Not a Failure of Capitalism—A Failure of Government

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Since the beginning of the turmoil in the financial markets that is now commonly referred to as the "financial crisis," many voices have asserted that this is a "crisis of capitalism." These are not merely the voices of socialist groups, who could be expected to see this event as a vindication of their views;[1] government officials also joined the chorus,[2] as did many commentators on financial matters. As Samuel Brittan observed early in the mortgage meltdown that ultimately became the financial crisis, "Any failures on the financial side are sure to bring the opponents of capitalism out of their burrows. Pundits who until recently conceded that 'capitalism is the only game in town' are now rejoicing at what they hope is the longed-for death agony of the system."[3] Billionaire investor George Soros, who had been arguing at least since 1997 that the capitalist system was "coming apart at the seams," finally found vindication, telling a group in New York in February 2009, according to a Bloomberg News summary, that "the current economic upheaval has its roots in the financial deregulation of the 1980s and signals the end of a free-market model that has since dominated capitalist countries."[4] In 2009, the debate over the responsibility of capitalism for the current crisis rose to such significance that the *Financial Times* ran a gloomy series on the future of capitalism.[5]

An examination of these contributions shows that, with the exception of the socialist view, the critics are not actually recommending the abandonment of a market system but only the imposition of stronger forms of government control over markets through greater regulation and supervision. Much of the rhetoric about

[1]Barry Grey, "The Wall Street Crisis and the Failure of American Capitalism," World Socialist Website (16 September 2008): www.wsws.org/articles/2008/sep2008/lehm-s16.shtml.

[2]Chris Giles and Jean Eaglesham, "Another Country?" *Financial Times* (20 April 2009), quoting President Nicolas Sarkozy of France after the G–20 meeting in April 2009 that the world had "turned the page" on the dominant model of Anglo-Saxon capitalism; see also "Global Crisis 'Failure of Extreme Capitalism': Australian PM," Breitbart.com (15 October 2008): www.breitbart.com/article.php?id=081015113127.9uzhf7lf&show_article=1.

[3]Samuel Brittan, "The Financial Crises of Capitalism," *Financial Times* (8 May 2008).

[4]Walid el-Gabry, "Soros Says Crisis Signals End of a Free-Market Model (Update 2)," Bloomberg.com (23 February 2009): www.bloomberg.com/apps/news?pid=newsarchive&sid=aI1pruXkjr0s.

[5]www.ft.com/indepth/capitalism-future.

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crises or failures of capitalism either posits a straw man—an unfettered laissez-faire capitalism that does not exist in the United States, or for that matter anywhere else—or suggests that excessive deregulation has allowed banks to take excessive risks. It has certainly not been the policy of the U.S. government to allow financial markets to "regulate themselves," as some have claimed, although safety and soundness regulation—the supervision of the financial health of institutions—has been limited at the federal level to banks and to two government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac. Such regulation is logical because commercial banks are backed by the government through deposit insurance, a lender of last resort facility offered by the Federal Reserve, and a Federal Reserve payment system to which only banks have access. The GSEs, although not explicitly backed by the government, were seen in the markets as performing a government mission and, hence, as being government backed. Once any kind of financial institution is seen as being backed by the government, market discipline is severely impaired, and—to protect itself against losses—the government must impose some kind of safety and soundness regime.

Other major participants in financial markets—securities firms and insurance companies—are not backed by the government and are thus subject to a far less intrusive regulatory regime than banks are, but they nevertheless function within a complex web of regulation on business conduct and consumer protection. The condition of the banking industry today, far from offering evidence that regulation has been lacking, is actually a demonstration of the failure of regulation and its inability to prevent risk taking. Because this is not the first time that regulation has failed to prevent a major banking crisis, it makes more sense to question whether intrusive and extensive financial regulation and supervision is a sensible policy rather than to propose its extension to other areas of the financial sector.

What most critics of the current system do not seem to recognize is that the regulation of banks has been very stringent, particularly in the United States. As I will show, the commercial banks that have gotten themselves into trouble did so *despite* strong regulation. This is an uncomfortable fact—maybe what some would call an "inconvenient truth"—for those in the Obama administration and elsewhere who are advocating not only more regulation but also extending it to the rest of the financial system.

The critics seem to have been led into error by a faulty kind of inductive logic. It begins with the assumption that capitalism, if left unchecked by regulation, will produce instability. Thus, when instability appears—as it certainly has in the current financial crisis—it must be the result of a failure to adequately regulate financial markets. With this logical underpinning, critics almost uniformly make no effort to describe the "deregulation" that they are certain must have occurred. They may name a statute, such as the Gramm–Leach–Bliley Act of 1999, but they never explain how that law led to the current financial crisis, or any part of it. And because

they assume their worldview is correct almost by definition, they also assume that the evidence is there to support it and that actual evidence does not need to be collected or critically examined. A more logical—and less ideological—approach would be to look for the causes of instability first and to propose an appropriate remedy after the causes have been established. As I will argue later, if that had been done by the critics in this case, their indictment would not have extended to capitalism, or even the lack of regulation, but to government intervention in the housing finance system in the United States.

Did Deregulation or Nonregulation Cause the Financial Crisis?

A good example of the faulty approach to the causes of the financial crisis is the recent book *A Failure of Capitalism* by Judge Richard Posner. Certainly the most surprising member of the group that sees deregulation as the cause of the crisis, Judge Posner is a highly respected and prolific writer of articles and books as well as legal opinions. Because of his reputation as a leader of the judiciary and an advocate of using economic analysis to address legal questions, his position has attracted a lot of attention from the media, with reviews and articles in the *New York Times*, *New York Review of Books*, and the *Atlantic Monthly*. But like so many other critics, Judge Posner merely asserts that deregulation is the cause of the financial crisis; he never cites the laws he is blaming. Where he describes deregulation without citing actual laws, he gets it wrong in material respects. Moreover, and perhaps more important, he never successfully connects the "deregulation" he identifies with the causes of the crisis in any way that makes sense either as economics or logic.

An example is what seems to be the central argument in the book—that "deregulation" permitted other financial firms, particularly money market mutual funds, to compete with banks, requiring banks to pay more for their money and, in turn, seek and obtain deregulatory action that allowed them to take greater risks in their lending. Here is the argument in his words:

> One thing that made banks safe was that they were forbidden to pay interest on demand deposits, traditionally their major source of capital. . . [M]oney market funds arose to provide people with checkable accounts, just like bank accounts (although uninsured)—except that they paid interest. . . . The deregulatory strategy of allowing nonbank financial intermediaries to provide services virtually indistinguishable from those of banks, such as interest-bearing checkable accounts offered by money market funds, led inexorably to a complementary deregulatory strategy of freeing banks from the restrictions that handicapped them in competing with unregulated (or very lightly regulated) financial intermediaries—nonbank banks, in effect.

> As regulatory and customary restrictions on risky lending by banks eroded, banks became willing to make "subprime" mortgage loans—a euphemism for mortgage loans at high risk of defaulting.[6] (pp. 22–23)

There are many errors in this argument, and it is hard to know where to begin. First, money market funds were not the result of any kind of "deregulation." They were a product spawned by the mutual fund industry to take advantage of an ill-founded rate regulation on banks—the cap on bank interest rates that had been imposed by government regulation many years before. During the inflationary period of the late 1970s and early 1980s, interest rates in the money markets rose far above the 5 percent cap on bank interest allowed by a Fed-imposed limitation known as Regulation Q. As a result, funds flowed out of banks and into other instruments, such as Treasury bills and commercial paper. These instruments were sold in large principal amounts and were thus not suitable for retail investors.

Money market funds were an innovation that enabled retail investors and small businesses to participate directly in the safety and stability of investing in government securities and high-quality commercial paper by purchasing shares of a money market fund, which, in turn, bought and held these safe money market instruments. Prior to the advent of money market funds, bank deposits were the safest instruments for the retail investment because they were government insured. If bank interest rates had not been capped by government action, money market funds might never have developed. So, government *regulation* of bank deposit rates, not deregulation, was the initial cause of the competition banks encountered from money market funds.

Second, there is no evidence whatsoever that the higher costs of competing with money market funds caused banks to take greater risks in their lending, such as by purchasing subprime mortgages. For one thing, the threat from money market funds began in the late 1970s and accelerated in the 1980s until Regulation Q was abolished. Subprime lending did not begin in any size until more than 10 years later, in the mid-1990s, and did not become a major feature of the mortgage market until the early 2000s. The connection that Judge Posner draws between bank competition and bank risky lending on mortgages is simply wrong.

In addition, the idea that paying a market rate for funds might weaken banks, or require them to take more risks, harks back to the discredited idea—popular during the New Deal—that "excessive competition" is bad because it can be "ruinous" to competitors. The *benefit* of competition comes from the fact that it is ruinous to the less-effective competitors, forcing resources to flow to the more-effective ones. The focus on the health of individual firms, rather than on the benefits of competition itself for consumers and the health of the economy generally, is one of the mistakes most commonly made when discussing economics.

[6] Richard A. Posner, *A Failure of Capitalism: The Crisis of '08 and the Descent into Depression* (Cambridge, MA: Harvard University Press, 2009).

Glass–Steagall "Repeal." Another favorite target of the critics who are searching for deregulation in the U.S. financial system is the so-called repeal of the Glass–Steagall Act of 1933 by the Gramm–Leach–Bliley Act of 1999. For example, Kaufman writes:

> If you're looking for a major cause of the current banking meltdown, you need seek no farther than the 1999 repeal of the Glass–Steagall Act. . . . According to Wikipedia, many economists "have criticized the repeal of the Glass–Steagall Act as contributing to the 2007 subprime mortgage financial crisis. The repeal enabled commercial lenders such as Citigroup, the largest U.S. bank by assets, to underwrite and trade instruments such as mortgage-backed securities and collateralized debt obligations and establish so-called structured investment vehicles, or SIVs, that bought those securities."[7]

Wikipedia got it wrong. The portions of the 1933 Glass–Steagall Act relevant to this discussion consist of four small sections of text that did two things—prohibited commercial banks from (1) owning or dealing in securities or (2) being *affiliated* with firms that engage in underwriting or dealing in securities (i.e., investment banks). The Gramm–Leach–Bliley Act of 1999 (GLBA) repealed the affiliation restrictions of Glass–Steagall but left the restrictions on banks' securities activities intact. Thus, before the repeal, commercial banks could not underwrite or deal in securities, and the same rules applied to them after repeal. The only difference was that, after repeal, they were able to affiliate through subsidiaries and holding companies with firms engaged in underwriting and dealing in securities. In other words, the GLBA made no changes in what commercial banks themselves were permitted to do in the securities field. They remained forbidden to deal in or underwrite securities, including mortgage-backed securities or the other instruments mentioned in the Wikipedia entry.

But what about the affiliation repeal? Could it reasonably be argued that the affiliations now permitted between commercial banks and investment banks somehow caused commercial banks to take more risks or to behave less like banks? This is highly unlikely. Although all of the banks that got into trouble in the current financial crisis had securities affiliates, they got into financial difficulties because they made imprudent decisions as *banks*, not because of the activities of their securities affiliates. Citibank, Bank of America, Wachovia, IndyMac Federal Bank, Wells Fargo, and the rest weakened themselves by purchasing securities backed by mortgages and other assets that banks are allowed to hold as investments (but not to deal in or underwrite). Under banking rules, both before and after the repeal of the affiliation restrictions in Glass–Steagall, banks were permitted to hold asset-backed

[7]William Kaufman, "Shattering the Glass-Steagall Act," *Counterpunch* (19 September 2008): www.counterpunch.org/kaufman09192008.html. See also Nigel Lawson, "Capitalism Needs a Revived Glass-Steagall," *Financial Times* (15 March 2009).

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securities if the underlying assets, such as mortgages and credit card receivables, were assets that banks were generally permitted to hold.[8] In other words, the claim that the GLBA, by repealing Glass–Steagall's affiliation provisions, enabled banks to invest differently from how they could before the GLBA is wrong.

Similarly, none of the investment banks got into trouble because of the affiliations with banks that were permitted after the GLBA. Although all of them had small banks or S&Ls (savings and loan associations) as subsidiaries, the parent companies—Bear Stearns, Lehman Brothers, Merrill Lynch, Morgan Stanley, and Goldman Sachs—were completely independent of control by banks or bank holding companies and also got into trouble by making the same imprudent investments they were allowed to make before the GLBA was passed. In other words, the repeal of Glass–Steagall's affiliation provisions had no effect on these investment banks and was not responsible for the losses they suffered by holding mortgage-backed and other risky securities as assets.

"Deregulation" of Credit Default Swaps. One final argument concerning deregulation is the claim that deregulation or a mania for free markets caused the Clinton administration and the U.S. Congress to deregulate credit default swaps (CDS). The episode is complicated, but it is not an example of deregulation because CDS had *never* been regulated. In 1999, the chair of the U.S. Commodity Futures Trading Commission (CFTC) asserted that CDS were subject to regulation by the CFTC. Because the assertion raised questions about the continued legality of trading in these derivatives, the Clinton administration (including Robert Rubin and Lawrence Summers at the U.S. Department of the Treasury and Arthur Levitt at the U.S. Securities and Exchange Commission) sought legislation that would permanently bar the CFTC from regulating these swap transactions, thus removing any doubt as to the legality of the unregulated CDS market.

The role of credit default swaps in the financial crisis has been as exaggerated as the role of the Glass–Steagall "repeal." Once again, the complexities of the matter have eluded the media, which have simply reported what they were told by people who were themselves speculating about the effect of CDS. There is no evidence that CDS caused any serious losses to any individual firm or the market as a whole after Lehman Brothers failed, and there is no evidence that American International Group (AIG) had to be bailed out because its CDS liabilities would have damaged the market or caused a systemic breakdown.

Many of the media stories about AIG have focused on AIG's Financial Products subsidiary and the obligations that this entity assumed through CDS. However, it is highly questionable whether there would have been a significant market reaction if AIG had been allowed to default on its CDS obligations in

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[8] See Title 12, Code of Federal Regulations, Part 1, Sections 1.1–1.3.

September 2008. CDS are guarantee contracts that pay off when an issuer of a security defaults. If a CDS issuer fails, it is much the same as when a homeowner's insurance company goes out of business before there has been a fire or other loss to the home. In that case, the homeowner must go out and find another insurance company, but he has not lost anything except the premium he has paid. If AIG had been allowed to default, there would have been little if any near-term loss to the parties that had bought protection; they would simply have been required to go back into the CDS market and buy new protection. CDS contracts normally require a party like AIG that has sold protection (i.e., agreed to reimburse a counterparty's loss) to post collateral as assurance to its counterparties that it can meet its obligations when they come due. The premiums for the new protection might have been more expensive than what they were paying AIG, but even if that were true, many of AIG's counterparties had received collateral from AIG that could have been sold to defray the cost of the new protection.[9]

This analysis is consistent with the publicly known facts about AIG. In mid-March, the names of some of the counterparties that AIG had protected with CDS became public. The largest of these counterparties was Goldman Sachs. AIG's obligation to Goldman was reported as $12.9 billion; the others named were Merrill Lynch ($6.8 billion), Bank of America ($5.2 billion), Citigroup ($2.3 billion), and Wachovia ($1.5 billion). Recall that the loss of CDS coverage—the obligation in this case—is not an actual cash loss or anything like it; it is only the loss of a guarantee against a possible future default on a debt that is held by a protected party. For institutions of this size, with the exception of Goldman, the loss of AIG's CDS protection would not have been a problem, even if they had in fact already suffered losses on the underlying obligations that AIG was protecting. Moreover, when questioned about what it would have lost if AIG had defaulted, Goldman said its losses would have been "negligible." This claim is entirely plausible. Goldman's spokesman cited both the collateral it had received from AIG under the CDS contracts and the fact that it had hedged its AIG risk by buying protection from third parties against the possibility of AIG's default.[10] Also, as noted earlier, Goldman only suffered the loss of its CDS *coverage*, not a loss on the underlying debt the CDS was supposed to cover. If Goldman, the largest counterparty in AIG's list, would not have suffered substantial losses, then AIG's default on its CDS contracts would have had no serious consequences in the market.

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[9]A full description of the operation of credit default swaps appears in Peter J. Wallison, "Everything You Wanted to Know about Credit Default Swaps—But Were Never Told," *Financial Services Outlook* (December 2008): www.aei.org/publication29158.

[10]Mary Williams Walsh, "A.I.G. Lists Banks It Paid with U.S. Bailout Funds," *New York Times* (16 March 2009).

Inadequate Regulatory Authority. Finally, after considering all the allegations about the relationship between deregulation and the financial crisis, it is necessary to consider whether the problem is one of insufficient regulatory authority, rather than deregulation. The problem might not be that regulatory authority was taken away from the regulators by deregulation but simply that it was never given to them at all. That argument, however, is not supported by the facts. Since 1991, the regulators of all insured banks have had plenty of authority to crack down on bank risk taking. Their authority was significantly *strengthened* immediately after the S&L debacle, when much of the S&L industry collapsed and almost 1,600 commercial banks were closed by the FDIC. At that point, Congress adopted the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), a reform measure developed by the first Bush administration. FDICIA was a very tough regulatory law. Among other things, it provided for prompt corrective action (PCA) by supervisors when a bank's capital position began to erode. As that happened, PCA required regulators to take increasingly stringent actions to control the bank's activities and to close the bank entirely if they believed that it would become insolvent in the future. The law also provided for personal fines of up to $1 million a day on bank directors and officers who violated bank regulations. FDICIA was so tough that Alan Greenspan, then the chair of the Federal Reserve, complained that it was too tough on banks. He might have been on to something. Now, 18 years later, we are in the midst of the worst banking crisis since the Great Depression.

Thus, none of the explanations for the financial crisis that blame capitalism or deregulation, or Glass–Steagall, or any one of a number of other alleged deficiencies in the regulatory regime applicable to banks, has any validity. The banking system is in very bad shape today, as is the world's economy, but none of the explanations usually advanced by commentators, and reported in the media, can be plausibly shown to be a cause of the financial crisis.

If Deregulation or Nonregulation Did Not Cause the Financial Crisis, What Did?

Many analyses of the current crisis have pointed to the existence of a massive housing bubble that—according to the Case–Shiller Index—began to deflate in mid-2006. There is no question that the deflation of any large asset bubble will cause a downturn in the U.S. economy. Before the collapse of the housing bubble, a similar asset bubble in internet-related equities (known as the dot-com or tech bubble) caused a huge stock market decline and a recession when it deflated in 2001. Asset bubbles of various kinds are not unusual or unexpected, but they do not always cause worldwide financial crises. The key question is why the housing bubble that began to deflate in 2006 or 2007 had this effect.

It is a widely held, although by no means universally accepted, view that a principal cause of the Great Depression was government policy—particularly the actions of the Federal Reserve in tightening rather than loosening the money supply and credit as a major recession took hold. It is my view that U.S. government policy is again responsible for the current financial crisis. An explanation begins with some numbers that are not well known—even now. There are 25 million subprime and other nonprime mortgages currently outstanding in the United States, with an unpaid principal balance of more than $4 trillion. Subprime mortgages are loans made to people with blemished credit and low scores on the measures that are used to estimate credit quality. Other nonprime mortgages, which I will call Alt-A in this article, are considered poor quality because of the characteristics of the loans themselves and not the borrowers. Alt-A loans have adjustable rates, no or low down payments, and negative amortization or were made to people who did not have to state their income or to people whose income or jobs were not verified. Many of these borrowers were not intending to live in the homes they were buying but were investing or speculating in housing.

Twenty-five million subprime and Alt-A loans amount to almost 45 percent of all single-family mortgages in the United States. These poor quality mortgages are defaulting at unprecedented rates. As these mortgages decline in value, so does the capital and the financial condition of every bank and financial institution that is holding them. These include not only U.S. banks and financial institutions but also banks and other financial institutions around the world that invested in these mortgages, usually through mortgage-backed securities (MBS). More than any other cause, the sharp decline in the value of these mortgages accounts for the worldwide financial collapse we are now experiencing.

Financial institutions invested in these mortgages because they believed from historical evidence that Americans always pay their mortgages. This was certainly true when almost all mortgages were prime—made to people with jobs and substantial down payments and at fixed interest rates for 30 years. Even in the worst downturns, foreclosure rates rarely reached 4 percent. However, some projections of foreclosure rates for the subprime and Alt-A loans in the current downturn run as high as 30 percent—a completely unprecedented phenomenon, exceeding even the Great Depression.

The boom in subprime and Alt-A mortgages is something entirely new. These instruments always existed but were a small part of the total mortgage pool because of their high-risk characteristics. It was possible to have a profitable business as a subprime mortgage lender, but it was necessary to obtain a substantial risk premium to compensate for the high rate of foreclosure and loss. However, as outlined later, beginning in the early 1990s and continuing until 2007, government policy artificially inflated the value of subprime and Alt-A loans, reducing the necessary risk premium and leaving the holders of these mortgages with serious losses as they began to default.

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The government policies that ultimately caused these developments have a long history. Since the beginning of the 20th century, the United States has had a policy of fostering homeownership. This policy caused regular economic downturns as the government attempted by various means to make it easier for Americans to buy homes. As reported by Steven Malanga, the first major campaign along these lines was initiated by Herbert Hoover, who was alarmed by a decline in homeownership revealed by the 1920 census.[11] Hoover began a campaign to increase homeownership, and Congress cooperated in 1927 by freeing banks to make more mortgage loans. Homeownership rates did indeed improve, rising from about 46 percent when Hoover began his program to almost 48 percent in 1930, but the number of defaults rose substantially during the ensuing depression. After World War II, there was another effort to increase homeownership, but Malanga observes:

> As homeownership grew, political pressure to allow riskier loans increased. . . . Under pressure to keep meeting housing demand, the government began loosening its mortgage-lending standards [on FHA and VA loans]—cutting the size of required down payments, approving loans with higher ratios of payments to income, and extending the terms of mortgages. (pp. 3–4)

The failure rate on these government-backed mortgages spiked, but Malanga notes, "the foreclosure rate of conventional mortgages barely increased, since many traditional lenders had maintained stricter underwriting standards, which had proved a good predictor of loan quality over the years" (p. 4).

The differences between government policy and private-lending policies began to change in 1977, with the adoption of the Community Reinvestment Act (CRA), which gave regulators the right to deny bank applications for expansion if an applicant had failed to lend sufficiently in minority neighborhoods. As Malanga reported, the most significant denial came in 1979, when the Greater New York Savings Bank was denied the opportunity to open a branch on the Upper East Side of Manhattan because it had not lent enough in its Brooklyn home market. In the early 1990s, the Clinton administration revised the regulations under CRA so that banks were required to make the loans, not just show good faith efforts to find borrowers in underserved communities. That was a turning point. Although the government had previously taken the risks of making weak loans, now—through CRA—the government was requiring private banks to take risks they had previously eschewed.

Many of the communities that CRA was intended to benefit contained borrowers who had blemished credit or no money for down payments or who did not have steady jobs or incomes. That did not excuse banks from making mortgage loans to these borrowers. They were directed to use "flexible underwriting

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[11] Steven Malanga, "Obsessive Housing Disorder," *City Journal* (Spring 2009): www.city-journal.org/printable.php?id=4376.

standards." The bank regulators were supposed to enforce these rules. In effect, the regulators were required to suspend their normal attention to prudent lending. Loans they formerly would have criticized, they now had to consider good loans. In a letter sent to shareholders, the chairman of a local bank in Colorado described the difficulties of dealing with the regulators about CRA (the name of the bank has been withheld for obvious reasons):

> Under the umbrella of the Community Reinvestment Act (CRA), a tremendous amount of pressure was put on banks by the regulatory authorities to make loans, especially mortgage loans, to low income borrowers and neighborhoods. The regulators were very heavy handed regarding this issue. I will not dwell on it here but they required [our bank] to change its mortgage lending practices to meet certain CRA goals, even though we argued the changes were risky and imprudent.[12]

In the end, CRA did not produce enough weak loans to create a financial crisis, but it began the process of degrading the quality of mortgages to make them affordable for borrowers who had previously not been able to meet normal lending standards in the prime market. The flexible underwriting standards that the government wanted the banks to use really meant lowering down payments and not insisting on income, a steady job, or unblemished credit. The low-quality mortgages that were required by CRA—and approved by bank regulators—gradually spread to the rest of the mortgage market. By 2006, almost half of all mortgages made in the United States were subprime or Alt-A.

The vehicles for creating this astonishing growth of low-quality loans were two companies that were also subject—like regulated banks—to direct control by Congress: Fannie Mae and Freddie Mac. Being GSEs, Fannie and Freddie were—until they were taken over in September 2008 because they were insolvent—shareholder-owned entities that were chartered by Congress to perform a specific government mission. Initially, this mission was to maintain a liquid secondary market in residential mortgages, but their mission was expanded in 1992 to include promoting affordable housing. This obligation was backed up by regulatory authority that Congress granted to the U.S. Department of Housing and Urban Development (HUD). HUD's affordable housing regulations, implementing the new affordable housing mission of the two GSEs, were to be very important elements in the growth of subprime and other low-quality mortgages.

The importance of the GSEs sprang from their ability to access substantial and low-cost funding because of their perceived connection to the U.S. government. There were many reasons for this perception, but the fact that they were chartered by Congress to perform a government mission was probably the most important. Their government backing enabled them to raise funds cheaply—paying only a little more than the U.S. Treasury itself—and in virtually unlimited amounts. In addition,

[12] Letter, dated 20 January 2009, in possession of author.

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their capital requirements were set by statute at a very low level, so they were able to operate at leverage of 60:1. These advantages enabled them to dominate the mortgage finance market; by 2003, they were buying about 57 percent of all mortgages made that year and 79 percent of all the loans that fell within their lending limits.

HUD's requirements that Fannie and Freddie promote affordable housing were gradually escalated over the years. Initially, in the early 1990s, 30 percent of the mortgages that Fannie and Freddie purchased from banks and other originators had to be loans made to low- and moderate-income (LMI) borrowers. By 2005, about 55 percent had to be LMI and 25 percent had to be to low- or very low-income borrowers. The real work in reducing the quality of mortgage loans was, therefore, done by Fannie and Freddie, operating under the lash of HUD's affordable housing regulations.

By the time they were taken over by the government in September 2008, Fannie and Freddie were responsible for the credit risk on approximately $5.3 trillion in mortgages that they either held in portfolio or had guaranteed through MBS. Thus, when Fannie and Freddie started to reduce the quality of the loans they would buy from banks and others, it had a real impact on what kinds of loans the market produced. Their initial steps were modest, and the subprime and Alt-A loans they bought were generally of high quality within that group. But by 1998, Fannie was offering a mortgage with a 3 percent down payment, and by 2001, a mortgage with no down payment at all. During the 2000–03 period, when unusually low interest rates drove huge numbers of refinancings, Fannie and Freddie bought about $1.3 trillion of subprime and Alt-A loans and securities, amounting to about 25 percent of their total purchases in those years. Many of these would be prepaid or refinanced in later years because they were made to buyers who could not, or had no intention to, pay the cost of these loans when interest rates rose. As long as housing prices were rising, it was possible for home buyers to prepay their mortgages by selling the home for more than the principal amount of the loan, or in cases where they received a low "teaser" rate, to refinance into another short-term loan at a low rate before the loan reset to a higher market-based rate.

But in 2004, both GSEs started on what can only be called a binge. Over the period from late 2004 to 2007, when interest rates had risen again and refinancings were not driving volume, they purchased about $1.7 trillion in subprime and Alt-A loans—about 50 percent of their total purchases during a period when originations and refinancings were substantially lower than in the earlier period. At the time they were taken over by the government, the remnants of their earlier purchases amounted to $1.6 trillion in mortgages and securities—about 10 million loans and 34 percent of their single-family portfolio.

As a result primarily of Fannie's and Freddie's purchases, homeownership rates rose. From the 1960s until about 1995, the rate in the United States had remained at about 64 percent, but after that year, it began to rise. By 2000, it had risen to 67.3 percent, and to a high point of 69.2 percent in 2004. So, the policy of increasing

homeownership did work, but the unintended consequences were disastrous. Fannie's and Freddie's own losses will probably cost the taxpayers about $400 billion, perhaps more. But the other costs—the current financial crisis—are far worse.

Fannie's and Freddie's Role in the Financial Crisis

The connection between the GSEs' purchases and the current crisis is important to understand. Fannie's and Freddie's funding advantages allowed them to drive all private-sector competition to the edges of the housing finance market. This meant that Wall Street commercial and investment banks were relegated to buying and securitizing two kinds of mortgages—*jumbos*, which exceeded the size Fannie and Freddie were permitted by law to buy, and *junk*, which until the early 2000s, Fannie and Freddie would not buy in substantial amounts. For this reason, the subprime and Alt-A market was relatively small; the secondary market in these loans was carried on by commercial and investment banks, which would buy mortgages from the originators, package them into pools, and sell MBS backed by the payments of principal and interest on the mortgages in the pool. The pools were structured to create "tranches," or classes of securities with the same collateral but different levels of risk.[13] The lowest-risk tranche was typically rated AAA by the rating agencies; other tranches bore other ratings (sometimes also as high as AAA); and the highest-risk tranche was a small equity piece at the bottom of the structure.

This market was growing until 2003, when in the midst of a huge refinancing boom Fannie and Freddie started buying large amounts of the AAA tranches of the pools—known as "private label"—that Wall Street was creating. These purchases doubled in 2003 to $82 billion and doubled again in 2004 to $180 billion. In 2004, probably because they thought it was more efficient than paying Wall Street's fees for intermediation, they decided to buy large amounts of subprime and Alt-A loans directly from originators. Their chairmen—Franklin Raines of Fannie and Richard Syron of Freddie—went to meetings of mortgage bankers and other originators and asked for the mortgages of people with blemished credit. These loans were of substantial assistance to Fannie and Freddie in reaching HUD's increasingly ambitious affordable housing goals.

When someone with virtually unlimited funds asks for something as easy to deliver as subprime and Alt-A mortgages, the result is just as easy to predict: There was a huge frenzy at the originator level to produce the subprime and Alt-A loans that would then be sold to the GSEs or to the Wall Street investment banks and to commercial banks. In 2005, the GSEs began to buy large quantities of subprime and Alt-A loans directly from mortgage bankers and other firms, such as Countrywide

[13]A single pool of "collateral" (a group of mortgages) can be used to create tranches that differ in risk because they have different priority claims on the cash flows from the mortgages, much like senior and junior debt of a corporation, with an equity residual at the "bottom." Basically, all asset-backed (including mortgage-backed) securities' structures incorporate this design.

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Financial, that specialized in originating subprime and Alt-A loans. Meanwhile, they continued to buy AAA rated tranches of mortgage-backed securities from Wall Street—more than $500 billion of them between 2005 and 2007.

The GSEs' purchases—driven by their need to meet HUD's increasingly tough affordable housing regulations—affected the market for subprime and Alt-A loans in three ways. First, by increasing competition for these loans, the GSEs' purchases drove down the risk premiums that subprime loans usually carried, putting more potential buyers with blemished credit in a position to qualify for mortgages. Second, the competition between the GSEs and Wall Street drove the numbers of subprime and Alt-A loans still higher. And finally, the quality of these loans increasingly declined; the competitors were scraping the bottom of the potential borrower barrel. During this period, conventional prime loans (including jumbo loans) declined from 69 percent of all mortgages in 2003 to 36 percent at the end of 2006, and subprime and Alt-A loans increased from 20 percent of all originations to 46 percent. In 2006, almost half of all mortgages made in the United States were subprime and Alt-A loans. The GSEs were responsible for buying 39 percent of 2006 originations of subprime and Alt-A loans. In the end, including the loans underlying the AAA rated tranches that they bought from Wall Street, Fannie and Freddie held or guaranteed 34 percent of all subprime mortgages and 60 percent of all the Alt-A loans that were outstanding on 30 June 2008.

Although many have argued that it was Wall Street that led the subprime boom, that claim is disproven by the total number of subprime and Alt-A mortgages that Fannie and Freddie ultimately became responsible for. As subprime and Alt-A loans became a larger and larger proportion of all mortgages in the United States, it was the purchases by Fannie and Freddie that drove this growth. The conventional wisdom—that they were trying to compete for market share with Wall Street—seems contradicted by the fact that Fannie and Freddie ultimately acquired nearly as many of these mortgages as the rest of the market combined. The more plausible way to look at the issue is that Fannie and Freddie were, by and large, the creators of the subprime and Alt-A boom and that they did this for political reasons (discussed later) and *not* for the economic reasons that would motivate a Wall Street firm. They first stimulated the development of the Wall Street acquisition and distribution system by purchasing huge amounts of AAA rated private label tranches. Then, in late 2004, they began to buy these junk loans in ever larger amounts themselves, competing for product with Wall Street.

The GSEs' binge on subprime and Alt-A loans was obviously a disastrous business policy; it eventually destroyed two companies that had solid gold franchises. But it was also responsible for turning what would have been a troubling housing-bubble deflation into a worldwide financial crisis. Although U.S. taxpayers will have to bear the losses that Fannie and Freddie will realize from their purchases of subprime and Alt-A loans, banks and other financial intermediaries in the United States and around the world will suffer equally large losses because of the

MBS—based in part on subprime and Alt-A loans—that they purchased from Wall Street banks and securities firms. Although these are not the direct responsibility of Fannie and Freddie, the GSEs bear indirect responsibility for stimulating the explosive growth in junk mortgage loans beginning in 2004.

Why It Happened

The pressures that drove Fannie and Freddie to buy junk mortgages are complex. Most commentators point to their desire to take market share from Wall Street, but as noted earlier, this is highly implausible. Fannie and Freddie had funding at such low cost that they had no serious competition for any assets they were allowed to buy. Once Fannie and Freddie began to enter the market for subprime and Alt-A loans, it was just a matter of time before the Wall Street banks and securities firms would lose substantial portions of their market. Only an *expansion* of the market—the growth in subprime and Alt-A loans—would enable them to maintain a profitable business. So, the real question for policymakers is why Fannie and Freddie entered this market with such force beginning in late 2004.

One answer, of course, is HUD's affordable housing regulations. It is clear that the regulations were influential in determining what securities Fannie and Freddie purchased; subprime and Alt-A loans were both "goal rich" in terms of complying with the increasingly tight requirements for promoting "affordable" housing. We do not know the nature of any conversations that might have been held between the GSEs and the officials at HUD who oversaw the development of these regulations. But we do know from internal e-mail messages at Freddie and memoranda that were prepared at Fannie that both companies were well aware of the risks they were taking. It is difficult to believe that if the sole reason for taking those risks was to meet HUD's regulatory requirements, these risks could not have been brought to HUD's attention. In addition, many in the subprime housing business argue that there were plenty of high-quality subprime loans available in the market, but the GSEs did not look for them.

The most likely answer is that Fannie and Freddie were trying to retain support in Congress that would prevent new and tougher regulation. In 2003 and 2004, both companies had accounting scandals; they were found to have been manipulating their financial reports—to smooth earnings in Freddie's case and to hide massive hedging losses in Fannie's. At the time, there was a Republican Congress and a hostile Republican administration, raising the possibility that Congress might adopt legislation authorizing tough new regulation. Indeed, legislation of this kind passed the Senate Banking Committee in 2005 but never received a vote on the Senate floor. Alan Greenspan—who was highly regarded on Capitol Hill—was warning in virtually every appearance before Congress that the GSEs could cause a financial meltdown if they were not curbed, and economists at the Fed had recently done a study that showed the GSEs were not even successful in reducing interest rates for middle-class home buyers—the central justification they always claimed for their existence.

Under these circumstances, it is likely that Fannie and Freddie hoped to curry favor with their supporters in Congress by showing that they could boost homeownership rates, especially in low-income communities. If that was their strategy, it worked; there was no new legislation that curbed their activities until July 2008. But by then, it was too late.

Conclusion

Explanations for the current financial crisis range widely: Some see it as a crisis or failure of capitalism; others see it as a case of excessive deregulation or just not enough regulation. Still others cite the Fed's failure to raise interest rates quickly enough after the economy began to recover from the dot-com collapse. There is no question that a housing bubble grew in the first seven years of the 21st century and then abruptly collapsed. But housing and other asset bubbles have deflated rapidly before without such dire consequences. The reason that this housing-price deflation created what is essentially a worldwide financial crisis is that the mortgages produced in the United States, beginning early in the 2000s and accelerating until 2007, were of much lower quality than had ever been true in the past. Not only were borrowers of lower credit quality, but also the loans themselves were not backed by the down payments or other equity that encouraged borrowers to continue making mortgage payments after housing values fell below the principal amount of the mortgage. Thus, the most plausible explanation for the extraordinary losses associated with the collapse of this bubble is the unprecedented growth of subprime and Alt-A mortgages in the United States. At the height of the housing bubble, in 2006, almost half of all mortgages originated in the United States were subprime or Alt-A. When these mortgages began to default, it was at unprecedented rates, weakening the financial condition of banks and other financial intermediaries around the world.

The growth of the market in subprime and Alt-A loans can be directly attributed to the policies of the U.S. government. For much of the 20th century, the government attempted to foster homeownership in the United States. In most cases, the government took the risks associated with this policy. But beginning in the 1990s, Congress and the administration began to require that private enterprises—insured banks and the GSEs Fannie Mae and Freddie Mac—take on the risks of lending to potential home buyers who did not have the credit records or resources to meet their obligations. In this process, the usual mortgage standards that prevailed in the private housing finance market were eroded, and the housing bubble was gradually engorged with poor-quality mortgages. Without this factor—the element of government policy—the collapse of the great housing bubble of the early 21st century would not have been nearly as calamitous.

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