Click here for Full Issue of EIR Volume 13, Number 41, October 17, 1986

Federal mortgage guarantees: $1 trillion bomb about to go off

Federal agencies issued a staggering $170 billion in so-called "guaranteed pass-through mortgage securities" during the first three quarters of 1986—an annual rate of $227 billion, as much as the Federal government's own budget deficit. Backed by home mortgages, these securities bear the guarantee of the U.S. government, and are not much different in principle than the debt of the U.S. Treasury itself.

That compares to a mere $106 billion of such securities issued during 1985. The housing boomlet of the first half of 1986 has since attenuated; it represented the Reagan administration's last-gasp effort to promote a consumer-led "economic recovery," financed by massive foreign capital inflows. The Fed drove interest rates down as fast as it might, leading to a boom in mortgage refinancing, and particularly in resales of existing homes; the rise in mortgage rates since August, although modest, appears to have put an end to this. Throughout, the full faith and credit of the U.S. government stood behind the speculation in the housing markets.

Is that tidal wave of government-guaranteed paper sound, or will the taxpayers have to pick up the bill—as they are beginning to do for banking deregulation? A study released Sept. 25 by the Committee on Government Operations of the U.S. Congress gives a starkly negative answer to that question:

"The report examines the impact of faulty and fraudulent appraisals on the real estate loans of federally insured financial institutions; on residential loans guaranteed by the Veterans Administration (VA) and Federal Housing Administration (FHA); on the purchase of mortgages by the Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac); and on the mortgage insurance industry and mortgage-backed securities markets. It is based on an extensive hearing record, analysis of thousands of pages of documents, and interviews with knowledgeable public and private sector sources," the Committee writes.

The report's summary conclusion states:

"Faulty and fraudulent real estate appraisals have become an increasingly serious national problem. Their harmful effects are widespread, pervasive, and costly. They have seriously damaged and contributed directly to the insolvency of hundreds of the Nation's financial institutions and have helped cause billions of dollars in losses to lenders, private mortgage insurers, investors, and Federal insurance funds. Responsibility for this problem rests with those who perform appraisals or base lending and related mortgage insurance-investment decisions on appraisals they know or should have known were improper or inaccurate. Equally culpable are the Federal agencies that regulate or oversee lending and mortgage insurance-investment activities and programs."

The main public record available to Committee investigators concerns bank failures. The conclusion was remarkable: "Between January 1983 and mid-October 1985, the real-estate loan portfolios of more than 800, or 25%, of the approximately 3,200 federally-insured thrifts were found to have significant appraisal deficiencies. In more than 300 of these institutions, appraisal-related problems contributed significantly to their being placed in problem status or declared insolvent. The problem appraisals found in these 800-plus associations overvalued the collateral securing real-estate loans by an aggregate of $3 billion."

Troubled Bank of America, now apparently on the auction-block, and all of the billion-dollar bankruptcies among thrift institutions in the past year can be traced to real-estate problems, the report adds. Of course, since faulty appraisals only come out in the wash when a bank attempts to liquidate the collateral, and most institutions are holding onto bad real-estate precisely in order to avoid the collapse of such collateral, the $3 billion figure reflects a tiny fraction of the problem.

When the effective price declines of 25% to 40% do come out in the wash, *EIR* estimates, a total of $250 billion in real-estate loans will turn bad.

'Defective appraisals'

The banking problem is not the worst of it, though: "The subcommittee found substantial evidence of defective appraisals used to support real estate loans packaged and sold as mortgage-backed securities . . . to financial institutions and investors around the country.

"The absence of adequate appraisal information and data was one of the more glaring deficiencies found in the opera-

© 1986 EIR News Service Inc. All Rights Reserved. Reproduction in whole or in part without permission strictly prohibited.

tions and activities of almost every organization surveyed by the subcommittee. With some exceptions among the private mortgage insurers and the Federal Home Loan Board Banks, no other government or private-sector agency or institution systematically and regularly collects appraisal information; nor have any of them informally or formally studied the relationship between faulty and fraudulent appraisals and problems—e.g., losses—they've experienced."

Subcommittee Chairman Doug Barnard of Georgia expressed special dismay over the fact that federal agencies, which guarantee upwards of $1 trillion of mortgage-backed securities, have no idea what the underlying properties are really worth:

"We are troubled by some apparent inconsistencies," he wrote to the FHA, the biggest such guarantor. "You minimize the impact of faulty and fraudulent appraisals, and yet . . . you appear to have no basis for such a contention, since you state that no specific analysis of the relationship between appraisal problems and claims has been done and, moreover, that the data that would enable you to do so has only just begun to be collected. Also, while you conceded, in response to my question at the hearing, that it would be reasonable to assume that appraiser suspensions or removals would likely involve losses, you did not indicate that you had any idea how extensive this might be. . . . If such data is either not available or does not exist, how is Freddie Mac able to confirm or deny the existence of some relationship between appraisals and losses experienced in its mortgage purchase activities?"

Much of the subcommittee's Sept. 25 report is devoted to the documentation of a series of multi-million-dollar frauds perpetrated upon public and private lenders, in which a private-sector mortgage insurer was found to arrange insurance for virtually-worthless properties, and the mortgages subsequently were "repackaged" and sold on the securities market. It estimates that 10% of the Veterans Administration's $420 million loss in its 1985 loan guarantee program "was caused by inaccurate or dishonest appraisals," and that the Federal Housing Administration lost more than $200 million in 1985 for the same reason. "For the past several years," the report warns, "the FHA has been victimized by a continuing series of fraudulent schemes, which relied on falsified and highly inflated appraisal documents." Apart from the bite on government agencies, "At least 10-15% of the $1.3 billion in losses experienced by private mortgage insurers in 1984 and 1985 can be attributed to faulty and fraudulent appraisals performed in connection with the mortgages they insured."

The committee report notes sourly, "Further illustrating the impact of incomplete or wholly absent data, the FHA is still unable, even after the completion of a lengthy investigation, to provide an estimate of any projected and/or actual losses resulting from the fraudulent scheme perpetrated against it in Camden, N.J. Underscoring the significance of this point, investigations of activities strikingly similar to those involved in the Camden scheme are in progress in at least five other major metropolitan areas: Washington, D.C., Nashville, Atlanta, Houston, and Seattle."

The subcommittee's recommendations center on national regulation for real-estate appraisals. There they differ with the bank supervisory agencies. The bank regulators, in testimony before the subcommittee, played down the role of real-estate appraisals as such. An official of the Federal Deposit Insurance Corporation, Robert Miailovich, said, "The most important thing is evaluating the ability to repay and according to specified terms. The value of the collateral becomes increasingly important as one has to consider perhaps taking possession of that collateral and liquidating it as a fallback. Collateral and its value is what you have in the background, should the real source of repayment fail on you. So, the important thing is evaluating the borrower and the ability to repay."

Home prices on roller-coaster

That is true enough; and it should be added that the value of a home backing up a mortgage-security will vary if mortgage rates rise from their present 10% level to, say, 12 or 14%, or if regional or national unemployment reduces the pool of potential home-buyers. No appraisal, however regulated, honest or dishonest, can take into account such changes in money-market conditions, let alone general economic conditions, which can drastically alter home prices within a matter of months.

Depression conditions in at least 31 of the 50 states have wiped out both homeowners' ability to keep up mortgage payments, and the re-sale value of the homes backing up those mortgages. Earlier this year, the Government National Mortgage Association, one of the principal federal guarantors, had to sell hundreds of housing units which it acquired through foreclosure, in the already-depressed Florida real-estate market. Similar forced sales at a fraction of previously-appraised prices are taking place now throughout the oil belt.

The capitalization of the Federally-sponsored agencies is trivial relative to the potential demands upon them. The Federal National Mortgage Association has $92 billion in debt, and only $1.3 billion in capital. Losses in excess of that will presumably be borne by the Treasury.

What the combination of potential losses caused by fraud and deteriorating economic conditions, may turn out to be, the federal guarantors have no idea whatever. Nonetheless, the time bomb underneath these government agencies appears much larger than the problems facing any American financial institution, in proportion to the government guarantors' unprecedently large role in credit-issuance in the American economy. Their capital-cover is barely 1.5% against guarantees; anything above that adds to the federal deficit. Scores of billions of dollars could wind up on the plate of the U.S. Congress, now wrestling with a fiscal year 1987 deficit we estimate to exceed $270 billion.