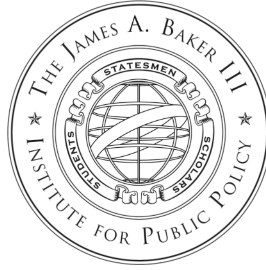

JAMES A. BAKER III INSTITUTE FOR PUBLIC POLICY
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THE FINANCIAL CRISIS OF 2008

BASED ON AN OCT. 15, 2008, PRESENTATION TO THE RIVER OAKS WOMEN'S BREAKFAST CLUB, HOUSTON, TEXAS

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The Nobel laureate and American economist Milton Friedman once said that policies should be judged not by their intention but by their outcomes. We desperately need to heed this advice now and in the future. The current financial crisis is the result of well-intentioned but economically unsound policies that were initiated and implemented by the federal government and private sector firms.

These notes are organized as follows. I start by reviewing how we got into this mess and discussing who is to blame (I particularly suggest reading this section). I also examine the immediate policies that have been proposed to stabilize the economy in the short term. I briefly mention some long-term reforms that could help reduce the likelihood of asset price bubbles in the future. Finally, I point out a few policies that should be rejected because they would increase the risk of a severe economic recession or depression.

How did we get into this mess?

It is helpful to step back and examine the increase in housing prices over the full boom-bust cycle.

Let's begin with the period from 1994 to 2001. Over this period, the homeownership rate increased by 3.8 percentage points and real house prices increased by 29 percent. Why did house prices increase over this period? Several factors were driving housing prices including:

- Economic recovery from 1990-91 recession;
- Relatively low mortgage interest rates in the mid to late 1990s (especially relative to the 1980s);
- Broadly based income growth in the mid to late 1990s;
- Increased lending to low- and middle-income households (the National Homeownership Strategy initiated by President Clinton, which I will discuss later) and
- Adoption of automated underwriting tools that increased efficiency in the mortgage underwriting.

After the dot-com bubble burst and Sept. 11, 2001, market dislocations led the Federal Reserve

to drastically cut short-term interest rates. This fueled the credit boom and was a major factor in the increase in housing prices to unsustainable levels. Housing prices peaked in the first quarter of 2006 at a level 87 percent higher than in 1994 and 54 percent higher than in 2001.

From 2001 to 2006, the United States entered a widespread credit mania that included:

- A boom of cash-out refinancing;
- Banks quick to loan money to anyone interested in buying a house — with seemingly little concern for true creditworthiness (this could be related to fact that private asset managers assumed that since Fannie Mae and Freddie Mac were implicitly insured, in essence they were insured, too);
- Exotic mortgage loans were created to fit people into houses they could not afford (payment options, adjustable-rate mortgages, balloon notes, interest-only, Alternative A-papers, etc.);
- Zero-percent financing on durable goods and automobiles.

The widespread use of credit to consume beyond our means led to deterioration in the balance sheets of U.S. households once housing prices stopped increasing at unreasonable rates. Business balance sheets also deteriorated over this period as businesses took on significant financing risks. This was especially true in the broker-dealer sector, which includes investment banks. Changes in the business sector included:

- Broker-dealer assets increased to almost four times the level of other business assets;
- Investment banks and other financial institutions used mortgage-backed securities to create earnings — under a seemingly implicit assumption that house prices would continue to increase indefinitely;
- Financial institutions also invested in long-term assets using significant short-term funding, which created earnings by exploiting a maturity mismatch between assets and debts. Short-term financing through commercial paper or the repo (repurchase agreement) market, was extremely cheap because the Fed kept the Federal funds rate artificially low.

As a result, firms had to roll over much of their short-term funding daily. Some broker-dealers were rolling over as much as 25 percent of their assets (more than double the levels in the mid '90s).

Then, starting last year, the subprime crisis made short-term financing hard to obtain. Housing foreclosures accelerated as current owners were unable to refinance (especially those with "flexible and innovative" mortgages — see "Who is to blame?" below). In some cases, low-down-payment homeowners had no financial stake in their home since they owed more on their home than it was worth — leading to a significant number of "walkaways."

The house of cards finally fell apart over the summer, when the declining housing market forced broker-dealer JPMorgan Chase & Co. to sell its mortgage-based securities at what would turn out to be a loss of nearly 80 percent.

This set off a chain of events, as mortgage losses led to capitalization problems across the industry. Since firms had very little information about the balance sheets of other firms, or even their own long-term exposure to "toxic" assets, lending slowed dramatically. Instead, firms sold their assets at fire-sale prices in an effort to stanch the bleeding on already decimated balance sheets.

With firms unable to raise cash and market confidence at a low point, financial institutions became extremely risk averse, and the credit market froze.

Who is to blame?

Needless to say, there is more than enough blame to go around. But the lion's share of the blame should lie at the feet of those agents that initiated the process that led to the current economic crisis.

Presidents Bill Clinton and George W. Bush, along with Congressional leaders, pushed for increasing the homeownership rate as a major social initiative. It is not a coincidence that in 1994 President Clinton requested that the U.S. Department of Housing and Urban Development (HUD) develop the National Homeownership Strategy — a strategy to significantly increase

homeownership, especially in low- and middle-income households. In a 1995 policy brief,[1] HUD describes its mission:

> "At the request of President Clinton, the U.S. Department of Housing and Urban Development (HUD) is working with dozens of national leaders in government and the housing industry to implement the National Homeownership Strategy, an unprecedented public-private partnership to increase homeownership to a record-high level over the next 6 years. The ideal of homeownership is so integral a part of the American Dream that its value for individuals, for families, for communities, and for society is scarcely questioned."

The language in this report is prophetic. Consider the following:

> "However, Federal institutions, policies, and programs alone cannot meet President Clinton's goal of record-high levels of homeownership within the next 6 years. Under the leadership of Secretary Cisneros, HUD has forged a nationwide partnership that will draw on the resources and creativity of lenders, builders, real estate professionals, community-based nonprofit organizations, consumer groups, State and local governments and housing finance agencies, and many others in a cooperative, multifaceted campaign to create ownership opportunities and reduce the barriers facing underserved populations and communities."

The cooperative, multifaceted campaign described in the National Homeownership Strategy was committed to:

> "MAKING FINANCING MORE AVAILABLE, AFFORDABLE, and FLEXIBLE. The inability (either real or perceived) of many younger families to qualify for a mortgage is

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[1] "Urban Policy Brief, Number 2," August 1995. U.S. Department of Housing and Urban Development. http://www.huduser.org/publications/urbaff/upb2.html

> widely recognized as a very serious barrier to homeownership. The National Homeownership Strategy commits both government and the mortgage industry to a number of initiatives designed to:
>
> > Cut transaction costs through streamlined regulations and technological and procedural efficiencies.
> >
> > ***Reduce downpayment requirements and interest costs by making terms more flexible***,[*] providing subsidies to low- and moderate-income families, and creating incentives to save for homeownership.
> >
> > ***Increase the availability of alternative financing products***[*] in housing markets throughout the country."

To put this simply, the government launched a campaign to increase homeownership by reaching out to populations that would have never qualified for a mortgage under standard financial practices. To do this, they loosened the restrictions on financing, opening the floodgates to financial institutions eager to find new customers, while creating an environment ripe for unethical (or at least questionable) lending practices. These are the seeds of the current economic crisis.

The Bush administration continued to water these seeds. At the signing of the American Dream Downpayment Act 2003, President Bush stated, "Government is supporting homeownership because it is good for America, it is good for our families, it is good for our economy." He acknowledged that the rate of homeownership was at a record high of 68.4 percent but stated that there is "room for improvement." To solve this "problem," the legislation provided $200 million per year in down payment assistance to more than 40,000 low-income families that could otherwise not afford to own a home. (That is $1 trillion of taxpayer money poured into the

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[*] Italics, bold font added for emphasis by author.

housing price bubble from 2003 to 2007!)

But others share the blame. Wall Street was all too willing to play along with this game and made scores of very poor decisions in the process. The rapid increase in housing prices from 2003 to 2006 coincided with an explosion in private asset-backed securities (those not backed by Fannie and Freddie). In addition, these assets are made up of some of the most risky types of exotic mortgage schemes. We must admit that many financial insiders acted inappropriately at best, and that some committed fraud and encourage deceptive practices while the government stood by and did nothing.

I do not believe that Wall Street (or government) is inherently corrupt. However, there is ample reason to be very concerned about the incentives facing our political and business leaders. The "get-rich-now" mentality is worrisome and seems to be completely grounded in a short-term focus with little regard for the long-term consequences.

The Federal Reserve is also to blame for allowing the flood of cheap credit to fuel the increase in housing asset values far above normal levels. In his book "The Age of Turbulence," Alan Greenspan states that he is "increasingly persuaded that governments and central banks could not have importantly altered the course of the boom either."[2] The fact is they helped create and fuel the boom. It is utterly ridiculous to state that alternative government and central bank policies could not have altered the run-up in housing prices.

The cheap credit policy of the Fed is also related to the maturity mismatch that I mentioned earlier. It allowed investment firms to finance long-term assets with large amounts of short-term debt, which was very cheap relative to other debt and equity finance options. In addition, low interest rates encouraged firms to offer adjustable-rate mortgages, which offered the potential for higher returns as interest payments would increase over time as the initial low interest rate reset. However, short-sighted (and deceptive) business practices failed to account for the massive

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[2] Greenspan, Alan. "Greenspan Says It's a Crisis We Had to Have," Oct. 9, 2008.
http://newmatilda.com/2008/10/09/greenspan-says-its-crisis-we-had-have

foreclosures that would be driven by the increases in mortgage payments.

The American consumer also deserves blame. Because we fail to save as a nation, foreign investors have invested heavily in American debt (much of which is implicitly backed by the American taxpayer). Consumerism is an addiction that is slowly destroying America. I think it speaks volumes that the term "American Dream" is now just a catch phrase for consuming more housing and other goods and is used in the title of irresponsible legislation that is aimed at supporting the consumption of goods beyond the means of many low- and middle-income Americans.

Yes, owning a home is a worthwhile endeavor, but it can also be a tremendous burden for many that are not financially capable of facing the inherent risk of asset ownership. We need to return to an American Dream that focuses on our inherent rights and freedoms to prosper, not on our material wants and desires.

What should we do now?

There is substantial disagreement about the potential for a depression similar to that of the 1930s. International Monetary Fund chief economist Oliver Blanchard and his colleagues stated the optimistic view that "there is no chance of a repeat of the global depression of the 1930s because the lesson of that painful decade has been learned."

The pessimistic view is espoused most ardently by Nouriel Roubini, a notable economist at New York University, who predicted the coming crisis more than two years ago. He warned in February 2008 that "there is now a rising probability of a catastrophic financial and economic outcome," and, in October 2008, he stated that "it is clear that the U.S. financial system is now in cardiac arrest and at risk of a systemic financial meltdown" as he outlined in February. He predicts that "radical policy action can only prevent what will now be an ugly and nasty two-year recession and financial crisis from turning into a systemic meltdown and a decade-long economic depression." While this is a rather extreme view, it is not completely without merit.

One thing that seems certain is that extraordinary steps must be taken to stabilize the economy.

There is general agreement that stabilizing housing prices is a necessary step to stabilize the economy. If not, housing prices may fall an additional 17 percent before reaching a bottom. Such a decline would increase the risk of a more severe financial and economic crisis.

Here are the major points of the government's current strategy, although many smaller actions have also been taken that are very important:

- In September 2008, the U.S. government seized control of Fannie Mae and Freddie Mac. A total of $200 billion was pledged by the U.S. government to prop up the struggling companies which hold or back a combined $5 trillion in home loans.
- Out of fears that a collapse of insurer American International Group, Inc. (AIG) would have dire national and global financial consequences, the U.S. government seized control of AIG. Why AIG but not Lehman Brothers Inc.? AIG had sold credit default swaps, insurance against bad loans, to almost every major financial company. Allowing AIG would to collapse would have had far reaching consequences in the financial sector. The government took a 79.9 percent equity stake in the firm and agreed to lend $85 billion to the company in September 2008. In October, the government provided an additional $37.8 billion to AIG in order to hold the company over until the asset sales are completed.
- After one failed attempt, Congress then crafted and passed an all-encompassing $700 billion bailout plan in early October 2008. The bailout allowed the Treasury to access a total of $700 billion in stages to buy troubled mortgage-related assets from financial institutions, thus purchasing a stake in these companies. However, it now appears that the Treasury will settle for an initial $250 billion infusion of cash in return for preferred shares. I prefer this strategy over the plan to buy troubled assets. The purchase of troubled assets seems much to difficult to implement as the government would have to know both which assets it should buy and how much it should pay for those assets.
- The bailout also called for the curbing of executive pay, set up two financial oversight committees, gave the Securities and Exchange Commission the power to change accounting rules, temporarily raised the Federal Deposit Insurance Corp.'s insurance cap from $100,000 to $250,000, as well as extended numerous tax breaks.

- Additionally, the plan sought to mitigate foreclosures by encouraging loan services to modify mortgages and, through the exemption from federal income tax, any debt forgiven by a bank to a borrower in foreclosure.

What should we do in the long term?

First, we must have an exit strategy to return ownership of firms to the private sector, and to ensure that the government refrains from unnecessary interference in the decisions of the banks that it infuses with capital.

The government must also implement reforms that will reduce the probability of asset-price bubbles and that will regulate financial innovation without being too restrictive. Some starting points are:

- The creation of a Financial Product Safety Board to evaluate financial products, such as mortgage loans;
- Leverage/capital ratios alone do not yield enough information to determine the financial strength of companies. We also need to consider the ratio of short-term liabilities and assets so that we can avoid the maturity mismatch problem;
- Improved financial disclosure — off-balance-sheet accounting is still a problem, despite Sarbanes-Oxley and the other post-Enron reforms;
- The United States should use covered bonds to finance mortgages and loans; they are similar in many ways to asset-backed securities. Two advantages are that they stay on the issuer's balance sheet and investors have two recourse options: the issuer and pool of assets.

The government also needs to sell its newly acquired shares of banks and other institutions as soon as is feasible.

And perhaps most importantly, as a nation we must get serious about solving the pending fiscal crisis. The current national debt is over $10 trillion and is continuing to increase. However, that is only the explicit debt of the United States. Including the unfunded promises of the U.S. government in the future increases the estimated national debt to $53 trillion (about $170,000 for

each American).

What not to do — lessons from the Great Depression

The federal government is largely responsible for the current crisis. There are some policies that the federal government should avoid to keep from exacerbating the current crisis. The federal government should NOT:

- Increase tax rates;
- Attempt to insulate domestic producers from foreign competition;
- Encourage unionization. For example, the United States should not pass the Employee Free Choice Act, which would effectively take away private union voting. This would increase unionization and, thus, increase unemployment and make the labor market less flexible. The Wall Street Journal quotes Target Corp. CEO Gregg Steinhafel as stating that "it could be very damaging to all of American business, and we stand strongly opposed to it." (The House of Representatives passed the Employee Free Choice Act on March 1, 2007. It was co-sponsored by 232 Democratic members of Congress and 45 Democratic members of the Senate, including Senator Barack Obama, D-Ill. The measure was not voted upon by the U.S. Senate.)