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ROOTS OF THE FINANCIAL CRISIS

THE ROLE OF GOVERNMENT POLICY

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INTRODUCTION

To some observers, the continuing struggles in U.S. markets, and mounting demands for higher spending and deeper government involvement, have signaled an even more fundamental transition for America's economy: the twilight of the free-market system itself. An analysis in *The Washington Post* gave an early account of the sentiment: "[T]he hands-off brand of capitalism in the United States is now being blamed for the easy credit that sickened the housing market and allowed a freewheeling Wall Street to create a pool of toxic investments that has infected the global financial system. Heavy intervention by the government, critics say, is further robbing Washington of the moral authority to spread the gospel of laissez-faire capitalism."[1]

This perspective, however, ignores the various ways government itself set the stage for the financial crisis that has played out this year. Although failures among private-sector actors and institutions were significant, the roots of the financial crisis can be traced to flawed government policies. For that matter, the housing sector – where most of the difficulties started – is hardly the kind of unbridled market the term *laissez-faire* suggests: it has substantial government components, including the financial and regulatory roles of large government agencies. In short, the current crisis reflects not a failure of the capitalist system, but the ways in which government *distorted* the functioning of private markets.

This paper shows how four key factors – which overlapped and interacted with one another – led to the crisis:

- Overly loose monetary policy earlier this decade that artificially lowered interest rates.
- Actions of two government-sponsored enterprises, Fannie Mae and Freddie Mac, that put taxpayer dollars at risk to chase profits.
- The government's push to lend money to those who could not afford it to buy homes.
- Private-market failures at each step in the "originate-to-distribute" mortgage credit model.

A clear understanding of these issues is especially critical now, as the 111th Congress weighs major policy decisions that will significantly affect the character of the U.S. economy for the next several decades.

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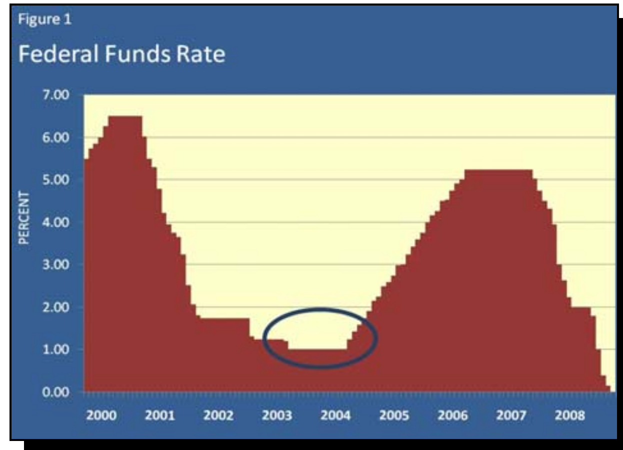
[1] Anthony Faiola, "The End of American Capitalism?," *The Washington Post*, 10 October 2008.

LOOSE MONETARY POLICY

The Federal Reserve set the stage for a wave of mortgage borrowing by keeping credit conditions too loose for too long earlier this decade. In response to the bursting of the high-tech bubble in 2000, the Fed began lowering interest rates in early 2001 to cushion the economic fallout; and it continued after that in response to the 2001 recession and the economic shock of the 9-11 terrorist attacks. It eventually drove down the target for the federal funds rate – the benchmark interbank lending rate in the U.S. – to just 1.0 percent by mid-2003, and held it there until mid-2004 (see Figure 1).



That fateful decision unleashed a number of economic forces that eventually led to a housing bubble. The macroeconomic recipe for an all-out push into the housing sector is clear from the data at the time. By mid-2003, the interest rate on a conventional 30-year mortgage dipped to an all-time low of just 5.25 percent. This stoked demand. New home construction rose to a 25-year high in late 2003, and remained at historic levels for 2 years.

Even with that brisk pace of home construction, demand outstripped supply and home prices began to rise at a dizzying pace. By 2004 and 2005, home prices were appreciating at nearly 15 percent a year. Cheap credit and sharply increasing home prices naturally pushed people into applying for home mortgages and provided incentives for current homeowners to purchase additional property for speculative purposes. In fact, economists at the Federal Reserve estimate the share of speculative real estate purchases (i.e. non-owner-occupied housing) jumped to roughly 17 percent in 2005 and 2006 at the height of the housing boom, up from just more than 6 percent a decade earlier.

Clearly, the availability of inexpensive credit was a principal contributor to the rise. The late economic historian Charles P. Kindleberger, after examining the anatomy of financial booms and busts going back to the 18th century, concluded monetary expansion played a key role in each speculative bubble. "Speculative manias," he noted, "gather speed through expansion of money and credit or perhaps, in some cases, get started *because* of an initial expansion of money and credit."[2]

Many well-known economists have critiqued the Fed's monetary policy for its role in the current crisis. John B. Taylor, a professor of economics at Stanford and author of the famous "Taylor rule" guideline for monetary policy, says the Fed made a mistake by keeping interest rates so low. Taylor's own monetary policy rule indicates that the Fed should have raised interest rates much

[2] Kindleberger, *Manias, Panics, and Crashes: A History of Financial Crises* (New York: Basic Books Inc., 1989), p. 57.

sooner than it did given the economic conditions at the time.[3] In a speech at a Federal Reserve monetary policy symposium late last year, Taylor said that "*a higher funds path would have avoided much of the housing boom* . . . the reversal of the boom and thereby the resulting market turmoil would not have been as sharp."[4]

Economists also have noted that important *global* financial developments in recent years have supported excesses in the U.S. housing market. Fed Chairman Bernanke has spoken of the so-called "global savings glut" and the increased flow of foreign money into dollar-denominated assets, which has led to a decline in long-term U.S. interest rates beyond what would normally be expected from the Fed's domestic monetary policy stance.[5] These lower interest rates have supported the demand for housing, and, by extension, the increase in residential real estate prices.

These global financial imbalances can take different forms and can have different causes. China, for instance, has traditionally fixed the value of its currency to the dollar at an artificially low level, which has contributed to a boom in its export sales to the U.S. The flipside of that export boom is that China receives substantial amounts of U.S. dollars, which it then recycles back to the U.S. through purchases of Treasury bonds. That flow of funding has helped to keep U.S. interest rates unusually low in recent years.

But the larger point is that actions on the part of the Federal Reserve *led* to an excess of global liquidity in recent years, setting the stage for disruptive financial imbalances. The Fed controls U.S. interest rates, but it is also the world's leading central banker, indirectly influencing interest rates in other countries and the global money supply. That is because many countries, particularly emerging market economies, peg their currencies, either formally or implicitly, to the U.S. dollar. To maintain their peg with the dollar, these countries often lower their interest rates in lockstep with the Fed. When the Fed aggressively lowered interest rates earlier this decade, many other countries followed suit and global liquidity skyrocketed. Economists at *Deutsche Bank* estimate the global money supply was expanding much faster than nominal GDP growth in these years, particularly between 2001 and 2003, when the Fed was aggressively slashing rates.[6] To the extent that an oversupply of global liquidity supported the creation of the U.S. housing bubble (through lower interest rates or the demand for new securitized products), it is important to recognize that the Fed's interest rate moves fostered the creation of that global liquidity.

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[3] The Taylor rule is a simple mathematical formula that sets an appropriate federal funds target in response to the performance of two economic variables: inflation and deviations from potential economic output. For instance, the rule prescribes that the Fed should raise interest rates when real GDP is increasing faster than potential GDP or inflation is higher than the Fed's long-term target. According to Taylor's formula, the federal funds rate should have been above 3 percent in mid-2003, given economic conditions, rather than 1 percent.

[4] John B. Taylor, *Housing and Monetary Policy*, remarks prepared for presentation at the Policy Panel at the Symposium on Housing, Housing Finance, and Monetary Policy sponsored by the Federal Reserve Bank of Kansas City in Jackson Hole, WY, September 2007. Italics added.

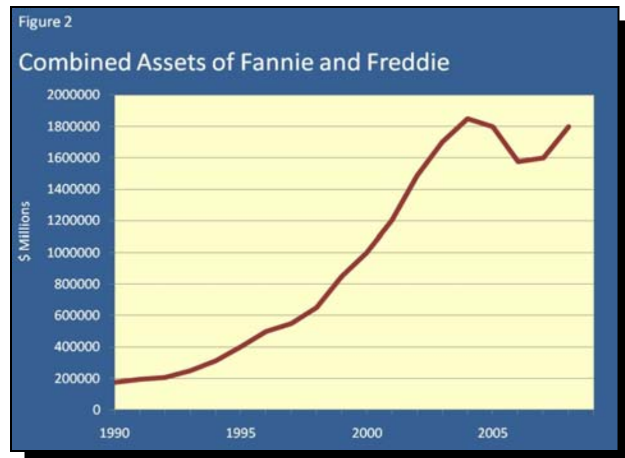
[5] Bernanke, remarks at the Sandridge Lecture, Virginia Association of Economics, Richmond, Va., 10 March 2005.

[6] Sebastian Becker, "Global liquidity 'glut' and asset price inflation: Fact or fiction?," *Deutsche Bank Research*.

FANNIE MAE AND FREDDIE MAC

Loose monetary policy was just one component of an overall system that encouraged risky mortgage lending and the diffusion of this risk throughout the financial system via mortgage-related securities. Standing at the center of this arrangement were two huge government-chartered agencies created to expand homeownership opportunities: the Federal National Mortgage Association [Fannie Mae] and the Federal Home Loan Mortgage Corporation [Freddie Mac]. They stoked the mortgage market by adding liquidity and signaled to everyone that the casino game of cheap money, low risk, and ever-rising home prices would last. Thus, Fannie and Freddie put their stamp of approval on a flawed system that blindly chased the higher yields of mortgage-backed securities that were marketed as risk-free investments.

The key to understanding Fannie's and Freddie's role in mortgage markets is acknowledging the power in their implied government backing. They are Government-Sponsored Enterprises [GSEs], private corporations that enjoy lower funding costs due to their government charters. Market participants have traditionally held the belief, confirmed by recent events, that the Federal Government would step in to rescue Fannie and Freddie if the firms fell into financial trouble.



That government backing bestowed a unique aura on Fannie and Freddie. They were by far the largest players in the mortgage market, and their business practices (credit rating, underwriting, risk modeling, and so on) were seen as the "gold standard" in the industry. Wherever they ventured in the market, others took it as a sign that it was safe to follow. More important, the government backing provided a huge source of profit for the two companies. They secured cheap funding to build up massive investment portfolios of mortgages and mortgage-backed securities, effectively making their money off the spread between their relatively low borrowing costs and the investment returns on their assets. Since 1990, their investment portfolios grew tenfold, from $135 billion to $1.5 trillion (see Figure 2).

Congress created the GSEs to "promote homeownership" by enhancing the supply of residential mortgage funding. That allowed the government to lean on Fannie and Freddie, or create certain regulatory requirements, to provide funding for mortgage loans to underserved individuals with the aim of expanding homeownership. For instance, in 1996, the Department of Housing and Urban Development [HUD] required that 42 percent of Fannie's and Freddie's mortgage financing should go to borrowers with income levels below the median for a given area.[7]

HUD revised the goals again in 2004, increasing them from 50 percent to 56 percent of their overall mortgage purchases, to be phased in over 4 years. In addition, HUD required that 12

[7] Russell Roberts, "How Government Stoked the Mania," *The Wall Street Journal*, 3 October 2008.

percent of all mortgage *purchases* by Fannie and Freddie be “special affordable” loans. These additional goals were made to borrowers with incomes less than 60 percent of an area’s median income. That number increased to 20 percent in 2000, and to 22 percent in 2005. The 2008 goal was 28 percent. Between 2000 and 2005, Fannie and Freddie met those goals every year, funding hundreds of billions of dollars worth of loans, many made to borrowers who entered into mortgages with down payments of less than 10 percent.[8]

In 1999, under pressure from the Clinton administration to expand home loans among low- and moderate-income groups, Fannie Mae introduced a pilot program in 15 major markets encouraging banks to extend mortgage credit to persons who lacked the proper credit histories to qualify for conventional loans. *The New York Times*, in a prescient comment on the program, remarked: “In moving, even tentatively, into this new area of lending, Fannie Mae is taking on significantly more risk, which may not pose any difficulties during flush economic times. But the government-subsidized corporation may run into trouble in an economic downturn, prompting an economic rescue.”[9]

During this period, the government also began to push Fannie and Freddie into the subprime market. In 1995, HUD agreed to let Fannie and Freddie purchase subprime securities that included loans to low-income borrowers and receive credit toward their affordable-housing goals. Subprime lending, it was thought, benefitted many borrowers who did not qualify for conventional loans. This decision would prove to have profound economic implications more than a decade later when Fannie and Freddie increased their purchases of subprime-backed securities by a dramatic amount to comply with these affordable housing goals.[10]

Subprime and near-prime loans jumped from 9 percent of securitized mortgages in 2001 to 40 percent in 2006. These mortgages required virtually no proof of income and little down payment. Meanwhile, mortgage originators, working alongside investment banks, packaged these dodgy home loans into complex securities and sold them to the financial market. Investors and credit rating agencies fundamentally misjudged the risk of these securities. As long as housing prices kept rising at double-digit rates, the situation was tenable. But this deck of cards was poised to collapse when the housing bubble burst and home prices (the underlying collateral for this system) began to decline.

The so-called “affordable housing” goals and other Federal policies pushed up the homeownership rate, which rose from 64 percent in 1994 to an all-time high of 69 percent in 2005. But these government policies also encouraged Fannie and Freddie to buy riskier loans and encouraged those who might not be ready to afford homes to take out mortgages. Both factors have been key contributors to the housing crisis. This system boosted home prices to an artificially high level and encouraged even greater borrowing and buying by those who could not afford it. Eventually, though, the bubble burst and the resulting wave of foreclosures will end up, ironically, *reducing* homeownership rates across the country.

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[8] Ibid.

[9] Steven A. Holmes, “Fannie Mae Eases Credit to Aid Mortgage Lending,” *The New York Times*, 30 September 1999.

[10] Roberts, op. cit

Fannie and Freddie spent a great deal on lobbying and public relations to preserve the unique private-public status that was at the center of their profit-making dynamic. According to the Associated Press, they "tenaciously worked to nurture, and then protect, their financial empires by invoking the political sacred cow of homeownership and fielding an army of lobbyists, power brokers and political contributors."[11] These lobbyists were especially adept at fending off legislation that might shrink Fannie's and Freddie's investment portfolios or erode their ties to the Federal Government, raising their borrowing costs. In fact, Franklin D. Raines, Fannie Mae's former chairman, once told an investor conference that "we manage our political risk with the same intensity that we manage our credit and interest rate risk," according to an account by Peter J. Wallison and Charles W. Calomiris, experts on GSEs at the American Enterprise Institute [AEI][12]. Raines' statement was undoubtedly true: over the past 10 years, Fannie and Freddie spent more than $174 million in lobbying.

Wallison and Calomiris trace Fannie's and Freddie's heavy involvement in subprime and near-prime mortgages to the period following their accounting scandals in 2003 and 2004 (see further discussion below). They write: "To curry favor with Congress, they sought substantial increases in their support of affordable housing, primarily by investing in risky and substandard mortgages between 2005 and 2007."[13] Data from these critical years before the housing crisis show Fannie and Freddie had a large direct and indirect role in the market for risky mortgage loans. From 2004 through 2006, the two GSEs purchased $434 billion in securities backed by subprime loans. In 2004 alone, the Fannie and Freddie purchased $175 billion in subprime mortgage securities, which accounted for 44 percent of the market that year.[14] Between 2005 and 2007, Fannie's acquisitions of mortgages with less than 10-percent down payments almost tripled. The market responded: although Fannie and Freddie attempted to target the least-risky loans, their purchases provided more cash for a larger subprime market. *The New York Times* notes: "[T]he ripple effect of Fannie's plunge into riskier lending was profound. Fannie's stamp of approval made shunned borrowers and complex loans more acceptable to other lenders, particularly small and less sophisticated banks."[15]

The symbolic act of these implicitly government-backed institutions purchasing these securities often meant more to the market in terms of vouching for the overall system than the sheer volume of their involvement. For instance, Fannie and Freddie became the largest purchasers of the higher-rated (AAA) tranches of the subprime pools that were securitized by the market. AEI scholars conclude that "without their commitment to purchase the AAA tranches of these (subprime) securitizations, it is unlikely that the pools could have been formed and marketed

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[11] Tom Raum and Jim Drinkard, "Fannie Mae, Freddie Mac Spent Millions on Lobbying," the Associated Press, 17 July 2008.

[12] Wallison and Calomiris, "The Last Trillion-Dollar Commitment: The Destruction of Fannie Mae and Freddie Mac," *Financial Services Outlook*, The American Enterprise Institute, September 2008.

[13] Ibid.

[14] Carol D. Leonnig, "How HUD Mortgage Policy Fed the Crisis: Subprime Loans Labeled 'Affordable,' The Washington Post, 10 June 2008.

[15] Charles Duhigg, "Pressured to Take More Risk, Fannie Reached Tipping Point," *The New York Times*, 5 October 2008.

around the world."[16] In other words, Fannie and Freddie played a pivotal role in the growth and diffusion of the mortgage securities that are now crippling the U.S. financial system.

Some defenders of Fannie and Freddie typically point out that, while the companies may have purchased some subprime-related securities for their investment portfolios, they did not package, guarantee, and sell these loans. The data tell a different story. Strictly speaking, Fannie and Freddie can only guarantee "conforming mortgages," loans below a certain dollar limit whose holders meet certain credit criteria. But the GSEs massaged the definition of "conforming loan," eroding the credit quality on these loans. For instance, in May 2008, Fannie and Freddie relaxed the down payment criteria on the mortgages they buy, accepting loans with down payments as low as 3 percent.[17]

More important, both companies markedly stepped up their guarantees on so-called Alt-A (i.e. "alternative") loans in recent years. These loans, dubbed by some analysts as the "new" subprime, require much less paperwork than traditional prime, conforming loans. In fact, these loans did not require the verification of income, savings, or assets for potential borrowers, and some of the more aggressive varieties were interest-only loans that allowed borrowers to defer principal payments.

It turns out that between 2005 and the first half of 2008, Fannie guaranteed at least $230 billion worth of these risky loans, more than three times the amount it had guaranteed on all past years combined (see Figure 3).[18] These Alt-A loans, which are increasingly turning sour amid the housing downturn, ended up being a key part of the mortgage giants' fall earlier this year. Fannie reported that *half* of its credit losses in the second quarter of 2008 came from Alt-A loans.[19] Many of these loans were concentrated in California, Florida, Nevada, and Arizona, where the housing bubble was particularly large and real estate speculation is common.

Wallison and Calomiris of AEI have scrubbed through the detailed investor reports of both Fannie and Freddie to find their *total* exposure to mortgages with subprime characteristics. These are essentially loans originated with the telltale signs of junk mortgages that are now experiencing high rates of defaults and foreclosure. Such a loan will have a Fair Isaac Corporation [FICO]

[16] Wallison and Calomiris, op.cit.

[17] Reuters, "Fannie Mae relaxes loan down-payment requirements," 19 May 2008.

[18] Duhigg, op.cit.

[19] James R. Hagerty, "Fannie, Freddie Share Spotlight in Mortgage Mess," *The Wall Street Journal*, 16 October 2008.

score of less than 620,[20] or a loan-to-value ratio greater than 90; or it may be a so-called "negative amortization" mortgage whose loan payments, at least initially, did not even cover the interest accumulated over each loan period.

The AEI analysis finds that, by the middle of 2008, Fannie Mae was exposed to $619 billion worth of these various mortgages through its primary mortgage guarantee business *and* its investment portfolio purchases. Similarly, Freddie Mac was exposed to roughly $392 billion of mortgages with subprime characteristics by the middle of this year, Wallison and Calomiris found. Therefore, prior to their financial collapse, *Fannie and Freddie held or guaranteed more than $1.0 trillion in unpaid principal balance exposure on various high-risk loans.*[21]

While Fannie and Freddie enjoyed special benefits as government-sponsored enterprises, even these advantages could not protect them from the trouble they created for themselves by pursuing risky investments for higher profits. In 2003 and 2004, Federal officials found that Fannie and Freddie engaged in "extensive financial fraud," which involved manipulating earnings over a 6-year period so that its executives could collect millions of dollars in bonuses.[22] The companies were forced to pay $400 million in penalties for their wrongdoing, but their proponents in Congress continued to defend them from fundamental reform. In 2005, for instance, the Senate Banking Committee reported a strong GSE reform bill that prohibited the companies from holding investment portfolios, but the legislation eventually died. A successful bipartisan effort to rein in Fannie and Freddie could have prevented them from stoking the market for subprime mortgages, and would have narrowed the scope of the problem.[23]

THE GOVERNMENT PUSH TO EXPAND HOMEOWNERSHIP

Through a variety of programs and agencies, the Federal Government, both explicitly and implicitly, promoted lending and borrowing to expand homeownership. These include the home mortgage interest tax exclusion, the Federal Housing Administration [FHA], and the aforementioned housing corporations Fannie Mae and Freddie Mac. The role of Fannie Mae and Freddie Mac in the current crisis is detailed above. An additional component – one that affects private banks – is another homeownership effort called the Community Reinvestment Act [CRA].

The CRA, passed in 1977, encouraged banks to extend credit to "underserved" populations. This caused an 80-percent increase in the number of bank loans going to low- and moderate-income families. The legislation requires that all banks insured by the Federal Government "help meet the credit needs of its entire community." Hence each bank is examined periodically by the Federal

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[20] A FICO score is a measure of credit risk. These scores, the most used in the world, are available through all the major consumer reporting agencies in the United States and Canada: Equifax, Experian, TransUnion, and Pay Rent, Build Credit Inc.

[21] Wallison and Calomiris, op.cit.

[22] Kathleen Day, "Study Finds 'Extensive' Fraud at Fannie Mae," *The Washington Post*, 24 May 2006.

[23] Wallison and Calomiris, "Blame Fannie Mae and Congress for the Credit Mess," *The Wall Street Journal*, 23 September 2008.

agency responsible for supervising it: the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, or the Office of Thrift Supervision.[24]

In 1997, the investment firm Bear Stearns, now bankrupt and taken over by the Federal Government,[25] did the first securitization of CRA loans, a $384-million offering guaranteed by Freddie Mac. Over the next 10 months, Bear Stearns issued $1.9 billion of CRA mortgages backed by Fannie or Freddie. Between 2000 and 2002, Fannie Mae issued $20 billion in securities backed by CRA mortgages.[26]

The Federal Government also has created two affordable housing funds financed through GSEs. The first was established in 1989 and is financed through the Federal Home Loan Banks – 12 private banks that, like Fannie and Freddie, are chartered by the Federal Government. Together, they form a third housing GSE and help infuse liquidity into the housing market. They act as a bank's bank, lending to member banks who pledge mortgages as collaterals to obtain loans.[27]

This fund is really a collection of 12 funds, in that each Home Loan Bank is required to establish an "Affordable Housing Program" to subsidize the interest rates for member banks so they may engage in lending for long-term, low- and moderate-income, owner-occupied and affordable rental housing at subsidized interest rates. Since 1995, the Home Loans Banks have been required to use 10 percent of the previous year's earnings for this subsidized lending, subject to a minimum annual combined contribution of $100 million.

The funds may also give out grants to provide equity for low-income projects. Between 1990 and 2004, the Home Loan Banks have paid out more than $2 billion through their member banks, with nearly 430,000 housing units subsidized. In 2004, $229 million was made available by the banks to subsidize 39,802 units of owner-occupied or rental housing.[28] The program provides an off-budget means for the Congress to fund housing assistance in a way that is hidden from the public.

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[24] Testimony of Sandra F. Braunstein, Director, Division of Consumer and Community Affairs, the Community Reinvestment Act, before the Committee on Financial Services, U.S. House of Representatives, 13 February 2008.

[25] Steven A. Holmes, "Fannie Mae Eases Credit to Aid Mortgage Lending," *The New York Times*, 30 September 1999.

[26] "Fannie Mae Increases CRA Options (Community Reinvestment Act)," *ABA Banking Journal*, November 2000. It should be noted that, notwithstanding the Bear Stearns troubles, analysis suggests that CRA-covered institutions have experienced lower default rates than have independent mortgage originators not covered by the program. This lower default rate for the CRA-covered group holds even after adjusting for the fact that CRA institutions have different overall loan portfolios than do independent mortgage originators. CRA loans have not been free of problems, but relative to non-CRA institutions, their performance has been better.

[27] The Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Public Law 101-73.

[28] *Report of the Horizontal Review of the Affordable Housing Programs of the Federal Home Loan Banks*, 15 March 2005.

The second fund came in 2008, enacted into law on 30 July 2008.[29] Payments – divided into two separate components, the Housing Trust Fund and the Capital Magnet Fund – are borne by Fannie and Freddie, who are each required to pay into the funds 4.2 basis points for each dollar of unpaid principal balance of their total new business purchases into the funds. These payments are to be used by the Federal Housing Finance Agency [FHFA] to increase and preserve the supply of rental housing for the low-income and homeless, and to increase home ownership for "low- and extremely low-income persons." The Congressional Budget Office estimated this fund would pay out $5.8 billion in subsidies through 2018.[30]

In each of the affordable housing funds paid for by the three GSEs, the director of the FHFA may suspend the payments if he finds they would contribute to their financial instability. It is unclear, now that Fannie and Freddie are in conservatorship, whether the payments into the Housing Trust Fund and the Capital Magnet Fund will continue.

Today, 3 million to 4 million families are expected to lose their homes to foreclosure because they cannot afford their high-interest subprime loans. Lower-income and minority home buyers, those supposed to benefit from the government's actions, are falling into default at a rate three times that of other borrowers. With these defaults, the damage to homeowners, neighborhoods, State and local governments as the tax base shrinks, and now to all American taxpayers, is immense.[31]

FAILURE OF OVERSIGHT AND PRIVATE-SECTOR MALFEASANCE

While government policies set the stage for the housing crisis, there were also serious failures among private-sector actors and institutions at each step of the so-called "originate-to-distribute" model of mortgage credit: at loan origination, securitization, rating, and risk management. As Fed Chairman Bernanke has put it, the model "spreads risk and reduces financing costs, offering greater access to capital to a wide range of borrowers while allowing investors greater flexibility in choosing and managing credit exposures."[32] But severe weaknesses in application of the model played key roles in the current financial crisis, as described below.

Mortgage Originators. Mortgage originators had lax underwriting standards, extending loans to subprime borrowers with little income documentation and no money down. Part of the problem at this step, the critical point at which customers are being sold loans, was that the mortgage originators focused on the quantity of loan amounts and not the quality of the underlying loans, because revenues were tied closely to volume. The compensation of mortgage brokers was also tied to the interest rates and fees paid by customers, which gave the broker a financial incentive to

[29] H.R.3221, the Housing and Economic Recovery Act of 2008, Public Law 110-289.

[30] Congressional Budget Office, H.R. 3221, the Housing and Economic Recovery Act of 2008, 23 July 2008.

[31] Leonnig, op.cit.

[32] Bernanke, remarks at the Federal Reserve Bank of Chicago's Annual Conference on Bank Structure and Competition, 15 May 2008.

push clients into subprime, rather than lower-cost prime loans. At Countrywide, for instance, brokers who sold subprime loans received commissions that were more than twice as high as the commissions for higher-quality loans.[33] Given some of these incentives among originators and brokers, it is not clear that consumers had access to all the information needed to decide which type of mortgage loan to select. Other evidence suggests that there was outright fraud in the origination of mortgage loans.

Securitizers. Loan packagers and securitizers then pooled these mortgages together and created complex and often opaque structured products from these loans, such as mortgage-backed securities [MBS] and collateralized debt obligations [CDO]. These structured products were sometimes used to create other structured products, in so-called "two-layer securitizations." The bottom line is that these products were far more complex than their plain-vanilla predecessors and their returns could be quite volatile.

Credit Rating Agencies. Credit rating agencies, meanwhile, failed to adequately measure the risks of these new products, especially their performance if home prices fell sharply. Chairman Bernanke has noted that the methodologies, data, and even the underlying assumptions the agencies used to rate these products proved "deficient" in many instances.[34] These credit-rating agencies were paid by the sellers of mortgage-backed securities, creating a disincentive to fully reflect the risks of these products. Many of the securities were highly rated at inception, but when mortgage defaults increased and losses began to mount, these securities were sharply downgraded. The sharp ratings move from investment grade to "junk" undermined investor confidence in many asset-backed securities as well as the credit rating agencies themselves.

Investors. Private investors often failed to perform their due diligence on these mortgage-backed products, put too much faith in the rating agencies, and did not fully appreciate the risks involved.

Risk Management. Financial institutions failed to adequately manage their firm-wide exposures to these products. Some of these products were even maintained off the balance sheet in special conduits (structured investment vehicles, or SIVs). When investors eventually pulled back from these products, some institutions had to bring these vehicles back onto their balance sheets, creating funding pressures and declines in capital ratios. Ultimately, these institutions were forced to hoard capital and could not extend new credit to the economy.

Regulatory Practices. Certain aspects of the regulatory structure, taken together, have inadvertently exacerbated the market turmoil. Especially significant are the "mark-to-market" accounting rule, the abolition of the so-called "uptick rule," and the expanding use of financial instruments known as "credit default swaps."

The mark-to-market standard obligates financial institutions to value their mortgage-related assets at current market prices. But a hallmark of this financial crisis is that the market for these assets has essentially dried up. That means "current" asset valuations are based on fire-sale prices driven by market fear and a lack of liquidity rather than reasonable estimates of fundamental value. The

[33] Gretchen Morgenson, "Inside the Countrywide Lending Spree," *The New York Times*, 26 August 2007.

[34] Ben S. Bernanke, remarks at the Federal Reserve Bank of Chicago's Annual Conference on Bank Structure and Competition, 15 May 2008.

mark-to-market rule has forced many important financial institutions to sharply write down the values of their assets during this period of market turmoil, presenting an excessively negative impression of their financial health and solvency. A number of analysts have recommended suspending or reforming mark-to-market accounting during this period of intense market turbulence. One potential reform would entail the use of some sort of rolling, historical average to value these assets, rather than simply a moment-by-moment market snapshot.

Some analysts also have criticized last year's decision by the Security and Exchange Commission to abolish the so-called "uptick rule." The rule, in effect since the late 1930s, required that an investor betting on a declining stock price could only initiate a transaction to "sell short" after the stock had moved up in price. This regulation was meant to prevent sharp declines in stock prices that can result from short sellers manipulating the market. Restoring the "uptick rule" could dampen some of the extreme volatility that has been roiling markets in this period of crisis.

The use of "credit default swaps" [CDS], complex financial derivatives that transfer the default risk on underlying securities between buyers and sellers, have grown tremendously over the past decade and have linked many large financial institutions to one another based on their exposures and activity in this market. The problem is that this market is not transparent, because these derivatives are traded "over the counter," rather than on a regulated, exchange-traded platform. Lacking any centralized clearinghouse for these CDS means regulators cannot adequately track the volumes and prices of these increasingly important financial instruments, and cannot gauge which institutions are building up potentially dangerous levels of exposure to these contracts. Many financial market experts have proposed moving the CDS to a more standardized, exchange-traded platform, making this market more transparent. The shift to a centralized clearinghouse for these trades would also allow the SEC to better investigate fraud and manipulation in this market.

Adjusting these rules, which were mostly instituted during more "normal" market conditions, could restore much-needed stability and confidence to financial markets.

Efforts to Influence Key Policymakers. Countrywide, the Nation's biggest mortgage lender before the housing crash, tried to curry favor with policymakers by offering low-cost loans to Members of Congress, officials at HUD, and executives at Fannie and Freddie. As part of its VIP loan program, Countrywide offered loans with favorable terms to officials such as Henry G. Cisneros and Alfonso R. Jackson, former HUD secretaries; James A. Johnson, Daniel H. Mudd, and Franklin D. Raines, former chief executives of Fannie Mae; Jamie S. Gorelick, former vice chairman of Fannie Mae; and certain well-positioned Members of the U.S. Senate.[35] Countrywide also had a close, mutually beneficial relationship with Fannie Mae. Countrywide was Fannie Mae's biggest customer. In 2007, one-third of the mortgages Fannie purchased and guaranteed came from Countrywide.[36] Some former Countrywide officials now occupy high-level jobs at Fannie and Freddie.[37] This close relationship is particularly troublesome given Countrywide's

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[35] Dan Golden, "Angelo's Many 'Friends,'" *Conde Nast Portfolio*, August 2008; and "Countrywide Made Home Loans to Gorelick, Mudd – Leading Democrat, Ousted Fannie Chief Deny Any Favoritism," *The Wall Street Journal*, 25 September 2008.

[36] Maurna Desmond, "B of A's Bailout Benefit," Forbes.com, 8 September 2008.

[37] Dan Golden, "Angelo's Fannie Pack," *Conde Nast Portfolio*, 17 July 2008.

role in the subprime mortgage mess. The company was the largest peddler of subprime mortgages in 2006 and 2007 and it is currently facing lawsuits from States claiming it used hidden fees and false marketing claims in its mortgage originations.[38] Countrywide has also been under investigation by the FBI for misrepresenting the quality of its mortgages in securities filings.[39]

CONCLUSION

The financial crisis that unfolded this year had numerous causes, and Wall Street is not free of blame. Clearly the government must modernize its regulatory system, improve transparency, and assure those who take risks are fully accountable for their actions.

But the government stood at the center of the crisis. Whether through artificially low interest rates, a push to expand lending to those who lacked the means to repay it, or the securitization or purchase of risky mortgage-backed securities sold as though they held AAA quality, the government – through its agencies or the housing GSEs – was the driving force behind the troubles that developed.

Congress must recognize the ways in which government contributed to the problem, and should guard against a regulatory over-reaction formulated in the heat of the current crisis that may have unintended consequences down the road. Harvard economist Edward L. Glaeser, writing in *The New York Times*, laid out a commonsense goal for any reform agenda: "We do need new and better regulations, but the current public mood seems to be guided more by a taste for vengeance than by a rational desire to weigh costs and benefits. Before imposing new rules, we need to think clearly about what those rules are meant to achieve and impose only those regulations that will lead our financial markets to function better."[40]

[38] Bob Ivry and David Mildenberg, "Bank of America's Countrywide Tab Signed by Taxpayers," *Bloomberg*, 25 June 2008

[39] Riley McDermid, "Probe looks at Countrywide's origination practices," *The Wall Street Journal*, 11 March 2008.

[40] Glaeser, "Better, Not Just More, Regulation," *The New York Times*, 28 October 2008.

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