'Fannie and Freddie Were Lenders': U.S. Real Estate Bubble Nears Its End

by Richard Freeman

The U.S. financial system is now dependent to an unprecedented degree upon one prop: the greatest housing-real estate bubble in human history. A hyperinflationary spiral has sent home prices shooting up by 10-40% annually in recent years—depending on the region of the country—and artificially pushed the price of millions of homes into the $400,000 to $1 million range or above. Already in 2001, one out of every ten homes for sale in the United States was priced at $1,000,000 or more. Since then, prices, assessments, real estate taxes, and mortgage credit volume have continued to spiral upwards, even as the productive economy staggered downhill. Many homes today are simultaneously glorified shacks—with plastic exteriors and gold-plated faucets in the bathroom—and yet unaffordable to most American families.

This housing bubble is without precedent, far larger than the 18th-Century Mississippi Bubble of Venetian-Scottish agent John Law. In 1717, Law established the Mississippi Company and issued shares to the public, initially against the supposed wealth to be drained from France's Louisiana Territories in North America, and eventually against the value of all of France's colonial trade. These were shares, effectively, against ground-rent. In 1719, the value of the Mississippi Company's paper shares rose to 40 times their original value, and many times the wealth that possibly could back them up. In 1720, the shares collapsed, bankrupting the nation of France. The U.S. housing bubble's stated ground-rent value is 1,000 times greater than that of the Mississippi Bubble. Unless corrective measures are taken, the inevitable collapse and the ensuing devastation will destroy millions of families.

The cumulative value of all homes in America is now an astounding $12.04 trillion, which is only $3 trillion less than the hyperinflated value of all the stocks traded in America. People have been deluded into buying homes in the $250,000 to $500,000 range, on the grounds that if they can hold on to them for two to five years, they will be able to re-sell them at an even higher price; or, alternatively, that these are the only homes available, and that if they don't buy them now, however overpriced, prices will go even higher and become further out of reach. Millions of families are spending 35 to 50% of their annual income on mortgage or rent payments.

There is a physical constraint on their ability to pay, and thus, ultimately, a constraint on the housing bubble itself: These families are one or two missed paychecks, or the loss of a job, away from defaulting on a mortgage. Default rates on mortgages insured by the Federal Housing Administration—used primarily by families of middle or modest income—have recently reached 10% in some urban areas of the United States. As a wave of cumulative mortgage defaults spreads, the housing market will implode, wiping out trillions of dollars in housing values.

In testimony on April 17, before Congress' Joint Economic Committee, Federal Reserve Board Chairman Alan Greenspan foolishly denied that there is a housing bubble, and asserted that housing conditions are "scarcely tinder for a speculative conflagration." Greenspan's statements fall under the heading of "he doth protest too much."

On May 28, the 2004 Presidential pre-candidate Lyndon LaRouche told an international webcast audience: "We are sitting on top of a real-estate bubble collapse in the United States today; the Fannie Mae/Freddie Mac bubble is about to blow. What day it's going to blow, I don't know. But it's going to blow. People are going to find that houses which they have listed as mortgages at a half million [dollars] or so, plus or minus, in the Washington, D.C. area, or the New York area, these shacks will probably be lucky to go for $100,000 redeemable value. People are going to be wiped out. Jobs are going to be wiped out. Firms are going to be closed down."

The Two 'Golems' of the Bubble

The housing bubble has been developing for two decades, and it has been undergoing accelerated growth since 1995. It is under the control of Fed Chairman Greenspan, acting on behalf of the Wall Street-City of London oligarchical financiers. Greenspan depends upon the huge sums of liquidity pumped in by the Federal National Mortgage Association (Fannie Mae) and the Federal Home Mortgage Loan Corporation (Freddie Mac), through the secondary home real estate market, which they control. Fannie Mae and Freddie Mac—which are *private corporations*, not government agencies—are the linchpin of the housing bubble; without them, it could not exist. The City of London-Wall Street financiers' objective, and also that of Fannie Mae, is to inflate housing prices through increases of "fictitious value," thereby increasing the

size of mortgages needed to buy the houses at inflated prices, and thus, increasing the principal and interest-rate cash that can be gouged from households. It is an unadulterated looting operation.

Without the huge margin of Fannie- and Freddie-generated liquidity, the housing mortgage market would not be the size that it is, and without an enormous mortgage market, there absolutely could be no housing bubble.

Since 1995, the housing bubble has required between $400 to $600 billion per year in new mortgages to finance homeowners' purchase of new and existing homes at inflated prices. Between 1995 and 2001, banking institutions (including savings and loan institutions) lent $2.25 trillion in new housing loans to prospective home-buyers. But during the same interval, banking institutions lent only $1.29 trillion in loans of all types, including to commerce and industry, to consumers (for car purchases, etc.), and for housing. This seems impossible. How could banks lend more for housing, at $2.25 trillion, than they lend to the entire economy, at $1.29 trillion, when the latter includes housing as a sub-sector? The answer: the great Fannie Mae and Freddie Mac lending machine. Between 1995 and 2001, Fannie and Freddie (and a few similar, smaller agencies) acquired almost three-quarters of the $2.25 trillion in new mortgage loans that all banks had made. Upon getting cash from Fannie and Freddie, the banks made new housing loans. Since 1995, Fannie and Freddie, et al., accounted for almost three-quarters of all housing mortgages.

The housing bubble can only function if it pushes home prices up; the home price can only go up, if there is a mortgage to purchase the home at the increased price. Without Fannie Mae and Freddie Mac, the home mortgage market would have been only one-quarter as large as it actually was. A housing bubble could not exist in that framework.

Fannie Mae and Freddie Mac have raked in huge profits from the housing bubble. But they have also concentrated in themselves, an enormous exposure to mortgage debt—a concentration even greater than the 35% of all financial derivatives contracts sitting in one bank, J.P. Morgan Chase—and have issued some obligations which are very risky. Thus, it is ironic that the housing market depends on Fannie Mae and Freddie Mac, which are in such rotten condition that they could puncture the very housing bubble which they are called upon to support.

How It Grows

To understand the importance of Fannie Mae and Freddie Mac, one must understand the rudiments of the housing financing market. To buy a home, a prospective purchaser must have the financial means: Either the purchaser is wealthy enough to buy the home in cash, or—in most cases—the purchaser takes out a mortgage loan. Commercial banks, and savings and loan associations are the financial institutions most likely to originate a mortgage loan. The primary mortgage-lending institution can hold that loan until maturity—30 years, for example—collecting, during this time, interest and principal payments.

However, the primary mortgage-lending institution can exercise a second option: After originating the mortgage loan, it can sell it off. Two of the leading corporations that could buy the mortgage from the primary institution—known as secondary market corporations—are Fannie Mae and Freddie Mac. As a result of Fannie Mae and/or Freddie Mac buying the mortgage from the primary lending institution, that primary institution now has cash, which it can use to originate a new mortgage.

This process can be, and is, repeated several times during the course of the year, for each primary-mortgage lending institution in America. Thus, Fannie Mae and Freddie Mac act as a spigot pouring liquidity into the U.S. mortgage market.

There is another step to this process. When a primary mortgage lending institution offers to sell a mortgage loan it has originated, Fannie Mae or Freddie Mac can do one of two things. They can, as described, buy the mortgage loan outright and hold onto it (Fannie and Freddie issue bonds in their own names, and use the proceeds from the bond sale to buy mortgage loans). Or, they can pool several mortgage loans together, into a derivatives-like instrument, called a Mortgage-Backed Security (MBS); put a guarantee on it; and sell it to a third party—such as a mutual fund, a pension fund, or an insurance company. In the latter case, the pension fund or mutual fund end up owning the MBS, which gives them a claim to the underlying principal and interest stream of the mortgage. Thus, it is the cash from the pension fund, or mutual fund, etc., which is going into the housing market, having been drawn into that market by Fannie Mae and Freddie Mac as issuers of securities.

Volcker Destroys Traditional Home Financing

In the post-World War II period to 1963, when a previous generation of Americans bought their homes, the purchase cost reflected the cost of construction, such as materials and labor, plus a moderate, but fair profit for the homebuilder. It also reflected the cost of the land, which was not high. For financing, a traditional relationship existed with savings and loan institutions, so that the home purchaser could readily obtain a 30-year mortgage, usually at a 5-6% interest rate which would make the mortgage affordable. As late as the 1950s, the median price of an American home was less than $15,000.

In the mid-1960s, the financier oligarchy moved America away from a producer to a consumer society, by introducing the "post-industrial society" policy, which also shattered the workable housing relationships. There were a few key benchmarks in this process.

In 1979, then Federal Reserve Board Chairman Paul Volcker instituted the New York Council on Foreign Relations' policy of "controlled disintegration of the economy,"

so that the commercial banks' prime interest rate reached 20.5% by December 1980. This policy intentionally shattered manufacturing, agriculture, and infrastructure, and built a gigantic speculative bubble. It also crushed the savings and loan associations, which were the mainstay of the housing industry. They then had to pay interest rates of 15-18% to attract and hold depositors, but they were earning only about 5% on the mortgage loans they had previously made. The negative spread of 10-13% caused the S&Ls huge losses.

In 1982, the disastrous Garn-St Germain law, which deregulated the banking system, was approved, removing the wise and longstanding restrictions which had severely limited the amount of money the S&Ls could invest in *commercial* real estate. Advised to invest in commercial real estate to make up the losses that Volcker's policy had created in housing, the panicked S&Ls lost more than a quarter of a trillion additional dollars. The bailout of these losses in the mid-1980s, became known as the S&L debacle.

In 1986, the Tax Reform Act was passed, which created tax breaks for speculative shelters in real estate. By this point, the bankers thought it timely to introduce the full speculative virus into the home real estate market. Home prices rose, although there was a downturn in the 1989-91 period. By 1995, Fed Chairman Greenspan, who had been nurturing the housing bubble since he was ensconced in that post in 1987, let out all the stops to pump up the bubble. Fannie Mae and Freddie Mac began priming the bubble with hundreds of billions of dollars in funds per year.

Today, the basic characteristic of the housing market has been altered so that it is entirely different from what it had been in the mid-1960s. The home's principal function is no longer shelter and development of a family, obtained through the instrument of the mortgage market; rather, the home has become the mere instrument of the housing market bubble. The home price is a function of whatever the hyperinflationary housing spiral can drive it up to.

For the banks, the objective is to create fictitious value in a home, through a fake appreciation in price. To comprehend what fictitious value is, consider the example of a home built in 1992, and sold then for $100,000, which is now priced on the market for $225,000. *The $125,000 increase in the home's price represents fictitious value.* In real physical construction terms, the home has depreciated for ten years, and is *worth less;* even if there were home improvements made to keep the home at the same functional level, it is worth, at most, $100,000.

Take any other useful entity, such as a car or a machine tool. One could not put ten years of wear and tear on it, and then sell it for twice what it was worth ten years ago. However, this is what is done with housing.

The process is the same in the case of a McMansion, which sells for $400,000, but is made of the shoddiest material, and is only worth $125,000. The difference of $275,000, between what it sells for and what it is worth, *is fictitious.*

For the banks, the aim is: *If the price of a home can be fictitiously doubled, say to $400,000, then the market value of the mortgage attached to the home can be fictitiously doubled to $400,000, and the income cash flow stream of principal and interest payments that can be looted, can be doubled.* The banks pre-figure what principal and interest cash stream they want to realize from a mortgage, and then set the price of the house at a level that will allow them to extract, through an attached mortgage, that principal and interest cash stream.

This is the system that the banks put into place during the course of the 1980s, and which Greenspan and Fannie Mae have geared up full force since 1995. It is completely unsustainable and unstable.

Explosion in Home Prices

There is an explosion of home prices since 1995, but especially since 1999, in the hot markets in New York, Florida, California, and Greater Washington, D.C.—the last of which may be the hottest market in the nation. Greater Washington includes Washington, D.C. proper; Arlington and Fairfax Counties in northern Virginia; and Montgomery County in Maryland. **Table 1** and **Table 2** show, respectively, the average and median prices of homes in this region.

In Washington, D.C. proper, in 1999, the average price of a home was $264,668. Now, less than two and one-half years

TABLE 1
Greater Washington, D.C. Median Home Price

Year	Washington, D.C.	Montgomery Cty, Md.	Arlington Cty, Va.	Fairfax Cty, Va.
1999	$179,500	200,000	259,000	215,000
2000	175,600	217,500	305,000	235,000
2001	224,000	244,900	360,000	272,880
March 2002	245,000	260,000	380,000	299,000

TABLE 2
Greater Washington, D.C. Average Home Price

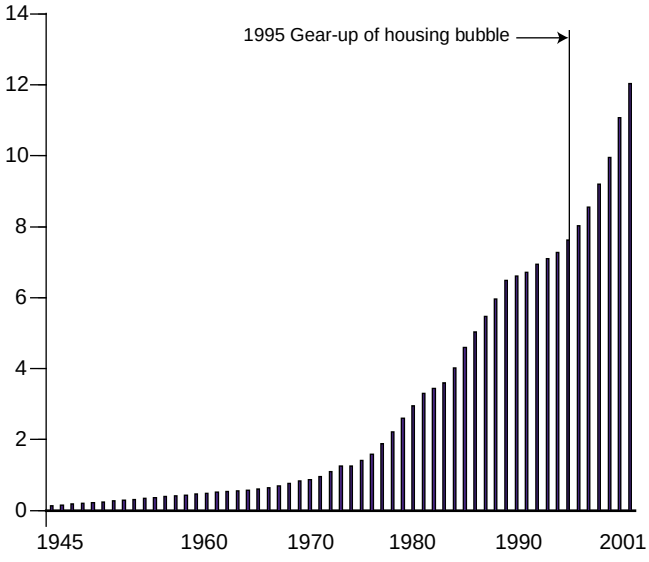
Year	Washington, D.C.	Montgomery Cty, Md.	Arlington Cty, Va.	Fairfax Cty, Va.
1999	$264,668	176,000	294,156	132,667
2000	291,601	284,667	338,711	291,548
2001	349,669	312,411	394,319	332,695
March 2002	367,676	324,326	416,579	341,680

Source: Greater Capital Area Association of Realtors.

FIGURE 1

Hyperinflation in Home Real Estate Valuation, 1945-2001

($ Trillions)

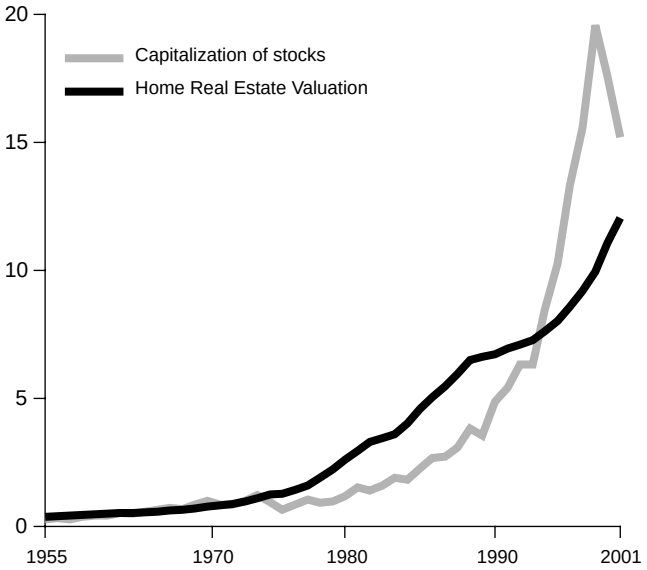


Source: Federal Reserve Board of Governors, "Flow of Funds Accounts."

FIGURE 2

Home Real Estate Valuation vs. Capitalization of All Stocks Traded in United States

($ Trillions)



Source: Federal Reserve Board of Governors, "Flow of Funds Accounts."

later, it has jumped to $367,676, a compounded annual rate of increase of 16%. (During this time, the median home price increased at a compounded annual rate of 15%.)

Elsewhere in the area, the pattern is the same. In Fairfax County, in northern Virginia, between 1999 and the present, the average single family home price skyrocketed from $132,667 to $341,680, a staggering compounded annual rate of increase of 38.4%. In Arlington County, in northern Virginia, the average price of a home has jumped to $416,579. In the Greater Washington, D.C. region as a whole, the average single family home price is above $340,000, and rising at an incredible rate.

During 2001, home prices for the entire states of California, Florida, and Massachusetts, rose by more than 10%, and in portions of New York, by more than 15%.

This explosion in home prices increased the collective valuation of all household-owned home real estate in America. **Figure 1** shows that since 1950, the value of all U.S. households' home real estate holdings rose steadily. Then it rose more rapidly during the 1980s, reaching $6.608 trillion by 1990.

But between 1990 and 1995, the collective value of all homes rose only by $1 trillion. However, since then, under the deliberate manipulation of Alan Greenspan, nurtured by the Fannie Mae-Freddie Mac money-pumping machine, it shot upward: Just between 1999 and 2001, the collective valuation of all households' home real estate holdings increased by $2.084 trillion to $12.04 trillion, a rise of 20.9% during those two years.

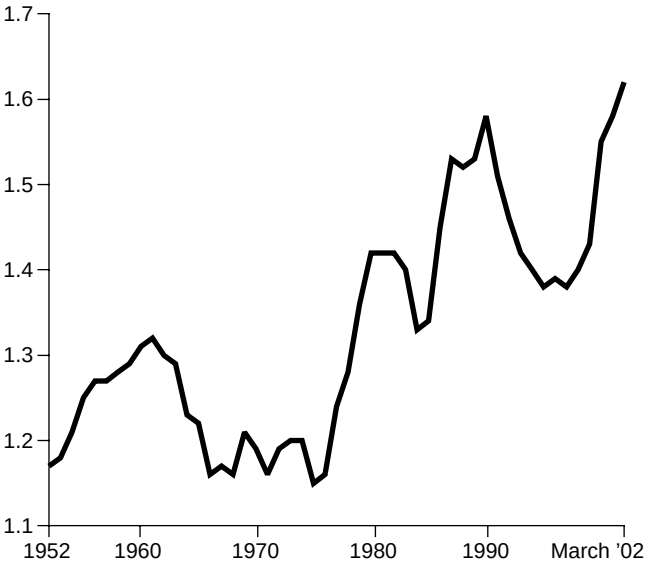
The increase in the collective valuation of all household-owned homes achieved the bankers' prime objective: Against that valuation, a tremendous amount of mortgages and secondary forms of mortgage-based debt could be floated, thus increasing the rate of looting through interest and principal mortgage streams, as we shall show.

The sharp jump in the collective valuation of all household-owned homes, makes it, along with derivatives, the chief element of the dynamic that is holding up the U.S. speculative bubble. **Figure 2** shows the trajectory of the collective valuation of households' home real estate holdings versus that of the capitalization of all stocks traded on stock markets in the United States. With the rupturing of the New Economy stocks, between 1999 and 2001, $4.5 trillion of fictitious valuation of stocks has been wiped out. The collective value of U.S. households' home real estate holdings is now just $3 trillion less than the stock market capitalization of all U.S. firms.

According to *EIR*'s estimation, $6 trillion of the $12.04 trillion valuation of household-owned home real estate is *fictitious,* debt and liquidity artificially forced into the housing market over the past few decades, especially since 1995. This gives an estimate of the amount of hot air which will be wiped out in this market in a collapse of the bubble, driving home prices down with explosive impact.

FIGURE 3

Ratio of Home Real Estate Valuation to Disposable Personal Income Surges

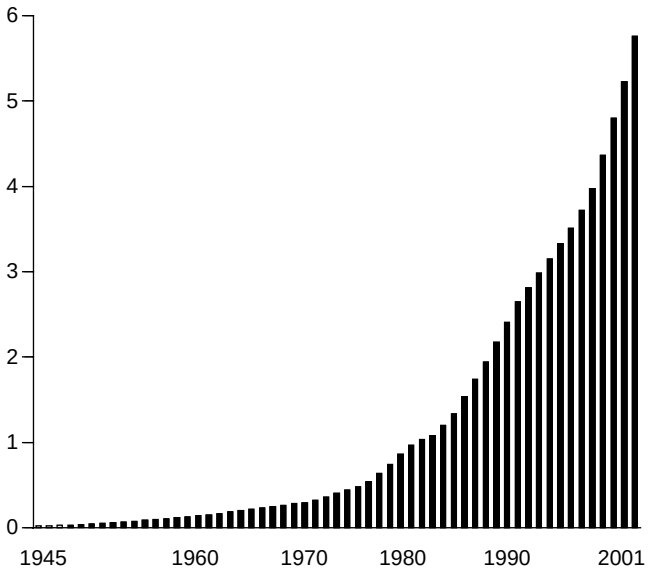


Sources: Ian Morris, HSBC Securities.

FIGURE 4

Hyperbolic Growth in Home Mortgage Debt, 1945-2001

($ Trillions)



Source: Federal Reserve Board of Governors, "Flow of Funds Accounts."

Cost and Quality

Two other characteristics distinguish the new housing market.

First, the cost of homes has reached a dangerous multiple of average income. **Figure 3** shows the ratio of total home real estate valuation to total disposable (after-tax) personal income, complied by Ian Morris, an analyst at HSBC Securities. It now has reached 1.62, its highest level in this 50-year series. However, the cost of a home becomes even worse, when the mortgage interest costs are figured in, which will be examined shortly below.

Second, the quality of homes. The homes of today have several glaring problems. The new homes that sell for $300,000 to $750,000 are frequently made with the shoddiest material. They are built with doors made of cardboard cores instead of wood; no cross-braces under the joists of floors to support them and prevent shaking; and the proverbial 2-by-4 piece of wood shaved down to 1.5 by 3.5 inches. Whereas 50% of the siding in houses in the 1970s was made of brick, today less than 30% of housing siding is made of brick.

Thousands of homes, priced at one-half million dollars and up, have their elegant looking facades made out of—stryofoam. The Maday family, for example, of Reston, Virginia, moved into a $522,000 home in late 1996, having been told they had an exterior of stucco (a mixture of cement and limestone), which is typically ¾ to 1 inch thick. They found that their house had a ⅛ inch coating of styrofoam. The styrofoam trapped water and developed a "99% moisture reading," and as a result, the walls rotted away. An Aug. 29, 2001 *Boston Globe* article exposed the fact that thousands of McMansions from northern Virginia, to Connecticut, to Illionis have been constructed with styrofoam fronts.

Figures 4 and **4A** document, since 1950, the increase in the volume of U.S. household home mortgage debt outstanding. This grew steadily up to 1980, and then afterward, at a faster rate. Starting 1995, the banks, collaborating closely with Greenspan and the money-pumping of Fannie Mae and Freddie Mac, caused the level of mortgage debt outstanding to grow at an accelerating rate: Just between 1999 and 2001, it jumped by nearly $1 trillion, to reach $5.757 trillion.

The more a home costs, the more cumulative interest a mortgage borrower must pay, and the more interest the bankers collect, even if the interest rate remains the same.

Figure 5 shows for the period 1963-2001, the total cost to purchase a new home, on a 30-year mortgage. The purchase price used for this demonstration, is the nationwide median cost of a new home, as reported by the National Association of Realtors. The interest rate is the fixed interest rate prevailing for that year. In 1963, the median cost of a new home was $18,000. The total cumulative cost to buy the new home on a 30-year mortgage, was $34,616: $18,000 paid in purchase

FIGURE 4A

U.S. Household Debt

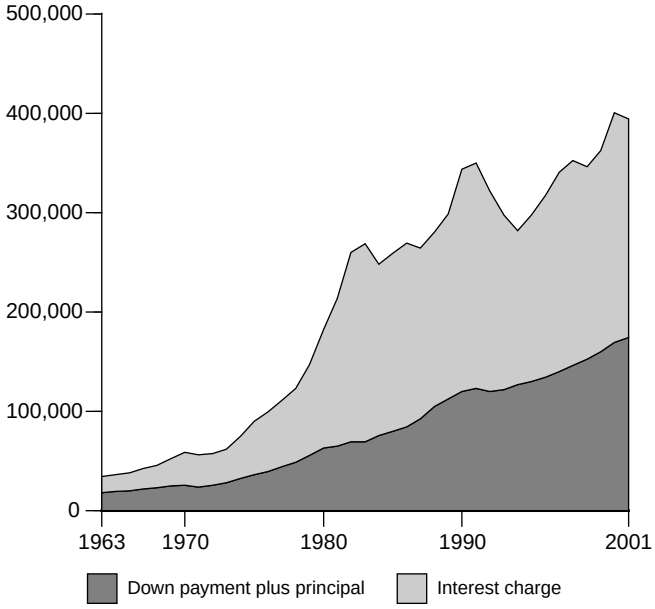
($ Trillions)

Source: Federal Reserve Board of Governors, "Flow of Funds Accounts."

FIGURE 5

Total Cost of New Home Has Soared

(Dollars)



Sources: National Association of Realtors; *EIR.*

price (which is broken down into down payment, and principal), and $16,616 paid in interest. In 2001, the median cost of a new home was $174,000. The total cumulative cost to buy a new home on a 30-year mortgage leapt to $393,986: $174,000 paid for the median purchase price, and $219,986 paid in cumulative interest. So, today, the mortgage-payer must pay nearly a quarter of a million dollars in interest. The cumulative interest cost, which in 1963 was somewhat lower than the purchase price, in 2001's "low-rates" market was nearly 1.3 times greater than the original $174,000 purchase price of the house.

According to the U.S. Department of Housing, the total monthly "home cost" should not exceed 28% of a household's gross income. The "home cost" consists of the mortgage interest and principal payment, plus the home insurance payment, plus the home property tax due.

How able are home-purchasers to finance the mortgage? Let us utilize a strictly standard arrangement. If a household were to buy a new home, at the median price of $174,000 (in the above example), on a 30-year mortgage, putting the (now standard) 10% of the home purchase price down in a down-payment, and financing the rest in a mortgage at the prevailing fixed interest rate of 7.04%, then its mortgage payment of principal and interest, would be $12,553 per year ($1,046 per month). On such a home, the home insurance and home property tax would be approximately $1,920 per year. Thus, the total "home cost" would be $14,473 on an annual basis. If, according to HUD, the "home cost" should be no more than 28% of total household income, then $14,473 is 28% of $51,689. A household would need an annual income of $51,689 to afford the "home costs" of a median priced home of $174,000.

Sixty percent of American households do not have an annual income of $51,689. Three-fifths of American households could not afford to purchase and live in such a home.

Rising Market, Falling Living Standards

How is it possible for families to buy these homes, and for Fannie Mae to constantly boast that the rate of home ownership, including among minorities, is rising?

Millions of households have bought homes by "getting in over their heads." They are paying 35%, 45%, and even more of their annual income, on the home mortgage. This makes them dangerously vulnerable. Some think that if they own the house for 2-5 years, it will rise in price by $100,000-150,000, and they will sell to the "next guy," in a rising real estate market. Soon there will not be a next guy. Many, many families hold two, two-and-one-half, or three jobs among the family's members to pay for the home. The next round of layoffs that wipes out one of these jobs, will leave them unable to pay their mortgage, leading to default.

Some other families bought homes in the $350,000 to $1 million range, because they earned money from stock capital gains, stock options, bonuses in the financial and high-tech industries, etc. That is drying up on a large scale.

For some households, the fact that they can borrow new money against the value of their home, each time the value of their home rises, keeps them in the game.

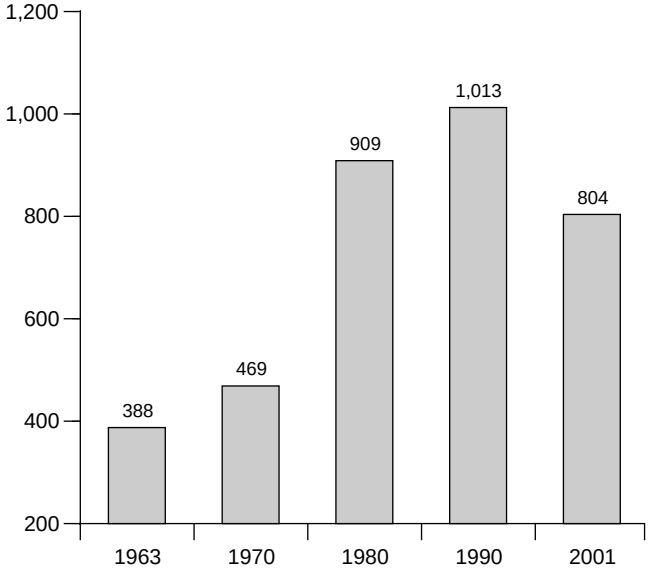
Overall, Greenspan has engineered relatively low interest rates, both to keep the financial markets going, but in large measure to keep the housing bubble afloat. The need to raise interest rates, for example, to prop up the collapsing U.S. dollar, would destroy the interest rate environment that is essential to keeping the housing bubble alive.

The key constraints, which govern everything, are living standards and the real physical economy's productivity. For the lower 80% of the population, living standards, measured by market baskets of consumer and producer goods, are falling. They appeared to be, falsely, propped up by stock capital gains, and the like. One cannot long increase home prices, such as in the Greater Washington area, by 15 to 38% annually, and increase the mortgage interest income streams which are to be extracted, by a similar percentage, from households whose living standards, in reality, are falling by 1 to 2% per annum.

If one clears away all the clutter, home prices have gotten much more expensive. One measure that *EIR* has developed is straightforward. The U.S. Department of Labor's Bureau of Labor Statistics provided information on the value of the weekly paycheck of the average non-agricultural worker. If this worker were to buy a new median-priced home, how many of his paychecks would it take for him to pay off the home, including the interest costs on a 30-year mortgage? The answer is shown in **Figure 6.** In 1963, it required 388 paychecks; in 2001, it required 804 paychecks. In terms of the employee's paycheck, the home is 2.07 times more expensive. The reason for this has to do with the fall in living standards, but also with the shooting-up of home prices.

In earlier periods, such as around 1980, in which the number of paychecks required to buy a home rose, this was due to a spike (Paul Volcker's deliberate spike) in interest rates. Today, when interest rates are relatively low, the fact that it requires a large number of paychecks to buy a home, indicates just how serious the problem is.

FIGURE 6
Number of Weekly Paychecks Needed To Buy a New Home



Sources: National Association of Realtors; Department of Labor, Bureau of Labor Statistics; *EIR.*

The Intervention of Fannie and Freddie

What has kept the housing bubble functioning, especially since 1995, is the massive role of Fannie Mae and Freddie Mac.

One must know how these agencies work. Fannie Mae presents itself in its public relations campaign as "Building the American Dream." It holds big events with legislators, in particular black and minority legislators, spending lavish amounts of money around the country. It puts more ads on the radio and in the newspaper, than almost any major corporation. It probably has one of the biggest patronage machines in the nation, reaching deep into every state.

What does one expect of a private corporation, which, if it were a bank, would be the third largest bank in the world, and which makes money hand over fist in the real estate market?

Fannie Mae is positioned as the key prop in the housing bubble (what is said of it applies as well to its smaller cousin, Freddie Mac). But Fannie Mae has as much "radioactive" financial risk as any institution in the world. Fannie Mae built up this financial risk in the process of constructing the housing bubble.

A crucial bank that has shaped the agenda of Fannie Mae is Lazard Frères investment bank, a powerful cog in the international Wall Street-City of London oligarchy. Fannie Mae Chairman Franklin Raines spent ten years working at Lazard. Lazard counts in its network the Graham family that owns the *Washington Post.* (In 1995, Franklin Raines, working with the *Post*'s Katharine Graham, established the Financial Control Board, which destroyed Washington, D.C.)

Fannie Mae had started out in 1938, not as an instrument of speculation, but as part of President Franklin Delano Roosevelt's New Deal. As the accompanying box shows, in the short run, its function was to get the lagging home mortgage lending started again, and more broadly, to contribute to the growth of a financial market to make it possible to purchase

affordable housing.

In the beginning, Fannie Mae existed as a government agency. In 1954, it was turned into a mixed, part-private, part-government agency, and in 1968, it was transformed into a totally private corporation, issuing its own stock, which was bought by private investors, and eventually became listed on the stock exchange. For the most part, all through this period, up to the mid-1970s, Fannie Mae fulfilled its original function: It brought liquidity into the housing market in moderate quantities, and functioned as a subordinate agency in that market.

However, starting in 1979-81, at precisely the time that then-Fed Chairman Volcker instituted the policy of "controlled disintegration of the economy," new lending policy changes were made at Fannie Mae. These changes were intended to bring eventually a flood of money into the housing market, from both outside "third party investors"—using the derivatives-like instruments called Mortgage-Backed Securities—and from the corporation itself. The seeds of the housing price explosion planted in 1979-81, came to fruition from 1995 to the present.

Prior to the late 1970s, there had been two principal forms of lending; this transformation added a third.

The first and simplest form of lending is the primary mortgage loan. The second form is that involving Fannie Mae: A mortgage-lending financial institution makes a mortgage loan, but instead of holding onto it, it sells it to Fannie Mae, and uses the cash to make a second loan. It can repeat the process, of selling the second loan to Fannie Mae, and make a third, fourth, and so on, loan. In this manner, a mortgage-lending financial institution could make five loans for $150,000. It sells the first four loans to Fannie Mae (which buys them with proceeds from the issuance of its bonds) and keeps the fifth loan. At the end of the process, the mortgage-lending institution has one loan totalling $150,000 on its books, and Fannie Mae has loans totalling $600,000 on its books.

These were the only two types of lending up to 1979-81, when the third type was introduced: Fannie Mae began creating Mortgage-Backed Securities. As the risk on the MBS became greater, the risk that Fannie Mae had became greater. But this is part and parcel of how the mortgage market, and thus the mortgage-bubble, expanded.

The Mortgage-Backed Security

In the case of the MBS, Fannie Mae gathers its purchased mortgages from different mortgage-lending institutions, and pools them together. For example, Fannie Mae may bundle a

The Origins of Fannie Mae

The Federal National Mortgage Administration (Fannie Mae) arose as a feature of the New Deal. During 1933-34, the Roosevelt Administration responded to a housing crisis, which developed out of the overall breakdown of the economy and financial system. Millions of workers lost their jobs, and without income, defaulted on their home mortgages; the banks foreclosed on hundreds of thousands of homes, and families were tossed onto the street. Banks, claiming fears that any *new* home mortgages would end in default also, cut back lending by 1934 to 60% below the pre-1929 peak. With the mortgage financing market drying up, new home construction shrivelled.

In response, the Roosevelt Administration created a new government agency, the Home Owners Loan Corporation (HOLC), as a subsidiary of the Reconstruction Finance Corporation. The HOLC attacked the problem of defaults. It enabled the refinancing of existing mortgages that were in default status, with new mortgages. Between 1933 and 1936, the HOLC refinanced one-fifth of existing urban home mortgages, which were either in default or close to default. As a result, very few mortgages ended up in liquidation, and this put a stop to the home foreclosures.

At the same time, the Roosevelt Administration addressed the issue of how to get the banks to make new home mortgage loans. In 1934, legislation created the Federal Housing Administration (FHA), with two principal purposes. First, the FHA provided for insurance of principal and interest payments on long-term home mortgage loans made by banks and lending institutions. Second, the FHA Act (under Title III) provided for a secondary housing market to be established. In 1938, under this provision, the Federal National Mortgage Association (Fannie Mae) was created. Fannie Mae would pay cash to buy any FHA-insured mortgage that a bank sought to sell. Fannie Mae would put the mortgage in its portfolio, collecting all the interest and principal to the maturity of the mortgage. With the cash for the mortgage that it sold to Fannie Mae, a bank could make a new mortgage, increasing the scope of mortgage financing.

Fannie Mae had the authority to issue its own bonds, in order to attract the funds with which it, in turn, bought mortgages from banks.

For the next three decades, Fannie Mae bought home mortgages from banks and lending institutions, but always with the objective of *keeping the housing market in such manner that homes were inexpensive, and affordable relative to average family income.* Its objective meant that there be no housing bubble like that of today.

thousand 30-year fixed-interest mortgages, each worth roughly $100,000, and pool them together into a $100 million Mortgage-Backed Security. Fannie Mae puts a loan guarantee on the MBS, for which it earns a fee. Fannie Mae promises that in case there is a default on the MBS, Fannie Mae will pay the interest and principal "fully and in a timely fashion." The MBS, once it has Fannie Mae's guarantee on it, is sold to outside investors in denominations of $1,000 and up. The insurance funds, pension funds, and so forth, become the owners of the MBS, but if anything goes wrong, Fannie Mae is responsible.

From the standpoint of those building the mortgage bubble, the MBS taps into a broader layer of funds to be used for housing, on the order of additional trillions of dollars. The sources of funds that can support the housing bubble have been extended very far into the U.S.—and international—financial markets.

In 1979-81, the Volcker polices caused Fannie Mae some losses, like those of the S&Ls. In 1981, David Ogden Maxwell became chairman of Fannie Mae. Maxwell overhauled the corporation and began issuing MBS, which had not been issued except in minuscule volumes before then. Maxwell's career path led into the circles of Lazard Frères investment bank: Today, Maxwell is on the board of Washington's Urban Institute, which is run by the Graham family of the *Washington Post,* itself part of the Lazard network.

However, not satisfied with "plain vanilla" MBS, Fannie Mae found that it could take these securities and *pool them once again,* into an instrument called a Real Estate Mortgage Investment Conduit (REMIC) (which is also known as "restructured MBS" or a collateralized mortgage obligation [CBO]). These REMICs are derivatives, of increasing complexity. They are pure bets, although they are also sold to institutional investors, and individuals, to draw money into the housing bubble.

There are many types of REMICs; we will look at two of them. There is a REMIC called a STRIP, in which the interest payments on the mortgages underlying the REMIC, are stripped from the principal, and the interest stream is sold separately as one REMIC instrument, and the principal amount is sold as another. In fact, the principal amount itself can be broken up into several instruments reflecting different time-periods during the life of the mortgages, called tranches, each of which is sold separately, and has a different level of risk. There is a REMIC called a "floater," in which the interest rate on the instrument floats in direct proportion to the movement—up or down—of the international interest rate called the London Interbank Offered Rate (LIBOR); there is an "inverse floater," in which the interest rate of the instrument floats in inverse proportion to the LIBOR.

Approximately half of all Fannie Mae's MBS have been transformed into these highly speculative REMIC derivative instruments.

Thus, what started out as a simple home mortgage, has been transmogrified into something one would expect to find at a Las Vegas gambling casino. Yet the housing bubble now depends on precisely these instruments as sources of funds.

The 1995 Bubble

By 1995, Fannie Mae had been transformed, the MBS and REMICs were widely marketed and in use, and the housing market had been totally changed. The old days of the financing of a home at an affordable price were gone. The plan of the banks, and Alan Greenspan, was to create a bubble: to finance homes at increasingly fictitious prices. Simply put, to realize a fictitious increase in home price, say from $100,000 to $250,000, there had to be an increase in mortgage size, and not just one mortgage, but tens of thousands of mortgages. This, in turn, required a gigantic inflow to the housing market, of funds which had had nothing to do with its functioning.

During the bubble period 1995-2001, the volume of mortgage loans in the United States increased by $2.249 trillion. But the volume of mortgage loans by the primary mortgage-lending institutions, such as commercial banks and S&Ls, *which they held on their books,* only increased by $592 billion. They generated only one-quarter of the increase in the volume of mortgage debt during this period. The remaining three-quarters of the loans were conveyed to Fannie Mae, Freddie Mac, and cousins like the Federal Home Loan Bank Board. Fannie Mae took the dominant role, accounting by itself for 35.5% of all the money that flowed into home mortgages since 1995. But this was not an act of largesse: During this period, Fannie Mae raked in $25 billion in profits, and the financiers achieved their purpose of setting off a hyperinflationary housing bubble.

Yet, by its very "success," Fannie Mae turned itself into a time-bomb, completely contaminated by the cancer of housing speculation it made possible.

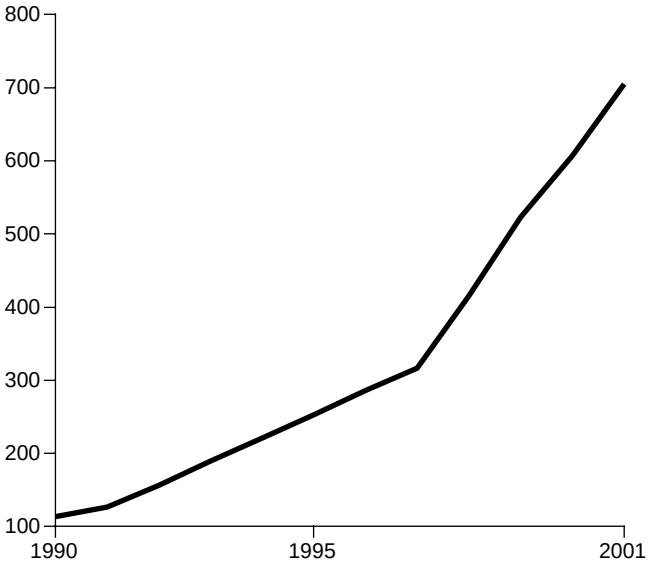
To understand the root of its crisis, look at the rapid growth of its four key parameters. **Figure 7** shows Fannie Mae's ownership of mortgages, which it purchased from mortgage lending institutions; by the end of 2001, this stood at $705 billion. **Figure 8** shows Fannie Mae's debt, mostly its bonds, which it principally incurred to raise the cash to buy the mortgages it now owns; by the end of 2001, this reached $764 billion. **Figure 9** shows the Mortgage-Backed Securities that Fannie Mae created through pooling of primary mortgages; by the end of 2001, this reached $859 billion. Finally, **Figure 10** depicts the "regular" derivatives obligations Fannie Mae contracted, such as interest rate swaps (but not counting the above MBS), and which it claims are necessary for doing business; by the end of 2001, this reached $533 billion.

Of the four parameters, the first is the only one that represents an asset for Fannie Mae. It represents a steady stream of interest and principal payment that Fannie Mae collects. The other three parameters represent obligations, which are very risky. These three types of obligations fed, and fed off, the housing bubble's constant rapid growth of the last six

FIGURE 7

Fannie Mae's Ownership of Home Mortgages

($ Billions)

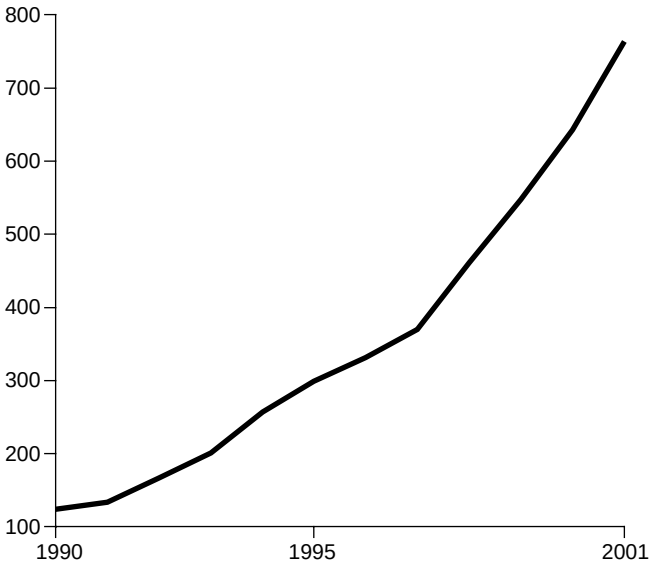


Source: Federal National Mortgage Association (Fannie Mae).

FIGURE 8

Fannie Mae's Oustanding Debt

($ Billions)

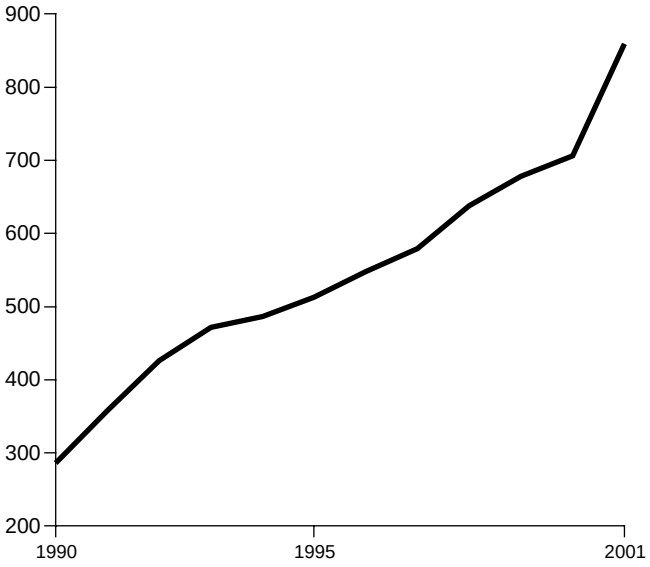


Source: Fannie Mae.

FIGURE 9

Fannie Mae's Mortgage-Backed Securities Issued to Outside Investors

($ Billions)

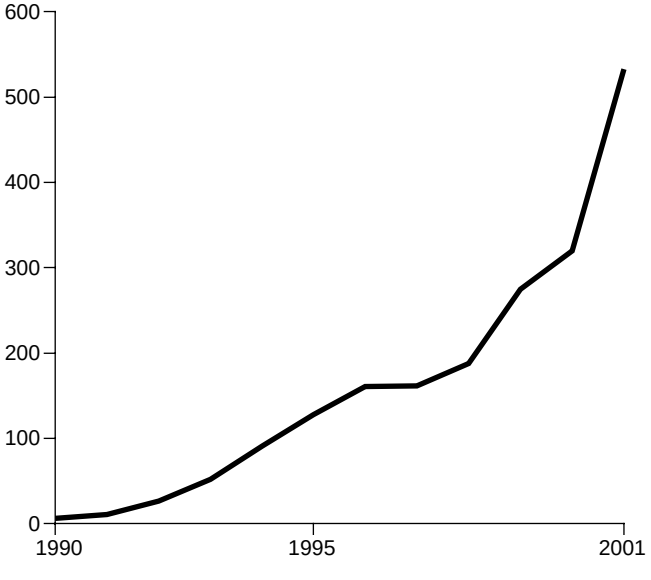


Source: Fannie Mae.

FIGURE 10

Fannie Mae's Derivatives Obligations

($ Billions)



Source: Fannie Mae.

years in particular.

But a wave of mortgage defaults is inevitable. As that occurs, the three risky obligations amplify the crisis, and threaten the bankruptcy of Fannie Mae, and the housing market bubble which depends on Fannie, Freddie, et al.

The Threat of Leverage

Consider the first of the three risks: Fannie Mae's bonds, which make up over $700 billion of its outstanding debt total of $764 billion. The sole source of income, from which Fannie Mae can pay the interest and principal to its bondholders, is from the interest and principal that it collects on the mortgages that it owns. If a portion of these mortgages goes into default and ceases to pay interest or principal, Fannie Mae will not have sufficient cash to pay the holders of its bonds. If the situation worsens, Fannie Mae will default on its bonds.

So, whereas before one had one economic catastrophe—the default of some mortgages—because of the way the housing market is structured, this produces a second catastrophe—the default of Fannie Mae's bonds. Fannie Mae's bonded debt is at least ten times greater than that of any corporation in America. No company in America has ever defaulted on as much as $50 billion in bonds, and Fannie Mae has over $700 billion. With a bonded debt of that magnitude, a default would put an end to the U.S. financial system, right then and there.

Yet a second obligation compounds the problem. In addition to the mortgage bonds, Fannie Mae has put its guarantees on $859 billion of Mortgage-Backed Securities. In a crisis in the housing mortgage market, Fannie Mae could never meet the terms of its guarantee, that it would pay "the full and timely interest and principal," on the mortgages to which it gave a guarantee. By the time it made payment on $5 to $10 billion of the principal and interest of the MBS which it guaranteed, Fannie Mae would go bankrupt from this source, if it had not already defaulted on its bonds. The pension or other funds which had bought the MBS on its guarantees, would suffer tens of billions of dollars of losses.

Finally, Fannie has derivatives obligations: $533 billion in hedges, allegedly to protect it from risks, which themselves could go into default against its bank and other financial counterparties.

Fannie Mae's three risky obligations total over $2 trillion, vigorously used to inflate the housing bubble. Now, an increased default level among the $5.757 trillion in home mortgages, which by itself were not enough to bring down the whole housing market, would create a radioactive reaction inside Fannie Mae, causing it to bring down that market by defaulting on hundreds of billions of obligations.

While Fannie Mae was building up its risky obligations, so was its crony Freddie Mac. Freddie Mac's total of these three risky obligations is $2.91 trillion. (The smaller Freddie Mac's total is bigger than Fannie Mae's, because it has a much bigger derivatives portfolio.) Other institutions which perform functions similar to Fannie Mae, such as the Federal Home Loan Bank Board and private issuers of MBS, have approximately another $0.7 trillion in risky obligations. Thus, the total of housing-related high-risk obligations is roughly $5 trillion.

It should be kept in mind that if one starts with $5.757 trillion in mortgages, these $5.0 trillion in risky obligations are distinct from and in addition to the mortgages, and a total of $10.757 trillion is laden onto the homes and attached to the incomes of America's homeowners. A Mortgage-Backed Security is an instrument with its own risks, independent of those of the underlying mortgages. For example, a dramatic change in interest rates or even a significant increase in *prepayments* of mortgages can wipe out MBS value, quite as efficiently as the increase in mortgage defaults. In the case of the REMIC portion of MBS, this risk is considerable. Fannie Mae's financial paper is a ticking time-bomb threatening to bring the whole leveraged operation down.

Mortgage Financing Props Up Consumer Bubble

This is already far too dangerous, but the financier oligarchs decided to extend the housing bubble to do double duty, to support consumer spending, to halt the rate of economic decline. It thus serves now not only as a bubble for housing values in their own right, but the Wall Street-City of London circles are encouraging homeowners to borrow against the increases of fictitious value in their home to extract "wealth" with which to engage in consumer spending. This is known as the wealth effect.

While it is commonly thought that stock market capital gains have held up consumer spending, a recent study by a team led by Yale economist Robert Shiller, shows otherwise. In the study, entitled "Comparing Wealth Effects: The Stock Market Versus the Housing Market," Shiller shows that for every 10% gain in the stock market, there is a 0.2 to 0.3% gain in consumer consumption; while for every 10% gain in the housing market, there is a 0.62% increase in consumer consumption. Whether or not the numbers are precise, the rough comparison of boosts in consumer spending, is two to one in favor of the housing bubble.

Households are finding two ways to get their hands on some of the fictitious value of their homes: cash-out refinancing, and home equity loans. Under cash-out refinancing, a homeowner takes out a new, larger mortgage on his home, whose value has been artificially pumped up by general speculation. With the new cash, he pays off his first mortgage, pays off his credit card debt, and has money to buy a spate of consumer goods. According to Fannie Mae, in 1993, homeowners extracted approximately $28 billion in cash, from cash-out refinancing; but this tripled to $80 billion in 2001. With an equity loan, the homeowner borrows against a portion of the equity existing in his house (rather than refinancing the

entire mortgage, as with cash-out refinancing).

The amount of home equity loans outstanding stagnated between 1990 and 1995, only rising from $235.9 billion to $289.3 billion. Then, as "Bubbles" Greenspan et al. pumped the bellows, the amount of home equity loans soared, reaching $701.5 billion in 2001. The amount of home equity loans is larger than all borrowing by credit cards in the United States.

A Federal Reserve Board economist told *EIR* that half of the value of all home equity loans does not go for home improvements, but for consumer expenditures and paying down credit card debt. Others indicate that as much as 60% of home equity loans—over $400 billion a year—is for consumer cash and credit card expenditures.

The banks have made it very easy to get home equity loans since the mid-1990s, and now promote "home equity lines of credit," where the homeowner borrows, not a fixed amount—as was the case with the old home equity loan—but an almost unlimited amount of credit.

Write It Down Before It Falls Down

The housing bubble, represented by $12.04 trillion in homeowner home real estate valuation, and $10.757 trillion in original home mortgage and secondary housing market paper, is the biggest such bubble in history. It has more than doubled its size since 1995.

Signs now exist of an increase in mortgage problems: In the first quarter of 2002, more than 4.65% of mortgage loans nationwide were delinquent (30 days past due), the highest level in ten years, and the rate of mortgage defaults is rising. Fannie Mae has taken extraordinary measures to roll over troubled homeowners' mortgages, in order not to have the level of defaults show up. But the housing bubble cannot be sustained. The principal boundary condition is reality: Households with declining real standards of living, are not able to take out of their incomes what is necessary to pay rising home prices, and the demands of ever larger mortgages.

Lyndon LaRouche has proposed putting the financial system through Chapter 11 bankruptcy reorganization, as part of the process of a New Bretton Woods monetary system. That would include writing down a good part of the mass of U.S. housing paper. If that is not achieved, as mortgage defaults increase, beyond the ability of Fannie Mae and Greenspan to control them, the leverage that has been built into the housing market will come undone, with lightening de-leveraging of the entire market. Six trillion dollars of fictitious real estate value will deflate rapidly. Mortgage defaults will intensify, and millions of families will be devastated. The grand payoff is that the housing bubble's puncture will bring down consumer spending, and the U.S. financial system which Greenspan et al. built it to sustain.