# The Financial Crisis: A Failure of American Enterprise

> I made a mistake in presuming that the self-interest of organizations, specifically banks and others, were such that they were best capable of protecting their own shareholders and their equity in the firms.
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> So the problem here is something which looked to be a very solid edifice, and, indeed a critical pillar to market competition and free markets, did break down.
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> --Alan Greenspan at Congressional Committee for Oversight and Government Reform on October 23, 2008

In a one hundred-plus page dissent from the conclusions of the Financial Crisis Inquiry Commission, avoids assigning any responsibility to corporate management at the firms that failed, and instead Peter Wallison of the American Enterprise Institute (AEI) argues: "…the housing bubble of 1997-2007 would not have reached its dizzying heights or lasted as long, nor would the financial crisis of 2008 have ensued, but for the role played by the housing policies of the United States government over the course of two administrations." (See note.[1])

Peter Wallison's argument can be summarized as:

1. Government forced Government Sponsored Enterprises (GSEs) and others to originate poor quality loans to meet affordable housing (AH) goals.
2. The market grossly underestimated the quantity of poor quality loans.
3. The failure of those loans led to massive financial disruption due to mark-to-market accounting for private label mortgage backed securities (PLMBS).
4. Government intervention in Bear Stearns stopped panic temporarily, but created moral hazard that was realized when Lehman was not saved.

While there is some truth to each of these points, this narrative does not hold up to close scrutiny. In each case the main arguments fall short of the full truth.

***Point 1. The Government forced GSEs to originate poor quality loans to meet affordable housing (AH) goals.***

Wallison's argument conflates affordable housing, subprime, alt-A and non-traditional mortgages (NTM). In fact, as Wallison shows in his Table 5, Alt A loans did not meet the GSEs Low & Moderate Income Base Goal or the Special Affordable Goal. These loans could not have been purchased or guaranteed by the GSEs to meet these goals. Table 12 makes it clear why these were not AH loans. The weighted average FICO score for the Alt-A loans at Fannie Mae was 719, just 5 points lower than the average FICO score of 724 for the overall book of business. In addition, the average unpaid balance of the Alt-A loans was $170,250, more than $20,000 higher than the average loan size of the overall book. Clearly these weren't acquired to meet affordable housing goals.

While the Alt-A loans weren't the AH goal loans, they were the largest contributor to Credit losses at Fannie Mae. His Table 12 also shows that Alt-A loans were 45.6% of the credit losses at Fannie Mae in 2008 for their single family mortgage credit book of business. While conflating NTM and AH loans makes it seem that AH goals were the cause of the losses, the facts show otherwise.

Fannie Mae did in fact acquire loans specifically to meet its affordable housing goals. These are detailed in Wallison's Table 6. For these loans, Fannie Mae "waived some of its regular underwriting requirements," according to Wallison. These loans also have very high Seriously Delinquency Rates.

While these loans seem to support Wallison's analysis, the total number of loans originated under these programs was a whopping 507,560. Almost 50% of those were originated in 2007, too late to contribute to the housing bubble. To put this number in perspective, Wallison claims there were 27 million NTMs that led to the financial crisis. These loans make up fewer than 2% of the total.

The GSEs did in fact contribute significantly to the growth of the subprime market through their purchases of highly rated (AAA) private label mortgage backed securities (PLMBS). These purchases served the twin goals of helping the GSEs to meet their AH goals and arbitraging their agency status. However in this role, they were not the primary determinants of underwriting standards, as will be discussed later.

***Point 2. The market grossly underestimated the quantity of poor quality loans.***

As with the first point, there is a grain of truth in this statement as well. The market did likely underestimate the number of loans which did not meet traditional underwriting standards in the market. However, this was not the only source of risk not fully understood by the market. In general, during the period leading up to the crisis, most market participants did not believe that home prices would fall significantly (say greater than a 10% drop) on a national basis in a period of high employment, economic growth and high liquidity. Furthermore, the market did not fully understand the full extent of the level of fraud and lax underwriting in the market. That is, while they knew that there were loans with lower FICO scores, reduced documentation, higher LTVs and greater use of second liens, they did not know that the underwriters had failed to verify even the few underwriting characteristics.

Our analysis shows that non-agency loans originated in 2005 to 2007 had 50% higher default rates than similar loans from other time periods with the same loan characteristics and experiencing the same drop in home prices. The large pending lawsuits of representations and warranties and the large buy back exposure of the major banks to the GSEs are evidence of the decline in the quality of the underwriting process.

In addition, the growth of Credit Default Swaps (CDS) and the ABX index, created an additional source of risk to the market. These instruments multiplied the amount of credit risk in the financial system. The risk of any individual loan could be multiplied in the capital markets. For every billion dollars gained by hedge funds such as John Paulson's, a billion of dollars were lost elsewhere. In addition, the market did not know where these exposures were located in the financial system. The losses associated with the Citigroup Structured Investment Vehicles (SIVs) and the financial crisis in Iceland, are examples of the "interconnections" which were invisible to investors prior to the crisis.

ABX and the CDS on PLMBS did in fact serve a useful purpose. Collateralized Debt Obligations (CDOs) were structured in such a way as to avoid a direct measurement of the value of the underlying securities. ABX allowed for direct trading—both long and short—of the junior tranches of subprime PLMBS. Trading in ABX revealed how overvalued these securities were and may have led to the end of the origination of low quality loans.

***Point 3. The failure of those loans led to massive financial disruption due to mark-to-market accounting for private label mortgage backed securities (PLMBS).***

Perhaps half a truth is better than no truth. I strongly support Wallison's contention that mark-to-market accounting was a major contributor to the financial panic in 2007 and 2008. In our work, we saw a marked decline in panic and a rise in the value of PLMBS after FASB adopted new rules in April 2009. I believe, as does Wallison, that this issue has not received sufficient attention.

On the other hand, Wallison downplays the role of the shadow banking system, or perhaps better called the parallel banking system. The parallel banking system includes financing provided by money market funds and repurchase agreements. The central feature of these mechanisms is that they are essentially "mark-to-market." Because these systems rely on asset valuations they are more susceptible to runs when asset values fall, even if the asset values fall due to increases in risk aversion, rather than increases in expected losses.

To my way of thinking, we had two powerful self-reinforcing trends operating side-by-side and interacting. One trend was rising home prices leading to reduced underwriting requirements and lower cost financing reinforcing the growth of home prices. The other trend was a move toward greater leverage and lower costs in the financing of assets in the parallel banking system. When home prices stopped rising and defaults began to increase, the higher loan losses lead to a reduction in the availability of mortgage credit. This reduction in mortgage credit led to further declines in home prices, feeding the negative feedback cycle, much as described by Wallison.

In addition, uncertainty about the value of PLMBS, led to a retraction in the amount of financing available to investors in PLMBS. The retraction of credit led to further drops in the value of these securities and then to the drop in value of other securities as the amount of credit available through the shadow banking system dropped precipitously. The reduction in lending led to reduced economic activity and higher unemployment which then had the cross effect of increasing defaults and driving the housing market lower.

Perhaps if there had been a housing bust with no shadow banking system there would not have been a crisis of the magnitude that we experienced. Perhaps if the troubled assets in the shadow banking system had not been housing related there would not have been the economic spillover. But we did have both and they strongly interacted to reinforce the downward trend, and as Wallison points out, mark-to-market accounting put pressure even on institutions within the traditional banking system.

It would be wrong however to say that the parallel banking system was operating well prior to the crisis. There were many excesses in the system. Leverage was high, the liquidation of the Bear Stearns leveraged mortgage hedge funds, questionable liquidity guaranties like those of the Citibank SIVs, and Merrill Lynch's retention of large portions of their CDO issuance exacerbated, if not caused, the rapid decline in market confidence in the shadow banking system.

***Point 4. Government intervention in Bear Stearns, stopped panic temporarily, but created moral hazard that was realized when Lehman was not saved.***

Wallison is criticizes the government for bailing out Bear Stearns and believes that the bankruptcy of Lehman would not have created a crisis if Bear had been allowed to fail. During the crisis, the government, whether in the form of Treasury or the Federal Reserve, took a number of extraordinary steps to prop up both the regulated banks and the parallel banking system. There is little doubt that these steps reduced panic and saved the U.S. from a worse financial crisis.

It is interesting that the bailout of Lehman is one area of disagreement between the majority commission report and the other three dissenters. This debate remains open. It is unclear if allowing Bear to fail would have been better or worse in the long run. (I believe it would have been worse.) There is no doubt that the failure of Lehman was disruptive and that much of that disruption related directly to Lehman. On the other hand, it is not clear that rescuing Lehman would not have led to a similar or worse meltdown due to the fragile state of the financial system at that time. (In retrospect, my belief is that it would have been better to find a non-bankruptcy resolution for Lehman.)[2]

What is clear is that the failure of Lehman was not tied only to the subprime mortgage meltdown. By the time of Lehman's failure, the mortgage portion of the crisis was already over a year old. There had been numerous efforts to measure the size and extent of subprime exposure. Liquidity risks, beyond those associated with mortgages were rattling the market. In was in this context that Lehman fell.

Thus we see that Wallison's attempt to lay the entire financial crisis at the feet of government housing policy falls short. As other commentators have pointed out, the crisis was a result of a complex web of factors.

**Critque of Wallison's Mode of Analysis**

More disturbing than the fact that Wallison overplays his hand in condemning housing policy for the financial crisis is that throughout the presentation there are many failures of analysis. The Dissent contains a variety of misleading comments and wrong conclusions. These appear to be either a deliberate attempts to mislead, or lack of understanding of the basic facts. I will focus on three examples.

***Statement 1. "… the credit risk of two-thirds of all of the NTMs in the financial system was held by the government or by entities acting under government control…" (p. 456)***

This conclusion is based upon the fact that Wallison identifies in Table 1, 19.2 million subprime and alt-A held or guaranteed by Fannie Mae, Freddie Mac, FHA, other Federal agencies, the Home Loan Banks and originated under CRA or other HUD programs. He then identifies a total of 7.8 million of these loans held by or guaranteed by others including PLMBS.

Quick analysis shows that 19.2 divided by 27 is in fact more than two-thirds, in fact it is about 71%. The second column of the table, however, shows that on the basis of unpaid principal that same ratio is $2.7 trillion divided by $4.6 trillion or 58%. 58% is under two-thirds, but still quite large. By presenting the analysis in loans rather than in dollars, Wallison overstates the size of the government involvement.

It also turns out that the $2.7 trillion includes about $240 billion of private label MBS. I believe it would be quite a stretch to claim that the GSEs holds the credit risk on those loans when they own AAA bonds and the junior bonds are providing the bulk of the credit support. With this adjustment, the Government share drops to 53%.

And now to the denominator: Wallison claims that there was $1.9 million of other NTMs outside government control, primarily in 7.8 million loans in PLMBS. However, this analysis then ignores all of the loans (not MBS) held by depositories that met his definition of NTM. As this should include all of the interest only and high LTV loans, not to mention second liens held outside the GSEs, this is likely a significant number. Supposing that this number is about $1 trillion then the government role would shrink well below 50%. Since the numerator was enlarged by including loans that Wallison classified as NTM based on loan characteristics, the same must be done for the denominator. It is likely that the $1 trillion estimate of additional non-government, non-PMBS NTM understates the true extent of NTM under the Wallison loan based definitions.

Given the size of the GSEs, it is not surprising that they would be significant participants in NTMs, but the government was not an outsized cause of NTMs or of reduced underwriting quality. Other studies have shown that the share of losses associated with the GSEs is well below their market share of loans.

***Statement 2. "CDOs…were just another example of the way in which subprime and other high risk loans were distributed throughout the world's financial system. The question still remains why so many***

***weak loans were created, not why a system that securitized good assets could also securitize bad ones." (p. 447)***

Slightly rearranging Wallison's quote brings us to what I believe is a major cause of the housing meltdown. *A system which would securitize bad assets just like they were good assets would create many weak loans.* As I wrote in August of 2007, well before the housing meltdown metastasized into the financial crisis, "In the simplest terms, what went wrong in the subprime mortgage market is that the people responsible for making loans had too little financial interest in the performance of those loans and the people with financial interest in the loans had too little involvement in the how the loans were made."[3]

As I described in that piece, CDOs purchased a large portion of the subordinate classes of PLMBS. CDO managers had little incentive to evaluate the quality of the underlying loans, and were generally depending on rating agency requirements to structure these transactions. Investors relied on rating agencies, since the CDOs for the most part were too complex to evaluate. A market which provides cheap financing and little or no screening for loan quality can be and was the reason why so many weak loans were created.

Wallison dismisses this mechanism with a few words and thereby misses a crucial ingredient in the meltdown.

***Statement 3: "These entities … were compelled to compete…" (p. 444)***

I find this to be a very strange statement. This and similar ideas appear in multiple places in the dissent. In general, AH requirements (where they exist) are in the form that a certain percentage of a firm's business meets pre-specified goals. The idea behind this is that the firm is gaining certain advantages from other parts of its business that government believes should be used to extend its business to the underserved.

For example, the GSEs need to have a certain percentage of their business serving low to moderate income (LMI) income families. Let's suppose that percentage is 60%. Let's also suppose that the GSE's current book of business has 500,000 loans that meet the goals out of a total of 900,000. Thus, it only has a 55% LMI percentage. It would seem that the GSE would need to originate another 100,000 LMI loans to meet the requirement. However, the GSE has another choice. It can alter our old friend the denominator. If the GSE would reduce its non-qualifying originations by 67,000 it would meet the requirements. Thus the requirement to have a certain LMI percentage is not a requirement to enter into unprofitable business, but is a requirement to balance goal-satisfying and non-goal-satisfying loans.

Fannie Mae claimed that meeting the AH goals cost them about $400 million in 2006. This is of course a very large number. But it is only 10% of Fannie Mae's net income in 2006. Fannie Mae made large profits on its status as a GSE. The AH guidelines provided restrictions on allocation of the activities engaged in by the GSEs. However, nothing in the guidelines limited the ability of the GSEs to shrink their overall business. In this light the increase in the AH goals may have been an attempt to reduce the size and excess profits of the GSEs, not an attempt to increase their affordable lending.

The same analysis applies to all of the firms in the mortgage market. Competition may force you to exit a market, but competition should not be viewed as an excuse to take on excessive risk. Competition may be fair or unfair, but a firm is never "compelled to compete." A firm chooses to compete and management should be held responsible for that choice.

Let’s revisit Wallison’s conclusion: “…the housing bubble of 1997-2007 would not have reached its dizzying heights or lasted as long, nor would the financial crisis of 2008 have ensued, but for the role played by the housing policies of the United States government over the course of two administrations.”

If Wallison’s thesis is correct and firms were “compelled to compete” then we must also conclude that the following corollary is also true:

*Corollary: American private enterprise is too weak to overcome pressure from the government to engage in self-destructive activities in certain markets rather than exit those markets or find a non-destructive way to meet government requirements. Even firms that are not subject to the government pressure engage in destructive behavior (due to competition) to aid other firms subject to government pressure. Furthermore, individuals will commit fraud to help firms satisfy government objectives.*

**Summary:**

Wallison is critical of the commission for its failure to explore alternative hypothesis including the ones he proposes.  He does not blame the staff.  Wallison writes: “The Commission’s failures were failures of management.”

That may or may not be true.  However, I believe that there is little doubt that the failures of AIG, Countrywide, Washington Mutual, New Century, Ameriquest and the GSEs; the massive losses at Merrill Lynch and Citibank; and the failure to properly rate MBS and CDOs by Standard & Poor’s and Moody’s were, in large part, failures of management.

These failures included:

- Facilitating fraudulent loan origination and inadequate underwriting procedures
- Knowingly misstating the risk of mortgage loans
- Falsifying financial statements
- Knowingly applying inadequate correlation assumptions to CDOs
- Creating and selling MBS and CDOs which were likely to fail
- Allowing excessive leverage and excessive concentrations of risk
- Trading firms holding or guaranteeing risky assets rather than distributing risk
- GSE expansion into higher risk, non-mission Alt-A loans
- Growing a business that is likely to implode

I believe it is clear that these failures of management contributed to the financial crisis and may have been at the heart of the cause of the crisis.  However, whether or not these management failures caused the crisis or if the crisis were the result of government housing policies or uncontrollable macroeconomic forces, the crisis revealed many failures in our way of doing business.

Therefore, a fundamental question that should be addressed is how to avoid similar failures of management in the future.  So far, the reaction of private enterprise has been to blame government policies, rather than ask, “What are the structural flaws of private enterprise that lead to these management failures and how they can be addressed?" A full analysis would address which flaws are best addressed through regulation and which flaws require changes in business structure.

If American private enterprise does not understand and address the failures of management that contributed to the crisis, then similar crises could occur again in the near future. If American private enterprise does not address these issues, then government will be compelled to constrain enterprise so as to limit the activities that led to the crisis, possibly limiting the growth possibilities of our economy. To date, neither business nor government has taken adequate steps to address the causes of the crisis; instead, there has been too much focus on the failures of government either in commission or omission, and insufficient focus on why there were failures of management in the industry.

Andrew Davidson
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[1] In a May 7th 2010 at the Federal Reserve Chicago Bank Structure Conference Alan Greenspan echoed much of the sentiments of the Wallison dissent. He indicated that the GSEs exacerbated demand for subprime mortgages to meet their "exceptionally large 'affordable housing' mandates and also said, "in September 2008, had the share of financial assets funded by debt been significantly less concentrated in U.S. highly leveraged mortgages, it is questionable whether the deflation of asset prices would have fostered a default contagion much, if any, beyond that of the dotcom boom." Unlike his October 2008 testimony, Greenspan's May 2010 talk did not discuss the role of management in protecting their shareholders, but instead focused on the insufficiency of regulatory capital and liquidity requirements to shield debt holders from the risk of rapid asset deflation.

[2] I also suspect that if the Government had utilized the dreaded and discredited forbearance with Fannie Mae and Freddie Mac the dimensions of the crisis could have been much narrower. The government could have allowed Fannie and Freddie to continue to operate with falsely inflated capital and the Fed could have provided short term funding with the GSE's MBS as collateral. The NY Fed ending up buying a significant portion of the GSE MBS later in the crisis anyway. We will never know if such a step would have helped or hurt market confidence.

[3] Six Degrees of Separation, Andrew Davidson & Co, Quantitative Perspectives, August 2007. http://www.ad-co.com/pubs_pipeline_article/6