

# HISTORY AND BACKGROUND

## KEY TERMS AND PHRASES

Allodial	Mortgage
Bond	Mortgage-backed securities
Collateral	Negotiable instrument
Commercial paper	Points
Conduit	Pooler
Default	Primary market
Discount	Promissory note
Feudal	Secondary market
Foreclosure	Security interest
Hypothecation	Yield
Loan originator	

## LEARNING OBJECTIVES

At the conclusion of this chapter, students will be able to:

- Describe the origins of real estate finance and landownership
- Understand the development of and compensation for financing
- Explain the basics of the mortgage loan market
- Explain the role of financial market instruments in the development of the real estate finance industry
- Discuss the future of mortgage financing
- Describe the real estate cycle

## INTRODUCTION

The history of real estate financing presents a fascinating record of civilization's learning to live with, and enjoying the benefits of, the land upon which it lives. Sir Leonard Woolley, excavating the Mesopotamian city of Ur, found cuneiform texts in the financial district that dated



from the early years of the reign of King Rim-Sin (1822–1763 B.C.E.), who ruled from the capital city of Larsa, a few miles north of Ur, shortly before Hammurabi's time.<sup>1</sup> Woolley's excavations reveal that ancient residents of Ur buried their personal financial records, along with their ancestors, in the floors of their houses for safekeeping. Marc Van De Mieroop, a professor of history at Columbia University, used Woolley's careful excavation notes to describe the "mortgage" lending activities of one businessman, Dumuzi-gamil, whose ancient cuneiform business and accounting records show deeds and security instruments, and a sale of these notes to two other ancient investors, Nur-ilishu and Sin-ashared. Indeed, these are likely the first documented secondary-market participants for mortgage loans. While the private ownership of land can be traced back to civilizations existing over 3,800 years ago,<sup>2</sup> only in the last several hundred years has it become possible for the average person to own land. Nevertheless, many of the practices used in modern real estate financing trace their origins to earlier civilizations.

The underlying principle of real estate finance has changed very little over the centuries, and remains rather simple. It involves the pledging

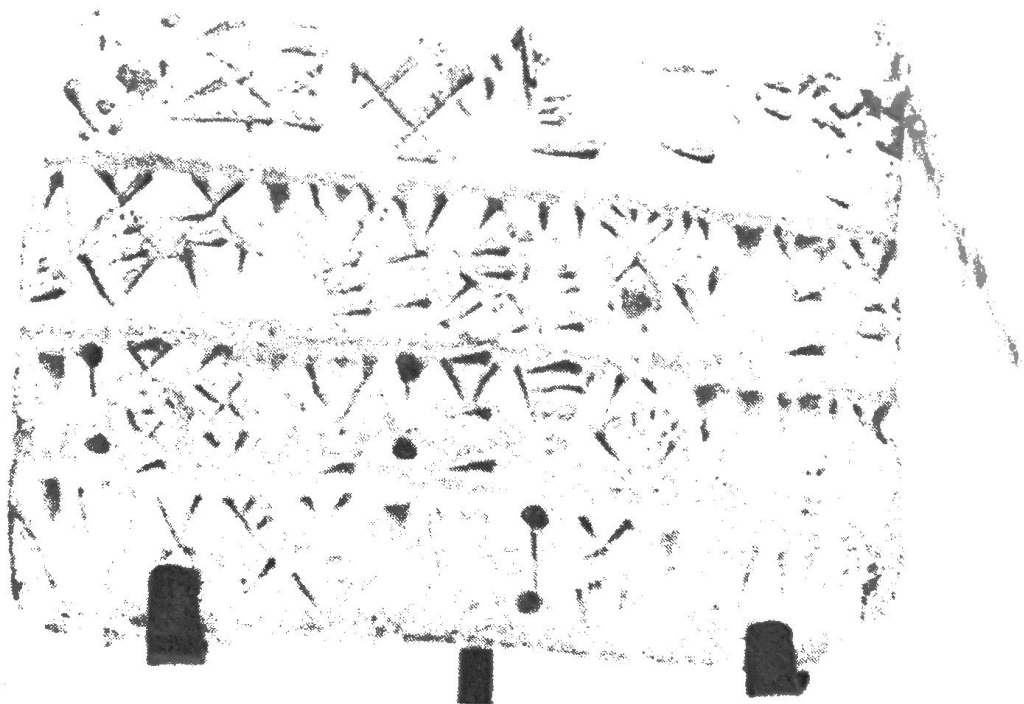


ILLUSTRATION OF ACCOUNTING RECORDS OF  
SECURITY TRANSACTION FROM 2900 BC  
UNDER REIGN OF JEMDET NASR

Source: <http://www.elixirofknowledge.com/2011/01/history-mystery-firstwritten-word.html>

<sup>1</sup> Van De Mieroop, Marc. *Society and Enterprise in Old Babylonian Ur*. Berlin: Dietrich Reimer, 1992.  
<sup>2</sup> Stolper, Matthew W. *Entrepreneurs and Empire*. Leiden: Nederlands Instituut voor het Nabije Oosten, 1985.

of land as collateral to secure a loan. Over time, the rights to land that can be pledged have undergone some changes; however, the availability of money that can be borrowed continues to reflect an earlier record of restricted practices and very limited pools of money. The development of private landownership has required stable legal systems for the enforcement of that ownership and the right of the lender (a.k.a. mortgagee) to take and enforce a **security interest**—normally a mortgage or deed of trust recorded to perfect the lender's collateral.

## LANDOWNERSHIP

The pledging of land as collateral has long been a normal protection for the lender. The way in which land is pledged has to do with how it is owned. The concept of ownership has developed along two paths: the **allodial** concept of ownership and the **feudal** right of ownership. In Roman times, the allodial system applied. The ownership of land by individuals was absolute. The landowner had few limitations or restrictions on the right to use or dispose of it.

The feudal system came into existence as continental Europe developed. In medieval times, as Roman authority disintegrated, marauding tribes became more common. In return for protection from these marauders, small groups of people would grant a form of landownership to a leader. Occupants of the land held rights to their parcels as tenants and paid fees consisting of produce from the land and personal services due to the "landlord." Thus, the feudal system primarily granted the right to occupy and use land owned by a social superior. English land law developed as a modified feudal system dating from the Norman Conquest in 1066.

While both these systems have shaped the ownership of property in the United States, the allodial concept dominates. Ownership of real property in the United States is considered free and absolute, subject only to governmental and voluntary restrictions. As the country grew, states developed a variety of laws governing landownership and how property rights could be conveyed. The early colonies on the East Coast preserved much of English law, including its concept of male dominance in marriage, in its laws relating to property rights. The southwestern states were more influenced by Spanish law and its concept of family protection, which is the source of community property laws in marriage and homestead protection in those states. Louisiana is unique in its adherence to

the Napoleonic Code. The result has been a mix of real property laws that require different mortgage documents for each state.

## BACKGROUND OF FINANCING

In earlier civilizations, landownership was restricted and the availability of borrowed money was limited. There were no insurance companies or depository institutions with cash to loan. In Roman society, landowners were joined in the *curia* with tax gatherers who made funds available for loans. In medieval Europe, only a few wealthy individuals were capable of loaning money. Access to this money was limited to elite classes that, by definition, were the landowners. Thus, land became a fairly standard form of collateral.

Historically, the growth of widespread landownership parallels the increase in pools of money available for long-term loans. With the advent of the Industrial Revolution in the eighteenth century, more individuals became capable of producing wealth with their ideas and their machinery. People began to find that other options were open to them; the life of a serf grubbing an existence from the land owned by the nobility was no longer the only way to sustain a living. With more widespread wealth came the demand for ways to make better use of accumulated money, and the seeds of our publicly owned savings institutions began to grow.

The economics of the development of housing are important for many reasons. Estimates from a 2011 study performed by the National Association of REALTORS® indicate that the median sale price of a new home contributes \$58,792 to the economy. Home ownership rose from about 40% in 1940 to a peak of 68% in 2005, and has dropped to 64.4% at the end of the third quarter of 2014.<sup>3</sup>

## FINANCING REAL PROPERTY LOANS

Real property financing is the pledging of land as collateral to borrow money. **Collateral**, in this case meaning something of value, is conveyed by a limited pledge as protection for a lender to assure repayment of a loan. The pledge as protection for a lender is called **hypothecation**, which comes from the Latin word *hypotheca*,<sup>4</sup> a term signifying taking a security interest similar to the security interests used in the lending laws of the

<sup>3</sup> Current Population Survey/Housing Vacancy Survey, Series H-111, U.S. Census Bureau, Washington, D.C. Accessed Nov. 16, 2014 at <http://www.census.gov/housing/hvs/files/qtr314/hown314.png>

<sup>4</sup> Roby, Henry John. *Roman Private Law in the Times of Cicero and of the Antonines*. Cambridge: Cambridge Univ. Press, 1902.

Roman Empire; the borrower remains in possession of the property while also offering security for the loan. It is only by defaulting on the loan agreement that a borrower can forfeit possession of and title to the property. **Default** is nonperformance of an obligation that is part of a contract. Failure to repay a loan is the most common act in default, and can activate rights that allow a lender to claim title to the pledged property.

The loan itself is evidenced by a **promissory note**, which is an unconditional written promise of a person (or persons) to pay a certain sum to another party. The "loan agreement" is commonly identified as a **mortgage**. A mortgage pledges property (collateral) as security for the note. The mortgage and the promissory note are interlinked documents, and if the note is not paid or another form of default occurs, the terms of the mortgage instrument can trigger action allowing the lender to take title to the property. Such action is called **foreclosure**, which means that the property offered as collateral for the loan is sold to satisfy the debt. The instruments and steps just discussed will be more fully explained in later chapters, but the underlying procedure remains the same: land is pledged as security for a loan by a conveyance that limits the lender to claiming title only if a default occurs.

### Compensation for Borrowed Money

Even in earlier societies, pledging rights to landownership as security for a loan meant some kind of compensation was due to the lender. This fact created a problem because charging interest for the use of one's money was considered a sin by many religious groups, including Christians, until the Middle Ages. Acceptable income was essentially only that earned by one's labor. Even today, in many parts of the world, some societies do not permit interest to be paid for the use of another's money. To bypass the religious constraint, a common practice developed: charging for the use of money "up front"—that is, deducting the cost of the borrowed money from the amount loaned and calling it something other than interest. Just call it a discount.

A **discount** is a portion of the loan amount taken by a lender as a cost for borrowed money. It is measured today in **points**; one point is one percent (1%) of the loan amount. In financial markets today, some borrowed money is paid for with interest only, some with discount only, and some by a combination of the two. Discounts collected tend to increase the yield on the amount loaned. Real property loans are most often paid for through a combination of interest and discounts.

## THE MORTGAGE LOAN MARKET

The mortgage loan market functions at two different levels: the **primary market**, which is loan origination, and the **secondary market**, which consists of investors who purchase loans made by others.

A person or company seeking mortgage loan contracts or customers is called a loan originator. The **loan originator** may be a bank, an insurance company, a mortgage company, or other entity. The negotiation involves the loan amount, interest rate and discount to be charged, the collateral, qualification of the borrower, and the terms for repayment of the loan. Each of these important items will be discussed in later chapters.

Once a loan has been finalized, the promissory note and its security instrument become salable to others. Almost every mortgage note is written as a **negotiable instrument**, which means that the holder of the note has the right to sell it. Even so, the originator may opt to retain the loan in its own investment portfolio to earn the interest and discount it produces. If the originator makes the decision to sell the loan, a secondary-market investor is contacted to purchase the loan. The purchaser is most interested in two aspects of the loan: (1) its quality, meaning its level of risk, and (2) its yield.

Secondary-market purchasers consider interest relatively unimportant; it is the yield that matters, as that is the return that will be received. **Yield** is a combination of the interest plus the discount. If the interest is too low, the discount must be increased to make up any difference necessary to meet the secondary-market yield requirement.

The secondary market for mortgages can be affected by changes in both the economy and the demand for money. Changes in the real estate cycle, covered later in the chapter, can be made more or less extreme by changes in the economy and the demand for money.

## FINANCIAL MARKET INSTRUMENTS

An increasing portion of the money flowing into residential loans comes from the sale of various kinds of securities in the financial markets, rather than from savings deposits. The sale of securities is the business of investment bankers and stockbrokers. It is the method by which corporations raise equity money and one way they borrow money. Because of the importance of this market, students of real estate finance should understand terminology that applies to securities and the purpose for which securities are issued.

Corporations can be financed through the sale of securities, paper certificates that represent some kind of an investment in the corporate structure. There are two major classes of securities: (1) stock certificates, representing an ownership, or equity, interest in the corporation; and (2) bonds, representing a loan to the corporation. Stock evidences ownership; bonds evidence indebtedness.

## Where Are We Now?

### Lender's Willingness to Loan Money Coupled with the Availability of Lendable Funds

During the Great Depression of the late 1920s and the early 1930s, the federal government took steps to encourage lenders to make mortgage loans. It accomplished this aim by creating the Federal Housing Administration (FHA), which insured loans against default. However, there was little money available to lend. Deposits in banks and savings institutions, historically used to make loans, were virtually depleted. So the federal government created the Federal National Mortgage Association, which was authorized to purchase loans insured by the FHA. This practice allowed lenders to make loans without depleting their deposits. As a result, lenders had a new source of mortgage money. When Fannie Mae was privatized in 1968, its function as the principal purchaser of FHA mortgages was assumed by the Government National Mortgage Association. The mortgage crisis that erupted in 2008 raised the importance of the FHA; its market share of the number of new home loans increased from 5% in 2006 to nearly 50% by June of 2010. That created an anchor to support the fragile new home construction market until the conventional mortgage market recovered. A fall 2014 survey performed by the Mortgage Bankers Association indicates that the FHA still has 9.6% of all loan applications.

## Stock Certificates

Shares of stock representing an ownership interest in a corporation are not relevant to the subject of real estate finance and will not be considered further in this text. The category is mentioned here only to distinguish it from bonds, which are debt instruments.

## Bonds

A corporation can borrow money through the sale of bonds to investors. Thus, the corporation gains an additional source of funds not generally available to an individual or even to small, lesser-known corporations. To those unfamiliar with financial markets, the idea of “selling” a bond does not appear to relate to “borrowing” money. However, a **bond** is exactly that—a debt instrument representing borrowed money. Principal on bonds must be repaid with interest, and interest can be used as an expense for income tax purposes. Shares of stock carry no obligation for the corporation to repay the purchases’ investment; nor are the dividends paid to shareholders tax deductible. Bonds are offered in several categories:

**Debenture bonds.** An unsecured promise to repay; in effect, a corporate IOU. The sale of debenture bonds is widely used by the Federal National Mortgage Association (Fannie Mae) to raise most of the money it needs to buy mortgages for its own portfolio.

**Mortgage bonds.** Secured by a pledge of real estate.

**Equipment bonds.** Secured by a pledge of equipment such as railroad cars or airplanes.

**Utility bonds.** May be secured by a pledge of certain assets of a state-regulated utility company.

**Government bonds.** Federal government promises to pay (no specific assets pledged) with maturity over ten years.

**Municipal bonds.** Can be state or municipal issue, may or may not pledge tax or improvement revenue, and offer interest that is exempt from federal income tax with certain limitations. This category of bond may be used for the private purpose of financing home and apartment loans.

**Mortgage-backed bonds.** Secured by the pledge of a large pool of mortgage loans. The loans are normally held by a trustee or a pooler that issues the mortgage-backed security. A **pooler** is a corporation, such as investment banker Salomon Smith Barney, Inc., that buys loans to create these pools. This concept of pooling is used by those referred to as mortgage conduits. The earliest pooling was represented by collateralized mortgage obligations, or “CMOs,” a special-purpose entity wholly separate from the institution(s) that created it. The entity

is the legal owner of a set of mortgages, called a pool. From the early poolers, there evolved two general types of **conduit** lenders. The most popular during the last decade were those that simply purchased loans in order to securitize them. This is the basis of conduit lending. The other type of conduit lender also services loans. One example was Bear Stearns and Company, which, prior to its merger with JPMorgan Chase, was a major conduit that serviced the loans it securitized and sold as mortgage-backed securities (MBS) or real estate mortgage investment conduits, also called "REMICs." REMICs function somewhat like CMOs, piecing together mortgages into pools based on risk and issuing bonds or other securities to investors. These securities would then trade on the secondary-mortgage market like MBS.

## THE SECURITIES MARKET

To qualify for sale to the general public, securities must have prior approval by the federal Securities and Exchange Commission (SEC). Each state adds its own security requirements for the protection of consumers. Regulatory approval is based primarily on the disclosure of relevant financial information, not on an issue's potential value. Approved securities are bought and sold daily on major exchanges throughout the world, but sales are dominated by the New York markets. Stock exchanges deal in securities that trade in fairly large volumes and offer near-continuous price quotes.

Mortgage-backed bonds, more commonly called **mortgage-backed securities**, may bypass federal and state regulatory approval if underwritten by certain federal agencies, such as Fannie Mae and Freddie Mac. However, a growing category of privately issued, mortgage-backed securities must comply with SEC regulations.

Mortgage-backed securities are bought and sold every day in the financial markets and trade at fluctuating prices. Since almost all of them offer holders a fixed return on investment, value in a resale is sensitive to the fluctuation of interest rates. The fixed interest rate on such a security (the face rate or nominal rate) controls the price for which it may be sold. If market interest rates go up, the price falls. The reason is that a security purchased at the lower price still receives the fixed interest on the initial face amount, resulting in an increased return to match the higher interest rates. Thus, there is an inverse movement in the bond

market. If bond prices rise, interest rates are falling; if bond prices fall, interest rates are rising.

Bonds and mortgage-backed securities are normally offered in \$1,000 denominations or multiples of \$1,000, and the price can be quoted in a dollar amount or as a percentage figure.

### Example

A \$10,000 bond offers a coupon interest rate of five percent (5%), paying \$500 each year to the holder of the bond. Assume that, for some valid reason, the bond is sold at a discount for \$9,250 (the “price” could also be quoted as a percentage at 92.5%). The party paying \$9,250 still receives an interest payment of \$500 each year, which amounts to a return of 5.41% on the \$9,250 invested. At maturity, the issuer of the bond is required to redeem the paper at its face amount of \$10,000. Thus, the bond holder picks up an additional \$750, which is the difference between the \$9,250 paid and the face amount of \$10,000 at which the bond was redeemed. Therefore, the total return, or yield, on the investment includes both the annual interest and the price differential when the bond is redeemed. However, if the bond is sold prior to maturity, the holder could sustain a loss if the market is down—meaning, in this instance, that interest rates have risen and a greater discount must be given to match the yield.

### *Commercial Paper*

One other type of corporate borrowing should be mentioned, as it is used to finance construction by a few large builders. This is the sale of commercial paper. **Commercial paper** is a simple promise to pay that is unsecured (a corporate IOU). The term is short, generally between one day and 270 days. The largest issuer of commercial paper, General Electric Credit, uses it to finance its various financial services operations. Yields offered on commercial paper are usually competitive with short-term money market rates, running about one-half to one percent higher than 90-day Treasury bill yields. During the recent financial crisis, the Federal Reserve (the Fed) created the Commercial Paper Funding Facility (CPFF) to provide a liquidity backstop to U.S. issuers of commercial paper. This was

critical for large corporations' liquidity, since the size of the market had shrunk to 1.7 trillion in 2008—down from \$2.2 trillion a year earlier—imperiling the ability of companies to produce goods and services.<sup>5</sup> The CPFF was intended to improve liquidity in short-term funding markets and thereby contribute to the greater availability of credit for businesses and households. Under the CPFF, the Federal Reserve Bank of New York financed the purchase of highly rated, unsecured, and asset-backed commercial paper from eligible issuers via eligible primary dealers. The CPFF began operations on October 27, 2008, and ceased to operate on February 1, 2010. By 2014, the commercial paper market was well recovered, with rates on 90-day A2/P2 commercial paper hovering at 4/10th of 1% versus the astounding 4% seen in 2008.<sup>6</sup>

### *Competitive Market*

A considerable variety of investments exist in the securities market. Each type of security must compete with other kinds based on their returns, or yields. Both the price at which a security is offered and the interest to be paid affect yield. The yield demanded by an investor varies with both risk and the length of time of the investment. The higher the risk, the higher the yield must be; the longer the term, the higher the yield required. Therefore, interest rates on mortgage loans must be competitive with other available security investments.

### *Investment Risk*

For a mortgage-backed security, the risk is low. After all, each loan held in a pool usually carries some kind of default insurance (private mortgage insurance, FHA, or VA). In today's market, about half of mortgage-backed securities are guaranteed by a federal agency, and thus are doubly insured. Federal agency underwriting is a form of credit enhancement that reduces risk, allowing a lower yield requirement. This lower yield requirement is reflected in lower interest rates for the borrower.

---

<sup>5</sup> "The Commercial Paper Squeeze: Why It Hurts." *Bloomberg News*, Sept. 29, 2008. Accessed Dec. 15, 2014 at <http://www.businessweek.com/stories/2008-09-29/the-commercial-paper-squeeze-why-it-hurts>*businessweek-business-news-stock-market-and-financial-advice*

<sup>6</sup> Federal Reserve Bank. "Commercial Paper Rates and Outstanding Summary." Report released on Dec. 15, 2014 as of Dec. 12, 2014.

## A LOOK AT THE FUTURE

The function of a mortgage-backed security is to convert a mortgage loan into a financial instrument that can be more easily sold to investors. By opening the financial markets as a source of money to fund mortgage loans, adequate money at a competitive cost for sound loans has become more available.

The fuel that has expanded this market is federal agency underwriting. Federal agency underwriting accounts for more than half the funding of all residential loans. Four federal agencies are involved, of which Fannie Mae and Freddie Mac are the largest. These two agencies fall under the oversight authority of the Federal Housing Finance Agency. The Federal Housing Administration (FHA) falls under the Department of Housing and Urban Development, or HUD. Ginnie Mae is limited to underwriting FHA and VA loans, and is also a part of HUD. The fourth agency, the Federal Agricultural Mortgage Corporation, or “Farmer Mac,” was formed in the mid-1980s. Farmer Mac was deemed to have too many restraints and was not very active. Therefore, in 1996, Congress gave Farmer Mac similar powers to Fannie Mae and Freddie Mac, although Farmer Mac is limited to underwriting agricultural loans and rural home loans outside incorporated areas. These Government-Sponsored Enterprises (GSEs) are now under the oversight of the Federal Housing Finance Agency (FHFA), created on July 30, 2008, when President George W. Bush signed into law the Housing and Economic Recovery Act of 2008. The Act created a regulator with the authority necessary to oversee vital components of the nation’s secondary mortgage markets: Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. In addition, this law combined the staffs of the Office of Federal Housing Enterprise Oversight (OFHEO), the Federal Housing Finance Board (FHFB), and the GSE mission office at the HUD. With financial crisis facing the world, strengthening the regulatory and supervisory oversight of the 14 housing-related GSEs seemed imperative. The hope is that the establishment of FHFA will promote a stronger, safer U.S. housing finance system. In December 2009, the combined debt and obligations of these GSEs totaled \$5.5 trillion—around half of the \$11.7 trillion in U.S. residential mortgage debt. Since Fannie Mae and Freddie Mac were placed into government conservatorship in 2008, the Federal Reserve Bank has been the primary purchaser of both of these GSE’s mortgage-backed securities. The Federal Reserve Bank thus served as the purchaser

of last resort for over \$1.47 trillion of Fannie Mae and Freddie Mac MBS through November 2009,<sup>7</sup> keeping the mortgage lending markets open. Representatives of the Federal Reserve Bank announced that the Bank would pull out of this market in the first quarter of 2010; however, officials later discovered that such a change would have too great a negative impact on the mortgage market and mortgage rates. The Fed was still making purchases in July 2010 that at the time totaled \$2.31 trillion.<sup>8</sup> The Federal Reserve Bank has maintained that the purchases made between March and July of 2010 were intended only to “stabilize” the market, and most purchases made after March of 2010 appear to have been sold by the Fed to commercial banks and others in the aftermarket. Since August of 2014, the Fed continues to purchase mortgage-backed securities as part of its extended support of the housing industry. The Federal Open Market Committee (FOMC) directed the Open Market Trading Desk (the Desk) at the Federal Reserve Bank of New York to purchase additional MBS and longer-term Treasury securities. Moreover, the FOMC directed the Desk to maintain its existing policies of reinvesting principal payments from the Federal Reserve’s holdings of agency debt and agency MBS and of rolling over maturing Treasury securities at auction. The FOMC noted that these actions should put downward pressure on longer-term interest rates, supporting mortgage markets.<sup>9</sup> Considering the impact of these GSEs on the U.S. economy and mortgage market, it is critical that we intensify our focus on the oversight and restructuring of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks.

Constraints increasingly imposed on underwriters’ loan purchase policies have put a vertical halt to the subprime mortgage market. As a result, pressure has been applied by HUD to direct activities into more diverse areas of lending. Four results are probable: (1) an increase in home loans available to minority groups, immigrants, and those in underserved urban areas; (2) a growth in the offerings and market share of Federal Housing Administration (FHA) mortgage loans; (3) the rehabilitation of Fannie Mae and Freddie Mac from government conservatorship and the

<sup>7</sup> Federal Reserve Bank. Federal Open Market Committee press release, Dec. 16, 2009.

<sup>8</sup> Federal Reserve Bank. News and Events, Regulatory Reform, “Agency Mortgage-Backed Securities (MBS) Purchase Program.” Accessed Dec. 25, 2010 at [http://www.federalreserve.gov/newsevents/reform\\_mbs.htm](http://www.federalreserve.gov/newsevents/reform_mbs.htm)

<sup>9</sup> Why is the Desk purchasing agency MBS? From the Federal Reserve Bank of New York FAQs, Agency MBS Purchases website. Accessed Dec. 12, 2014 at [http://www.newyorkfed.org/markets/ambs/ambs\\_faq.html](http://www.newyorkfed.org/markets/ambs/ambs_faq.html)

market acceptance without Federal Reserve Bank market intervention of their issues of MBS; and (4) the emergence of private mortgage-backed securities that have a retained loss interest by the mortgage loans' original lenders as a market discipline to diminish the moral hazard that was created by the recent originate-to-distribute model, which has been blamed for the recent mortgage crisis.

## THE MORTGAGE CRISIS DEVELOPMENT

Up to this point, most responses to the mortgage crisis have focused on efforts to stem the negative effects on homeowners, financial institutions, mortgage markets, and investors. However, it is important to understand how we as a society got into this position. There are no simple answers, but what follows are some of the generally agreed-upon causes of the crisis.

A low interest rate environment was created by two destabilizing events:

1. the technology stock bubble burst; and
2. terrorists attacked the United States.

In response, the Federal Reserve lowered interest rates to help calm financial markets, lowering its Fed Funds target rate from 6.5% at the end of 2000 to 1.75% at the end of 2001. The Fed continued to make other rate cuts until the target rate reached 1.0% in June 2003, and did not begin to raise rates until mid-2004. This long period of low interest rates has been confirmed by economists, regulators, and capital markets experts as a contributor to the housing bubble, as it inordinately stimulated demand for mortgage debt and housing price inflation. At the same time, white collar crime units were shifted to Homeland Security efforts; these units were not replaced between 2001 and 2007, allowing fraudsters to instigate problems with greater impunity. Even in 2012, the FBI white collar crime units had not reached even 20% of their former investigative staffing levels.

- A renewed refinance boom occurred at a level unequaled in history. This boom caused lenders to expand their operations to meet additional demand along with the already increased demand for housing allowed by the low interest rate environment. When the eventual satiation of refinance demand occurred, many lenders, accustomed to easy and plentiful profits, began to offer more innovative loan products to bring new borrowers to the market. These included not

only subprime products with lower credit and asset requirements of borrowers, but also novel payment plans such as interest-only and option ARM mortgages that allowed some borrowers to qualify for larger homes and others to enter the housing market for the first time.

- The passage of the Housing and Community Development Act of 1992 amended the charter of Fannie Mae and Freddie Mac to reflect Congress's view that these GSEs "have an affirmative obligation to facilitate the financing of affordable housing for low-income and moderate-income families."<sup>10</sup> Fannie Mae and Freddie Mac were required to meet the "affordable housing goals" set by the Department of Housing and Urban Development. In 1999, the Clinton administration placed pressure on Fannie Mae and Freddie Mac to expand mortgage loans to low- and moderate-income borrowers by increasing the ratios of their loan portfolios in distressed inner city areas designated in the CRA of 1977. These two policy decisions allowed Fannie Mae and Freddie Mac to promote the widespread use of high LTVs. Fannie Mae began offering a 97% LTV program in 1994. Industry experts issued strong objections to this decision, citing Fannie Mae's early 1980s experiment allowing five percent-down loans in Texas—a decision that proved disastrous, with one in four borrowers defaulting. Ongoing competitive pressure and the lure of high profits pulled Fannie Mae and Freddie Mac into the subprime market, leading to the introduction of first-time home buyer programs with up to 105% LTV. Thus, the stage was set for the demise of these organizations. By 2001, Fannie Mae and Freddie Mac controlled the subprime market, "having . . . absorbed the largest and best parts of the 'old' subprime world that developed over the 1990s using risk-based pricing. They continued to make mortgage loans to borrowers with FICO scores of around 540,"<sup>11</sup> and made up to 105% LTV loans as late as the first quarter of 2007.
- The profitability of mortgage securitization and the moral hazard facing many lenders with larger operations and falling demand from borrowers caused lenders to further reduce underwriting standards or simply ignore them. This increased loan production that was facilitated by the

<sup>10</sup> U.S. Code, Title 12§4501. Cornell University Law School, Legal Information Institute at point (7). Accessed Aug. 11, 2011 at <https://www.law.cornell.edu/uscode/text/12/4501>

<sup>11</sup> LaMalfa, Tom. Mortgage Corner column, *Holm Mortgage Finance Report*, Jan. 19, 2001.