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THOUGHTS ON THE REAL ESTATE CRISIS

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There are multiple versions of what went wrong with our system and caused the current real estate mess. I'm going to join the fray here by offering up my own version.

Politicians have been falling all over themselves blaming the bankers, when they themselves are equally at fault. I am not trying to defend the bankers, nor in particular the investment bankers. In fact, they were way overleveraged going into 2007, with leverage up to 30 times their capital. This is the equivalent of having assets of \$1 and borrowing \$30. That can only lead to trouble. The banks also benefited in a big way from packaging mortgages into bonds and selling them. The mortgage back market was and is a huge market. To be fair to the bankers, it looks like most of the money they had to take from the government has been paid back, and in the end the government will actually make money on the TARP bailout. Nevertheless, the politicians are still blaming the bankers and never themselves!

So, where did politicians lead us astray in their quest to champion homeownership for the masses? We can start with the continued support of Fannie Mae (FNM) and Freddie Mac (FRE). Both Government Sponsored Enterprises were created by Congress to enhance the flow of credit and reduce the costs for residential mortgages. Perhaps necessary in the 1930's, these entities carried asymmetric risk profiles: shareholders and executives prospered during good times while taxpayers bore the burden of losses when things unraveled. Despite calls for FNM and FRE to be closed, it is no surprise politicians resisted given the combined lobbying effort by both organizations totaled \$170 million in the decade ending in 2008. FNM and FRE were enabled by Congress to grow out of control and use leverage that made Bear Stearns and Lehman Brother's look conservative. Given the advanced state of our capital markets there is absolutely no need for either of these companies to exist.



It took the rating companies like Moody's to complete the mess. They were giving A ratings to packages of mortgages that clearly were not A paper. These inflated ratings only made it easier for the banks to sell the mortgage bonds.

So what has changed? Not enough for sure! The government is still trying to manipulate the real estate market through Fannie and Freddy and many stimulus programs, with mixed results. Some would argue that a better path is to let the chips fall as they may, allow more foreclosures, and let market forces finally clean up the real estate market. I don't know if I completely agree, because some of what the government has done has kept the crisis from becoming even worse. In my view, however, it is now time for the government to step away from the market and close Fannie and Freddy as soon as possible.

Twenty-five years or so ago, the real estate mortgage market was much simpler. Banks qualified a borrower, lent the money, and kept the loan. Since they were keeping the loans, banks had a vested interest in making sure the borrowers were solvent and would remain so. Unfortunately, that practice evolved into banks simply originating the loans, then moving them to Fannie and Freddy as soon as possible. This new routine led banks to care little about the borrower's credit, focusing instead only on the origination fees (points) they were earning. Clearly we need to move back toward this earlier model and away from the government's involvement. There is little evidence that is happening yet, but one can only hope.