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Introduction

What Really Caused the World's Worst Financial Crisis and Why It Could Happen Again

Who controls the past controls the future.

GEORGE ORWELL, *1984*

The 2008 financial crisis was a major event, equivalent in its initial scope—if not its duration—to the Great Depression of the 1930s. Government officials who participated in efforts to mitigate its effects claim that their actions prevented a complete meltdown of the world's financial system, an idea that has found many adherents among academic and other commentators. We will never know, of course, what would have happened if these emergency actions had not been taken, but it is possible to gain an understanding of why they were considered necessary—that is, the likely causes of the crisis. The history of events leading up to the crisis forms a coherent story, but one that is quite different from the narrative underlying the Dodd-Frank Act.

Why is it important at this point to examine the causes of the crisis? After all, the crisis is six years in the past, and Congress and financial regulators have acted, or are acting, to prevent a recurrence. Even if we can't pinpoint the exact cause of the crisis, some will argue that the new regulations now being put in place will make a repetition unlikely. Perhaps. But these new regulations—specifically those authorized in the Dodd-Frank Act adopted by Congress in 2010—

have slowed and will continue to slow economic growth in the future, reducing the quality of life for most Americans. If these regulations were really necessary to prevent a recurrence of the financial crisis, then there might be a legitimate trade-off in which we are obliged to sacrifice economic freedom for the sake of financial stability. But if the crisis did not stem from a lack of regulation, we have needlessly restricted future economic growth.

In the wake of the crisis, many commentators saw it as a "crisis of capitalism," an inevitable consequence of the inherent instability—as they see it—of a free-market or capitalist system.[1] The implication was that crises of this kind will be repeated unless we gain control of the financial and economic institutions that influence the direction of our economy. That was the unspoken impulse behind the Dodd-Frank Act and the underlying assumption of those who imposed it.

But it is not at all clear that what happened in 2008 was the result of insufficient regulation, deregulation, or an economic system that is inherently unstable. On the contrary, there is compelling evidence that the financial crisis was the result of the government's own housing policies. These policies, as we will see, were based on an idea—still popular on the left—that underwriting standards in housing finance are excessively conservative, discriminatory, and unnecessary. If it is true that the crisis was the result of government policies, then the supposed instability of the financial system is a myth, and the regulations put in place to prevent a recurrence at such great cost to economic growth were a serious policy mistake. Indeed, if we look back over the last hundred years, it is difficult to see instability in the financial system that was not caused by the government's own policies. The Great Depression, now more than eighty years ago, probably doesn't qualify as a financial crisis; although financial firms were affected, it was a broadly based economic recession, made worse and prolonged by the Federal Reserve's mistaken monetary policies. One would have to go back to the Panic of 1907 to find something comparable to what happened in 2008, and few would claim that a financial system is inherently unstable if its major convulsions occur only once every hundred years.

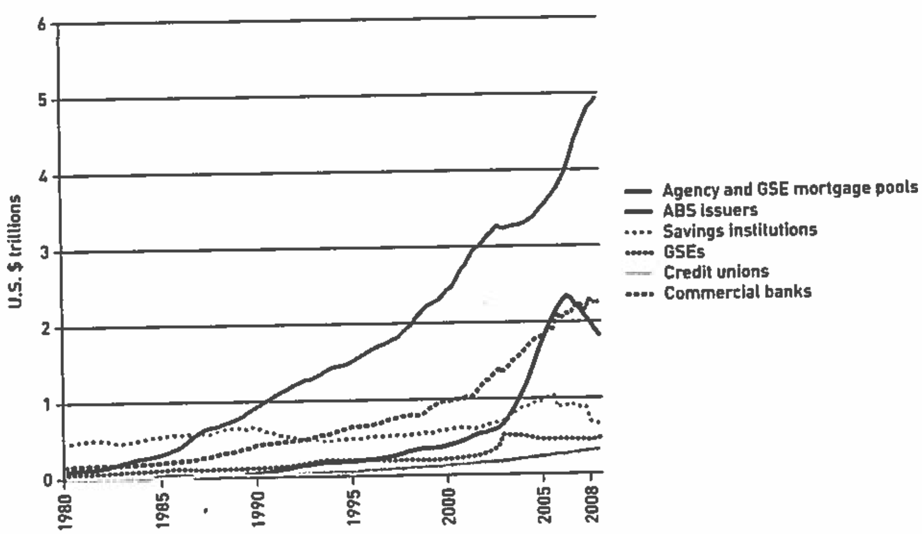
How, then, did government housing policies cause the 2008 fi-

nancial crisis? Actually, "cause" is too strong a word. Many factors were involved in the crisis, but the way to think about the relationship between the government's housing policies and the financial crisis, as I will discuss in this book, is that the crisis would not have occurred without those policies; they were, one might say, the *sine qua non* of the crisis—the element without which there would not have been a widespread financial breakdown in 2008. In this sense, throughout this book, I will say that the U.S. government's housing policies caused the crisis.

The seeds of the crisis were planted in 1992 when Congress enacted "affordable-housing" goals for two giant government-sponsored enterprises (GSEs), the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). Before 1992, these two firms dominated the housing finance market, especially after the savings and loan (S&L) industry—another government mistake—had collapsed. The role of the GSEs, as initially envisioned and as it developed until 1992, was to conduct what were called secondary market operations. They were prohibited from making loans themselves, but they were authorized to buy mortgages from banks, S&Ls, and other lenders. Their purchases provided cash for lenders and thus encouraged homeownership by making more funds available for additional mortgages.

Other government agencies were involved in housing finance, notably the Federal Housing Administration (FHA), the Veterans Administration (VA), and the Department of Agriculture's Rural Housing Service (RHS), but the GSEs were by far the most important. By the mid-1980s, they were acting as conduits by packaging mortgages into pools and selling securities backed by these pools to investors in the United States and around the world. For a fee, they guaranteed that investors would receive the principal and interest on these securities that they had been promised. The increasing dominance of the housing market by the GSEs and the government is well illustrated in Figure 1.1, which covers both the mortgage pools they guaranteed and their portfolios of mortgages and mortgage-backed securities (MBS).

Although Fannie and Freddie, as they were called, were owned



Source: U.S. Flow of Funds, Federal Reserve, 1980–2009. Adapted from Tobias Adrian and Hyun Song Shin, "The Changing Nature of Financial Intermediation and the Financial Crisis of 2008–09," Federal Reserve Bank of New York, Staff Report no. 439, revised April 2010, p. 2.

FIG. 1.1. Total holdings of U.S. home mortgages by type of financial institution

by public shareholders, they were chartered by Congress and carried out a government mission by maintaining a liquid secondary market in mortgages. As a result, market participants believed that the two GSEs were government-backed and would be rescued by the government if they ever encountered financial difficulties. This widely assumed government support enabled them to borrow at rates only slightly higher than the U.S. Treasury itself; with these low-cost funds they were able to drive all competition out of the secondary mortgage market for middle-class mortgages. Between 1991 and 2003, the GSEs' share of the U.S. housing market increased from 28.5 percent to 46.3 percent.[2] From this dominant position, they were able to set the underwriting standards for the market as a whole; few mortgage lenders would make middle-class mortgages—by far the predominant market—that could not be sold to Fannie or Freddie.

THE DEVELOPMENT OF UNDERWRITING STANDARDS

Over time, the GSEs had learned from experience what underwriting standards kept delinquencies and defaults low. These standards required down payments of 10 to 20 percent, good borrower credit histories, and low debt-to-income (DTI) ratios after the mortgage was closed. These were the foundational elements of what was called a prime loan or a traditional mortgage, discussed more fully in chapter 2. Mortgages that did not meet these standards were called "subprime" if the weakness in the loan was caused by the borrower's credit standing, and were called "Alt-A"* if the problem was the quality of the loan itself. Among other defects, Alt-A loans might involve reduced documentation; negative amortization; a borrower's obligation to pay interest only; a low down payment; a second mortgage; cash-out refinancing; or loans made to an investor who intends to rent out the home. In this book, subprime and Alt-A mortgages are together called nontraditional mortgages, or NTMs, because they differ substantially in default risk from the mortgages that Fannie and Freddie had made traditional in the U.S. housing finance market. Many observers of this market believe that tight underwriting standards—occasionally called a "tight credit box"—adversely affect the homeownership rate in the United States; however, even though the GSEs insisted on tight underwriting standards before 1992, the homeownership rate in the United States remained relatively high, at 64 percent, for the thirty years between 1965 and 1995.

The GSEs were subject to some statutory restrictions on their activities. In addition to the prohibition on direct lending to homebuyers, they could not acquire mortgages that were larger than a certain size (this was known as the "conforming loan limit," a statutory formula that allowed loan size to grow as housing prices rose), and

*The term Alt-A is said to derive from the market practice of referring to the GSEs as "Agencies." Alt-A mortgages were said to be "Alternative to Agencies" or mortgages that the GSEs wouldn't buy. Ironically, in order to meet the affordable-housing goals, the GSEs eventually became the biggest buyers of Alt-A loans.

after 1992 they were subject to prudential regulation by the Office of Federal Housing Enterprise Oversight (OFHEO), an agency of the Department of Housing and Urban Development (HUD). HUD was also their "mission regulator," with power to ensure that they were performing the role that the government had assigned to them. Most important, as mission regulator, HUD was given authority under the 1992 legislation to administer the affordable-housing goals, which are discussed at much greater length in later chapters of this book.

THE AFFORDABLE-HOUSING GOALS AND THE DECLINE IN UNDERWRITING STANDARDS

In a sense, the ability of the GSEs to dominate the housing finance market and set their own strict underwriting standards was their undoing. Community activists had had the two firms in their sights for many years, arguing that their underwriting standards were so tight that they were keeping many low- and moderate-income families from buying homes. Finally, as housing legislation was moving through Congress in 1992, the House and Senate acted, directing the GSEs to meet a quota of loans to low- and moderate-income borrowers when they acquired mortgages. At first, the low- and moderate-income (LMI) quota was 30 percent: in any year, at least 30 percent of the loans Fannie and Freddie acquired must have been made to LMI borrowers—defined as borrowers at or below the median income in their communities.

Thirty percent was not a difficult goal. It was probably true at the time the affordable-housing goals were enacted that 30 percent of the loans Fannie and Freddie bought had been made to LMI borrowers. But in giving HUD authority to increase the goals, Congress cleared the way for far more ambitious requirements—suggesting in the legislation, for example, that down payments could be reduced below 5 percent without seriously impairing mortgage quality. HUD received the signal. In succeeding years, HUD raised the LMI goal in steps to 42 percent in 1997, 50 percent in 2001, and 56 percent in 2008. Congress also required additional "base goals" that encompassed low- and very-low-income borrowers and residents of minority areas described as "underserved." HUD increased these base goals between 1996 and 2008, and at a faster rate than the LMI goals. Finally, in 2004, HUD added subgoals that provided affordable-housing goals credit only when the loans were used to purchase a home (known as a home purchase mortgage), as distinguished from a refinancing. As discussed later, it was much more difficult to find high-quality home-purchase mortgages than loans that were simply refinancing an existing mortgage.

As HUD increased the goals after 1992, it became considerably more difficult for the GSEs to find creditworthy borrowers, especially when the quota reached and then exceeded 50 percent. To do so, Fannie and Freddie had to reduce their underwriting standards. In fact, as we will see, that was explicitly HUD's purpose. As early as 1995, the GSEs were buying mortgages with 3-percent down payments, and by 2000 Fannie and Freddie were accepting loans with zero down payments. At the same time, they were compromising other underwriting standards, such as borrower credit standing and debt-to-income ratios (DTIs), in order to find the NTMs they needed to meet the affordable-housing goals.

New, easy credit terms brought many new buyers into the market, but the effect spread far beyond the LMI borrowers whom the reduced underwriting standards were intended to help. Mortgage lending is a competitive business; once Fannie and Freddie started to loosen their underwriting standards, many borrowers who could have afforded prime mortgages sought the easier terms now available so they could buy larger homes with smaller down payments. As early as 1995, Fannie's staff recognized that it was subsidizing homebuyers who were *above* the median income, noting that "average pricing of risk characteristics provides insufficient targeting of the subsidy. The majority of high LTV [loan-to-value] loans go to borrowers with incomes above 100% of the area median."[3] Thus, homebuyers above the median income were gaining leverage, and loans to them were decreasing in quality. In many cases, they were withdrawing cash from the equity in their homes through cash-out refinancing, further weakening the quality of the mortgages. Although the initial objective had been to reduce underwriting standards for low-income borrowers, the advantages of buying or refinancing a home with a low down payment were also flowing to high-income borrowers. Fannie never cured this problem. By 2007, 37 percent of loans with down payments of 3 percent or less went to borrowers with incomes above the median.[4]

Because of the gradual deterioration in loan quality after 1992, by 2008 half of all mortgages in the United States—31 million loans—were subprime or Alt-A. Of these 31 million, 76 percent were on the books of government agencies or institutions like the GSEs that were controlled by government policies.* This shows incontrovertibly where the demand for these mortgages originated. Table 1.1 shows where these 31 million loans were held on June 30, 2008.

THE GSES' FAILURE TO DISCLOSE THEIR RISK-TAKING

Even today, the numbers and dollar value of the NTMs in Table 1.1 are considerably larger than the numbers for subprime or Alt-A loans in most academic and government papers or reports. This discrepancy is explained by the fact that, after the affordable-housing requirements were adopted, the housing finance market underwent a radical change that was never fully grasped or understood by most market observers. Before 1992, it was relatively easy to tell the difference between a subprime loan and a prime loan. Subprime loans were a niche market, perhaps 10 percent of all mortgages; they were made by specialized lenders. The GSEs seldom acquired these loans. A subprime loan, therefore, was one made by a subprime lender, or a loan that Fannie and Freddie wouldn't buy. After the enactment of the affordable-housing requirements, however, the GSEs began to acquire loans that were subprime or Alt-A by their characteristics—that is, they might not have been originated by a subprime lender or insured by the FHA, but they had the same deficiencies as traditional subprime or Alt-A loans, and they performed the same way.

However—and this is a key point—even after they began to acquire large numbers of subprime mortgages, the GSEs continued to define subprime loans as mortgages that they bought from subprime lenders or that had been sold to them as subprime mortgages.[5] This misleading definition allowed them to maintain for many years that their exposure to subprime or Alt-A loans was minimal. In addition, when lenders reported their loans to organizations such as First American LoanPerformance, Inc. (now CoreLogic), a well-known data aggregator and publisher in the housing market, loans that had

*Throughout this book, for ease of reference, I refer to institutions that were compelled to acquire NTMs by government regulations as "government agencies." Many of them, such as FDIC-insured banks and even Fannie Mae and Freddie Mac, are not government agencies in the sense that they are funded by the government. However, they played a role in the financial crisis because their activities with respect to mortgage underwriting were subject to government control and regulation. FDIC-insured banks, for example, were subject to the Community Reinvestment ACT (CRA), which required them to make loans in their service areas that did not meet their regular underwriting standards.

TABLE 1.1. Entities holding credit risk of subprime and other high-risk mortgages as of June 30, 2008

Entity	Subprime and Alt-A loans (millions)	Unpaid principal amount ($ trillions)
Fannie Mae and Freddie Mac	16.5	2.5
FHA and other federal[a]	5.1	0.6
CRA and HUD programs	2.2	0.3
Total federal government	23.8	3.4
Other[b]	7.5	1.9
Total	31.0[c]	5.3

Sources: The data in this table and others throughout this book are drawn from research by Edward J. Pinto of the American Enterprise Institute. This table reflects the results of the analysis in Studies 1 and 2 in Pinto's "Three Studies of Subprime and Alt-A Loans in the U.S. Mortgage Market," September 29, 2014, http://www.aei.org/publication/three-studies-of-subprime-and-alt-a-loans-in-the-us-mortgage-market/.

[a]"FHA and other federal" includes Veterans Administration, Department of Agriculture, Federal Home Loan Banks, and others.

[b]"Other" includes subprime and Alt-A private MBS issued by Countrywide and Wall Street.

[c]Figure rounded.

been sold to Fannie and Freddie were classified as prime loans. The GSEs took adantage of this highly misleading classification system, failing to acknowledge loans with subprime characteristics as subprime or Alt-A, even though these loans would inevitably have much higher rates of default than prime loans. LoanPerformance and other data aggregators such as Inside Mortgage Finance (IMF), not in the business of classifying loans, simply assumed that loans sold to the GSEs were prime loans and carried them in that category. IMF noted, "Some subprime and Alt-A originations were likely reported by lenders as conventional conforming mortgages if they were sold to Fannie Mae or Freddie Mac."[6] For that reason, many respected academic, government, media, and professional commentators who discuss the financial crisis did not at the time of the crisis—and still do not—understand that the number of NTMs in the financial system was far higher in 2008 than what LoanPerformance's data showed, and the number of prime loans, accordingly, was much lower.[7] In December 2011, three top officers of both Fannie and Freddie were sued by the Securities and Exchange Commission (SEC) for failing to disclose that they had been acquiring subprime loans in substantial numbers. This was confirmed by Fannie and Freddie in non-prosecution agreements with the SEC, discussed in chapter 3.[8] The NTM numbers used in this book will include loans that should properly be labeled subprime or Alt-A because of their characteristics, not because the GSEs or the originators of these loans happened to label them that way. Indeed, after they were taken over in a government conservatorship, Fannie and Freddie disclosed the extent of their exposure to NTMs.

The failure of the GSEs to report the full extent of their NTM acquisitions is only one of the factors that might account for the general failure of risk managers, rating agencies, regulators, and housing market analysts to recognize the dangers that were building up in the mortgage market through the mid-2000s. Other elements were the growth of the bubble, which (as discussed below) tends to suppress delinquencies and defaults; the fact that no one could imagine a decline in housing prices nationally of 30–40 percent, or indeed a decline of 30–40 percent anywhere;[9] and the misplaced belief that automated underwriting had made it possible to eliminate much of the risk in subprime lending.

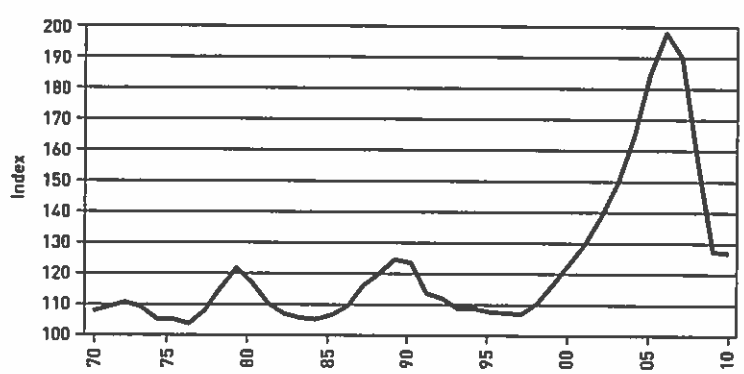
Unfortunately, some of the largest financial institutions were victims of the same misapprehensions as regulators and academics about the quality of the mortgages outstanding and the safety of the mortgage market, but they have been blamed by the government, the media, and ultimately the American people for excessive risk-taking. This view, a product of both the absence of accurate data and the government's efforts to avoid blame, has led to calls for what are essentially pubic hangings of the alleged malefactors—principally banks and their managers. Although placing responsibility for the financial crisis where it belongs may be seen by some as a defense of the banks and their officials, it is not.[10] Clearly, the private sector made serious errors in the crisis, but one fact is difficult to dismiss: the banks and investment banks got into serious trouble because they kept—they did not sell—the mortgage-backed securities, based on NTMs, that declined so sharply in value in 2007 and 2008. Two academics, Viral V. Acharya and Matthew Richardson, argue that the banks held onto the AAA-rated tranches (the levels most protected against loss) of these disastrously risky securities in order to evade the Basel capital regulations,[11] but at some level they must have believed that these instruments were safe. Ironically, if the banks had sold these securities, the losses would have been distributed more widely throughout the global financial system, where there was more capital to absorb them; instead, the losses were concentrated in the largest financial institutions in the United States and abroad, creating a financial crisis when these firms were so weakened that they could not continue to supply liquidity to the financial system.

THE GREAT HOUSING BUBBLE, 1997–2007

With all the new buyers entering the market because of the affordable-housing goals, together with the loosened underwriting standards the goals produced, housing prices began to rise. By 2000, the developing bubble was already larger than any bubble in U.S. history, and it kept rising until 2007, when—at nine times larger than any previous bubble—it finally topped out, and housing prices began to fall. Figure 1.2, based on Yale professor Robert Shiller's data, shows the extraordinary size of the 1997–2007 housing bubble in relation to the two other significant bubbles of the postwar period.

The growth and ultimate collapse of the 1997–2007 bubble seems consistent with economist Hyman Minsky's model for what eventually becomes a financial crisis or panic; many economists and policy makers have commented on this similarity.[12] Although Minsky posited a wholly private sector–driven financial crisis, his theory neatly fits the government-driven financial crisis of 2008. It begins with a "displacement"—some kind of shock to the market that creates unusual profit opportunities. As described in Charles Kindleberger and Robert Aliber's *Manias, Panics, and Crashes*: "Assume an increase in the effective demand for goods and services. After a time, the increase in demand presses against the capacity to produce goods. Market prices increase, and the more rapid increase in profits attracts both more investment and more firms."[13]

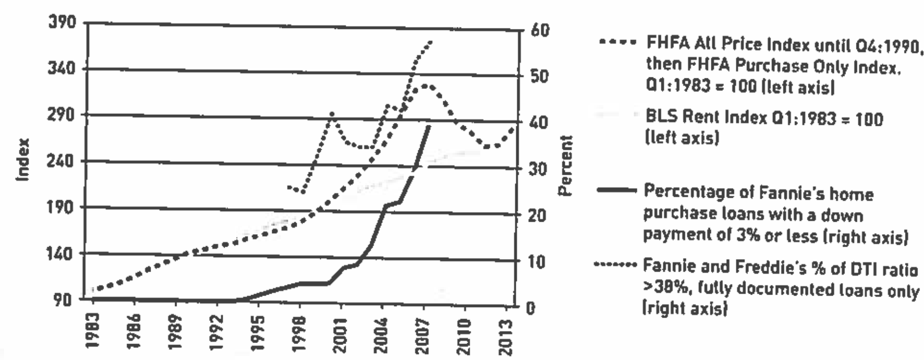
The shock to the market in the case of the 1997–2007 bubble was the newfound and strong interest by Fannie and Freddie in NTMs, beginning in 1993. The GSEs' demand, pressing against the existing supply, created new profits for subprime lenders such as Countrywide, as well as realtors, homebuilders, and banks. Minsky also



Source: Data from Robert Shiller.

FIG. 1.2. Real home prices from 1970 to 2010 per the Shiller home price index

posited that there must be a continuing injection of new funds in order to maintain the necessary euphoria. The gradual increase in the affordable-housing goals and the growing size of Fannie and Freddie as financing sources appear to satisfy this requirement between 1997 and 2007, accounting for the continued growth of the bubble. Figure 1.3 shows that between 1983 and approximately 1997 the trend in home prices tracked rental values as calculated by the Bureau of Labor Statistics (BLS). Then, beginning somewhere between 1995 and 1998, home prices began a sharp rise. The figure shows a correlation between the beginnings of the bubble and what might be called a Minsky event—the displacement or shock in the form of a sudden rise in the GSEs' appetite for lower-quality loans, reflected in their acceptance of DTI ratios greater than 38 percent and down payments of 3 percent or less. Low down payments were of particular importance here. If a potential buyer has a down payment of $20,000, he or she could buy a $200,000 house if the required down payment is 10 percent. But if the required down payment is 5 percent, as it quickly became after the adoption of affordable-housing goals, the same buyer could buy a $400,000 house. In this way, lower down payments made much more credit available for mortgages and thus enlarged the market for more expensive houses.



Sources: Federal Housing Finance Agency; Bureau of Labor Statistics; Department of Housing and Urban Development; Consumer Financial Protection Bureau.

FIG. 1.3. The Minsky event implicit in the 1997–2007 housing bubble

The principal beneficiaries of these policies were the realtors, and they joined community activists as cheerleaders for lower underwriting standards. The principal victims, in addition to the taxpayers, were the low-income homebuyers who lost their homes when the inevitable recession arrived.

Housing bubbles tend to suppress delinquencies and defaults while the bubble is growing. As prices rise, borrowers who are having difficulty meeting their mortgage obligations are able to refinance or sell the home for more than the principal amount of the mortgage. In these conditions, potential investors in mortgages or in mortgage-backed securities receive a strong affirmative signal; they see high-cost mortgages—loans that reflect the riskiness of lending to a borrower with a weak credit history—but the expected number of delinquencies and defaults have not occurred. They come to think that "this time it's different," that the risks of investing in subprime or other weak mortgages are not as great as they'd thought. At the same time, Fannie and Freddie were arguing that the automated underwriting standards they had developed allowed them to find good mortgages among those that would in the past have been considered subprime or Alt-A. For example, in a 2002 study, two Freddie Mac officials reported: "We find evidence that AU [automated underwriting] systems more accurately predict default than manual underwriters do. We also find evidence that this increased accuracy results in higher borrower approval rates, especially for underserved applicants."[14] The superiority of new technology, rather than the existence of a bubble, was thus used to explain the lower rates of default observed in the market.

These factors brought many new investors into the market, looking to invest in securities backed by NTMs. These were private mortgage-backed securities (PMBS), also called private label securities, or PLS, which were securitized and sold by commercial banks, investment banks, subprime lenders, and others. Although never before a large part of the mortgage market, PMBS (denoted as ABS issuers in Figure 1.1), much of them backed by subprime and Alt-A mortgages, became a booming business, especially from 2004 through 2006, as private securitizers discovered ways to compete with securitizations by Fannie and Freddie. Still, although the private securitization system challenged Fannie and Freddie during these years, the NTMs securitized by the private sector were only 24 percent of the NTMs outstanding in 2008, showing that PMBS and the financial institutions that held them were not the major source of the bubble or the crisis.

Housing bubbles are also by definition procyclical. When they are growing they feed on themselves to encourage higher prices, through higher appraisals and other mechanisms, until prices get so high that buyers can't afford them no matter how lenient the terms of a mortgage. But when bubbles begin to deflate, the process reverses. It then becomes impossible to refinance or sell a house that has no equity; financial losses cause creditors to pull back and tighten lending standards; recessions frequently occur; and low appraisals make it difficult for a purchaser to get financing. As in the United States today, many homeowners suddenly find that their mortgage is larger than the value of the home; they are said to be "underwater." Sadly, many are likely to have lost their jobs because of the conditions in the economy brought on by the housing decline but cannot move to a place where jobs are more plentiful because they can't sell their home without paying off the unpaid mortgage loan balance. In these circumstances, many homeowners simply walk away from the mortgage, knowing that in most states the lender has recourse only to the home itself. This, of course, weakens the banking system, with many banks left holding defaulted mortgages and unsalable properties. These banks are then required to reduce their lending in the hope of restoring their capital positions, which diminishes the credit available to consumers and business and impedes a recovery.

With the largest housing bubble in history deflating, and more than half of all mortgages made to borrowers who had weak credit, high debt ratios, or little equity in their homes, the number of delinquencies and defaults in 2008 was unprecedented. One immediate effect was the collapse of the market for private mortgage-backed securities. Investors, shocked by the sheer number of defaults that seemed to be under way, fled the market. Mortgage values fell along with housing prices, with dramatic effect on the PMBS market, as