Statement before the Housing Financial Services Committee
On The Financial Crisis Inquiry Commission

# The Financial Crisis Inquiry Commission

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Chairman Bachus, ranking member Frank, and members of the Committee:

It is a pleasure for me to appear before you today. As requested by the Committee's invitation letter, my testimony discusses the findings of the Commission's majority and minority, an assessment of the Dodd-Frank Act in light of these findings, and the reason for the Commission's inability to reach a consensus. Before turning to the substance of the Commission's majority and dissenting reports, I would like to comment on how the Commission was organized and run.

## The Commission's Process

From the beginning of the Commission's substantive operations, it was not run as I would have expected. It seemed to me that the financial crisis of 2008 was a matter of such importance that it deserved a serious inquiry, similar to the work of the so-called 911 Commission. The financial crisis was an unprecedented event, possibly the worst financial catastrophe in U.S. history, and will be studied by historians, economists and other scholars for years in the hope of understanding what caused it and how similar events can be avoided.

So I was honored to have been nominated as a member of the FCIC by the minority leader of the House of Representatives at the time, John Boehner, and I was looking forward to participating in a study that—in light of the seriousness of the matter the Commission was charged with investigating—would be thorough and objective. It might not find agreement on the causes of the financial crisis, but it would provide some early guidance to Congress about what remedies were necessary and to the scholars and others who will be studying this issue for years to come.

That is not what I experienced.

I would have expected that, at the outset of the Commission's work, the members would discuss what they thought were the most important issues for the staff to investigate. If I had made a list at that time, it would have included many of the ideas—hypotheses, I would have called them—that were current in public discussion at the time and for that reason alone deserved to be looked into in detail. These included the possibility that the crisis was caused by easy Fed monetary policy in the early 2000s, a flood of funds from abroad looking for high returns, the repeal of a portion of the Glass-Steagall Act, fair value or mark-to-market accounting, government housing policies and the role of the government-sponsored enterprises, the causes of the housing bubble, lack of or insufficient regulation, interconnections among financial institutions, and many others. My initial view was that many of these hypotheses were not factors in the crisis, but I thought they should be investigated so that the Commission could provide to Congress, scholars and the American people the best answers that a thorough and objective investigation could reveal.

As it turned out, the members of the Commission never had an opportunity to discuss these issues. The members were appointed in July 2009 and the first few months of the Commission's existence were spent in hiring the staff and establishing the basic rules for how the Commission would operate. By the late fall of 2009, we were ready to begin the substantive portion of the Commission's work. However, there was never a time during this period when the members were invited to sit around a table and consider what issues the Commission would actually investigate. Instead, in early December, we were given a list of the public hearings that the Commission would conduct. The list included Subprime Lending, Securitization and the GSEs, the Shadow Banking System, Credit Rating Agencies, Complex Financial Derivatives, Excessive Risk and Financial Speculation, Too Big to Fail, and Macroeconomic Factors. This list pretty well traces the work of the Commission thereafter, except that no hearing was ever held on Macroeconomic Factors. Why these particular subjects were chosen was never explained. Moreover, since the work of the staff was going to be devoted to preparation for the hearings, the list of hearing topics meant that the focus of the Commission's work had essentially been determined for us, before any of us had had a chance to consider alternative approaches or additional subjects. The Commission majority report reflects its concentration on just these topics and little else.

What this meant was that a large number of important issues were not addressed in any detail by the Commission. These included many of the items I mentioned above that remain controversial and unexamined as significant causes of the financial crisis. This doesn't mean that the Commission majority did not discuss or mention one of these subjects in their report, only that they did not do a sufficient investigation to produce data or useful observations to support the assertions in their report.

Even on the question of housing, subprime lending and the GSEs, a matter that I considered of major importance, the majority's focus was on management errors that caused the GSEs to fail rather than what contributions the GSEs might have made to the unprecedented number of subprime and other weak loans in the U.S. financial system. Later in this testimony, I will explain why I believe this issue was crucial for study by the Commission, but it never received any significant attention—as shown in the Commission majority's report.

One particular example illustrates the Commission's lack of interest and objectivity on this subject. In March 2010, Edward Pinto, a resident fellow at the American Enterprise Institute (AEI) who had served as chief credit officer at Fannie Mae, provided to the Commission a 70-page, fully sourced memorandum on the number of subprime and other high risk mortgages in the financial system immediately before the financial crisis. In that memorandum, Pinto recorded that he had found over 25 million such mortgages (his later work showed that there were approximately 27 million).[1] Since there are about 55 million mortgages in the U.S., Pinto's research indicated that, as the financial crisis began, *half* of all U.S. mortgages were of inferior quality and liable to default when housing prices were no longer rising. In August, Pinto supplemented his initial research with a paper documenting the efforts of the Department of Housing and Urban Development (HUD), over two decades and through two administrations, to increase home ownership by reducing mortgage underwriting standards.[2]

This research raised important questions about the role of government housing policy in promoting the high risk mortgages that played such a key role in both the mortgage meltdown and the financial panic that followed. Any objective investigation of the causes of the financial

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[1] Edward Pinto, "Triggers of the Financial Crisis" (Triggers memo). http://www.aei.org/paper/100174

[2] Edward Pinto, "Government Housing Policies in the Lead-up to the Financial Crisis: A Forensic Study," http//ww.aei.org/docLib/Government-Housing-Policies-Financial-Crisis-Pinto-102110.pdf

crisis would have looked carefully at this research, exposed it to the members of the Commission, taken Pinto's testimony, and tested the accuracy of Pinto's research. But the Commission took none of these steps. Pinto's research was never made available to the other members of the FCIC, or even to the commissioners who were members of the subcommittee charged with considering the role of housing policy in the financial crisis.

Accordingly, the Commission majority's report ignores hypotheses about the causes of the financial crisis that any objective investigation would have considered, while focusing solely on theories that confirm one political narrative about the financial crisis. This is not the way a serious and objective inquiry should have been carried out, but that is how the Commission used its resources and its mandate.

There were many other deficiencies. The Commission's report claimed that it interviewed hundreds of witnesses, and the majority's report is full of statements such as "Smith told the FCIC that…." However, unless the meeting was public, the commissioners were not told that an interview would occur, did not know who was being interviewed, were not encouraged to attend, and of course did not have an opportunity to question these sources or understand the contexts in which the statements quoted in the report were made. Thus, the extensive use of interviews—instead of references to documents—raises a question whether there was bias in seeking particular statements from interviewees, and whether their statements were challenged in any way, with documentation or otherwise, during the interviews. The Commission majority's report uses the opinions of its interviewees as substitutes for hard data, which is notably lacking in their report; opinions in general are not worth much as evidence, especially in hindsight and when given without opportunity for challenge. The Commission claims that it reviewed millions of pages of documents. It probably received millions of pages of documents, but whether they were actually reviewed is doubtful. Very little in the report quotes from documents the Commission received, rather than from people it interviewed.

The Commission's authorizing statute required that the Commission report on or before December 15, 2010. The original plan was for us to start seeing drafts of the report in April. We didn't get any drafts until November, when we started to receive drafts of chapters in no particular order. We were given an opportunity to submit comments on these chapters in writing, but never had an opportunity to go over the wording as a group or to know whether our comments were accepted. We received a complete copy of the majority's report, for the first time, on December 15. It was almost 900 double-spaced pages long. The report was to be approved eight days later, on December 23. That is not the way to achieve a bipartisan report, or the full agreement of any group that takes the issues seriously.

In summary, the overall direction of the Commission majority's report was determined before the Commission started its work. It focused on issues that were part of one well-known ideological narrative for the financial crisis, and never paid serious attention to other views. It was not in any sense an objective or thorough investigation, did not produce any facts or data that could aid scholars in the future (although its disclosure of documents might assist scholarly research), and in my view was a waste of the taxpayers' money.

## The Substantive Reasons for my Dissent

Since the commission's mandate was to explain what caused the financial crisis, my dissent focuses almost entirely on that question. George Santayana is often quoted for the aphorism that "those who cannot remember the past are condemned to repeat it." Attempting to identify the causes of the financial crisis, however, shows that Santayana's idea was a bit facile. Although we know what happened in the past, there is still debate about what caused it to happen. The continuing appearance of revisionist histories about important events such as our own Civil War or the Great Depression testifies to the protean quality of the past. The difficult task for historians, economists, and public policy specialists is to discern which, among a welter of possible causes, were the significant ones—the ones without which history would have been different.

Using this standard, I believe that the *sine qua non* of the financial crisis was the US government's housing policies; these fostered the creation of 27 million subprime and other risky loans, half of all mortgages in the United States, which were susceptible to default when the massive 1997–2007 housing bubble began to deflate. If the US government had not chosen this policy path—feeding the growth of a bubble of unprecedented size and an equally unprecedented number of weak and high-risk residential mortgages—I do not believe that the great financial crisis of 2008 would have occurred.

This conclusion has significant policy implications. If as I believe government housing policy was responsible for the financial crisis, it was not caused by failures of regulation or risk management, or by predatory lending, unregulated derivatives, or compensation structures on Wall Street. That is not to say that these other factors did not have some role once the mortgage meltdown began in 2007, but only that without the unprecedented number of subprime and other high risk mortgages, fostered principally by the U.S. government's housing policy, there would have been no serious and widespread losses that ultimately triggered the financial crisis. Accordingly, the significant restrictions that were placed on the U.S. financial system by the Dodd-Frank Act (DFA) were not necessary to prevent another financial crisis. Under these circumstances, I believe a full review of the DFA and its effect on future growth in our economy is warranted.

In the balance of this testimony, I will refer to subprime and other high risk mortgages as nontraditional mortgages (NTMs). They are and were nontraditional because they generally lacked the qualities of the loans that were routinely made in the United States—and purchased by Fannie and Freddie—prior to the imposition of the affordable housing requirements in Title XIII of the Housing and Community Development Act of 1992 (the GSE Act).[3] Before the GSE Act, mortgages generally required down payments of 10 to 20 percent, a good credit rating, and a reasonable debt-to-income ratio. The reason for this was that the GSEs' charters both required that they only purchase mortgages that would be "acceptable investments for institutional investors."[4] Many of the mortgages made after 1992 were NTMs because—for the reasons outline below—they lacked the features that would have made them acceptable for institutional investors. Interestingly, after the crisis, and with some relief from the affordable housing

[3] Public Law 102-550, 106 Stat. 3672.

[4] Section 1719 of Fannie's charter stated: "[T]he operations of the corporation…shall be confined…to mortgages which are deemed by the corporation to be of such quality, type, and class as to meet, generally, the *purchase standards imposed by private institutional mortgage investors*."[4] [emphasis added]

requirements, the GSEs' credit underwriting standards seem to have returned to where they were before 1992.

The US government's housing policies were intended to increase homeownership by providing low-income borrowers with increased access to mortgage credit. To achieve this objective, the Department of Housing and Urban Development (HUD) in both the Clinton and George W. Bush administrations carried on an intensive effort to reduce mortgage underwriting standards. For this purpose, HUD used (i) the affordable-housing requirements imposed on Fannie and Freddie in the GSE Act, (ii) its control over the policies of the Federal Housing Administration (FHA), and (iii) a "Best Practices Initiative" for subprime lenders and mortgage banks such as Countrywide, to encourage greater subprime and other high-risk lending.

Ultimately, all these entities, as well as insured banks covered by the Community Reinvestment Act (CRA), were compelled to compete for mortgage borrowers who were at or below the median income in the areas where they lived. Because prime borrowers were not easy to find among such borrowers, mortgage underwriting standards had to be reduced in order to find mortgages that met the government's demands. This inevitably increased the numbers of NTMs far beyond what the market would have produced without government influence, and contributed importantly to the growth of the 1997–2007 housing bubble.

When the bubble began to deflate in mid-2007, the millions of low-quality loans produced by this competition began to default in unprecedented numbers. The effect of these defaults was exacerbated by the fact that few if any investors—including housing-market analysts—understood at the time that Fannie Mae and Freddie Mac had been acquiring large numbers of NTMs to meet HUD's affordable-housing goals. Thus, when the large number of mortgages began to default in 2007, investors were shocked and fled the multitrillion-dollar market for private mortgage-backed securities (MBS), dropping MBS values—and especially those MBS backed by NTMs—to fractions of their former prices. Mark-to-market accounting then required financial institutions to write down the value of their assets, reducing their capital and liquidity positions and causing great investor and creditor alarm.

In this environment, the government's rescue of Bear Stearns in March 2008 temporarily calmed investor fears but created significant moral hazard; investors and other market participants reasonably believed after the rescue of Bear that all large financial institutions would also be rescued if they encountered financial difficulties. However, when Lehman Brothers—an investment bank even larger than Bear—was allowed to fail, market participants were shocked; suddenly, they were forced to consider the financial health of their counterparties, many of which appeared weakened by losses and the capital writedowns required by mark-to-market accounting. This caused a halt to lending and a hoarding of cash—a virtually unprecedented period of market paralysis and panic that we know as the financial crisis.

**Finding the Cause**

Many commentators, as well as the commission majority and the three Republican members of the Commission (Bill Thomas, Keith Hennessey and Douglas Holtz-Eakin, whom I shall call the THH Dissenters), have expressed disagreement with my view of the causes of the financial crisis; they argue that the crisis was more complex and cannot be explained by any single cause. However, everyone agrees that the financial crisis *had* a single cause: the mortgage meltdown in late 2007 and the resulting delinquency and default of an unprecedented number of US mortgages. As the commission majority said, “While the vulnerabilities that created the potential for crisis were years in the making, it was the collapse of the housing bubble—fueled by low interest rates, easy and available credit, scant regulation, and toxic mortgages—that was the spark that ignited a string of events, which led to a full-blown crisis in the fall of 2008.” Indeed, most of the commission majority’s report was taken up with anecdotes about how financial institution managers and regulators failed to recognize the growth of the housing bubble and prevent the buildup of NTMs in the US financial system.

Since a mortgage meltdown was the acknowledged trigger of the financial crisis, a commission charged with determining what caused the financial crisis should want to find out why there was such a massive accumulation of NTMs—the “toxic mortgages” described above—that defaulted when the bubble deflated. Why, for example, did the underwriting standards that had prevailed for many years in the US mortgage market suddenly begin to deteriorate in the early 1990s? If the financial crisis was in fact caused by the default of these mortgages, why these NTMs were created was clearly the key question for the commission’s inquiry. Unfortunately, neither the commission majority nor the THH dissenters made any significant effort to address this central issue.

For example, the majority’s report says only that the “toxic mortgages” were “fueled by low interest rates and easy and available credit.” Exactly how low interest rates and easy and available credit caused a decline in underwriting standards is never explained. Similarly, the THH dissent says that “tightening credit spreads, overly optimistic assumptions about US housing prices, and flaws in primary and secondary mortgage markets led to poor origination practices.” How tightening credit spreads and the other factors led to “poor origination practices” is never addressed. In effect, both the majority report and the THH dissent treat the existence of 27 million weak loans as a “given”—a starting point for which no explanation is required.

This is not a minor flaw in their arguments. It is a serious failure to address the one aspect of the financial crisis that distinguishes it from all previous financial disruptions and crises. Before the 2008 crisis, the United States had frequently experienced extended periods of low interest rates, large flows of funds from abroad, and excessive optimism about the future of housing prices. We also had the same general regulatory and financial structure and a private financial system in which managements were expected to anticipate and act on risks to their firms. None of these conditions or factors, separately or together, had ever before resulted in a mortgage-based financial crisis. The one element in the 2008 financial crisis that was completely unprecedented was the presence of 27 million NTMs; never in the past were half of all mortgages in the United States in danger of delinquency and default when a housing bubble deflated. Treating this factor as a given is a classic case of ignoring the elephant in the room, and it prevented the commission majority and the THH dissenters from gaining a clear understanding of the mechanism through which the 2008 crisis came about.

My dissent addresses this error. It attempts to explain why there were so many NTMs in the US financial system in 2008, how the massive number of these loans caused the extraordinary size and longevity of the 1997–2007 bubble, and how the collapse of the bubble and the private MBS market caused the weakness of financial institutions around the world.

**The Deterioration of Underwriting Standards**

It seems obvious that such a large number of NTMs could not have accumulated in the US financial system unless there had been a serious decline in mortgage underwriting standards. Why that decline occurred is a major piece of the crisis puzzle. For fifty years following World War II, US residential mortgages were solid assets, bought and held as investments by banks and other financial institutions in the United States and around the world. During this period, there were two major US housing bubbles—in 1979 and 1989—but when they deflated they resulted only in local losses. If housing prices ever fell nationally—and this is a debated question—it was never more than by a small percentage. It again seems obvious that the reason for this stability was the existence of strong underwriting standards, requiring down payments and good credit records for those who wanted to buy homes.

Why were previous (traditional) underwriting standards abandoned? As I discuss in my dissent, the deterioration of mortgage underwriting standards began in 1992, when Congress adopted the GSE Act and imposed what were called "affordable housing (AH) goals" on Fannie Mae and Freddie Mac. Under these requirements, a certain percentage of mortgages purchased by Fannie and Freddie had to be loans to low- and moderate-income (LMI) borrowers—home buyers whose income was at or below the median income in the areas where they lived. This was the initial step in a US government social policy that eventually had the desired effect: it made substantial amounts of mortgage credit available to LMI borrowers for the first time, and it succeeded in increasing the homeownership rate in the United States from 64 percent (where it had been for thirty years) to more than 69 percent in 2004. However, this policy also created a ten-year housing bubble of unprecedented size, and the growth of the bubble—by suppressing delinquencies and defaults as housing prices climbed—fostered a large market for securitized NTMs held by financial institutions in the United States and around the world. When the bubble collapsed, these NTMs became the toxic assets that endangered the stability and solvency of many financial institutions and caused others to become insolvent or illiquid.

Initially, Congress set the AH goals at 30 percent; 30 percent of the loans the GSEs bought from originators had to be loans to LMI home buyers. In the succeeding fifteen years, HUD tightened and extended these requirements so that by 2007, 55 percent of all loans had to qualify as affordable-housing loans to LMI borrowers. HUD also added various subgoals that required loans to borrowers at or below 80 percent and 60 percent of area median income, and these subgoals were enlarged even more substantially than the main LMI goal. Generally speaking, once the AH goals exceeded 50 percent, the GSEs had to find one goals-eligible mortgage for every prime mortgage they bought. Since not all NTMs were goals-eligible, the GSEs had to buy more NTMs than the goal requirement in order to be sure in any year that they exceeded the goal. As discussed in my dissent, this requirement forced Fannie and Freddie into adopting various schemes to manipulate their reported numbers by paying originators to defer delivering prime loans or temporarily "renting" subprime loans from others in order to meet the goals for a particular year.

With HUD's increasingly aggressive affordable-housing requirements, and several entities competing for the same borrowers, it was simply not possible to find enough prime borrowers among the targeted LMI group to meet the government's demands without reducing mortgage underwriting standards. It's that simple. In my view, this is the only plausible explanation for why mortgage underwriting standards declined so significantly between 1992 and 2007.

To illustrate what happened to mortgage underwriting standards during this fifteen-year period, consider down payment requirements. By 2000, Fannie Mae was offering to buy loans with zero down payments. As described below, originators found that they could make loans to people with little or no down payment resources and still sell those loans to Fannie or Freddie. Between 1997 and 2007, Fannie and Freddie bought over $1 trillion in mortgages with down payments of 5 percent or less. In 1990, only one in two hundred purchase money mortgages (that is, not refinances) had a down payment requirement of less than 3 percent, but by 2007 almost 40 percent of all purchase money mortgages had down payments of that size. The credit quality of borrowers also declined. Between 1997 and 2007, Fannie and Freddie bought $1.5 trillion in subprime loans and over $600 billion in loans with other deficiencies that would have made them unsalable in 1990.[5] Officials of Fannie and Freddie attended meetings of mortgage originators to ask for more subprime loans.[6]

**HUD's Role**

Although there might be some question about whether HUD intended this result, and thus whether the decline in underwriting standards was a deliberate policy of the US government, HUD made no effort to hide its purposes. In statements over several years, the department made clear its intent to reduce mortgage underwriting standards. I have included three of these statements below, the first made in 2000 when HUD was increasing the affordable-housing goals for Fannie and Freddie:

> Lower-income and minority families have made major gains in access to the mortgage market in the 1990s. A variety of reasons have accounted for these gains, including improved housing affordability, enhanced enforcement of the Community Reinvestment Act, *more flexible mortgage underwriting*, and stepped-up enforcement of the Fair Housing Act. *But most industry observers believe that one factor behind these gains has been the improved performance of Fannie Mae and Freddie Mac under HUD's affordable lending goals. HUD's recent increases in the goals for 2001–03 will encourage the GSEs to further step up their support for affordable lending*.[7] (emphasis mine)

Similarly, in 2004, when HUD was again increasing the affordable-housing goals for Fannie and Freddie, the department stated:

> Millions of Americans with less than perfect credit or *who cannot meet some of the tougher underwriting requirements of the prime market* for reasons such as inadequate income documentation, limited downpayment or cash reserves, or the desire to take more cash out in a refinancing than conventional loans allow, rely on subprime lenders for access to mortgage financing. *If the GSEs reach deeper into the subprime market*, more borrowers will benefit from the advantages that greater stability and standardization create.[8] (emphasis mine)

[5] Peter J. Wallison, *Dissent from the Majority Report of the Financial Crisis Inquiry Commission*, p. 65.
[6] Id., p. 60
[7] US Department of Housing and Urban Development, *HUD's Affordable Housing Goals for Fannie Mae and Freddie Mac*, Issue Brief No. V (Washington, DC, January 2011), 5, www.huduser.org/Publications/PDF/gse.pdf (accessed February 4, 2011).
[8] Final Rule, http://fdsys.gpo.gov/fdsys/pkg/FR-2004-11-02/pdf/04-24101.pdf

Finally, the following statement appeared in a 2005 report commissioned by HUD:

> More liberal mortgage financing has contributed to the increase in demand for housing. During the 1990s, lenders have been *encouraged by HUD and banking regulators* to increase lending to low-income and minority households. The Community Reinvestment Act (CRA), Home Mortgage Disclosure Act (HMDA), government-sponsored enterprises (GSE) housing goals and fair lending laws have strongly encouraged mortgage brokers and lenders to market to low-income and minority borrowers. *Sometimes these borrowers are higher risk, with blemished credit histories and high debt or simply little savings for a down payment. Lenders have responded with low down payment loan products and automated underwriting, which has allowed them to more carefully determine the risk of the loan.*[9] (emphasis mine)

These statements are strong evidence that the decline in mortgage underwriting standards between 1992 and 2007 did not just happen; nor was it the result of low interest rates, flows of funds from abroad, or any of the other events or conditions suggested by the Commission majority and the THH dissenters. By putting the GSEs and several other entities into competition for the same LMI borrowers HUD succeeded in its policy of reducing mortgage underwriting standards.

**The Majority Report**

Because of its refusal to consider the reasons for the decline in underwriting standards, the commission majority was forced to argue that the low quality of so many loans in the US financial system resulted from a failure to regulate loan originators, especially mortgage brokers. As is true throughout the majority report, the discussion in this area is critical of certain practices in the market but educes no data on how widespread these practices were or how significant they might have been in contributing to the financial crisis.

In any event, what the majority report failed to recognize or communicate is that brokers do not finance mortgages. Before they make a mortgage, they must have a buyer to provide the financing. The reason that brokers were so active during the housing boom is that they could always find a buyer for the mortgages they were originating—and most of the time that buyer was Fannie, Freddie, FHA, a subprime lender involved in a HUD program, or a bank that needed certain kinds of mortgages to comply with the CRA. If those government mandates had not existed—if the GSEs and others had not been required by law to buy affordable-housing loans—many fewer NTMs would have been originated. Subprime lending would have remained what it was before 1992, a niche business. Instead, the commission majority argued that the brokers were the source of the problem—as though regulating their activities was the solution to excessive subprime lending rather than ending the government mandates that made it possible for brokers, whether unscrupulous or honest, to find buyers for the NTMs they originated.

The commission majority ended this portion of its report by concluding that "there was untrammeled growth in risky mortgages. Unsustainable, toxic loans polluted the financial system

[9] US Department of Housing and Urban Development, Office of Policy Development & Resesarch, *Recent House Price Trends and Homeownership Affordability* (Washington, DC, May 2005), 85, www.huduser.org/Publications/pdf/RecentHousePrice.pdf (accessed February 4, 2011).

and fueled the housing bubble."[i] This statement is correct if one considers the 27 million NTMs that existed in the US financial system before the financial crisis. However, the commission majority failed to produce data that connect the abusive practices the report condemns, such as yield-spread premiums, to any given number of NTMs. Without this data, it is impossible for anyone to conclude that abusive lending practices or predatory lending had any significant effect on the financial crisis. This is true throughout the commission majority's report. Because the majority refused to do a thorough analysis of why and how so many NTMs were originated, they were left to claim that "toxic loans polluted the financial system and fueled the housing bubble" without any supporting evidence.

There is some irony here. Although no statistics for the prevalence of predatory lending were ever produced, the commission majority identified it as a cause of the housing bubble and, presumably, the financial crisis; yet, even though the commission had substantial data showing that Fannie and Freddie had made 12 million NTMs—enough to drive them deep into insolvency—it concluded that the role of these two GSEs in the crisis was only "marginal." The political bias in this conclusion is clear.

**The Commission Majority's Treatment of Fannie and Freddie**

In the preface to its report, the Commission majority stated: "The GSEs participated in the expansion of subprime and other risky mortgages, but they followed rather than led Wall Street and other lenders in the rush for fool's gold. They purchased the highest rated non-GSE mortgage-backed securities and their participation in this market added helium to the housing balloon, but their purchases never represented a majority of the market." This is a myth, but has become a widely believed fallacy. Even the administration's recent housing proposal states: "Initially, Fannie Mae and Freddie Mac were largely on the sidelines while private markets generated increasingly risky mortgages…But as their combined market share declined—from nearly 70 percent of new originations in 2003 to 40 percent in 2006—Fannie Mae and Freddie Mac pursued riskier business to raise their market share and increase profits."

These statements neatly encapsulate both the Commission majority's errors and the remarkable persistence of the false narrative about the financial crisis that both the Commission and the Obama administration have embraced. The facts demonstrate that Fannie and Freddie acquired the NTMs that eventually caused their insolvency and the financial crisis for only one reason—because of the AH goals—and not because they were seeking profits or attempting to recover market share.

The Commission majority's report focused almost entirely on the market for private mortgage-backed securities, which they called Private Label Securities (PLS). This market included about 7.8 million securitized NTMs in 2008, less than one-third of the 27 million low quality loans that were outstanding in 2008. The balance, about 19.2 million loans were held or guaranteed by Fannie and Freddie, FHA and other government holders, insured banks and S&Ls covered by CRA, and Countrywide and other lenders that had pledged to reduce underwriting standards under a HUD program called the "Best Practices Initiative." The Commission majority also focused only on a short period in between 2004 and 2007, and virtually ignored everything that had happened in the mortgage market before that time. Both were serious errors. The 7.8 million NTMs that underlay the PLS were certainly contributors to the crisis, but their contribution was far less than the GSEs and other government-mandated buyers of these loans and, even more important, the whole PLS market would not have existed if the government-mandated buyers had not created an unprecedented housing bubble that grew for 10 years between 1997 and 2007.

Most housing bubbles last only three or four years. This was true of the housing bubbles we experienced in 1979 and 1989. Both lasted about that long, and when they deflated caused only local housing losses, not the 30 percent national housing price decline we have experienced. The reason that housing bubbles eventually deflate is that delinquencies start to show up, investors leave, the bubble flattens, and everyone else either gets out or licks their wounds. The 1997-2007 lasted 10 years because there was one investor in the market—the U.S. government—that was following a social policy and was not worried about losses. Long after private investors would have left the market, HUD was still raising the affordable housing goals for the GSEs, and the GSEs were still meeting them by competing for NTMs with FHA and the other institutions that were also subject to government mandates.

Housing prices continued to rise as a result of these government-backed investments, and when these prices rise they suppress delinquencies and defaults. This is because homeowners who cannot meet their mortgage obligations can usually refinance their mortgages (having acquired some equity in the home because of rising prices) or sell the home and pay off the mortgage. In addition, because of their inherent riskiness, most of the loans that were supported by rising prices carried high interest rates. Accordingly, investors were seeing pools of high interest rate loans that were not showing the delinquencies and defaults that would have been commensurate with the expected risks. This is what stimulated the growth of the PLS market beginning in the early 2000s. Nevertheless, this market did not pass $100 billion until 2002, about 4 percent of the entire housing market that year. At that point, the bubble was already five years old, longer than any bubble in the past century. But as the government continued to pump funds into affordable housing, the bubble continued to grow—and with it the attractiveness of PLS based on NTMs. By 2004, the PLS market had reached 15 percent of the entire housing market, and continued to grow rapidly thereafter as investors in the U.S. and abroad became avid buyers of assets that seemed to offer very high risk-adjusted returns.

Because the Commission majority did not consider any NTM purchases prior to 2003, they had no perspective on what Fannie and Freddie were doing before 2003, and could not see the contribution of government-mandated purchases to the growth of the bubble. In their report, the PLS market just appeared out of nowhere, for no particular reason, in 2003 or 2004. This led the Commission majority to accept and propagate the false idea that Fannie and Freddie followed "Wall Street" into subprime lending.

In fact, it was the other way around. Because of the affordable housing requirements, Fannie and Freddie had been buying subprime and other NTMs since the early 1990s. Indeed, the GSEs began to acquire high loan-to-value (LTV) mortgages (a kind of NTM) in 1994, shortly after the imposition of the AH goals, and by 2001—before the PMBS market reached $100 billion in annual issuances—the GSEs had already acquired at least $700 billion in NTMs, including over $400 billion in subprime loans.[10] In 2002 alone, when the entire PLS market finally exceeded $100 billion for the first time (reaching $134 billion), the GSEs bought $206 billion in subprime loans and $66 billion in other NTMs.

[10] Wallison, *Dissent*, Table 7, p.65

In other words, it would be more accurate to say that Wall Street followed the GSEs into subprime lending. This was true in two ways—the GSEs were heavy buyers of subprime loans and other NTMs before there was any Wall Street securitization of NTMs, and the GSEs' purchases built the 1997-2007 housing bubble, which provided the necessary conditions (high yields and low delinquencies) which made the PLS market possible. The GSEs were also the largest buyers of the PLS backed by NTMs. As the majority report itself points out, their purchases reached 40 percent in 2004.[11]

In its effort to obscure the government's role in the financial crisis, the Commission majority does not even mention the statements by HUD quoted above—statements that show the department's unequivocal commitment to reducing underwriting standards—and it makes transparent efforts throughout its report to suggest that Fannie and Freddie were no more than marginal players in the accumulation of NTMs in the financial system.

There is a long and tedious effort in the majority's report to demonstrate that Fannie and Freddie got into trouble because they bought NTMs in order to make profits or to recover the market share they had lost to the PLS market in 2005 and 2006. This is what the majority described as "Fannie Mae's quest for bigger market share, profits, and bonuses, which led it to ramp up its exposure to risky loans and securities as the housing market was peaking." Although various GSE officials are quoted to the effect that the AH goals were not the reason for these purchases, the documents say otherwise.

My dissent, based on these documents, shows unequivocally that market share was not a factor. Among other things, (i) the GSEs' market share did not increase in 2005 or 2006, (ii) they did not lower their G-fees, which would have made them more competitive and increased market share, (iii) their regulator at that time (OFHEO) did not want them to increase their risks and wouldn't have allowed them to do it; and (iv) their market share finally did increase in 2007, when the number of delinquent and defaulting mortgages had brought the PLS market to a halt, leaving Fannie and Freddie with a clear field to buy as many NTMs as they wanted. The fact that they then went ahead and purchased more NTMs—while everyone else had left the market because of the delinquencies of those very mortgages—shows again that their motive was the pressure to meet the AH goals and not profit or market share.

Moreover, the idea that they bought mortgages for profit that only a few years later made them deeply insolvent is absurd on its face. Anyone who was observing the market at that time would have seen that delinquencies among NTMs were increasing rapidly. Other issuers—certainly as interested in profits as the GSEs—were abandoning the market entirely and trying desperately to hedge their NTM risks.

Finally, here is a statement from Fannie's 2006 10-K, which makes clear that it was the affordable housing goals—and nothing else—that were the cause of their financial collapse:

> [W]e have made, and continue to make, significant adjustments to our mortgage loan sourcing and purchase strategies in an effort to meet HUD's increased housing goals and new subgoals. These strategies include entering into some purchase and securitization transactions with *lower expected economic returns than our typical transactions*. We

[11] FCIC, *Majority report*, p.123

> have also relaxed some of our underwriting criteria to obtain goals-qualifying mortgage loans and increased our investments in higher-risk mortgage loan products that are more likely to serve the borrowers targeted by HUD's goals and subgoals, *which could increase our credit losses.* [emphasis supplied][12]

This statement also shows, as my dissent demonstrates, that the AH goals were responsible for the GSEs' acquisition of large numbers of NTMs. The fact that neither the Commission majority nor the administration even bothered to read Fannie's own statements about why that firm bought NTMs shows the power of the false narrative that the GSEs' bought NTMs for market share or profit. It shows that people will believe what they want to believe, not what the facts support or require.

Sometimes, the commission majority's efforts to protect Fannie and Freddie were unintentionally humorous. One example involves piggyback loans. Fannie and Freddie were required by their charters to limit their purchases to mortgages with loan-to-value ratios of no more than 80 percent, unless the borrower paid for mortgage insurance. "Worried about defaults," the Commission majority intoned, "the GSEs would not buy mortgages with downpayments below 20% unless the borrower bought mortgage insurance." By 2000, however, as I report in my dissent, Fannie was offering to buy loans with *no* down payment and no mortgage insurance. How did it do this? The commission report is a bit cagey: "Unluckily for many homeowners, for the housing industry, and for the financial system, *lenders* devised a way to get rid of the [insurance requirement] that had added to the cost of homeownership" (emphasis mine). The Commission majority is blaming the lenders for coming up with the piggyback mortgage in which, as the commission reports, "[t]he lender offered a first mortgage for perhaps 80% of the home's value and a second mortgage for another 10% or even 20%. . . . Lenders liked them because the smaller first mortgage—even without mortgage insurance—*could potentially be sold to the GSEs*"[13] (emphasis mine), as though the GSEs knew nothing about these transactions.

These piggyback loans were risky: "[T]he piggybacks added risks. A borrower with a higher combined [loan-to-value ratio] had less equity in the home…. should the payments become unmanageable in a falling market, the borrower might owe more than the home was worth. Piggyback loans—which often required nothing down—guaranteed that many borrowers would end up with negative equity if house prices fell."[14] So the commission majority starts its discussion with a statement that suggests the GSEs were cautious and conservative (they were "worried about defaults" and so "would not buy mortgages with downpayments below 20%"), but ends with a description of a common transaction—the piggyback loan—in which Fannie and Freddie bought loans with no down payment and no mortgage insurance, loans the commission majority itself characterizes as risky. Given that Fannie was offering a zero down payment mortgage in 2000, without any mortgage insurance, it is obvious that the firm knew it was buying loans with piggyback mortgages and no down payment at all. In fact in 2008, both Fannie

[12] Fannie Mae 2006 10-K, p146
[13] FCIC, Majority Report, p.110
[14] Ibid.

and Freddie disclosed that they had made sizable purchases of piggyback loans that had materially added to their exposure to loans with downpayments of 5% or less.[15]

This example confirms several important points in my dissent: the GSEs bought risky loans that were bad for borrowers because they had no down payment and that led to defaults when the bubble deflated; they both hid and enhanced their risk-taking by evading the mortgage-insurance requirement through piggyback loans; and the commission majority was willing to protect Fannie and Freddie in its report by suggesting that the “lenders” made up the whole piggyback idea so they could sell the loans to Fannie and Freddie—as if Fannie and Freddie did not realize what they were buying. Despite this inculpatory discussion, the commission majority was still able to claim that the role of Fannie and Freddie in the financial crisis was “marginal.” After understanding the pressures on the GSEs created by the AH goals, it is imagine what impelled Fannie and Freddie to enter into these risky transactions; apparently, the commission majority was unable to do so.

**The THH Dissent**

Three of the Republican members of the FCIC—Bill Thomas, Keith Hennessey and Douglas Holtz-Eakin (the THH dissenters)—wrote a separate dissent. Their views were contained in an op-ed article the THH dissenters published in the *Wall Street Journal*[16] on the same day that the majority report was released, as well as their dissent itself. In the *Journal* article, the THH Dissent argues that both the majority report and my dissent are too simple as explanations of the financial crisis. Instead, they “subscribe to a third narrative—a messier story that emphasizes both global economic forces and failures in US policy and supervision. Though our explanation of the crisis doesn’t fit conveniently into the political order in Washington, we believe that it is far superior to the other two.”

Both the *Journal* article and the THH dissent say that “the crisis was the product of ten different factors. Only when taken together can they offer a sufficient explanation of what happened.” In other words, this is a “perfect storm” analysis, in which the event in question—the financial crisis—only occurred because the stars were aligned in a particular way. It suggests that if all ten factors were really necessary for the financial crisis to occur, we need not worry about another crisis; the statistical likelihood that all these elements will again come together at the same time is vanishingly small. This is not only inherently implausible but also provides no guidance to policymakers about what actions they should take to prevent a recurrence.

There are several respects in which this dissent is similar to the majority report. First, it has no explanation to support its assertion that “tightening credit spreads, overly optimistic assumptions about US housing prices, and flaws in primary and secondary mortgage markets led to poor origination practices.” Since poor origination practices—that is, low mortgage underwriting standards—were the principal reason that the US financial system was weighed down with subprime and other risky loans, it was incumbent on the THH dissenters to explain how these factors led to low underwriting standards. They never do. Second, in attempting to explain the proliferation of low-quality mortgages in the US financial system, they identify “easy

[15] Fannie Mae 2007 10-K, p. 128

[16] Bill Thomas, Keith Hennessey, and Douglas Holtz-Eakin, “What Caused the Financial Crisis,” *Wall Street Journal*, January 27, 2011.

financing," "ineffective regulatory regimes," "irresponsible lenders," and "lenient regulatory oversight" of mortgage originators—all ideas that dominated the commission majority's report—but do not explain why mortgage underwriting standards declined in the first place.

As noted above, none of these elements would have resulted in a proliferation of low-quality loans unless there were *buyers* with reduced mortgage underwriting standards. There were such buyers: government agencies, GSEs, and banks subject to the CRA, all of which were operating under government-mandated requirements that forced them to reduce their underwriting standards. Also, as also discussed above, after the bubble had grown for seven years because of government-mandated purchases of NTMs it spawned the development of a substantial market in MBS backed by NTMs. This was because the bubble itself had obscured the delinquencies and defaults that would normally occur with these low quality loans—giving investors the impression that high yielding NTMs did not involve substantial risk and stimulating the development of a market in PLS. Accordingly, the PLS market would never have developed without the government's role in stimulating an unprecedented 10 year housing bubble.

The THH dissent also argues that the U.S. government's housing policy could not have been responsible for the financial crisis because many other countries had housing bubbles and those countries did not have the same housing policies as the U.S. This is another error. Housing bubbles occur naturally, because of the tendency of human beings to believe that economic or financial conditions will continue in the same direction—that the usual cycles are no longer applicable. The error in the THH dissent was to believe that the bubbles that deflated in other countries caused the financial problems in those countries. This is not correct. A recent study by Dwight Jaffee shows that in no other developed country was the deflation of the housing bubble remotely as destructive as in the U.S.[17] In the U.K., for example, average mortgage losses were about 2.6 percent, while in the U.S. the average was over 9 percent, and the losses among subprime loans were approximately were 25 percent. In other words, it was the content of the bubble that was important, not the fact that there was a bubble. The financial difficulties in other countries came from other weakenesses in their financial or economic systems and from the fact that investors and financial institutions in those countries had invested in MBS backed by U.S. NTMs.

Finally, and most troubling, is the THH dissent's focus on risk management, which also parallels the commission majority's report. As they put it, "An essential cause of the financial and economic crisis was appallingly bad risk management by the leaders of some of the largest financial institutions in the United States and Europe." This idea was supplemented in the *Journal* article with this statement: "Managers of many large and midsize financial institutions amassed enormous concentrations of highly correlated risk . . . and they amplified this risk by holding too little capital relative to the risks and funded these exposures with short-term debt. . . . They assumed such funds would always be available. Both turned out to be bad bets." No data are presented for these statements.

As it happens, there are data on the question of asset concentrations, and they raise questions about the statement that financial institutions held "enormous concentrations" of high-risk mortgages. *Inside Mortgage Finance*, a major source for data on mortgages and MBS, publishes an annual report on mortgage-related holdings of financial institutions. These data

[17] Wallison dissent (AEI print), Table 2, p.19

show that in December 2008 all US financial institutions (excluding Fannie and Freddie and the Federal Home Loan Banks) held a total of $951 billion in MBS not guaranteed by Fannie or Freddie.[18] The Fed's flow of funds data indicates that the assets of all these institutions at that time totaled $ $40 trillion.[19] Accordingly, the nonagency MBS held by all US financial institutions was about 2.3 percent of their total assets. That does not sound like an "enormous concentration." If we just look at commercial banks, they had $13 trillion in assets and held $210 billion in MBS,[20] again representing 2 percent of assets and roughly 20 percent of capital. *Inside Mortgage Finance* also has data for the top twenty-five bank holding companies. If we look just at the top four bank holding companies, we get approximately the same result ($5 trillion in assets and $110 billion in nonagency MBS again is less than 2 percent and less than 20 percent of capital).[21] In contrast, during the early 1980s, the major U.S. banks held debt of Brazil, Argentina and Mexico—all of which were unable to meet their dollar obligations—which were in the aggregate 147 percent the capital of the eight largest U.S. banks.[22] Moreover, the total bank holdings include all MBS, not just those backed by subprime or other risky mortgages; accordingly, the holdings of the so-called "toxic assets" would have been smaller.

But going beyond data, it is troubling that the THH dissenters believe that a generalized failure of risk management was a cause of the crisis. This idea is inherently implausible. Given the widespread nature of the financial crisis, a very large number of financial institutions in all developed countries would be subject to this criticism. Since virtually all of them were in trouble in the crisis, there would have been what might be called a universal failure of proper risk management throughout the financial markets. Needless to say, it is highly unlikely that the managements of all the world's major financial institutions would become incompetent at the same time. In the real world, some banks and financial institutions fail, but others are better managed and survive. This suggests that something happened to create the financial crisis that was beyond the experience and expectations of the managements of all these institutions. My dissent suggests what that was: the collapse of the US housing bubble and the sudden appearance in late 2007 of an unprecedented number of delinquencies and defaults among the 27 million subprime and other high-risk loans outstanding in the United States. This caused the collapse of the MBS market and doubts about the solvency or stability of banks and other financial institutions that held these assets. Criticizing the managements of all the world's major financial institutions without understanding the facts of which they were aware at the time is simply hindsight.

Second, by suggesting—along with the Commission majority—that a major cause of the financial crisis was the wholesale failure of bank and financial-institution managements, the THH dissent endorsed a policy foundation for more regulation as well as the underlying rationale for the Dodd-Frank Act. After all, if the managements of virtually all the world's financial

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[18] Inside Mortgage Finance, *The 2009 Mortgage Market Statistical Annual, Volume II* (Bethesda, MD, 2009), 277.

[19] Fed Flow of Funds Data, http://www.federalreserve.gov/releases/z1/current/z1.pdf, L 109, L114-L123

[20] Inside Mortgage Finance, *2009 Mortgage Market Statistical Annual, Volume II*, 2.

[21] Ibid., 283

[22] Federal Financial Institutions Examination Council (FFIEC), *Country Exposure Report* (December 1982), 2; and FDIC,*Reports of Condition and Income* (December 31, 1982)

institutions cannot be trusted to manage their firms, then—to protect the public—governments must oversee them. Yes, it is all hindsight, and highly implausible, but that is exactly the rationale that the Democratic Congress used in designing and enacting the Dodd-Frank Act—and, unfortunately, the implicit policy message of the THH dissent.

**Conclusion**

There is powerful evidence that the financial crisis was caused by government housing policies and not by a lack of regulation or the simultaneous failures of risk management among the world's largest financial institutions. Under these circumstances, as I state in my dissent, there is reason to doubt that the Dodd-Frank Act was necessary to prevent another financial crisis. It is more likely that a change in government housing policy would provide greater protection against a repetition than the Dodd-Frank Act, with none of the adverse effects that the act is likely to have on economic growth in the United States.

United States House of Representatives
# Committee on Financial Services

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Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

| **1. Name:** | **2. Organization or organizations you are representing:** |
|---|---|
| Peter J. Wallison | No organization; testimony is mine |
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| **4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?** | **5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?** |
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