Independence (in footnotes) refers to equality of rights, not resources. Yet, social justice calls for some equity. The resolution then is some balance between the freedom to capitalize on market opportunity and the distributive justice. That freedom to capitalize on market opportunity is a strong incentive to productive efforts, especially innovation. The benefits must be attractive enough to call forth the efforts ant talents. Yet, equity calls for some semblance of equality, not only in opportunity but in assurance of some minim al standard of living and fair share of society's production.

What is an equitable balance in society's production is the subject of substantially different views. The last few decades have been heavily skewed toward the concentration of wealth, in some measure as a result of the political economy. While that trend may reverse next year, the historic pattern of regulation has had a pendulum swing that overshoots the mark.

My personal judgment is that justice calls for a movement towards the center, but that there is a risk that the policies will overshoot the mark. The key funded proposal of SCRC through HHI and its co-funders contains the following statement: "In evaluating each of the proposals, we will be guided by the following criteria: i) *Fairness:* the issue arises of who will be helped and who *should* be helped. While few would dispute that help would be appropriate to subprime borrowers who were misled by lenders and put into loans they could not afford (especially for borrowers who were refinancing a home in which they previously held equity), there is much less sympathy for speculators who took out loans hoping to flip the home for a profit a few months later. At the other end is the question of whether the misled homebuyer is any more worthy of assistance than the misled investor who bought a security purported to be of AAA quality as a way of improving their return. Ii) *The Net Impact or Bang for the Buck*: Any analysis of these programs needs to look at the total macroeconomic effects (the benefits to the economy of stemming the decline of home prices and bolstering credit markets), relative to the amounts involved, and iii) *The Distributional Impact,* i.e. the disaggregated effects on different players in the housing market and different geographic areas. We will also approach the proposals from the point of view of iv) *The Source of Financing*, and the implications thereof, as well as the v) *Future Mitigation of Moral Hazard and Return to Business as Usual, i.e.* the sunset clause in each proposal and the potential for speedy recovery."

That statement is in accord with the concept of justice espoused here in "Developing Policy for Dealing with the Subprime Crisis: A Matter of Justice." The White Paper which encompasses that project and the best analyses we can muster in the time frame is in process and is the focus of the forthcoming September 15 Subprime Crisis Research Council conference to be held in Washington.

Additional support for carrying the work forward in 2009 is hereby being sought. Potential funders will be invited to the conference.

[xi] The essay titled "Marketing Toxic Tranches: Including the Other Parts of the Mortgage Derivatives Underlying the Subprime Crisis," was distributed September 22, 2008 to a limited readership and is included in the draft of the report to Homer Hoyt Institute and other funders of the Subprime Crisis Research Program administered in conjunction with the Subprime Crisis Research Council (SCRC). These are available on request.