NATIONAL CENTER FOR POLICY ANALYSIS

The Mortgage Meltdown

Backgrounder No. 179 by Chanan Steinhart[1] September 2015

The 2008 financial crisis was one of the most severe economic breakdowns in the history of the world.[2] The crisis was a classic financial bubble with all the classic attributes thereof: greed, misallocations, malinvestment and irrationality. This bubble and the subsequent financial meltdown is a story about the U.S. housing market.

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Creating a Bubble

Although many people, organizations, policies and regulations contributed to the creation of the housing bubble and the ensuing 2008 crash, the overriding issue, or the "original sin," involved the incredible availability of cheap money for housing purchases. The abundance of money dedicated to housing fueled the bubble and enabled Wall Street's dubious behavior.

Interest Rates. The story of this bubble starts at the end of the previous one. The dot-com bubble, created after years of speculative investing in internet businesses, burst around 2000. After the collapse of the dot-com bubble, the U.S. economy fell into a recession. The federal government, however, aimed to avoid recessions and corrections at almost any price. To avoid a necessary economic correction, the Federal Reserve came to the rescue and reduced a key interest rate (the rate banks charge each other to borrow funds overnight, called the federal funds rate) 11 times throughout 2001. By November 2002, the interest rate dropped to 1.25 percent. This reduction aimed to encourage "liquidity," that is, borrowing, and with it, economic activity.

Mortgage interest rates also fell significantly. These low mortgage rates and the Fed near-zero interest rates created a rush by Wall Street firms to lend money. Looking for better yields, these firms started pushing money into the mortgage market. Also, for international investors, nothing seemed more lucrative and safe than investing in U.S. mortgages backed by collateral as solid as U.S. homes.

The Fed's low interest rates encouraged new debt-money creation, which, in the eyes of the Fed, meant economic stimulation. The Fed believed the housing market would replace dot-com businesses as a generator of economic activity. The rise in home prices would encourage not only more home building, but would also incite people to take loans out against their homes and use these loans for consumption, which would further stimulate the economy.

Rising Home Prices. In 1945, average inflation-adjusted housing prices in the United States were more or less what they had been 55 years earlier in 1890. [See Figure I.] For the next 55 years, home prices remained within a narrow band (plus or minus 12 percent). In fact, in 1995, prices returned to their 1890- 1945 levels.

In the early 2000s, however, home prices doubled. A housing bubble ensued due to a variety of factors. As money rushed toward this newly discovered opportunity, prices started to rise fast, bringing in more new home buyers and encouraging more home construction:

- Home prices grew rapidly across the nation. From 2000 to 2006, the median sales price of existing single-family homes rose by 56 percent, or 7.7 percent per year.[3]
- For example, in Bakersfield, California, where home starts doubled and home values grew even faster from 2001 to 2006, wide-open farm fields were plowed under and divided into thousands of building lots.[4]
- Home prices jumped 11 percent in Bakersfield in 2002, 17 percent in 2003, 32 percent in 2004 and 29 percent in 2005.[5]

"Many houses became a commodity for trading"

So-called "hot" markets, like Las Vegas, Florida and California, experienced even higher increases. As the buying frenzy spread, people started buying dozens of homes with the goal of renovating and selling them for a quick profit. Many houses became a commodity for trading, rather than properties where people lived. David Gussmann, a former vice president at Fannie Mae, told the Financial Crisis Inquiry Commission that in one package of 50 securitized loans his analysts found one purchaser who had bought 19 properties, falsely identifying himself each time as the owner of only one property, while another had bought five p operties.[6]

Housing Construction Boom. Rising home prices and easy availability of mortgage loans led to a construction boom.

- From 2002 to 2006, the number of new single family home built grew to more than 1.4 million per year.
- The amount of new home construction peaked at 1.8 million in 2005 and 2006; this was 25 percent to 50 percent more than in the period between 1985 and 1998.
- In the 5 years from 2002 to 2006, 2.2 million more homes were built than in the preceding 5 years.[7]

Even though this growth was not tied to real demand based on population growth, the housing inventory kept increasing. Meanwhile, officials in Washington cheered because increasing home ownership by expanding loan accessibility remained a long-time goal of successive presidential administrations. This policy somehow completely disregarded the question of whether the market and the people taking out the loans could handle the long-term burdens of such loans.

Mortgage Markets

The U.S. government had a long history of creating policies aimed at increasing homeownership among the American population. However, those goals eventually led to the loosening of borrowing standards, which caused a mortgage meltdown.

The Role of Government-Sponsored Enterprises. There are two government-sponsored enterprises (GSEs), the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, known as Fannie Mae and Freddie Mac, respectively, whose exact purpose is increasing homeownership.

Fannie Mae was established in 1938 with the mandate to buy mortgages from lending banks that followed certain guidelines set by the Federal Housing Administration — the office now within the U.S Department of Housing and Urban Development (HUD) responsible for guaranteeing FHA-approved home loans. The intent behind Fannie Mae was to ensure banks had an ongoing supply of money for mortgages. Fannie Mae then held the mortgages in its portfolio, or to a lesser degree, resold these mortgages to other investors. For the following 30 years, Fannie Mae was the only player buying mortgages from mortgage originators, in what is known as the secondary mortgage market. In 1968, Congress reformed the organization and turned it into a publicly traded company. Fannie Mae was still in the same business, but had become a GSE.

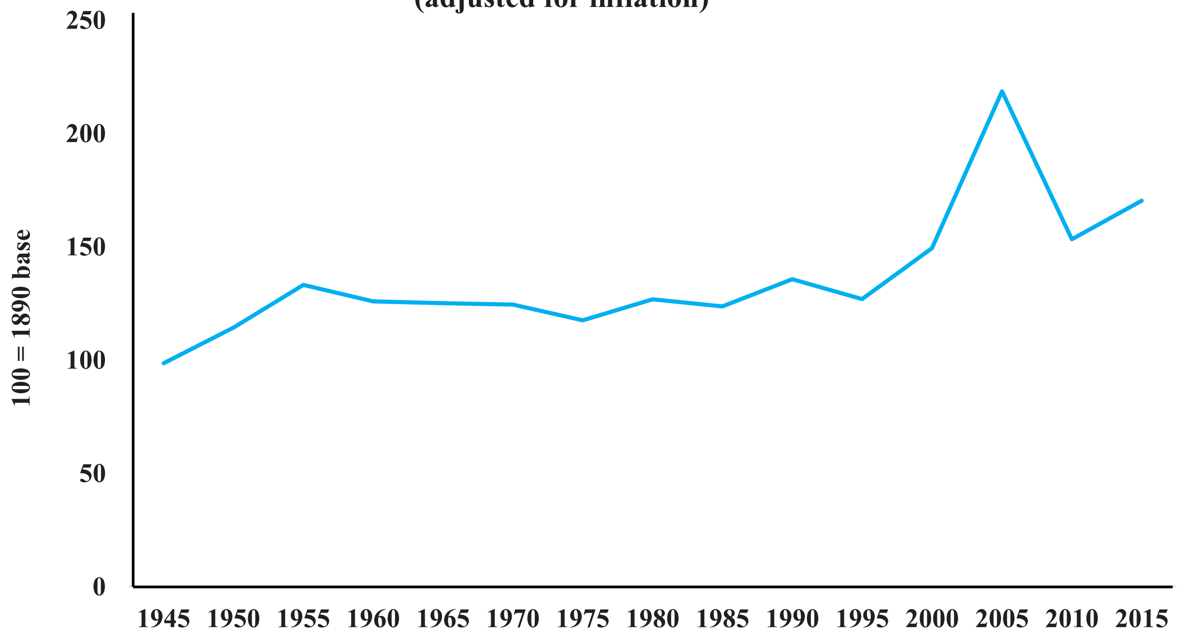
In 1970, the government set up a second GSE, Freddie Mac. The federal government required both to meet affordable housing mortgage purchase goals, set annually by HUD. To accomplish this, the U.S. government gave the two GSEs line of credits through the U.S. Treasury and exempted them from Securities and Exchange Commission registration and bank regulations on security holdings. The government also allowed them to have extremely low reserve ratios; one had a 2.5 percent reserve on loans and the other a 0.45 percent reserve. Both GSEs then repackaged and resold these loans as mortgage-backed securities — financial instruments that represent ownership of debt secured by a group of mortgages.

In the late 1980s and 1990s, Fannie Mae grew into the largest firm in the U.S. housing finance ecosystem Correspondingly, the obligations of the GSEs and the mortgage-backed securities they guaranteed grew almost 350-fold in 20 years: from $7.59 billion in 1990 to $1.4 trillion in 1995 and then to $2.4 trillion in 2000. All of these obligations were backed by only $37.5 billion of shareholder equity, which was their cash on hand, amounting to only 1.5 percent of the companies' liabilities. Here fractional-reserve banking reached its high point. These two organizations practically held a license to print money and use it to buy mortgages from banks and other mortgage originators. This setup created a potentially endless supply of money for mortgages.

Lowering Lending Standards. At this point the only two things preventing money from flooding the housing market were interest rates and stricter lending standards. The Federal Reserve, and the federal government and Wall Street, respectively, were loosening these controls, however, as the housing market went into hyperdrive in the early 2000s.

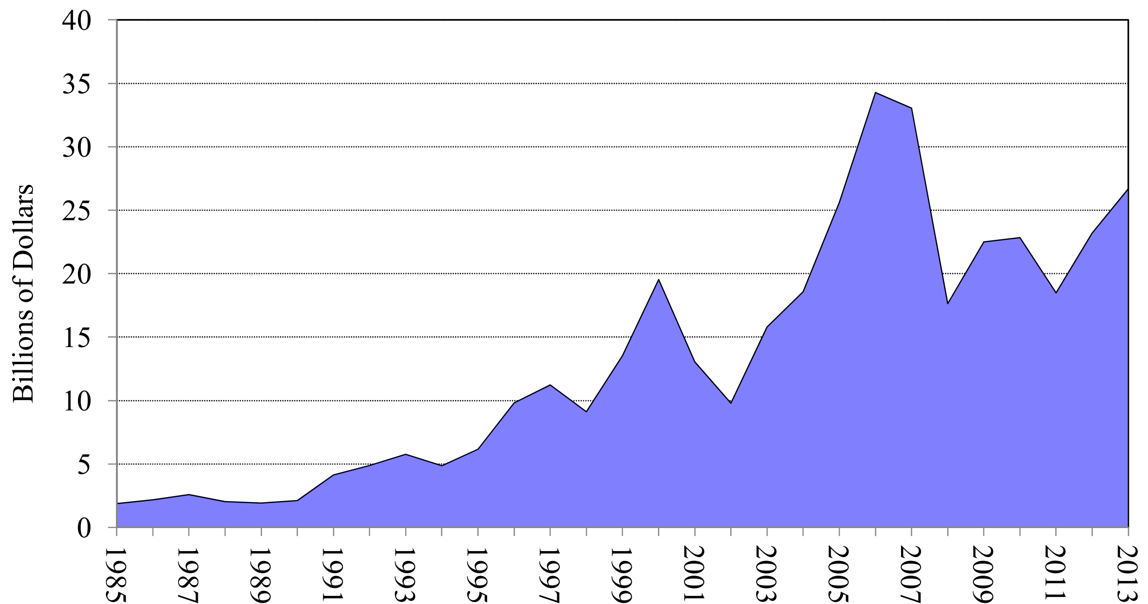
Even with the help of low interest rates, mortgage originators still had to bring in new borrowers to take out loans in order to continue growing the mortgage business. The market needed borrowers willing to take out new mortgages and buy all those newly built houses. So as the pool of traditionally qualifie borrowers started to dwindle, mortgage originators loosened requirements for borrowers. In the market of mortgage originators, Countrywide Financial Corporation was among the most important, if not *the* market leader. In 2006, Countrywide originated around 20 percent of all mortgages in the United States. Countrywide was also deeply involved in approving and issuing nontraditional loans; that is, loans that do not meet lending qualificati n standards. An inspection by the banking supervision division of the Federal Reserve found that in 2005 nontraditional loans made up 59 percent of originations at Countrywide, 58 percent at Wells Fargo and 51 percent at National City. The inspection found that "two-thirds of the nontraditional loans made by the banks in 2003 had been what is known as 'liar loans' or loans missing the basic documents needed to qualify for a mortgage."[8]

Figure I
Case-Schiller Index of Housing prices, 1945-2015
(adjusted for inflation)



Source: Case-Schiller Home Price Index by Year.

Still, “originating what was sellable in the secondary market” remained the business strategy of choice. Countrywide indeed proceeded to sell 87 percent of the $1.5 trillion in mortgages it originated from 2002 to 2005 to secondary buyers; Fannie Mae was one of its top buyers.[9] As risk in lending increased, so did the creativity in making loans available.



Note: The bonus pool reflects cash payments and deferred compensation for which taxes have been withheld.
Prepared by the Office of the State Comptroller, March 12, 2014

Mortgage originators began introducing new sets of loans, which Fannie and Freddie bought up. These new sets included nonprime mortgages, namely Alternative A-paper loans (Alt-A), or loans that do not include the borrower’s necessary financial documentation; and subprime loans, or loans with much higher interest rates than those offered to the most qualified borrowers Banks offered these to individuals who could not qualify for prime rate loans, typically due to low credit ratings. According to the Government Accountability Office, in 2006 subprime loans accounted for 34 percent of the overall mortgage market. They grew from an estimated $171 billion in 2002 to $877 billion in 2005.[10]

Private Sector Actors. Fannie and Freddie were not the only ones owning or guaranteeing mortgages. By this time, pooling large collections of mortgages together into a bundle and selling the package to investors as a mortgage-backed security had become standard practice. Financial investors and institutions the world over purchased hundreds of billions of dollars in mortgage-backed securities. Large institutions like American International Group (AIG), one of the largest insurance companies in the United States, then used credit default swaps — insurance policies on bonds investors acquired — to insure many of these mortgage-backed securities against default.

In 2006, everyone, from the Fed to Wall Street, was happy. Ever-increasing home prices created a wealth effect that enticed tens of millions of households to pull equity from their mortgages and spend the money on consumption. Meanwhile, the New York State Comptroller's Office reported executive and employee bonuses almost doubled over a three-year period from 2004 to 2006, from $18.6 billion in 2004 to $34.3 billion in 2006, averaging almost $200,000 per employee. [See Figure II.] In fact, Wall Street’s largest investment bank, Goldman Sachs, dedicated $16.5 billion to year-end bonuses. The chairman was paid a record $54 million in 2006, while top management received $25 million each. The CEO of Morgan Stanley, the country’s second-largest investment

bank, made $40 million in stock and options. Other financial institutions like Lehman Brothers and Bear Stearns paid out about $12 billion in bonnuses, averaging some $300,000 per employee.[11] At Merrill Lynch, the company disbursed $5 billion to $6 billion in bonuses.[12] Bonuses were almost three times the size they had been 10 years prior, and almost 10 times the size of 1990 bonuses.

The Housing Bubble

By 2006, the economy displayed all the classic characteristics of a financially-driven bubble. Construction of new homes outpaced demand and homeowners began defaulting in record numbers.

Housing Industry and Stock Market Signal the Coming Crash. Builders constructed millions of unneeded houses, 15 percent to 20 percent larger in size than houses of the previous decade, peaking at 3.5 million vacant houses.[13] Coincidently, residential construction jobs grew from 5.5 million in 1996 to 7.4 million jobs at the peak of the bubble in 2005. Had there not been a bubble, it is estimated that there would have been 1.7 million to 2.2 million fewer residential construction-related jobs in 2008.[14]

The stock market also reflected the housing bubble The Dow Jones and S&P 500 almost doubled from late 2002 to late 2007. By December 2007, however, the collapse had begun. The value of financial institution shares dropped and financial companies posted large losses. By early 2008, more and more homeowners were defaulting on loans, Wall Street was posting dismal results, and financial institutions stock prices were declining sharply.

The burden of debt taken on by the American public grew at an unprecedented rate: "Overall mortgage indebtedness in the United States climbed from $5.3 trillion in 2001 to $10.5 trillion in 2007. The mortgage debt of American households rose almost as much in the six years from 2001 to 2007 as it had over the course of the country's more than 200-year history."[15]

Though the signs of something going wrong were all over the place, those on Wall Street and at the Federal Reserve continued business as usual. The debt-money machine plowed ahead. Richard Bowen described the moment as "Wall Street [moving forward] — ordering up loans, packaging them into securities, taking profits, earning bonuses." From the third quarter of 2006 forward, "banks created and sold some $1.3 trillion in mortgage-backed securities and more than $350 billion in mortgage related CDOs."[16] It took more than a year for the news to receive the attention it merited. By mid-2007 the entire scheme started to unravel entirely. By the time the Fed finally was willing to recognize that something was wrong, it was far too late.

The Bubble Bursts. Throughout 2007 and into 2008, housing prices fell and foreclosures rose. This slowdown placed pressure on those financial sector holding, guaranteeing and insuring mortgages and their derivatives. The first warning sign came in July 2007 when Bear Stearns, one of Wall Street's largest investment banks, announced that its two subprime hedge funds had lost nearly all of their value amid a rapid decline in the market value of subprime mortgages. By mid-March 2008, Bear Stearns had hit a brick wall. With the help of the Federal Reserve — in the form of $30 billion — JP Morgan agreed to acquire the company. The price was set at $2 a share, a stunning fall from its $172 share price just four months prior. Those in the financial community believed they had narrowly averted a major catastrophe.

As the bubble entered its final stage in late 2007-early 2008, Fannie Mae and Freddie Mac owned or guaranteed some $5.3 trillion of mortgages while holding barely 2 percent of this sum in capital. All major financial institutions had bought large quantities of mortgage-backed securities as well, exposing themselves to great risk. The largest insurance companies insured mortgage-backed securities via credit default swaps, which spread the risk even further. By late 2007, and to an even greater extent in 2008, the bubble had begun collapsing. Housing prices plummeted 18 percent from mid-2007 to mid-2008, and defaults on mortgage loans and foreclosures piled up. These defaults created mounting losses for the GSEs holding or guaranteeing these mortgages. In time, these losses wiped out the GSEs' entire capital. By September 2008 the companies were practically insolvent.

The Federal Response. On September 6, 2008, the Federal Housing Finance Agency (FHFA) — an independent federal regulator for the secondary loan market — placed Fannie Mae and Freddie Mac into conservatorship, essentially taking over the two companies. Nevertheless, problems remained. From January 2008 through the third quarter of 2010, the two GSEs lost $229 billion. The Congressional Budget Office

(CBO) projected that the cost of the GSEs' failure could reach $389 billion by 2019.[17] The failure of Fannie Mae and Freddie Mac prompted investors and institutions to scramble for cover, sell toxic assets and pull their money out of risky institutions.

Lehman Brothers, the fourth largest investment bank in the United States with almost $20 billion in revenue, 28,000 employees, and $600 billion in assets and liabilities, fell soon after. On September 10, just four days after the government placed Fannie Mae and Freddie Mac in conservatorship, Lehman Brothers announced its financial losses. Yet, Secretary of the Treasury Paulson refused to extend the same help offered to Fannie and Freddie. On September 15, Lehman Brothers filed fo bankruptcy, stunning Wall Street.

On that same day, Merrill Lynch — with 64,000 employees and $64 billion in revenue, ranked number 70 in the Fortune 500 list of largest global companies for 2007 — posted large mortgage losses and was unable to finance its short-term debts. Bank of America bought Merrill Lynch after the federal government threatened it would remove top executives if they did not go through with this deal.[18] Then AIG, which had insured some $441 billion worth of mortgage-backed securities, closed its doors. As more and more mortgages defaulted, AIG had to pay out insurance claims. To make matters worse, the downgrade of the rest of the securities, which hadn't defaulted yet, required AIG to come up with additional collateral reserves as insurance for those securities. Luckily for AIG, the government concluded that it could not be allowed to go the way of Lehman and thus, on September 16, committed $180 billion to its rescue.

Hedge funds, commercial banks, and investment banks all came under huge pressure from investors trying to get their money out of harm's way. In the next 10 days, the Fed provided $300 billion to commercial and investment banks in hopes of stemming the tide. On September 20, the Treasury sent Congress a proposal known as Troubled Asset Relief Program (TARP), which would authorize the spending of $700 billion to buy the toxic mortgage-related assets (that is, the packaged and securitized dubious mortgages) from financial institutions. This convenient initiative would remove the toxic assets from the financial institutions' balance sheets and replace them with freshly printed dollars. More than 700 institutions and companies nationwide received TARP's hundreds of billions of dollars, including $81 billion to automobile manufacturers and auto financing companies.

Ripples throughout the Economy. The damage of the financial crisis quickly spread to Main Street. Credit froze almost overnight, causing disruptions in the day-to-day operations of businesses throughout the economy. A sharp drop in consumer spending followed. Meanwhile, construction companies laid off workers previously engaged in unnecessary construction and finance. Rising unemployment led to further cutbacks in consumer spending, which led to more layoffs, which in turn led to more consumer spending cuts and so on. By December 2009, the U.S. economy had lost some 8 million jobs, and the number of unemployed and under-employed reached some 17 percent of the workforce.

Some 8 million families had their homes foreclosed or put in the foreclosure process. Prices plummeted 32 percent nationwide, and in the previously "hot" markets like Nevada, Florida and California, prices tanked nearly 50 percent. State and local governments also felt the pain. As property and sales tax incomes fell, so did tax revenues; and when the incoming money dwindled, the demand for government assistance such as unemployment benefits, welfare, Medicare and Medicaid rose sharply.

The stock market followed the overall decline. The Dow Jones Industrial Average (DJIA), which was around 14,000 in mid-2007, fell to a low of 6,600 by March 2009. *Simultaneously* the S&P 500 fell almost 60 percent from 1,560 to 680 points, where it had been in 2002, pre-bubble.

Faced with a growing crisis, the Federal Reserve and the federal government turned to printing and creating money at an unprecedented scale. Following the hundreds of billions of TARP relief dollars, Congress enacted the $700 billion American Recovery and Reinvestment Act *(ARRA)*, better known as the stimulus package. That was enough, and the Federal Reserve then embarked on a series of programs known as Quantitative Easing (QE). Through three QE programs, the last one ending in late 2014, the Federal Reserve created about $3.5 trillion in new money and "lent" it to the Treasury and to financial institutions.

The bailout, the stimulus and QE programs opened the gates to a new level of government deficit. In the four years prior to the crisis, the average federal budget deficit stood at $300 billion a year. After the financial meltdown the deficit shot up more than fourfold: to $1.4 trillion in 2009, $1.3 trillion in 2010, $1.3 trillion in 2011, $1.1 trillion in 2012 and $680 billion in 2013,

increasing the debt from $10 trillion dollars in September 2008 to $18 trillion by December 2014.[19]

The Fed not only flooded both American and international markets with trillions of new dollars, but it also pushed interest rates down to zero, literally. In June 2012, the interest (or yield) on 10-year government bonds fell to a 200-year low. This and the QE programs pushed the stock market up to record levels.

Conclusion

September 2008 saw the violent collapse of the mother of all economic bubbles, which wrought havoc on both the national and international economy. Yet, the government's principal economic representatives, Ben Bernanke and Tim Geithner, continued serving as heads of the Fed and the Treasury, respectively. And the government took no legal action against any bank or other financial institution, or their top executives.

Similarly, the Financial Crisis Inquiry Commission (FCIC) report received very limited attention from the public and the press. The *Wall Street Journal* stashed an article on the report on page A4, and put it sixth in the Business & Finance column, right below some news about Amazon's mixed earnings. The *Washington Post* concluded that "the report does not contain any major revelation that would fundamentally alter popular perceptions of the crisis." The *New Yorker* went down a similar path, covering the report with an article titled "Crisis Panel's Report Parsed Far and Wide" which was placed on the *New Yorker* website below stories like: "US Approves Genetically Modified Alfalfa."[20] With this level of accountability and responsibility we will soon see the manifestation of the saying, learn from history or you are doomed to repeat it.

Chanan Steinhart is a business leader, strategic consultant to several major tech companies, and the author of A Brief History of Money: How We Got Here and What's Next.

Notes

1. Adapted from Chanan Steinhart, *A Brief History of Money: How We Got Here and What's Next* (San Francisco: Market Street Publishing, 2015). Available at http://www.amazon.com/Brief-History-Money-Here-Whats/dp/0990847306/ref=cm_cr_pr_product_top?ie=UTF8.

2. "Financial Crisis Inquiry Report," Financial Crisis Inquiry Commission, February 2011, page 354. Available at http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf.

3. "Housing Wealth and Consumer Spending," Congressional Budget Office, January 2007. Available at http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/77xx/doc7719/01-0 housing.pdf.

4 "Financial Crisis Inquiry Report," page 161.

5. Ibid.

6. Ibid.

7. Information obtained and summarized from NAHB/Wells Fargo Housing Market Index and U.S. Census Bureau.

8. "Financial Crisis Inquiry Report," page 20.

9. Ibid.

10. Jason Thomas and Robert Van Order, "A Closer Look at Fannie Mae and Freddie Mac: What We Know, What We Think We Know, and What We Don't Know," George Washington University, March 2011, page 4. Available at http://business.gwu.edu/wp-content/uploads/2014/05/A-Closer-Look-at-Fannie-Mae-and-Freddie-Mac-What-We-Know-What-We-Think-We-Know-and-What-We-Dont-Know.pdf.

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15. "Financial Crisis Inquiry Report," page 7.

16. Ibid., page 19.

17. Ibid., page 321.

18. House of Representatives, "Activities of the Committee on Oversight and Government Reform," House Report 111-705, January 2011. Available at http://www.gpo.gov/fdsys/pkg/CRPT-111hrpt705/html/CRPT-111hrpt705.htm.

19. Treasury Direct. Available at http://www.treasurydirect.gov/NP/debt/current.

20. Ryan Chittum, "Financial Crisis Inquiry Commission FAIL," *Colombia Journalism Review*, January 28, 2011. Available at http://www.cjr.org/the_audit/financial_crisis inquiry_commi.php?page=all.

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