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How Did We Get into This Financial Mess?

by Lawrence H. White

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Executive Summary

As policymakers confront the ongoing U.S. financial crisis, it is important to take a step back and understand its origins. Those who fault "deregulation," "unfettered capitalism," or "greed" would do well to look instead at flawed institutions and misguided policies.

The expansion in risky mortgages to underqualified borrowers was encouraged by the federal government. The growth of "creative" nonprime lending followed Congress's strengthening of the Community Reinvestment Act, the Federal Housing Administration's loosening of down-payment standards, and the Department of Housing and Urban Development's pressuring lenders to extend mortgages to borrowers who previously would not have qualified.

Meanwhile, Freddie Mac and Fannie Mae grew to own or guarantee about half of the United States' $12 trillion mortgage market. Congressional leaders pointedly refused to moderate the moral hazard problem of implicit guarantees or otherwise rein in their hyperexpansion, instead pushing them to promote "affordable housing" through expanded purchases of nonprime loans to low-income applicants.

The credit that fueled these risky mortgages was provided by the cheap money policy of the Federal Reserve. Following the 2001 recession, Fed chairman Alan Greenspan slashed the federal funds rate from 6.25 to 1.75 percent. It was reduced further in 2002 and 2003, reaching a record low of 1 percent in mid-2003—where it stayed for a year. This set off what economist Steve Hanke called "the mother of all liquidity cycles and yet another massive demand bubble."

The actual causes of our financial troubles were unusual monetary policy moves and novel federal regulatory interventions. These poorly chosen policies distorted interest rates and asset prices, diverted loanable funds into the wrong investments, and twisted normally robust financial institutions into unsustainable positions.

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Introduction

Mortgage foreclosure rates in the United States have risen to the highest level since the Great Depression. The nation's two largest financial institutions, the government-sponsored mortgage purchasers and repackagers Fannie Mae and Freddie Mac, have gone into bankruptcy-like "conservatorship." Several major investment banks, insurance companies, and commercial banks heavily tied to real estate lending have gone bankrupt outright or have been sold for cents on the dollar. Prices and trading volumes in mortgage-backed securities have shrunk dramatically. Reluctance to lend has spread to other markets. To prepare the ground for a return to normalcy in American credit markets we must understand the character of the problems we currently face and how those problems arose.

What *Didn't* Happen

Some commentators (and both presidential candidates) have blamed the current financial mess on greed. But if an unusually high number of airplanes were to crash this year, would it make sense to blame gravity? No. Greed, like gravity, is a constant. It can't explain why the number of financial crashes is higher than usual. There has been no unusual epidemic of blackheartedness.

Others have blamed deregulation or (in the words of one representative) "unregulated free-market lending run amok." Such an indictment is necessarily skimpy on the particulars, because there has actually been no recent dismantling of banking and financial regulations. Regulations were in fact intensified in the 1990s in ways that fed the development of the housing finance crisis, as discussed below. The last move in the direction of financial deregulation was the bipartisan Financial Services Modernization Act of 1999, also known as the Gramm-Leach-Bliley Act, signed by President Clinton. That act opened the door for financial firms to diversify: a holding company that owns a commercial bank subsidiary may now also own insurance, mutual fund, and investment-bank subsidiaries. Far from contributing to the recent turmoil, the greater freedom allowed by the act has clearly been a blessing in containing it. Without it, JPMorgan Chase could not have acquired Bear Stearns, nor could Bank of America have acquired Merrill Lynch—acquisitions that avoided losses to Bear's and Merrill's bondholders. Without it, Goldman Sachs and Morgan Stanley could not have switched specialties to become bank holding companies when it became clear that they could no longer survive as investment banks.

What *Did* Happen—and Why?

The actual causes of our financial troubles were unusual monetary policy moves and novel federal regulatory interventions. These poorly chosen public policies distorted interest rates and asset prices, diverted loanable funds into the wrong investments, and twisted normally robust financial institutions into unsustainable positions.

Let's review how the crisis has unfolded. Problems first surfaced in "exotic" or "flexible" home mortgage lending. Creative lenders and originators had expanded the volume of unconventional mortgages with high default risks (reflected in nonprime ratings), which are the housing market's equivalent of junk bonds. Unconventional mortgages helped to feed a run-up in condo and house prices. House prices peaked and turned downward. Borrowers with inadequate income relative to their debts, many of whom had either counted on being able to borrow against a higher house value in the future in order to help them meet their monthly mortgage payments, or on being able to "flip" the property at a price that would more than repay their mortgage, began to default. Default rates on nonprime mortgages rose to unexpected highs. The high risk on the mortgages came back to bite mortgage holders, the financial institutions to whom the monthly payments were owed. Firms directly holding mortgages saw reduced cash flows. Firms holding securitized mortgage bundles (often called "mortgage-backed securities") additionally saw the expectation of continuing reductions in cash flows reflected in declining market values for their securities. Uncertainty about future cash flows impaired the liquidity (resalability) of their securities.

Doubts about the value of mortgage-backed securities led naturally to doubts about the solvency of institutions heavily invested in those securities. Financial institutions that had stocked up on junk mortgages and junk-mortgage-backed securities found their stock prices dropping. The worst cases, like Countrywide Financial, the investment banks Lehman Brothers and Merrill Lynch, and the government-sponsored mortgage purchasers Fannie Mae and Freddie Mac, went broke or had to find a last-minute purchaser to avoid bankruptcy. Firms heavily involved in guaranteeing mortgage-backed securities, like the insurance giant AIG, likewise ran aground. Suspect financial institutions began finding it difficult to borrow, because potential lenders could not confidently assess the chance that an institution might go bankrupt and be unable to pay them back. Credit flows among financial institutions became increasingly impeded by such solvency worries.

Given this sequence of events, the explanation of our credit troubles requires an explanation for the unusual growth of mortgage lending—particularly nonprime lending, which fed the housing bubble that burst —leading in turn to the unusual number of mortgage defaults, financial institution crashes, and attendant credit-market inhibitions.

There is no doubt that private miscalculation and imprudence have made matters worse for more than a few institutions. Such mistakes help to explain which particular firms have run into the most trouble. But to explain *industrywide* errors, we need to identify policy distortions capable of having industrywide effects.

We can group most of the unfortunate policies under two main headings: (1) Federal Reserve credit expansion that provided the means for unsustainable mortgage financing, and (2) mandates and subsidies to write riskier mortgages. The enumeration of regrettable policies below is by no means exhaustive.

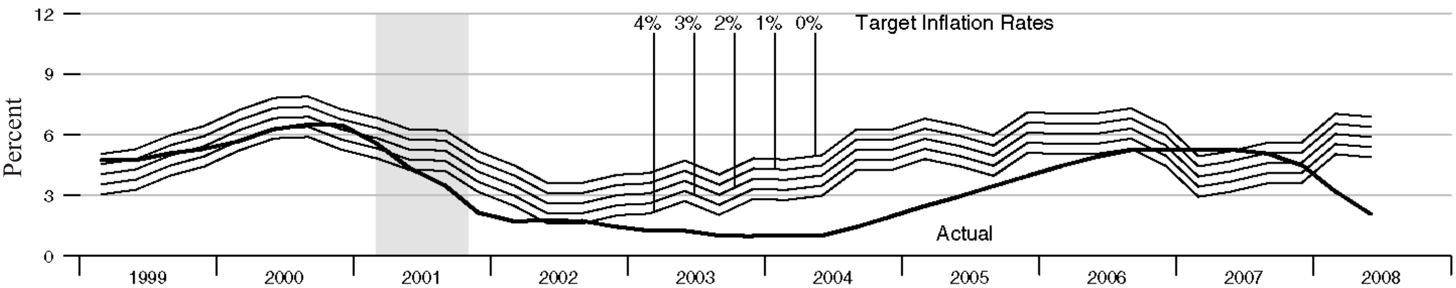
Providing the Funds: Federal Reserve Credit Expansion

In the recession of 2001, the Federal Reserve System, under Chairman Alan Greenspan, began aggressively expanding the U.S. money supply. Year-over-year growth in the M2 monetary aggregate rose briefly above 10 percent, and remained above 8 percent entering the second half of 2003. The expansion was accompanied by the Fed repeatedly lowering its target for the federal funds (interbank short-term) interest rate. The federal funds rate began 2001 at 6.25 percent and ended the year at 1.75 percent. It was reduced further in 2002 and 2003, in mid-2003 reaching a record low of 1 percent, where it stayed for a year. The *real* Fed funds rate was negative—meaning that nominal rates were lower than the contemporary rate of inflation—for two and a half years. In purchasing-power terms, during that period a borrower was not paying but rather gaining in proportion to what he borrowed. Economist Steve Hanke has summarized the result: "This set off the mother of all liquidity cycles and yet another massive demand bubble."

The so-called Taylor Rule—a formula devised by economist John Taylor of Stanford University—provides a now-standard method of estimating what federal funds rate would be consistent, conditional on current inflation and real income, with keeping the inflation rate to a chosen target rate. The diagram below, from the Federal Reserve Bank of St. Louis, shows that from early 2001 until late 2006 the Fed pushed the actual federal funds rate below the estimated rate that would have been consistent with targeting a 2 percent inflation rate. A fortiori the Fed held the actual rate even farther below the path, consistently targeting stability in nominal income (see

In the recession of 2001, the Federal Reserve System began aggressively expanding the U.S. money supply.

Figure 1
Federal Funds Rate and Inflation Targets



Source: Federal Reserve Bank of St. Louis, *Monetary Trends* (October 2008).

Figure 1). The diagram shows that the gap was especially large—200 basis point or more—from mid-2003 to mid-2005.

The demand bubble thus created went heavily into real estate. From mid-2003 to mid-2007, while the dollar volume of final sales of goods and services was growing at 5 percent to 7 percent, real estate loans at commercial banks were growing at 10–17 percent.[1] Credit-fueled demand pushed up the sale prices of existing houses and encouraged the construction of new housing on undeveloped land, in both cases absorbing the increased dollar volume of mortgages. Because real estate is an especially long-lived asset, its market value is especially boosted by low interest rates. The housing sector thus exhibited more than its share of the price inflation as predicted by the Taylor Rule.

The Fed's policy of lowering short-term interest rates not only fueled growth in the dollar volume of mortgage lending, but had unintended consequences for the *type* of mortgages written. By pushing very-short-term interest rates down so dramatically between 2001 and 2004, the Fed lowered short-term rates relative to 30-year rates. Adjustable-rate mortgages (ARMs), typically based on a one-year interest rate, became increasingly cheap relative to 30-year fixed-rate mortgages. Back in 2001, nonteaser ARM rates on average were 1.13 percent cheaper than 30-year fixed-mortgages (5.84 percent vs. 6.97 percent). By 2004, as a result of the ultra-low federal funds rate, the gap had grown to 1.94 percent (3.90 percent vs. 5.84 percent).[2] Not surprisingly, increasing numbers of new mortgage borrowers were drawn away from mortgages with 30-year rates into ARMs. The share of new mortgages with adjustable rates, only one-fifth in 2001, had more than doubled by 2004. An adjustable-rate mortgage shifts the risk of refinancing at higher rates from the lender to the borrower. Many borrowers who took out ARMs implicitly (and imprudently) counted on the Fed to keep short-term rates low indefinitely. They have faced problems as their monthly payments have adjusted upward. The shift toward ARMs thus compounded the mortgage-quality problems arising from regulatory mandates and subsidies.

Researchers at the International Monetary Fund have corroborated the view that the Fed's easy-credit policy fueled the housing bubble. After estimating the sensitivity of U.S. housing prices and residential investment to interest rates, they find that "the increase in house prices and residential investment in the United States over the past six years would have been much more contained had short-term interest rates remained unchanged."[3] Even Alan Greenspan, who otherwise protests his innocence, has acknowledged that "the 1 percent rate set in mid-2003 . . . lowered interest rates on adjustable-rate mortgages and may have contributed to the rise in U.S. home prices."

The excess investment in new housing has resulted in an overbuild of housing stock. Assuming that the federal government does not follow proposals (tongue-in-cheek or otherwise) that it should buy up and then raze excess houses and condos, or proposals to admit a large number of new immigrants, house prices and activity in the U.S. housing construction industry are going to remain depressed for a while. The process of adjustment, already well under way but not yet completed, requires house prices to fall and workers and capital to be released from the construction industry to find more appropriate employment elsewhere. Correspondingly, an adjustment requires the book value of existing financial assets based on housing to be written down and workers and capital to be released from writing and trading mortgages to find more appropriate employment elsewhere. No matter how painful the adjustment process, delaying it only delays the economy's recovery.

Mandates and Subsidies to Write Risky Mortgages

In 2001, the share of existing mortgages classified as nonprime (subprime or the intermediate category "Alt-A") was below 10 percent. That share began rising rapidly. The nonprime share of all *new* mortgage originations rose close to 34 percent by 2006, bringing the nonprime share of existing mortgages to 23 percent. Meanwhile the quality of loans within the nonprime category declined, because a smaller share of nonprime borrowers made 20 percent down payments on their purchases.[4]

The expansion in risky mortgages to underqualified borrowers was an imprudence fostered by the federal government. As elaborated in the paragraphs to follow, there were several ways that Congress and the executive branch encouraged the expansion. The first way was loosening down-payment standards on mortgages guaranteed by the Federal Housing Administration. The second was strengthening the Community Reinvestment Act. The third was pressure on lenders by the Department of Housing and Urban Development. The fourth and most important way was subsidizing, through implicit taxpayer guarantees, the dramatic expansion of the government-sponsored mortgage buyers Fannie Mae and Freddie Mac; pointedly refusing to moderate the moral hazard problem of implicit guarantees or otherwise rein in the hyper-expansion of Fannie and Freddie; and increasingly pushing Fannie and Freddie to promote affordable housing" through expanded purchases of nonprime loans to low-income applicants.

The Federal Housing Administration was founded in 1934 to insure mortgage loans made by private firms to qualifying borrowers. For a borrower to qualify, the FHA originally required—among other things—that the borrower provide a nonborrowed 20 percent down payment on the house being purchased. Private mortgage lenders like savings banks considered that to be a low down payment at the time. But private down payment requirements began falling toward the FHA level. The FHA reduced its requirements below 20 percent. Private mortgage insurance arose for non-FHA borrowers with down payments below 20 percent. Apparently concerned for bureaucratic reasons with preventing its "market share" from shrinking too far, the FHA began lowering its standards to stay below those of private lenders. By 2004 the required down payment on the FHA's most popular program had fallen to only 3 percent, and proposals were afoot in Congress to lower it to zero.[5] Mortgages with very low down payments have had very high default rates.

The Community Reinvestment Act, first enacted in 1977, was relatively innocuous for its first 12 years or so, merely imposing reporting requirements on commercial banks regarding the extent to which they lent funds back into the neighborhoods where they gathered deposits. Congress amended the CRA in 1989 to make banks' CRA ratings public information. Further amendments in 1995 gave the CRA serious teeth: regulators could now deny a bank with a low CRA rating approval to merge with another bank—at a time when the arrival of interstate banking made such approvals especially valuable—or even to open new branches. Complaints from community organizations would now count against a bank's CRA rating. Groups like ACORN (the

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Association of Community Organizations for Reform Now) began actively pressuring banks to make loans under the threat that otherwise they would register complaints in order to deny the bank valuable approvals.

In response to the new CRA rules, some banks joined into partnerships with community groups to distribute millions in mortgage money to low-income borrowers previously considered noncreditworthy. Other banks took advantage of the newly authorized option to boost their CRA rating by purchasing special "CRA mortgage-backed securities," that is, packages of disproportionately nonprime loans certified as meeting CRA criteria and securitized by Freddie Mac. No doubt a small share of the total current crop of bad mortgages has come from CRA loans. But for the share of the increase in defaults that *has* come from the CRA-qualifying borrowers (who would otherwise have been turned down for lack of creditworthiness) rather than from, say, would-be condo-flippers on the outskirts of Las Vegas—the CRA bears responsibility.

Defaults and foreclosures are, of course, a drag on real estate values in poor neighborhoods just as in others. Federal Reserve Chairman Ben Bernanke aptly commented in a 2007 speech that "recent problems in mortgage markets illustrate that an underlying assumption of the CRA—that *more* lending equals *better* outcomes for local communities may not always hold."[6] (If only Alan Greenspan had recognized that such a warning applies to credit markets generally and the nation as a whole, he might not have artificially expanded total credit so vigorously. We can only hope that Ben Bernanke will keep his own generalized warning in mind henceforth.)

Meanwhile, beginning in 1993, officials in the Department of Housing and Urban Development began bringing legal actions against mortgage bankers that declined a higher percentage of minority applicants than white applicants. To avoid legal trouble, lenders began relaxing their down-payment and income qualifications.[7]

Congress and HUD also pressured Fannie Mae and Freddie Mac. A 1992 law, as described by Bernanke, "required the government-sponsored enterprises, Fannie Mae and Freddie Mac, to devote a large percentage of their activities to meeting affordable housing goals."[8] Russell Roberts has cited some relevant numbers in the *Wall Street Journal*:

> Beginning in 1992, Congress pushed Fannie Mae and Freddie Mac to increase their purchases of mortgages going to low- and moderate-income borrowers. For 1996, the Department of Housing and Urban Development (HUD) gave Fannie and Freddie an explicit target—42 percent of their mortgage financing had to go to borrowers with income below the median in their area. The target increased to 50 percent in 2000 and 52 percent in 2005.
>
> For 1996, HUD required that 12 percent of all mortgage purchases by Fannie and Freddie be "special affordable" loans, typically to borrowers with income less than 60% of their area's median income. That number was increased to 20% in 2000 and 22% in 2005. The 2008 goal was to be 28%. Between 2000 and 2005, Fannie and Freddie met those goals every year, funding hundreds of billions of dollars worth of loans, many of them subprime and adjustable-rate loans, and made to borrowers who bought houses with less than 10% down.[9]

Wayne Barrett of *The Village Voice* has likewise drawn attention to how Andrew Cuomo, as Secretary of HUD between 1997 and 2001, actively pushed Fannie Mae and Freddie Mac into backing the enormous expansion of the nonprime mortgage market. In the short run, Fannie Mae and Freddie Mac found that their new flexible lending lines were profitable, and they continued to expand their purchases of nonprime mortgages under the rising goals set by subsequent HUD Secretaries.[10]

The hyperexpansion of Fannie Mae and Freddie Mac was made possible by their implicit backing from the U.S. Treasury. To fund their enormous growth, Fannie Mae and Freddie

Mac had to borrow huge sums in wholesale financial markets. Institutional investors were willing to lend to the government-sponsored mortgage companies cheaply—at rates only slightly above those on the Treasury's risk-free securities and well below those paid by other financial intermediaries—despite the risk of default that would normally attach to private firms holding such highly leveraged and poorly diversified portfolios. The investors were so willing only because they thought that the Treasury would repay them should Fannie or Freddie be unable. As it turns out, they were right. The Treasury did explicitly guarantee Fannie's and Freddie's debts when the two giants collapsed and were placed into conservatorship.

Congress was repeatedly warned by credible observers about the growing dangers posed by Fannie Mae's and Freddie Mac's implicit federal backing. A leading critic was William Poole, then president of the Federal Reserve Bank of St. Louis, who as far back as 2003 pointedly warned that the companies had insufficient capital to survive adverse conditions, and that the problem would continue to fester unless Congress explicitly removed the federal backing from the two companies so that they would face market discipline.[11]

Congress did nothing. Efforts to rein in Fannie and Freddie came to naught because the two giants had cultivated powerful friends on Capitol Hill. At hearings of the House Financial Services Committee in September 2003, regarding Bush administration proposals to change the regulatory oversight of the GSEs, in his opening statement Rep. Barney Frank (D-MA) defended the status quo arrangement on the grounds that it enabled Fannie and Freddie to lower mortgage interest rates for borrowers:

> Fannie Mae and Freddie Mac have played a very useful role in helping make housing more affordable, both in general through leveraging the mortgage market, and in particular, they have a mission that this Congress has given them in return for some of the arrangements which are of some benefit to them to focus on affordable housing, and that is what I am concerned about here. I believe that we, as the Federal Government, have probably done too little rather than too much to push them to meet the goals of affordable housing and to set reasonable goals. . . . The more people, in my judgment, exaggerate a threat of safety and soundness, the more people conjure up the possibility of serious financial losses to the Treasury, which I do not see . . . the more pressure there is there, then the less I think we see in terms of affordable housing.[12]

In the very same statement Representative Frank denied that the GSE's debt had any federal backing:

> But there is no guarantee, there is no explicit guarantee, there is no implicit guarantee, there is no wink-and-nod guarantee. Invest, and you are on your own.[13]

Of course, Frank was thinking wishfully and ignoring the obvious. The very "arrangements which are of some benefit to them," that is, the arrangements that enabled Fannie Mae and Freddie Mac to borrow at low rates (in exchange for which privileges they were willing to accept affordable housing mandates), were nothing other than the implicit federal guarantees of their debt.

The hyperexpansion of Fannie Mae and Freddie Mac was made possible by their implicit backing from the U.S. Treasury.

Conclusion

The housing bubble and its aftermath arose from market distortions created by the Federal Reserve, government backing of Fannie Mae and Freddie Mac, the Department of Housing and Urban Development, and the Federal Housing Authority. We are experiencing the unfortunate results of perverse government policies.

The traditional remedy for the severely mistaken investment policies of private firms—shut and dismantle those firms to stop the

The most effective and appropriate form of business regulation is regulation by profit and loss.

bleeding, free their assets and personnel to go where they can add value, and make room for firms with better entrepreneurial ideas—is as relevant as ever. A financial market in which failed enterprises like Freddie Mac or AIG are never shut down is like an American Idol contest in which the poorest singers never go home. The closure of Lehman Brothers (and the near-closure of Merrill Lynch), by raising the interest rate that the market charges to highly leveraged investment banks, forced Goldman Sachs and Morgan Stanley to change their business models drastically. The most effective and appropriate form of business regulation is regulation by profit and loss.

The long-term remedy for the severely mistaken government monetary and regulatory policies that have produced the current financial train wreck is similar. We need to identify and undo policies that distort housing and financial markets, and dismantle failed agencies whose missions require them to distort markets. We should be guided by recognizing the two chief errors that have been made. Cheap-money policies by the Federal Reserve System do not produce a sustainable prosperity. Hiding the cost of mortgage subsidies off-budget, as by imposing affordable housing regulatory mandates on banks and by providing implicit taxpayer guarantees on Fannie Mae and Freddie Mac bonds, does not give us more housing at nobody's expense.

Notes

1. Federal Reserve Bank of St. Louis FRED database, series FINSAL and REALLN, year-over-year percentage changes, http://research.stlouisfed.org/fred2/series/FINSAL?cid=106 and http://research.stlouisfed.org/fred2/series/REALLN?cid=100. My thanks to George Selgin for drawing my attention to these numbers.

2. As reported by Freddie Mac, http://www.freddiemac.com/pmms/pmms30.htm.

3. Roberto Cardarelli et al., "The Changing Housing Cycle and the Implications for Monetary Policy," in *World Economic Outlook: Housing and the Business Cycle* (April 2008), ch. 3, p. 21, caption to fig. 3.12.

4. William R. Emmons, "The Mortgage Crisis: Let Markets Work, But Compensate the Truly Needy," *Regional Economist* (July 2008), http://www.stlouisfed.org/publications/re/2008/c/pages/mortgage.html.

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9. Russell Roberts, "How Government Stoked the Mania," *Wall Street Journal* (October 3, 2008), http://online.wsj.com/article/SB122298982558700341.html?mod=special_page_campaign2008_mostpop.

10. Wayne Barrett, "Andrew Cuomo and Fannie and Freddie: How the Youngest Housing and Urban Development Secretary in History Gave Birth to the Mortgage Crisis," *Village Voice* (August 5, 2008), http://www.villagevoice.com/2008-08-05/news/how-andrew-cuomo-gave-birth-to-the-crisis-at-fannie-mae-and-freddie-mac/1.

11. "Official Cites Risks of Fannie, Freddie," *Los Angeles Times* (March 11, 2003), http://articles.latimes.com/2003/mar/11/business/fi-freddie11.

12. *The Treasury Department's Views on the Regulation of Government Sponsored Enterprises: Hearing Before the Committee on Financial Services*, U.S. House of Representatives, 108th Congress, 1st Session (September 10, 2003), http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=108_house_hearings&docid=f:92231.wais.

13. Ibid.

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