IndyMac's Failure and the GSE Bailout: An Epitaph and Prognosis

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With the failure of IndyMac Bank on the heels of the fire sale of its big sister, Countrywide, it seems fitting to reflect on the market impact these companies have had industry wide and on homeowners across the nation. One lesson learned in life is that no company or individual is as good or bad as described by the press or perceived by the general public. Often success and reputation are a combination of luck, timing and talent, as the fate of IndyMac and Countrywide illustrate.

Over the last year it is been trendy to vilify these companies and their executive management, painting them with the same brush as the other short term players that drove the proliferation of aggressive mortgage products in the pursuit of collateral to securitize and outsized profits.. Unfortunately, long term success often breeds arrogance. Strategic errors, motivated by the belief that it was reasonable to succeed in the face of seemingly insurmountable headwinds (accelerating credit deterioration, falling housing prices, illiquidity and intense competition for capital), compounded with this arrogance to drive these long time staples of the mortgage industry to failure in the unprecedented environment that crippled so many other financial institutions.

IndyMac and Countrywide leave behind a positive legacy that goes well beyond the more recent circumstances leading to their demise. That legacy includes a long history of innovation, leadership and market competition that has aided thousands, if not millions, of homeowners over the years. Included in this legacy are:

- The development of suitable mortgage products that met the diverse socioeconomic demographics that became the hallmark of America's homeownership goals. While in recent years many products could be fairly characterized as aggressive and unsuitable for some borrowers, there is a much longer history of developing innovative and affordable non – conforming products that put deserving Americans into homes;

- The continued pursuit of a quality oriented credit culture that aligned with a core mortgage banking business of considerable scale. These companies

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were not the lenders of last resort, regardless of the product type. Mortgage brokers nationwide often found these companies more difficult to work with and redirected business to mortgage banking companies with weaker credit cultures and quality requirements. Even so, ill conceived products combined with rapidly declining market conditions can overwhelm the best of intents;

- Setting the standard for technology platforms designed to improve the credit process, customer service and loan servicing;

- Increasing market competition despite their beginnings as affiliated entities. The intense competitive attitude towards each other saved homeowner's thousands of dollars, particularly in the non-conforming Alt-A arena.

With the last of the large scale independent mortgage lenders gone, what does this mean for the role of the GSE's going forward? For the most part, the loss of these production giants is a non event.

With the Fed bailout of Bear Stearns, it became apparent that the "implicit" guarantee in favor of the GSEs took a leap in status, evolving to a virtually "explicit" guarantee. It was just a matter of semantics. With the most recent actions of the Fed to prop up the GSEs, there is no question as to economic viability – only as to the long term value to existing and future private shareholders.

In that regard, I am inclined to be counterintuitive and consider the GSEs value investments for those with the intestinal fortitude to hold on. Fears of legislation to require unprecedented levels of increases to capital are exaggerated and impractical. Even with the possibility of near term dilution, the prospects for the creation of considerable value over the long term is credible.

CEO David Maxwell was credited with turning around the ailing giant, Fannie Mae, in the early 1980s. Along with improving market conditions, that recovery was largely predicated on the GSE's standing as virtual oligopolies with unfettered pricing power coupled with unmatchable access to the capital markets for low cost funds. The GSEs enjoyed almost two decades of uninterrupted prosperity under these conditions. The pressure on sustaining earnings growth emerged in the mid to latter part of the 1990s when the GSEs abandoned a concentrated focus on the smaller high quality lenders in favor of a war for market share from the top ten national mortgage companies, compromising revenues, loan quality and local market expertise.

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The decimation of the private mortgage sector has re-established these dynamics for the GSEs. Given the severity of the current crisis and the political and regulatory issues that remain to be resolved, the GSEs are likely to once again hold the dominating status that prevailed during the prosperous years. In fact, there is empirical evidence that they have already begun to exercise pricing power by raising guarantee fees and imposing risk-based assessments for loans with lower down payments or other risk characteristics. These additional revenues will provide for ongoing contributions to loan loss reserves to cover the sins of the past. To some extent, the crisis has expanded their respective charters (significantly increasing the loan amounts they can purchase or securitize) after years of political battles with the private sector to rein in their charters – a complaint that the private sector often referred to as "charter creep".

Bailouts notwithstanding, it is still discouraging that political stalemates over remedial legislation, a confused monetary policy and the apparent exclusion of seasoned industry talent from the process, have deprived the housing market of much needed timely assistance. These flaws alone may have a greater impact on the markets and any possibility of the much needed timely economic recovery demanded by the American public.

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