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Feature

The True Story of the Financial Crisis

Its origins are in the federal government.

By Peter J. Wallison – From the May 2011 issue

As many readers of *The American Spectator* will know, I was a member of the Financial Crisis Inquiry Commission, a 10-member body appointed by Congress to investigate the causes of the financial crisis of 2008. The Commission issued its report in late January 2011, with a majority concluding that the crisis could have been avoided if the private sector had not taken so many risks and government regulators had not been asleep at the switch. I dissented from the majority's view, arguing in my dissent that the financial crisis would not have occurred if government housing policies had not fostered the creation of an unprecedented number of subprime and otherwise risky loans immediately before the financial crisis began.

After the majority's report was published, many people lamented that it was not possible to achieve a bipartisan agreement even on the facts. But the way the Commission was organized and run made this impossible. One glaring example will illustrate the problem. In March 2010, Edward Pinto, a resident fellow (and my colleague) at the American Enterprise Institute who had served as chief credit officer at Fannie Mae, sent the Commission a 70-page, fully sourced memorandum on the number of subprime and other high-risk mortgages in the financial system in 2008. Pinto's research showed that he had found more than 25 million such mortgages (his later work showed that there were approximately 27 million). Since there are about 55 million mortgages in the U.S., Pinto's research indicated that, as the financial crisis began, *half* of all U.S. mortgages were of inferior quality and liable to default when housing prices were no longer rising. In August, Pinto supplemented his initial research with a paper documenting the efforts of the Department of Housing and Urban Development (HUD), over two decades and through two administrations, to increase home ownership by reducing mortgage-underwriting standards.

This information, which highlighted the role of government policy in fostering the creation of these low-quality mortgages, raised important questions about whether the mortgage meltdown would have been so destructive if those government policies had not existed. Any objective investigation of the causes of the financial crisis would have looked carefully at Pinto's research, exposed it to the members of the Commission, taken Pinto's testimony, and tested the accuracy of his research. But the Commission took none of these steps. Pinto's memos were never made available to the other members of the FCIC, or even to the commissioners who were members of the subcommittee charged with considering the role of housing policy in the financial crisis.

Ultimately, I dissented from the Commission majority's report. There was no alternative. The Commission's management -- particularly its chairman, Philip Angelides, a former Democratic treasurer of California and unsuccessful gubernatorial candidate -- would not allow the staff to pursue any theories about the causes of the financial crisis other than those embodied in the standard left-wing narrative. And in the end a majority of the commissioners -- never having been presented with any contrary evidence -- signed on to a report that said the financial crisis could have been avoided if there had been better regulation of the private sector.

The question I have been most frequently asked about the Commission is why Congress bothered to authorize it at all. Without waiting for the Commission's report, Congress passed and the president signed the Dodd-Frank Act (DFA), far-reaching and highly consequential regulatory legislation that I believe will have a strong adverse effect on U.S. economic growth in the future. In enacting the DFA, Congress and the president acted without seeking to understand the true causes of the wrenching events of 2008, perhaps following the precept of the President's chief of staff -- "Never let a good crisis go to waste."

But to avoid the next financial crisis, we must understand what caused the one from which we are now slowly emerging, and take action to avoid the same mistakes in the future. If there is doubt that these lessons are important, consider the ongoing efforts to amend the Community Reinvestment Act of 1977 (CRA), which currently requires all insured banks and S&Ls to make loans to borrowers at or below 80 percent of the median income in the areas the banks service. If these loans were profitable, of course, there would be no reason to require by regulation that they be made. In the last session of the 111th Congress, a bill was introduced to extend the CRA to all "U.S. nonbank financial companies," and was lauded by House Financial Services Committee chairman Barney Frank as his "top priority." If enacted, the proposal would have applied to the whole financial community the same government social policy mandates that were ultimately responsible for the mortgage meltdown and the financial crisis.

Because of the 2010 election, it is unlikely that supporters of this idea will have the power to adopt similar legislation in the current Congress, but in the future other lawmakers with views similar to Barney Frank's may seek to mandate the same requirements. At that time, the only real bulwark against the government's use of private entities for social policy purposes will be a full understanding of how these policies were connected to the events of 2008.

What Caused the Financial Crisis?

GEORGE SANTAYANA is often quoted for the aphorism that "Those who cannot remember the past are condemned to repeat it." Looking back on the financial crisis, we can see why the study of history is often so contentious and why revisionist histories are so easy to construct. There are always many factors that could have caused a historical event; the difficult task is to discern which, among a welter of possible causes, were the significant ones -- the ones without which history would have been different.

Using this standard, I believe that the *sine qua non* of the financial crisis was U.S. government housing policy, which led to the creation of 27 million subprime and other risky loans -- half of all mortgages in the United States -- which were ready to default as soon as the massive 1997-2007 housing bubble began to deflate. If the U.S. government had not chosen this policy path -- fostering the growth of a bubble of unprecedented size and an equally unprecedented number of weak and high-risk residential mortgages -- the great financial crisis of 2008 would never have occurred.

In this article, I will outline the logical process that I followed in coming to the conclusion that it was the U.S. government's housing policies -- and nothing else -- that were responsible for the 2008 financial crisis.

The inquiry has to begin with what everyone agrees was the trigger for the crisis -- the so-called mortgage meltdown that occurred in 2007. That was the relatively sudden outbreak of delinquencies and defaults among mortgages, primarily in a few states -- California, Arizona, Nevada, and Florida -- but to a lesser degree everywhere in the country. No one disputes that the losses on these mortgages and the decline in housing values that resulted from the ensuing foreclosures weakened financial institutions in the U.S. and around the world and were the precipitating cause of the crisis.

This raised a significant question. The U.S. had experienced housing bubbles in the past. Since the Second World War, there had been two -- beginning in 1979 and 1989 -- but when these bubbles deflated they had triggered only local losses. Why was the deflation of the housing bubble in 2007 so destructive?

The Commission's answer was that there were weaknesses in the financial system -- failures of regulation and risk management, excessive leverage and risk-taking -- that were responsible for the ensuing devastation. To establish this idea, the Commission had to show that these weaknesses were something new. It didn't attempt to do this, although that was an essential logical step in establishing its point. And the Commission ignored a more obvious answer: the quality of the mortgages in the bubble. As I noted earlier -- and as the Commission never acknowledged or disputed -- by 2008, half all mortgages in the U.S. -- 27 million -- were subprime or otherwise risky loans. If the Commission had really been looking for the reasons that the collapsing bubble was so destructive, the poor quality of the mortgages in the bubble was a far more likely hypothesis than that there had been a previously undetected weakening in the way the U.S. financial system operated.

This in turn raised two other major questions. Why were there so many weak and risky loans in this bubble? What had happened to mortgage underwriting standards in the preceding years that caused such a serious deterioration in mortgage quality?

"Affordable Housing Goals" and the Deterioration in Underwriting Standards

RESEARCH SHOWED that the turning point came in 1992, with the enactment by Congress of what were called "affordable housing goals" for Fannie Mae and Freddie Mac. These two firms, which were shareholder-owned, had been chartered by Congress more than 20 years earlier to operate a secondary market in mortgages. The original idea was that they would buy mortgages from banks and other originators (Fannie and Freddie were not permitted to originate mortgages), standardize the mortgage document, resell those mortgages to institutional and other investors, and in that way create a national market for U.S. mortgages.

From the beginning, Fannie and Freddie's congressional charters required them to buy only mortgages that would be acceptable to institutional investors -- in other words, prime mortgages. At the time, a prime mortgage was a loan with a 10-20 percent down payment, made to a borrower with a good credit record who had sufficient income to meet his or her debt obligations after the loan was made. Fannie and Freddie operated under these standards until 1992.

The 1992 affordable housing goals required that, of all mortgages Fannie and Freddie bought in any year, at least 30 percent had to be loans made to borrowers who were at or below the median income in the places where they lived. Over succeeding years, the Department of Housing and Urban Development (HUD) increased this requirement, first to 42 percent in 1995, to 50 percent in 2000, and finally to 55 percent in 2007. It is important to note, accordingly, that this occurred during both Democratic and Republican administrations.

At the 50 percent level, Fannie and Freddie had to acquire at least one goal-eligible loan for every prime loan that they acquired, and since not all subprime loans were goals-eligible Fannie and Freddie were in effect required to buy many more subprime loans than prime loans to meet the goals. As a result of this process, by 2008, Fannie and Freddie held the credit risk of 12 million subprime or otherwise risky loans -- almost 40 percent of their single-family book of business.

But this was not by any means the full extent of the problem. HUD took Congress's enactment of the affordable housing goals as an expression of a congressional policy to reduce underwriting standards so that low-income borrowers would have greater access to mortgage credit. As outlined in my dissent, by tightening the affordable housing goals, HUD put Fannie and Freddie into competition with the Federal Housing Administration (FHA), a government agency with an explicit mission to provide credit to low-income borrowers, and with subprime lenders such as Countrywide, that had pledged to reduce underwriting standards in order to make more mortgage credit available to low-income borrowers. Moreover, all these organizations were joined by insured banks and S&Ls, which as noted above were required under the CRA to make mortgage credit available to borrowers who are at or below 80 percent of the median income in the areas where they live.

Of course, it is possible to find borrowers who meet prime loan standards among low-income families, but it is far more difficult to find such loans among these borrowers than among middle-income groups. And when Fannie, Freddie, FHA, subprime lenders like Countrywide, and insured banks and S&Ls are all competing to find loans to borrowers in the low-income category, the inevitable result was a significant deterioration in underwriting standards.

So, for example, while one in 200 mortgages involved a down payment of 3 percent or less in 1990, by 2007 it was one in less than three. Other credit standards had also declined. As a result of this government-induced competition, by 2008 19.2 million out of the total of 27 million subprime and other weak loans in the U.S. financial system could be traced directly or indirectly to U.S. government housing policies.

Private Sector Securitization of Subprime Loans

IF THE GOVERNMENT was responsible for 19.2 million of the 27 million subprime and other risky loans, that leaves 7.8 million similar loans that came from other sources. These were mortgages securitized by the private sector (often called Wall Street in the Commission's report) and held by financial institutions around the world. How were these mortgages the result of U.S. government housing policy?

This is an important question. Even though these privately securitized mortgages were less than one-third of the total number of subprime and other risky loans outstanding, they are the reason that banks and other loan originators generally have been blamed -- in the media, in most books and films about the financial crisis, and of course by the Commission -- for the financial crisis.

The securitization of subprime and other risky loans was also a new phenomenon in the housing bubble that ended in 2007, and it was a direct result of the extraordinary growth of the bubble itself. Most bubbles in the past lasted three or four years. In that time, delinquencies begin to appear and the inflow of speculative funds begins to dry up. The bubble that deflated in 2007, however, had an unprecedentedly long 10-year life. The reason was that the money flow into that bubble was not from private speculators looking for profit, but primarily from the government pursuing a social policy by directing the investments of companies or agencies it regulated or otherwise controlled.

Housing bubbles tend to suppress defaults. As housing prices rise, people who can't meet their obligations can sell the house for more than they paid, or can refinance, so delinquencies are limited. By 2002, five years into the bubble that began in 1997, investors were beginning to notice that subprime and other risky loans -- which usually carried higher than normal interest rates because of their risk -- were not showing delinquencies or defaults commensurate with their risks. In other words, the data suggested that mortgage-backed securities (MBS) made of these loans were offering unusually high risk-adjusted yields. This stimulated the development of a private market in securitized subprime loans -- something that had never existed before.

This market was about 4 percent of all mortgages made in 2002, but by 2004 had grown to 15 percent. It kept growing through 2005 and 2006, but completely collapsed in 2007, when the 10-year bubble finally topped out and began to deflate.

Thus, the 7.8 million subprime and other risky loans that were securitized during the 2000s and still outstanding in 2008 were also the indirect result of U.S. government housing policies, which had built an unprecedented bubble in the late 1990s. The bubble created the necessary conditions -- a long run of subprime loans without the expected losses -- for the growth of a huge securitization market in subprime and other risky loans in the mid-2000s.

Before leaving this subject, it is important to address one statement that has appeared again and again in the mainstream media, in statements by members of the Obama administration, and was repeated in the Commission report. This is the claim that Fannie and Freddie became insolvent because, seeking profits or market share, they "followed Wall Street" into subprime lending. This idea neatly avoids the question of why Fannie and Freddie became insolvent in the first place, and focuses the blame again on the private sector. The statement, however, as the following quote from Fannie's 2006 10-K report makes clear, is untrue:

> [W]e have made, and continue to make, significant adjustments to our mortgage loan sourcing and purchase strategies in an effort to meet HUD's increased housing goals and new subgoals. These strategies include entering into some purchase and securitization transactions with lower expected economic returns than our typical transactions. We have also relaxed some of our underwriting criteria to obtain goals-qualifying mortgage loans and increased our investments in higher-risk mortgage loan products that are more likely to serve the borrowers targeted by HUD's goals and subgoals, which could increase our credit losses.

Subprime and Other Risky Loans Cause the Financial Crisis

WITH HALF OF ALL mortgages weak and of low quality by late 2007, an eventual financial crisis was a foregone conclusion. No financial system could withstand the huge losses that occurred when the delinquencies and defaults associated with 27 million subprime and other risky loans began to appear. Alarmed by these unexpected and unprecedented numbers of these delinquencies and defaults, investors fled the multi-trillion dollar market for MBS, dropping MBS values -- and especially those MBS backed by subprime and other risky loans -- to fractions of their former prices.

Mark-to-market accounting then required financial institutions to write down the value of their assets -- reducing their capital positions and causing great investor and creditor unease. In this environment, the government's rescue of Bear Stearns in March of 2008 temporarily calmed investor fears but created significant moral hazard; investors and other market participants reasonably believed after the rescue of Bear that all large financial institutions would also be rescued if they encountered financial difficulties.

However, when Lehman Brothers -- an investment bank even larger than Bear -- was allowed to fail, market participants were shocked; suddenly, they were forced to consider the financial health of their counterparties, many of which appeared weakened by losses and the capital writedowns required by mark-to-market accounting.

This caused a halt to lending and a hoarding of cash -- a virtually unprecedented period of market paralysis and panic that we know as the financial crisis of 2008.

The Policy Stakes

THE FAILURE OF THE Financial Crisis Inquiry Commission to do its job is one more obstacle to persuading the American people that the Dodd-Frank Act is illegitimate and should be repealed. The act is far and away the most restrictive piece of legislation ever imposed on the U.S. economy, and it will have a long-term effect in slowing economic growth, just as the uncertainties it has created have already slowed the recovery from the recession. The DFA was sold to the American people by the media and the Obama administration as necessary to prevent another financial crisis, but as outlined in this article and made very clear in my dissent, the financial crisis was not caused by weak or ineffective regulation. On the contrary, the financial crisis of 2008 was caused by government housing policies -- sponsored and promoted by many of the same people who framed and ultimately enacted the DFA. If we don't learn that important lesson, we will make the same mistake again, and then we really *will* have another financial crisis.