

What Really Caused the Financial Crisis?



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The Story of the Financial Crisis Retold

Here are the highlights of the Financial Crisis Commission's report on what caused the great economic meltdown and who should share most of the blame. For one of the best reads this year, download the "Financial Crisis Inquiry Report" and settle in for 600 pages (less footnotes) of risk, greed, hubris, ignorance, incompetence, and fascinating exposé as the events leading up to the greatest financial crisis of our time are recounted in chilling detail. Fingers are pointed. Names are named. And no one is immune from implication in this most fascinating tale about a nation on the brink of financial disaster.

It all started with interest rates

The story begins at the turn of the millennium, when the Federal Reserve cut interest rates. With mortgage rates at all-time lows, home refinancings surged, causing total mortgage debt to soar from \$460 billion in 2000 to \$2.8 trillion in 2003.

Homeowners across the land pulled out equity that had been building up for decades and spent it on cars, vacations, college, medical bills, new kitchens with granite countertops, and daily living expenses. They paid off credit cards and then tapped their expanding lines of credit to borrow more.

Home prices started to climb, shooting up two- or three-fold in some areas in just five years. Americans

extracted \$2 trillion in home equity between 2000 and 2007, including \$334 billion in 2006 alone. Real estate speculators and potential homeowners stood in line outside new subdivisions to buy homes that had not even broken ground.

Then along came securitization

On the surface it looked like prosperity. But underneath something was going terribly wrong. Like a science fiction movie in which ordinary household objects turn hostile, familiar market mechanisms like the 30-year fixed-rate mortgage were being transformed. Wall Street labored mightily to meet the demand. New kinds of loans were packaged into new kinds of investment products and sold to yield-hungry investors around the world. Trillions of dollars were wagered on the idea that home prices would never go down and homeowners would never default on their mortgages.

Easy credit caused some people to borrow far more than they could ever expect to repay. Overall mortgage indebtedness climbed from \$5.3 trillion in 2001 to \$10.5 trillion in 2007. In many cases it wasn't even clear who the lender was. So many mortgages had been packaged into so many securities and sold to so many investors that the paper trail—if there was one—was nearly impossible to follow. But it didn't matter. These collateralized debt obligations (CDOs) were stamped with triple-A ratings, and that was good enough for most investors.

Those who wanted to hedge their bets bought credit default swaps, a type of insurance that paid the buyer in case the underlying mortgage holders defaulted. But since CDOs were triple-A rated and considered very safe, sellers of those credit default swaps figured they had it easy: they could collect more and more premiums on more and more mortgage debt and never have to worry about paying any claims.

Pretty soon Wall Street created synthetic CDOs. And credit default swaps, which had nothing backing them up but a promise between two parties, became the investment du jour. Credit default swaps were so widely traded between the investment banks and the big hedge funds that actual mortgages became almost irrelevant to the Wall Street money machine. Demand for mortgages began to fall. And thus began the toppling of the house of cards.

We won't give away the whole story. But as the report went to print, more than 26 million Americans were out of work. Four million families have lost their homes to foreclosure, and another four and a half million have slipped into the foreclosure process or are seriously behind on their mortgage payments. Nearly \$11 trillion in household wealth has vanished, with retirement accounts and life savings swept away. The collateral damage of the crisis has been real people and real communities. The impact is likely to be felt for a generation.

Conclusions

What follows is a Cliffs Notes version of the commission's conclusions. For backdrop and details, read the complete report.

- 1) The financial crisis was avoidable. The captains of finance and the public stewards of our financial system ignored the warnings and failed to question, understand, and manage evolving risks within a system essential to the well-being of the American public. The prime example is the Federal Reserve's pivotal failure to stem the flow of toxic mortgages, which it could have done by setting prudent mortgage-lending standards. The Federal Reserve was the one entity empowered to do so, and it did not.
- 2) Widespread failures in financial regulation and supervision proved devastating to the stability of the nation's financial markets. The sentries were not at their posts, in no small part due to the widely accepted faith in the self-correcting nature of the markets and the ability of financial institutions to effectively police themselves.

- 3) Regulators had ample power in many arenas, but they chose not to use it. To give just three examples: the Securities and Exchange Commission could have required more capital and halted risky practices at the big investment banks. It did not. The Federal Reserve Bank of New York and other regulators could have clamped down on Citigroup's excesses in the run-up to the crisis. They did not. Policy makers and regulators could have stopped the runaway mortgage securitization train. They did not.
- 4) Dramatic failures of corporate governance and risk management at many systemically important financial institutions were a key cause of this crisis. Too many of these institutions acted recklessly, taking on too much risk, with too little capital, and with too much dependence on short-term funding. In many respects, this reflected a fundamental change in these institutions, particularly the large investment banks and bank holding companies, which focused their activities increasingly on risky trading activities that produced hefty profits. They took on enormous exposures in acquiring and supporting subprime lenders and creating, packaging, repackaging, and selling trillions of dollars in mortgage-related securities, including synthetic financial products. Like Icarus, they never feared flying closer to the sun.
- 5) A combination of excessive borrowing, risky investments, and lack of transparency put the financial system on a collision course with crisis. In the years leading up to the crisis, too many financial institutions, as well as too many households, borrowed to the hilt, leaving them vulnerable to financial distress or ruin if the value of their investments declined even modestly.

For example, as of 2007, the five major investment banks—Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley—were operating with extraordinarily thin capital. By one measure, their leverage ratios were as high as 40 to 1, meaning for every \$40 in assets, there was only \$1 in capital to cover losses. Less than a 3% drop in asset values could wipe out a firm.

And the leverage was often hidden—in derivatives positions, in off-balance-sheet entities, and through “window dressing” of financial reports available to the investing public. But financial firms were not alone in the borrowing spree: from 2001 to 2007 national mortgage debt almost doubled, and the

amount of mortgage debt per household rose more than 63%, from \$91,500 to \$149,500, even while wages were essentially stagnant. When the housing downturn hit, heavily indebted financial firms and families alike were walloped.

- 6) The government was ill prepared for the crisis, and its inconsistent response added to the uncertainty and panic in the financial markets. Key policy makers—the Treasury Department, the Federal Reserve Board, and the Federal Reserve Bank of New York—that were best positioned to watch over our markets were ill prepared for the events of 2007 and 2008. From the spring of 2007 on, policy makers and regulators were caught off guard as the contagion spread, responding on an ad hoc basis with specific programs to put fingers in the dike.

There was no comprehensive and strategic plan for containment, because they lacked a full understanding of the risks and interconnections in the financial markets. Senior public officials did not recognize that a bursting of the bubble could threaten the entire financial system. In addition, the government's inconsistent handling of major financial institutions during the crisis—the decision to rescue Bear Stearns and then to place Fannie Mae and Freddie Mac into conservatorship, followed by its decision not to save Lehman Brothers and then to save AIG—increased uncertainty and panic in the market.

- 7) There was a systemic breakdown in accountability and ethics. Lenders made loans that they knew borrowers could not afford and that could cause massive losses to investors in mortgage securities. To pin this crisis on mortal flaws like greed and hubris would be simplistic. It was the failure to account for human weakness that is relevant to this crisis. The crisis was a result of human mistakes, misjudgments, and misdeeds that resulted in systemic failures for which our nation has paid dearly.
- 8) Collapsing mortgage-lending standards and the mortgage securitization pipeline lit and spread the flame of contagion and crisis. Many mortgage lenders set the bar so low that lenders simply took eager borrowers' qualifications on faith, often with a willful disregard for a borrower's ability to pay. As irresponsible lending, including predatory and fraudulent practices, became more prevalent, the Federal Reserve and other regulators and authorities heard warnings from many quarters.

Yet the Federal Reserve neglected its mission "to ensure the safety and soundness of the nation's banking and financial system and to protect the credit rights of consumers." From the speculators who flipped houses to the mortgage brokers who scouted the loans, to the lenders who issued the mortgages, to the financial firms that created the CDOs, CDOs squared, and synthetic CDOs: no one in this pipeline of toxic mortgages had enough skin in the game. They all believed they could off-load their risks on a moment's notice to the next person in line.

They were wrong. When borrowers stopped making mortgage payments, the losses—amplified by derivatives—rushed through the pipeline. As it turned out, these losses were concentrated in a set of systemically important financial institutions.

- 9) Over-the-counter derivatives contributed significantly to this crisis. The enactment of legislation in 2000 to ban the regulation by both the federal and state governments of over-the-counter (OTC) derivatives was a key turning point in the march toward the financial crisis. Without any oversight, OTC derivatives rapidly spiraled out of control and out of sight, growing to \$673 trillion in notional amount.
- 10) The failures of credit rating agencies were essential cogs in the wheel of financial destruction. The three credit rating agencies were key enablers of the financial meltdown. The mortgage-related securities at the heart of the crisis could not have been marketed and sold without their seal of approval. In 2006 alone, Moody's put its triple-A stamp of approval on 30 mortgage-related securities every working day. The results were disastrous: 83% of the mortgage securities rated triple-A that year were ultimately downgraded.

Argument for the dissent

Several members disagreed with the commission's conclusions and made their own points about the causes of the financial crisis.

- 11) The financial crisis was a direct result of U.S. government housing policy. Over 27 million non-traditional mortgages were made during the buildup of the housing bubble. Why were these loans made? The demand for mortgage-backed securities among private investors may have played a role, but the real demand was created by the government's housing policies, which required government agencies and certain private organizations to acquire, hold, or

securitize inferior mortgages. Deregulation, lack of regulation, predatory lending, or the other factors that were cited in the report of the FCIC's majority were not determinative factors.

The policy implications of this conclusion are significant. If the crisis could have been prevented simply by eliminating or changing the government policies and programs that were primarily responsible for the financial crisis, then there was no need for the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, adopted by Congress in July 2010.

Who saw it coming? And who didn't?

"They should have seen it coming."

"I never saw it coming."

"I saw it coming but there was nothing I could do about it."

In the decade preceding the collapse, there were many warning signs that house prices were inflated, that lending practices had spun out of control, that too many homeowners were taking on mortgages and debt they could ill afford, and that risks to the financial system were growing unchecked. But reactions to the growing seeds of crisis varied.

Former Fed chief Alan Greenspan didn't see it. He told the Commission, "History tells us [regulators] cannot identify the timing of a crisis, or anticipate exactly where it will be located or how large the losses and spillovers will be." Charles Prince, the former chairman and chief executive officer of Citigroup, didn't see it. He called the collapse in housing prices "wholly unanticipated." Even the legendary investor Warren Buffett, whose Berkshire Hathaway is a major shareholder of the rating agency Moody's, called the housing bubble a "mass delusion" shared by 300 million Americans.

On the other hand, Richard Breeden, the former chairman of the Securities and Exchange Commission appointed by President H.W. Bush, said, "Everybody in the whole world knew that the mortgage bubble was there:

You can't make trillions of dollars' worth of mortgages and not have people notice." Veteran bankers knew that prudent lending practices had been cast aside. But the desire for a "high and quick return" blinded them to the fiscal realities.

Paul McCulley, a managing director at PIMCO, told the Commission that he and his colleagues began to get worried about "serious signs of bubbles" in 2005. They sent out credit analysts to 20 cities to do what he called "old-fashioned shoe-leather research," talking to real estate brokers, mortgage brokers, and local investors about the housing and mortgage markets. After that, the company "severely limited" its participation in risky mortgage securities.

The Commission's intent in telling the story was to keep something like this from happening again. But what it doesn't address is the frustration felt by ordinary Americans who responsibly managed their debt and did everything they were supposed to do, only to have their savings and retirement accounts decimated when their investments lost value.

The Commission did a good job of casting blame so that those who had a hand in creating the crisis might refrain from doing it again. Now all we need is a guide for innocent bystanders who simply want to achieve some measure of financial security for themselves and their families without having to worry about some unknown financial crisis undermining their best efforts to work, save, and invest for the future.

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