Official Axed, Exposed Threat Of U.S. Housing Bubble Crash

by Richard Freeman

A new government report showing the underlying weakness of the U.S. housing market and financial system, and an immediate demand by Wall Street that the head of the reporting agency be fired, has revealed a bruising and crucial fight in Washington over a critical subject: the increasing rate of the financial disintegration, and what is to be done about it. The fight also shows the desperation of the Wall Street-City of London financier oligarchy, and the thuggery to which it will resort, to silence criticism and defend its unsalvageable, bankrupt financial system.

On Feb. 4, the Office of Federal Housing Enterprise Oversight (OFHEO), which has oversight over the two giant housing-finance enterprises known as Fannie Mae and Freddie Mac, released a report entitled, "Systemic Risk: Fannie Mae, Freddie Mac and the Role of OFHEO." Its report examined the potential for the generation of a systemic crisis at Fannie and/or Freddie.

After *pro forma* formulations that Fannie and Freddie are "fundamentally sound," and that the possibility of a serious crisis "is remote," OFHEO made a stunning statement about a worst-case scenario in which either Fannie or Freddie had a severe crisis which caused it to default on its debt. Such a default, it said, "could lead to contagious illiquidity in the market for those [debt] securities, [and] cause or worsen liquidity problems at other financial institutions . . . potentially leading to a systemic event." This systemic event would deliver a shock to the entire financial system, and a "substantial loss in economic activity."

The report discusses the emergency credit generation that the Federal Reserve System might have to undertake to try to stem the crisis; but concludes that were the crisis severe enough, either Fannie or Freddie might have to be put into receivership, which would mean their liquidation. Therefore, the report asks Congress to pass legislation that would give OFHEO authority to put these institutions into receivership.

Further, the OFHEO report discusses the risks to the financial system posed by derivatives—not simply the derivatives held by Fannie and Freddie, but the unregulated mountain of derivatives contracts in general.

'Doomsday Scenario'

The report set into motion a shockwave through the financial community. Sharon McHale, a Freddie Mac spokeswoman, told the Feb. 6 *Washington Post*, that the report's "doomsday scenario was so speculative, it's just incredible." But the full wrath came from the highest levels of the London-Wall Street banking community, which struck hard.

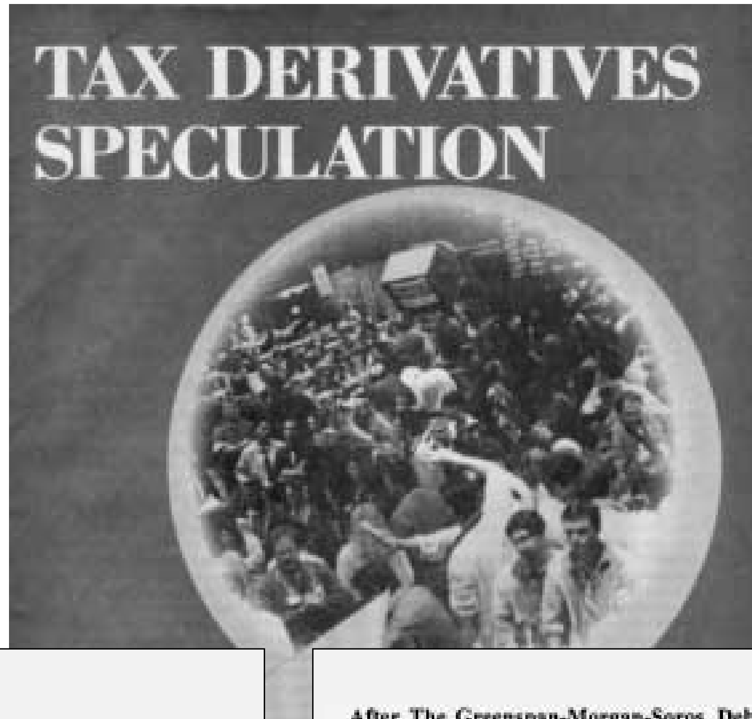
On Feb. 5, a mere 24 hours after the report's issuance, the Bush Administration demanded that OFHEO Director Armando Falcon submit his resignation. Falcon, who been appointed to this post in 1999 by President Bill Clinton, had overseen the report's release. While the Bush Administration delivered the order for Falcon to resign, both the circumstances of the firing and subsequent events make it clear that the actual order for the firing originated from inside the boardroom of J.P. Morgan Chase—the world's largest derivatives bank with $29 trillion in derivatives outstanding—and the boardrooms of other major institutions that are heavily invested in derivatives and housing market paper.

At the same time that it declared Falcon had "resigned," the Administration announced that it would nominate Mark C. Brickell, to replace him as Director of OFHEO. While the man on the street may never have heard of Brickell, he needs no introduction to those in the financial community: For the past decade and a half, he has spearheaded the fantastic, cancerous growth of derivatives.

For the entirety of the 1990s, Brickell headed Morgan Bank's mammoth derivatives trading operations, becoming a

The current Fannie Mae/Freddie Mac derivatives battle goes back a decade. In 1993, Lyndon LaRouche proposed that derivatives transactions be taxed, as a punitive action that would dry out the derivatives market. During 1993-95, Rep. Henry Gonzalez (D-Tex), chairman of the House Banking Committee, launched Congressional hearings to shine a spotlight on derivatives, and set the basis to constrict the trading of these dangerous instruments. Gonzalez' general counsel at that time, Armando Falcon, has now been summarily fired as head of the government agency overseeing Fannie Mae and Freddie Mac, for issuing a report foreseeing the potential for those enterprises to default.

In his capacity as Banking Committee Chairman, Gonzalez heard testimony from EIR's banking analyst John Hoefle, which dissected the derivatives bubble and how it spread to Mexico under NAFTA; and EIR economists Christopher White and Richard Freeman. LaRouche representatives met with 90 Congressional offices, and Gonzalez was attempting to get some form of Congressional action. J.P. Morgan's Mark Brickell studied the LaRouche proposals and personally organized the banking sector's counterattack against them through 1995. The Bush Administration has now named Brickell to replace the fired Falcon, overseeing Fannie Mae and Freddie Mac.



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By John Hoefle
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Executive Intelligence Review
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Testimony to the
Committee on Banking, Finance and Urban Affairs
U.S. House of Representatives
April 13, 1994

managing director of the bank. He held other critical posts. During this period, he became close friends with Phil and Wendy Gramm; the latter, as chairman of the Commodity Futures Trading Commission from 1988-93, made a series of rulings that opened up the floodgates of derivatives trading.

Brickell vs. LaRouche

But there is a still richer theme interwoven through this story, that has bearing on the matter today. During 1993-95, Congressman Henry Gonzalez (D-Tex.), then chairman of the House Banking Committee, organized an attempt to stop the spread of derivatives, on which and closely related subjects he held a series of Congressional hearings. During this time, Armando Falcon worked for Gonzalez' House Banking Committee. Members of the Economics staff of *EIR* submitted testimony for some of Gonzalez' hearings; the testimony was prepared under the supervision of *EIR* Founding Editor Lyndon LaRouche, today a 2004 Democratic Presidential precandidate. LaRouche had already warned in 1992 of the economic devastation that would be caused by the spread of the highly leveraged derivatives bets.

Mark Brickell also testified at the Gonzalez hearings, speaking on behalf of unrestricted derivatives trading growth, and officially representing Morgan and the world's leading derivatives trading institutions. And during 1993, Brickell, alarmed at the influence of LaRouche's idea of a tax to surgically puncture and end the derivatives bubble, formed and led from among his associates a "SWAT team" dedicated to directly blocking LaRouche's initiatives.

Thus, the nomination of Brickell to replace Falcon as the head of OFHEO, is a direct factional move by the most powerful banks. The financiers know that a key to holding up the entire speculative U.S. financial system, is the $11.7 trillion U.S. housing bubble, which Fannie Mae and Freddie Mac dominate. Brickell's new assignment would be to attempt to contain, by manipulation, any crisis at these two institutions, before it could generate an out-of-control systemic breakdown situation.

This is certainly a case of the fox guarding the hen house, but much more. Brickell is there to shut down any revelations of problems at Fannie Mae and Freddie Mac. Moreover, Brickell's job at OFHEO, were he to be confirmed, would be to handle problems at Fannie Mae and Freddie Mac which are far more serious in scope than even the Feb. 4 OFHEO report indicates.

For instance, Fannie Mae reported earlier this year that it had suffered $4.54 billion in derivatives losses during 2002 (in conformity with the practice of marking its derivatives portfolio "to market"), which slashed Fannie Mae's annual 2002 earnings by half. The real losses may be multiple times larger than Fannie reported: large financial institutions notoriously under-report their actual derivatives losses.

Fannie and Freddie's Instability

For the past two decades, the financial instability at Fannie Mae and Freddie Mac has grown to the point that their failure would bring down the U.S. financial system to which they are highly interconnected (see *EIR*, June 21, 2002, "Fannie and Freddie Were Lenders: U.S. Real Estate Bubble Is Near Its End"). To understand this, one has to understand how Fannie and Freddie work.

Formally known as the Federal National Mortgage Association, Fannie Mae was created by the New Deal in 1938. Its function was to provide liquidity to the housing market. After a mortgage lending institution originated a mortgage—say, for $50,000—Fannie Mae would purchase that mortgage from the lending institution for $50,000, and hold the mortgage to maturity. The mortgage lending institution now had $50,000 it obtained by selling the original mortgage to Fannie Mae; with this money it could make a second mortgage loan. Fannie Mae might buy the second mortgage loan from the mortgage lending institution. By the repeating of this process, Fannie Mae injected liquidity into the housing market, making it possible for mortgage lending institutions to increase the number of mortgage loans they could make.

To finance its operations—that is, to raise the cash with which it buys mortgages from mortgage lending institutions, Fannie Mae would issue bonds (which are a form of debt). As long as Fannie Mae carried out these operations to facilitate mortgage lending institutions in making mortgage loans so that consumers could buy houses at affordable, non-speculative prices, the process worked.

Formally known as the Federal Home Mortgage Loan Corporation, Freddie Mac was created in 1970 to perform a function very similar to that of Fannie Mae.

But starting the 1980s, Wall Street started to transform the functions and purposes of the two large mortgage corporations. Wall Street wanted a housing bubble, and Fannie and Freddie were transformed to become the major suppliers of funds to that bubble. The high prices of homes could only be made to stick if a sufficient volume of mortgages were created to finance the purchase of homes at those prices, including by people who couldn't afford them. Through the secondary mortgage market, Fannie and Freddie infused the mortgage market with cash, so that a mortgage lending institution could make over-leveraged mortgage loans to consumers and sell the mortgages to Fannie and Freddie. Once they gave the mortgage lending institution cash, the institution would make a new mortgage loan to a new consumer to purchase a home at a high price (this process does not include "jumbo" loans), and so forth.

During the past decade, millions of households bought homes at inflated prices, with accompanying mortgages that are likewise inflated. In millions of families, the mortgage payments consume 35-55% of their annual household income. There is not sufficient income left over for purchase of food, clothing, and other necessities. This is an unsustainable situation, and will ultimately end in default on the mortgage.

The two enterprises also engaged in "financial innovation," which may seem clever from an accountant's perspective, but enlarged the risk in reality. One new instrument is the mortgage-backed security (MBS): Fannie and Freddie would bundle a group of mortgages together, and sell them to investors. The enterprises would put a loan guarantee on the MBS, for which they earn a fee (thus boosting their earnings). In turn, Fannie and Freddie promise, in case of a default on the MBS, to pay interest and principal "fully and in a timely fashion" (thus considerably increasing their obligations).

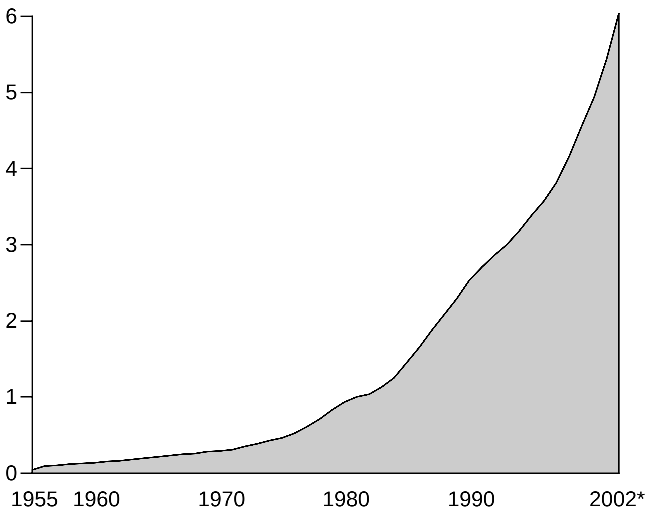
Over two decades, Fannie and Freddie built up on a large scale, three types of obligations: 1) the bonds (debt) that they issued; 2) the MBS which they guaranteed; and 3) the derivatives that they bought. Under the conditions of the transformation of the housing market during the past two decades, these obligations have become increasingly risky. Using the latest available figures, and adding together the three obligations, Fannie Mae and Freddie Mac now have a combined total of $4.89 trillion of such risky obligations outstanding. Other institutions that perform similar functions, such as the Federal Home Loan Bank Board, possess an additional $8.0 billion in such risky obligations. Thus, the total of housing-related high-risk obligations is roughly $5.69 trillion.

OFHEO Report on Systemic Risk

Figure 1 shows that by the end of 2002, households in America had an estimated $6.04 trillion in home mortgages.

It should be kept in mind that the $5.69 trillion in risky obligations are based on home mortgages, but they are independent instruments that are distinct from, and in addition to,

FIGURE 1
U.S. Home Mortgage Debt Tops $6 Trillion
($ Trillions)



*Projection, based on first three quarters

Source: U.S. Federal Reserve Board of Governors, *Flow of Funds Accounts.*

the $6.04 trillion in home mortgages. Adding the two together, there is a total of $11.73 trillion in housing-related paper, both primary and secondary. This is loaded onto the homes and attached to the incomes of America's homeowners. It is unsustainable.

The 115-page OFHEO report on Systemic Risk, which was two years in preparation, goes into waters that are rarely explored by an official government agency, because they are viewed as "too controversial." Knowing that, it appears that the report's authors did not stray far from the topic to discuss other real risks to Fannie and Freddie, because they feared the ensuing criticism of the report would be even harsher than it already has been. The report does not possess some of assessment of the U.S. housing bubble that *EIR* has published, but it is nonetheless very powerful.

The study focuses on what systemic risk is, and the damage that ensues from it. The OFHEO report states, "A systemic event is defined as a financial crisis that causes a substantial reduction in aggregate economic activity, such as housing starts, home sales, consumption, output and employment. . . . Systemic events occur not only in the economy, but also in other systems. In many groups of interrelated and interdependent living things, a breakdown in the functioning of one or a few entities can spread to many others, causing sufficient damage to harm the well being of the group or system as a whole."

The report says that no country in the world, large or small, has been immune to serious financial crises, "Between 1980 and 1995, over 130 of the member nations of the IMF—including the U.S.—experienced significant problems in their banking sectors that took the form of widespread failures, suspensions of the convertibility of bank liabilities, or large-scale government financial assistance to banks. Currency crises—speculative attacks on the value and devaluations of currencies, followed by efforts to defend that value by expending foreign reserves or raising interest rates—occurred in Europe in 1991-93, Latin America in 1994-95, and East Asia in 1997-98."

None of these events brought down the financial system, but as *EIR* has pointed out, they should be seen as the build up of a spreading and non-postponable process of financial disintegration, which will bring down a system that is decomposing. The world's major financial institutions are terrified by systemic risk. The OFHEO report cites a number of meetings during the past five years, that were convened or participated in by the Bank for International Settlements (the "central bank for central banks"), as well as the central banks—the U.S. Federal Reserve Board of Governors, the Bank of England, the Bank of Japan, and so forth. The plethora of such meetings instances the growing concern about systemic risk. However, the meetings' papers show that their convenors, while worried about systemic breakdown, for the most part chose the safety of examining past events. By contrast, the OFHEO report rigorously examines the massing of conditions under which a systemic breakdown would erupt in the future.

An 'Enterprise' Debt Default

The OFHEO report examines the points of vulnerability between the interrelated Fannie and Freddie on the one side, and the U.S. and world's banks and financial institutions, on the other. The OFHEO asks a very direct question: If, because of a severe financial problem, Fannie and/or Freddie were to default on their debt, what effect would radiate out to the U.S. and world financial system? This is far from an academic issue. Fannie and Freddie have a unique status; they are known as government-sponsored enterprises (GSEs): They were originally chartered by the U.S. government, but over stages, they have become totally private corporations. It is believed that Fannie and Freddie are the two most highly indebted private corporations in the world. According to the latest available data, as of late 2002, Fannie and Freddie had, respectively, $851.0 billion and $700 billion in outstanding debt, almost all of it in the form of bonds—that is, each institution has debt greater than that of Brazil.

A wide variety of parties hold large chunks of Fannie and Freddie debt: commercial and investment banks, hedge funds, insurance companies, foreign central banks, pension funds, mutual funds, private investors. They are all exposed to large losses, were either enterprise to default on its debt. OFHEO restricts its attention to the case of the commercial banks and savings institutions that operate in the United States, were Fannie and Freddie to default on their debt. More than half of these institutions hold Fannie or Freddie debt (called GSE debt in the report) in amounts equal to, or greater than, half of the bank's equity capital. A bank's equity capital is the value of its stock, which represents the funds that a bank would draw upon, in case of emergency, to cover its losses. Let us assume that a bank had equity capital of $500 million, and it held $250 million worth of Fannie Mae bonds, which defaulted. That would wipe out half of the bank's equity capital, and put it close to bankruptcy.

Using Federal Deposit Insurance Corp. data, the OFHEO report asserts: "At year-end 2001, over 4,800 commercial banks—over 60% of the banks in the banking industry—held GSE debt in excess of 50% of their equity capital." Most of these banks held less than $1 billion in assets, which means that several are significant in size, but smaller than the biggest banks. However, OFHEO reports, of the 400 banks operating in the United States "with assets of more than $1 billion, 123 institutions . . . owned GSE debt in excess of 50% of their equity capital."

This means that 4,800 banks own Fannie or Freddie debt paper that is equal to half of their equity capital; and that of the banks that are in this position, 123 are among the largest banks in the world. This means that a large part of the U.S. banking system, including its largest banks, would be sent lurching on the path to bankruptcy by an enterprise default. Many large foreign commercial banks that also hold a large amount of Fannie and Freddie debt, are in the same position as American banks. It is this reality, that a Fannie or Freddie debt default could occur, that led OFHEO to posit a chain of events—reported at the outset of the article—which "could lead to contagious illiquidity in the market for those [debt] securities, [which would] cause or worsen liquidity problems at other financial institutions . . . potentially leading to a systemic event."

OFHEO also focuses on the shock that could be transmitted from Fannie and Freddie in default to the financial system, and vice versa, because of these two institutions' derivatives holdings. As of the end of 2001, Fannie Mae held $533 billion in derivatives outstanding, and Freddie Mac held $1.05 trillion.

In a section on derivatives, the OFHEO report depicts the explosion of over-the-counter (OTC) derivatives, which are traded and customized by large financial institutions, and which are, in the main, unregulated. The report states that the OTC "contract exposes each party to credit risk—the possibility that the other party will not pay." Using the best available information, *EIR* estimates that the total outstanding notional value of derivatives worldwide is $300 trillion.

In its Chapter IV, "Assessing Systemic Risk," the OFHEO report assumes that, if just 5% of the notional value of the derivatives contracts outstanding of either Fannie or Freddie, were to be wiped out, then each of the several major banks, which are counterparties to Fannie and Freddie derivatives contracts, would suffer a loss equal to 4% of that bank's equity. But, the OFHEO report adds, "Other major counterparties, however, would incur credit losses equal to 15% to 30% of their equity." This is a very large loss, and one only has to ask, what would be the devastating effect, if instead of 5%, 25-40% or more of the notional value of Fannie or Freddie derivatives were wiped out.

'No Housing Bubble'

The report dodges some of the more risky, but accurate assumptions it could and should have made. These assumptions would have made it even more clear that a systemic breakdown of the U.S. financial system, triggered by a Fannie and/or Freddie meltdown, is not a hypothetical exercise, but an emerging event. Perhaps OFHEO's fear of incurring even harsher criticism held it back from making these assumptions. Most notably: The report repeatedly asserts there exists no evidence of a nationwide U.S. housing bubble, when one certainly exists.

An independent source, familiar with the methodology of the OFHEO report, stated that by the very assumptions that OFHEO makes, which are common to the housing industry, it would be very hard for OFHEO or any agency, to declare the existence of a bubble. In the industry, one key parameter is called the "loan-to-value ratio." This measures the value of a mortgage loan against the market price (value) of a house. The parameter is used to determine whether a household can get a mortgage, and often—but inaccurately—whether the household is able to pay for the mortgage. For example, assume a household has a $120,000 mortgage on a house whose market value is $200,000. Then the "loan-to-value ratio" is 60%. Moreover, assume that during the course of five years, the market value of the house artificially doubled to $400,000, and the homeowner, in order to extract cash, refinanced his or her mortgage from a level of $120,000 to a new one of $200,000 against the house. Consider what has happened: The loan-to-value ratio has actually fallen from 60% to 50%, which is considered an improvement; the household's mortgage debt is evaluated as a smaller percent of the total value of the house. Based on that situation, the OFHEO model would assume that as home prices reach ever higher and more unsustainable levels, as long as the loan-to-value ratio is falling, then the homeowner is less likely to default. Therefore, amazingly, if the possibility of defaults is allegedly reduced, there can be no housing bubble.

But assume, realistically, in our example, that during the course of five years, the household's annual income only rose from $35,000 to $40,000. Yet, the household's mortgage has gone from $120,000 to $200,000. In the real world, the household is less able to pay its mortgage. Were one of the wage-earners in the household to lose his or her job, or other source of income, the homeowners would definitely have to default on their mortgage. According to this source, it appears that the OFHEO model does not even take account of rising unemployment. Thus, in reality, the situation is worse than even OFHEO admits.

The OFHEO report finally examines what would happen during an escalating systemic meltdown. It cites the U.S. Treasury Department's statutory authority to make a loan for up to $2.25 billion each to Fannie and Freddie. However, as it dryly notes, such a small amount would be of little help during a generalized meltdown.

Next, the Federal Reserve System would have to step in. The Fed has two standard options it could use in any emergency, such as the 1998 Long Term Capital Management hedge-fund debacle: 1) It could lower the federal funds rate, to liquefy the banking system, and 2) It could make direct loans to the banks, through its discount window, also liquefying the banking system. In both cases, the banks could then use the liquidity extended by the Fed to try to prop up the failing Freddie or Fannie.

But, the OFHEO report then raises the possibility that this might not be sufficient. The Fed may have to up the ante and make loans on a large scale, directly to either Fannie or Freddie, something the Fed has never done before, but which OFHEO says the Fed could do under provisions of its charter. At this point, the crisis would be far advanced, and the Fed would have to funnel money into Fannie, Freddie, and the financial system as a whole, on a scale that would surpass a "wall of money."

However, as the crisis deepened, OFHEO, as a regulatory agency, would have the power to act as a conservator of Fannie or Freddie; that is, to take over and run the institutions. It would direct day-to-day operations, pay the creditors, and attempt to nurse the troubled institution back to health.

But were that to fail, and the crisis continue to build, OFHEO would then have to take the ultimate step: Put Fannie or Freddie into receivership; that is, *liquidate the institution.* OFHEO does not have this statutory authority, an authority it states that other Federal authorities which regulate financial institutions, do have. So, at its end, the report asks, "OFHEO recommends that the 1992 Act [which created OFHEO] be amended to allow the agency [OFHEO] to close and appoint a receiver to manage the affairs of an insolvent enterprise." This end-game move would bring down the U.S. housing bubble, with devastating implications for the financial system. That is what set off the alarm bells.

Bringing in Brickell

It is a known practice, that a bank or corporation will often euphemistically state, "We are looking at a few small areas that are not actual problems, but that could be troublesome in the future." What they are actually experiencing is quite different: They are in the midst of a full-fledged crisis. Seen from this perspective, the OFHEO Feb. 4 warning about systemic risk with regard to Fannie, Freddie, and the financial paper of the housing industry in the "future," may be a warning about a systemic event that is about to erupt right now.

Thus, Wall Street's reckless rush to fire Armando Falcon, whose only "crime" is that he warned of a seismic crisis; and his replacement with Mark Brickell, whose only qualification is 25 years of service at J.P. Morgan and other banks, slavishly pushing derivatives and other speculative instruments. Brickell's assignment at OFHEO would be not to regulate, but to act as a control point for Wall Street to crisis-manage the derivatives, mortgage, and other problems at Fannie, Freddie, and the roiled housing financial markets. A failure in the $11.7 trillion U.S. housing paper market would have Earth-shattering consequences.

Watching these bruising fights, Edgar Allan Poe's brilliant, anti-empiricist detective C. Auguste Dupin, would enjoy a hearty laugh. Dupin would recognize that the brutal firing of OFHEO Director Falcon, one day after OFHEO's report on "Systemic Risk," is the single biggest "piece of evidence" that Wall Street is hysterically scared, and has firsthand knowledge to confirm, that the OFHEO Feb. 4 report's warning of a systemic breakdown is correct. Dupin would rightly see Wall Street's behavior as validation of the OFHEO report's most severe warning, and know that the systemic event could unfold in the days directly ahead of us.