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## SIZING UP THE FCIC REPORT FIVE YEARS LATER

Edited by Alex J. Pollock

### INTRODUCTION

Ongoing debates about the financial crisis of 2007 to 2009 keep reminding us that economics is not a science. It can't be used by governments to manage economic and financial affairs to some preordained outcome. Not only is it rather poor at predicting the future, but its practitioners often are unable to agree even on how to interpret the past.

Nonetheless, accepted economic stories or myths do get established in the media and political mind. One example from a different crisis is that Herbert Hoover was a do-nothing president in the face of the developing depression. In fact, he was an energetic and ardent interventionist. The real question is whether his many interventions were good or bad.

What are the myths of our more recent crisis?

When it comes to the Financial Crisis Inquiry Commission, created by Congress in May 2009 to study the causes of the

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crisis,<sup>1</sup> we must remember that the “report” the 10-member commission finally delivered in January 2011<sup>2</sup> was actually three separate reports:

- The majority report, voted for by the six Democratic-appointed commissioners and no Republican-appointed commissioners, essentially concluded the primary cause was insufficient government intervention.
- A minority dissent of three of the Republican-appointed commissioners concluded the causes of the crisis were many and interacting, with plenty of blame to go around.
- A separate dissent by Peter Wallison argued in detail that the biggest problem was too much

1. Jesse Lee, “Protecting Homeowners, Protecting the Economy,” White House, May 20, 2009. <https://www.whitehouse.gov/blog/2009/05/20/protecting-homeowners-protecting-economy>

2. Financial Crisis Inquiry Commission, “Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States,” U.S. Government Printing Office, January 2011. <https://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf>

government intervention, resulting in extreme distortions in housing-finance markets.

In the five years since these reports, what more have we learned? From this distance, can we put the FCIC's majority and dissenting reports, and the crisis itself, into a convincing overall perspective?

The R Street Institute convened a panel of experts, including two former FCIC members, for a Feb. 4, 2016 conference on these issues.<sup>3</sup> The gathering served to provide an informed, insightful and provocative discussion. We are pleased to present this summary of their presentations.

## A POLITICAL COMMISSION

### Douglas Holtz-Eakin<sup>4</sup>

There have been times when I have tried very hard to forget the Financial Crisis Inquiry Commission. After all, taken at face value, it utterly failed in its mission to provide the American public a clear consensus explanation for what caused the crisis. Today's event makes it impossible to forget. Instead, I'm going to work through my post-traumatic stress disorder and talk a little bit about what we have learned in the past five years.

One lesson for me was how not to run a commission. I think Peter Wallison will agree with me that this was demonstrated by the days when the 10 commissioners sat in a room for literally a full day while the chair, Phil Angelides, encouraged us to come to a consensus – even as he refused to budge on his interpretation of the crisis. He also envisioned the group of 10 actually writing as a group a report detailing the causes of the financial crisis in the United States. It is simply no way to run a commission and it is very painful. For those of you who may end up in a similar position in the future, here is the lesson: get a chief of staff for your commission who is qualified to actually be a member of the commission. Tell him or her to write a report and then take that report to each commissioner and see what they agree and disagree with until you arrive at a consensus, if there is one.

The second thing I learned in the past five years – we knew it at the time but it is becoming increasingly clear – is that the commission was a political entity. Its ostensible task was to write an understandable report to the American people detailing the causes of the financial crisis and helping to ameliorate the chances of one happening again. That wasn't really its purpose. What became the Dodd-Frank legislation

was already moving; the administration had made its proposals before we even began to work. So the notion that some of this was informing some sort of legislative and/or regulatory response was never the agenda.

**“The other proactively bad development is creation of the Financial Stability Oversight Council. While a bad idea to begin with, its actual operation is almost like a Stalinist court system.”**

The real agenda was to deal with the politics of the financial crisis. The Democrats wanted the narrative for the cause of the financial crisis to be that greedy bankers rigged the game in Washington and imposed this crisis on the American people for their own benefit. It remains the prevailing view to this day. It is completely wrong, but it still has a phenomenal amount of resonance with the American people.

So in terms of politics, I learned a lot about how important it is to have a clean message. The dissent I wrote with Commissioners Keith Hennessey and Bill Thomas discussed 10 causes of the financial crisis. That is not a clean message. It is not something easily communicated to the American people. On the politics of setting the agenda for a sensible response, I do not think we were very successful.

Then there is the substance of the response, which I and the American Action Forum's Meghan Milloy addressed in a paper on the good, the bad and the ugly of the policies.<sup>5</sup> If you look at what the government has done since the commission, there are some things that make sense to me. It is good to see better-capitalized large financial institutions. Holding more capital covers a lot of sins. As banks hold their own capital, their own money is at risk and they will do better due diligence. Moreover, when mistakes are made, you will be able to absorb those losses. So that has been a step in the right direction.

I also think there was a modest step in the right direction with the credit rating agencies. Those agencies were one of the big surprises to me during my time on the FCIC, one of the big things I changed my mind about during the course of the deliberations. I went into the FCIC with a strong bias that the participants in these transitions – large, sophisticated institutions like Goldman Sachs and J.P. Morgan – were easily able to do their own due diligence on the securities, the underlying mortgages and their likely financial performance. The rating agencies would be irrelevant and it would not matter what label agencies put on a security, because the participants would know the truth. That turned out to not

3. R Street Governance Project Director Kevin R. Kosar was the co-organizer of this conference.

4. Douglas Holtz-Eakin is president of the American Action Forum and was a commissioner of the Financial Crisis Inquiry Commission.

5. Douglas Holtz-Eakin and Meghan Milloy, "FCIC Report: What have we learned since," American Action Forum, Feb. 4, 2016. <http://americanactionforum.org/insights/fcic-report-what-have-we-learned-since>

be the case. They did not do their due diligence; they just took the ratings. The ratings turned out to be more important than I thought. So closer scrutiny of the rating agencies is a beneficial thing going forward.

There have been some bad responses, as well. The narrative that fancy derivative transactions caused the financial crisis is all wrong. There was only one derivative involved in the crisis, and that was the American International Group credit default swaps. But on the basis of the false narrative, the United States undertook vast regulation of derivatives. The same observation is true for the Volcker Rule. There is no evidence that proprietary trading contributed to the financial crisis. It was not a trading crisis; it was fundamentally a lending crisis, with bad underwriting. The Volcker Rule is one of the most complex rules, expensive to comply with and serves no real purpose as a response to the crisis. The other bad response is a lot of the new disclosure requirements. The poster child for overreach on disclosures is the conflict mineral rule, which has decimated the Congo and done very little else. It is hard to defend those kinds of policies.

Finally, there are the ugly responses. Begin with orderly liquidation authority, which memorializes in statute the government's capacity to continue to prop up large financial institutions. As a result, it takes the basic bailout instinct of all regulators and now gives them more legal rope. It's important to remember that the notion of "too big to fail" is not a flaw of the private sector. It is the policymakers who are so risk-averse that they step in and do not allow institutions to fail. This makes it easier for them to do that, and it is a big step in the wrong direction.

The other proactively bad development is creation of the Financial Stability Oversight Council (FSOC). While a bad idea to begin with, its actual operation is almost like a Stalinist court system. Non-bank systemically important financial institutions (SIFIs) have no idea why they are SIFIs, and the court of appeals is simply the FSOC itself. I will go to my grave confused by the MetLife and Prudential SIFI designations, except as purely politicized actions. The FSOC is something I think we are going to wrestle with for a long time.

Lastly, I guess I remain naïve, because I would never have bet that I would be attending a forum on the fifth anniversary of the FCIC and there would have been no substantial reforms (or closure) for Fannie Mae and Freddie Mac. They made no sense in 2003 when I was at the Congressional Budget Office. They were living financial dynamite during the crisis. I thought, surely, that common sense would prevail and there would be no more housing government-sponsored enterprises. It is a real lesson in just how hard it is to get an obvious reform done in Washington.

## TWO ISSUES DESERVING GREATER ATTENTION

Thomas H. Stanton<sup>6</sup>

The Financial Crisis Inquiry Commission did most of its work in 2010, when many major actors, still shocked by the institutional and financial carnage of the crisis, were willing to talk. The commission made an important contribution to understanding and documenting the crisis and the way it unfolded.<sup>7</sup>

I served on the commission staff. We reviewed many thousands of pages of documents and interviewed CEOs, bankers, traders, risk officers, regulators, policymakers and many others. This was a mind-expanding experience. Based on increasingly extensive knowledge, we intensely debated what had happened and how the pieces fit together. The commission operated on a tight timeline and with significant budget constraints. My major regret is that I didn't have the knowledge upfront that we had later, so that we could have asked questions on a yet deeper level.

After the commission finished its work, I decided to look at organizational issues in more depth and wrote a book, "Why Some Firms Thrive While Others Fail: Governance and Management Lessons from the Crisis."<sup>8</sup> The book reports on four financial firms that successfully navigated the crisis and eight that came to grief. I concluded that the crisis was like Tolstoy's famous dictum, in reverse. Recall the first line of "Anna Karenina": "All happy families are alike; each unhappy family is unhappy in its own way." In the financial crisis, successful firms each had their own way to detect and manage risk; unsuccessful firms all were alike: they remained blissfully unaware as the crisis loomed.

One factor in the crisis was complexity, which occurred in multiple dimensions, including organizational (large, complex financial institutions with hundreds or even thousands of subsidiaries and affiliates); technological (increasingly complex mathematical models that often diverged from reality); and financial (products such as collateralized debt obligations, or CDOs).

Information flow was an essential antidote to complexity. While information at unsuccessful firms was bottled up in lower or middle levels of the organization, successful firms found ways to ensure that information went up and down the hierarchy and across organizational silos.

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7. Many of the commission's interviews and documents are available at <http://fcic.law.stanford.edu/>, with further material set to be released soon by the National Archives.

8. Thomas H. Stanton, "Why Some Firms Thrive While Others Fail: Governance and Management Lessons from the Crisis," Oxford University Press, 2012.

One successful example is JPMorgan Chase. In October 2006, well before the crisis broke, JPM's retail arm reported an increase in defaults and delinquencies in its subprime mortgage portfolio. Officials sent the information up to JPM's operating committee, which investigated and found that, if anything, JPM's default and delinquency rates were lower than those of competitors. The warning sign being validated, an order went down to JPM's investment banking arm to shed the company's exposure to subprime.

Information at Goldman Sachs, an investment bank, similarly went to decision makers for consideration. In December 2006, Goldman lost money on mortgage transactions that the company's models had forecast would be profitable. Dan Sparks, head of the Goldman mortgage desk, reported the unexpected loss to top management. The chief financial officer and other top people promptly visited Sparks and asked detailed questions about his mortgage operations. They decided that Goldman would, in the CFO's words, "get closer to home" and take a more balanced combination of long and short mortgage positions. While their business models and strategies differed, both JPM and Goldman successfully navigated the crisis.

On the public-sector side, complexity made it virtually impossible for bank supervisors to detect emerging risks at financial firms they supervised. Supervisors lacked resources and might station only a few dozen examiners on-site, even at the largest complex financial institutions. Examiners frequently lacked the knowledge, compensation or status of the bank officials whose work they tried to supervise. It was virtually impossible for a bank examiner to request that bank officials limit highly profitable activities merely to protect against risk that might materialize at some unspecified time in the future.

Finally, banks benefited from a weak legal framework that allowed supervised institutions to shop for the most congenial regulator; this further inhibited examiners from questioning bank decisions.

These factors led to a troubled culture among bank examiners. According to one study commissioned by the Federal Reserve Bank of New York, examiners were risk-averse; they feared speaking up and making a mistake. They had a check-the-boxes mentality; examiners were (and still appear to be) too focused on small demonstrable infractions, rather than larger issues, such as whether sufficient risk information was flowing promptly to decision makers in the firm and the board of directors.

The question then becomes how to improve the situation. Some aspects of the Dodd-Frank Act have had positive effects. Increased capital requirements encourage financial firms to shed their least attractive activities, thereby help-

ing to reduce organizational complexity. On the other hand, Dodd-Frank imposed burdens and detailed requirements on banks without addressing some fundamental issues.

**In the financial crisis, successful firms each had their own way to detect and manage risk; unsuccessful firms all were alike: they remained blissfully unaware as the crisis loomed.**

So how do we create a win-win? One positive step would be to try to create constructive dialogue between large complex financial firms and their supervisors. Financial firms may be in a good position to reduce distortions in the examiner culture, promote improved training and standards, and persuade supervisors to focus their scarce resources more on larger issues, such as the flow of information to decision makers about major risks. Good examiners can ask good questions, even if they don't know the answers, and good questions can bring issues to light, despite complexity. This is in the interests of financial firms, supervisors and the stability of the financial system.

Perhaps the best vision of a win-win comes from Edmund Clark, CEO of TD Bank, a Canadian firm that was successful in the crisis. As Mr. Clark puts it, there must be "productive working partnerships between the industry and its regulators, enabling both parties to agree in principle on what needs to be done, and on the least intrusive way in making it happen."

Canada is different from the United States. Nonetheless, Canada's relative success during the financial crisis showed that this is a vision worth striving for, as well.

## WHY A CRISIS CONSENSUS IS SO ELUSIVE

Philip Wallach<sup>9</sup>

More than eight years after the start of the crisis and five years since the Financial Crisis Inquiry Commission offered its official retrospective, one might think that we would have begun to gain historical perspective. But what stands out at this point is the failure of any consensus narrative to take a firm hold. Three competing stories are currently vying for supremacy.

The first two are versions of the "overcoming the monster" archetype, but with different monsters. In the first, which is the favored version of the establishment, the monster was a kind of amorphous terror that descended in 2007 and 2008:

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9. Phillip Wallach is a senior fellow in governance studies at the Brookings Institution. He is the author of "To the Edge: Legality, Legitimacy, and the Responses to the 2008 Financial Crisis."

the crisis itself. From the point of view of the leading crisis-fighters in government, the escalation of the crisis (distinct from the fact of falling house prices) was totally unpredictable and required great agility and guile to defeat. Naturally, they were up to the task, even when pesky political and legal constraints slowed them down.

Proponents of this view see “too big to fail” banks as a menace, but they tend to think that the monster-repellants deployed since the crisis — especially in the Dodd-Frank Act — are adequate to ensure that they no longer pose a grave danger to the system. They think the various attempts to pin blame for the crisis on government actors are almost entirely meritless and perverse — akin to “blaming the firemen for the fire.” This view has some star power behind it, mostly in the form of HBO’s movie based on the Andrew Ross Sorkin book “Too Big to Fail,” which featured William Hurt as Treasury Secretary Hank Paulson, Paul Giamatti as Federal Reserve Chairman Ben Bernanke and Billy Crudup as then-New York Fed Chairman Timothy Geithner.

The next narrative has managed an even more impressive cast. In the anti-Wall Street variant of the “overcoming the monster” tale, which probably has the largest following at this point, the villains are clearer: the big banks, which were public menaces hiding in plain sight. These greedy vampire squids (in journalist Matt Taibbi’s indelible styling)<sup>10</sup> were insufficiently policed by their regulators and, as a result, their predation shifted into overdrive and soon blew up the world. A few people — notably, former House Financial Services Committee Chairman Barney Frank, D-Mass. — subscribe to the basic Manichean outlook of this vision, but think balance has now been restored to the force by subsequent policy changes.

More often, those who subscribe to the anti-Wall Street view fear the “vampire squids” are still at-large; they are mostly unchecked or perhaps even emboldened by our timid post-crisis adjustments — and not in jail, where they properly belong. To slay these menaces, which pull the strings of our mainstream politicians with disturbing impunity, we need some pure-of-heart St. George to go forth (such as Sens. Bernie Sanders, Elizabeth Warren and Ted Cruz, or even Donald Trump — take your pick, depending on your aesthetic and political predilections). “The Big Short,” with its Oscar nominations and star-studded cast of Christian Bale, Ryan Gosling and Brad Pitt as the rare financiers clear-eyed enough to see the greed and stupidity of their kind, has given this narrative an extra boost.

The third major competing narrative, favored by a number of conservatives but definitely a minority position, is not an epic, but a tragedy. Indeed, it is a classic instance of what Albert Hirschman called the “perversity” thesis, in which good intentions for social improvement backfire when they are instantiated as misguided government programs that ultimately make things worse. As this school of thought’s leading light, Peter Wallison, has tirelessly argued, the pursuit of widespread homeownership through poor-quality loans by the government-sponsored enterprises Fannie Mae and Freddie Mac utterly distorted and degraded the mortgage-market processes for appropriately allocating credit. Wallison is Cassandra in this telling, with both political parties having failed to heed his prescient warnings and even now failing to take any effective action to prevent Fannie and Freddie from being able to do it again.

There are other narratives out there, to be sure. Wall Streeters have their own complicated versions of the story. Some of us trying to make sense of the crisis may mix and match from these tales, finding a mixture of truth and oversimplification in each of them. But most people want to adopt one tidy story and devote themselves to defending its truth and its implications of guilt — both because imposing order on messy facts makes us feel we are moving forward from the crisis, and because assigning guilt is one of the most powerful rhetorical devices for motivating further policy change.

And there’s the rub. Half a decade on, there is still an enormous demand for channeling crisis-related anger into dramatic political responses. Indeed, the need to do so has been a surprisingly central theme in the Democratic presidential primary contest. That unsatisfied appetite colors all of our attempts to understand the crisis today. Diagnosis is tightly tied to prescription, and there are plenty of commentators whose certainty about the prescription leads them to work backward to the diagnosis. Nearly all of us mixed up in the world of crisis wonkery harbor hopes of affecting the course of policy changes yet to come, and that makes it very difficult to sort through things in a dispassionate way.

This heated environment will cool over the coming years, but only to a point. Some of our leading minds are still arguing over the meaning and causes of the Great Depression three-quarters of a century after it ended, and they are not shy about drawing lessons for current policymakers. You might think that understanding financial crises isn’t rocket science, but the truth is that this sort of politically charged social science is much harder to get right.

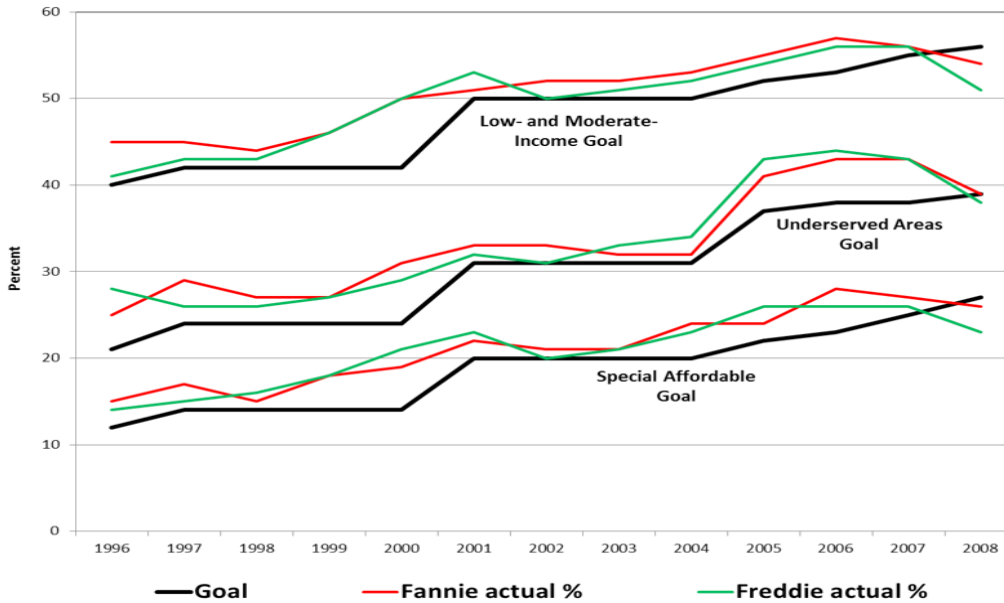
Aeschylus, who told Cassandra’s story, thought wisdom comes through suffering. In this case, the wisdom has not yet arrived.

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10. Matt Taibbi, “The Great American Bubble Machine,” *Rolling Stone*, April 5, 2010. <http://www.rollingstone.com/politics/news/the-great-american-bubble-machine-20100405>



FIGURE I: RISING FEDERAL AFFORDABLE HOUSING GOALS, 1996 TO 2007



## THE FCIC MISLED THE AMERICAN PUBLIC

Peter J. Wallison<sup>11</sup>

Everyone agrees that the 2008 financial crisis was the result of a “mortgage meltdown,” the default of an unprecedented number of subprime and Alt-A mortgages (often called non-traditional mortgages, or NTMs) in the U.S. financial system. The central question, then, is why so many of these NTMs were outstanding in 2008. The majority report of the Financial Crisis Inquiry Commission blamed insufficient regulation, which it said allowed the private sector — led by Wall Street — to originate and sell these deficient mortgages to unsuspecting buyers.

As a member of the FCIC, I argued that U.S. government policies — particularly the affordable housing goals (AH goals) imposed in 1992 on the government-backed mortgage giants Fannie Mae and Freddie Mac — were the real cause of the financial crisis. The goals required Fannie and Freddie, when they acquired mortgages from originators, to meet a quota of mortgages that had been made to homebuyers at or below the median income.

The U.S. Department of Housing and Urban Development was given authority to increase the goals and it did so, aggressively, over time. This forced Fannie and Freddie — which previously had limited their purchases to prime loans — to lower their underwriting standards; they could not find a sufficient number of prime mortgages to meet the goal quotas. Figure 1 shows the increases in the AH goals between 1996 and 2007.

Because Fannie and Freddie dominated the housing-finance system, the deterioration in their underwriting standards caused the standards in the mortgage market as a whole to decline. This built the enormous 1997 to 2007 housing-price bubble. When the bubble collapsed, the result was a nationwide decline in housing and mortgage values, the mortgage meltdown and, eventually, the financial crisis. I made this point in my dissent from the FCIC’s report and, with more data, in my 2015 book, “Hidden in Plain Sight: What Caused the World’s Worst Financial Crisis and Why It Could Happen Again.”<sup>12</sup>

The FCIC majority refused to consider this idea seriously, and focused its report entirely on the private sector:

[I]t 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.<sup>13</sup>

About Fannie Mae, the report said:

We find that the risky practices of Fannie Mae...particularly from 2005 on, led to its fall: practices *undertaken to meet Wall Street’s expectations for growth, to regain market share, and to ensure generous compensation for its employees.* Affordable housing goals imposed by the Department of Housing and Urban

11. Peter J. Wallison is the Arthur F. Burns Fellow in Financial Policy Studies at the American Enterprise Institute and was a commissioner of the Financial Crisis Inquiry Commission.

12. Peter J. Wallison, “Hidden in Plain Sight: What Really Caused the World’s Worst Financial Crisis and Why It Could Happen Again,” Encounter Books, January 2015.

13. FCIC, p. xvi, 2011.

Development (HUD) did contribute marginally to these practices.<sup>14</sup> [emphasis added]

Thus the FCIC’s claim was that Fannie bought the subprime and risky mortgages that ultimately caused their insolvency because these loans were profitable or enhanced their market share — what Wall Street wanted; the AH goals contributed only marginally. However, even I was surprised to find, when I finally got access to some of the FCIC’s records after the commission closed down, that the FCIC had received and ignored a great deal of documentation from Fannie and Freddie that contradicted its claims.

The examples are numerous, but a few are included below. They are all from Fannie, which is where the FCIC focused its attention, but Freddie’s documents are fully consistent with Fannie’s.

The report says that Fannie and Freddie had no difficulty meeting the goals. As evidence, the report states: “In fact, none of Fannie Mae’s 2004 purchases of subprime or Alt-A securities were ever submitted to HUD to be counted toward the goals.”<sup>15</sup> But here is a Fannie report to HUD from 2002 about its difficulty meeting the goals:

In 2002, Fannie Mae exceeded all our goals for the ninth straight year. But it was probably the most challenging environment we’ve ever faced. Meeting the goals required heroic fourth quarter efforts on the part of many across the company. Vacations were canceled. The midnight oil burned. Moreover, the challenge freaked out the business side of the house. *Especially because the tenseness around meeting the goals meant that we considered not doing deals — not fulfilling our liquidity function — and did deals at risks and prices we would not have otherwise done.*<sup>16</sup> [emphasis added]

In an Oct. 31, 2005 presentation to HUD, Fannie further cited several undesirable tradeoffs needed to meet the agency’s goals, including that “[d]eal economics are well below target returns; some deals are producing negative returns” and that “G-fees may not cover expected losses.”<sup>17</sup> Similarly, in a July 2007 staff meeting, the cost of meeting that year’s goals was placed at \$1.156 billion.<sup>18</sup> It doesn’t sound as though Fannie expected these loans to be profitable, or that they would please Wall Street.

14. FCIC, p. 323, 2011.

15. FCIC, p. 123, 2011.

16. Fannie Mae, “The HUD Housing Goals,” slide 5, FM-FCIC\_00172206, March 2003.

17. Fannie Mae, “Update on Fannie Mae’s Housing Goals Performance,” presentation to the U.S. Department of Housing and Urban Development, FM-FCIC\_00172185, Oct. 31, 2005.

18. Fannie Mae, “Plan to Meet Base Goals,” Forecast Meeting, slide 4, FM-FCIC\_00172469, July 27, 2007.

What about the FCIC’s statement that Fannie and Freddie bought these loans for market share? If Fannie and Freddie actually wanted to increase their market share, the way to do it was to reduce the fees they charged to guarantee mortgage-backed securities. That way, they would become a lower-cost provider than other channels that originators might use to sell their loans. But as shown in the following 2008 summary by their regulator, Fannie increased its average guarantee fees between 2004 and 2007.

TABLE I: FANNIE MAE GUARANTEE FEES, 2004 TO 2007

Year	Average guarantee fee (basis points)
2003	21.9
2004	21.8
2005	22.3
2006	22.2
2007	23.7

SOURCE: OFHEO<sup>19</sup>

Perhaps the most telling exclusion from the report were data published with Fannie’s 10-Q report for the second quarter of 2009 – after the firm was taken over by the government but almost two years before the FCIC issued its report. Table 2 includes an excerpt from the 10-Q that shows all the NTMs they held at that time. These amounted to \$838 billion, less than a third of Fannie’s \$2.8 trillion book of business, but they were responsible for 81 percent of its 2008 credit losses.

TABLE 2: FANNIE MAE CREDIT PROFILE BY KEY PRODUCT FEATURES (AS OF JUNE 30, 2009)

Product feature	Unpaid principle (\$B)	Percent of credit losses (%)
Negative-amortizing loans	13.7	2.9
Interest-only loans	183.2	34.2
Loans with FICO < 620	109.3	11.8
Loans with FICO ≥ 620 and <660	230.4	17.4
Loans with original LTV ration > 90%	262.6	21.3
Loans with FICO < 620 and original LTV > 90%	24	5.4
Alt-A loans	248.3	45.6
Subprime loans	7.4	2.0
<b>Subtotal of key product features</b>	<b>837.8</b>	<b>81.3</b>
Overall book	2,796.5	100.0

SOURCE: Fannie Mae<sup>20</sup>

19. James B. Lockhart, “Mortgage Markets and the Enterprises in 2007,” Office of Federal Housing Enterprise Oversight, pp. 33-34, July 2008. [http://www.fhfa.gov/PolicyProgramsResearch/Research/PaperDocuments/20080721\\_RP\\_Mortgage%20MarketsEnterprises\\_2007\\_N508.pdf](http://www.fhfa.gov/PolicyProgramsResearch/Research/PaperDocuments/20080721_RP_Mortgage%20MarketsEnterprises_2007_N508.pdf)

20. Fannie Mae, “2009 Second Quarter Credit Supplement,” p. 5, Aug. 6, 2009. [http://www.fanniemae.com/resources/file/ir/pdf/quarterly-annual-results/2009/q2credit\\_summary.pdf](http://www.fanniemae.com/resources/file/ir/pdf/quarterly-annual-results/2009/q2credit_summary.pdf)

The FCIC majority thus seemed to have made up its analysis for why Fannie and Freddie bought all these risky NTMs in order to fit the conclusion it wanted to reach: that insufficient regulation and Wall Street greed — and not government housing policy — caused the financial crisis.

This was a gross disservice to the American public, whose view of the financial crisis was deliberately distorted. The consequences include the 2010 Dodd-Frank Act, which has slowed the economy's growth, and the absurd fight in the current Democratic presidential race about who will punish Wall Street the most.

## IS HINDSIGHT 20/20?

Edward V. Murphy<sup>21</sup>

The Financial Crisis Inquiry Commission released thousands of pages of hearing testimony, interviews, interim reports and three official interpretations of the evidence. The three official opinions agree that something caused too much mortgage credit to inflate the housing bubble, although they disagree about the relative emphasis on private market failure, macroeconomic trends and government housing policy. Subsequent events and research bolstered some FCIC findings and cast doubt on others. It's likely that multiple causes contributed to the financial crisis; therefore, seemingly contradictory explanations may have elements of truth.

The consensus view is that residential mortgage delinquencies caused the initial disturbances in financial markets. In FCIC testimony, the heads of failing firms and contemporary regulators generally attribute declines in financial-market liquidity to uncertainty regarding the exposure of firms to subprime mortgages. Turmoil began in August 2007, when defaults rose in the relatively small subprime-mortgage market. Financial markets began to cut off funding to commercial paper backed by subprime loans.

The puzzle to many witnesses, articulated by economist Gary Gorton, was how subprime losses were magnified and spread throughout the financial system. FCIC witnesses testified that the complexity of the shadow banking system that securitized mortgage loans created uncertainty about financial health, and therefore credit dried up. Numerous memoirs and books subsequently buttressed this account of events after the fall of 2007.

The role of uncertainty in liquidity is complex. If full information had been available, would holders of mortgage-backed securities have had access to more or less credit? It

depends on whether mortgage-related losses exceeded ex ante expectations. Subsequent researchers identified housing-boom-era securities assessments that noted the vulnerability of MBS to house-price declines, with projections. Contemporary analysts disagreed about whether house prices would decline, but expected large losses if prices did decline. In hindsight, the magnitude of the house-price declines surprised most economists. It's not clear that if investors had known the magnitude of the fall in advance, MBS holders would have had access to more credit.

Liquidity is also a time concept. Would MBS holders have suffered smaller losses if they could have held the assets over a longer period? Because mortgage loans are collateralized by the house, a foreclosure sale extinguishes the current creditor's claims at the current price and precludes recovery from future price gains. Leveraged holders of defaulting mortgages had a solvency problem, not a liquidity problem. Therefore, illiquidity as a time concept applied to uncertainty as to which mortgages might default, not losses given a default.

Which mortgages had the largest surprise increase in defaults? FCIC research materials and testimony reveal contemporary decision-makers associated mortgage default with the subprime sector of the mortgage market. However, mortgage-industry jargon is sometimes used inconsistently. Sometimes the term subprime was used to describe the lender, but other times it was used to describe loan features or borrower credit score. An Alt-A loan generally meant a loan to a person with good credit, but with riskier mortgage features, not someone with a lower credit score.

Subsequent evidence suggests that people with good credit scores played a larger role in the housing bubble and in the foreclosure crisis than initially thought. There was a closer correlation between Alt-A loans and regions with housing boom and busts than with subprime. If the housing bubble had been inflated by lending to subprime borrowers, the share of the mortgage market made up of people with weak credit should have been expanding during the housing boom. Yet the 2014 FSOC report contains evidence that the opposite is true. During the boom, the foreclosure rate on subprime loans was falling but the foreclosure rate on prime loans was not. As a result, the share of total foreclosures due to people with good credit was rising even before the housing bubble burst.

Relatively rising foreclosure rates among Alt-A and prime borrowers also suggests that the role of Fannie Mae and Freddie Mac could be re-evaluated. On the one hand, the GSEs were subject to loan limits and the housing goals were defined by income and geography. The GSEs should have had a disproportionate impact on regions in which they could have a higher market share. Yet the housing boom was strong

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in places like California, where house prices exceeded the GSEs' loan limit. On the other hand, those who say the GSEs were not involved in the subprime market need to reassess the GSEs' portfolio. Subsequent research by Peter Wallison and Ed Pinto has shown that the GSEs' mortgages contained riskier features than originally thought. That doesn't necessarily mean that the housing goals were the primary driver, because it is also consistent with the use of Alt-A mortgages by high-income borrowers in California.

The rapid rise of securitization led some FCIC witnesses to conclude that financial innovation created problems that Congress did not consider when designing the financial regulatory system. However, a century ago, senators discussed forms of securitization during hearings on the bill that became the Federal Reserve Act. The definition of "bank" in the original Federal Reserve Act was sufficiently broad to allow such trusts to become members in the Federal Reserve System.

Some FCIC witnesses highlighted vulnerabilities of repurchase agreements during financial crises. However, have people considered repos during other financial crises? The 1933 Comptroller of the Currency report to Congress during the Great Depression showed that state banks turned to repurchase agreements as a source of liquidity when some of their other assets became illiquid.

In summary, like other reports to Congress, the FCIC provided invaluable detail. Also like other reports, researchers will continue to debate conflicting interpretations of the evidence.

## CONCLUDING REQUEST

The R Street Institute would be pleased to receive your further thoughts and comments on these issues. Please write to Alex Pollock at [apollock@rstreet.org](mailto:apollock@rstreet.org). Many thanks.

## ABOUT THE EDITOR

**Alex J. Pollock** is a distinguished senior fellow at the R Street Institute, where he works on financial policy issues including mortgage finance, banking, central banking, and the role of risk and uncertainty in financial systems. He is the author of *Boom and Bust: Financial Cycles and Human Prosperity*. Pollock was president and CEO of the Federal Home Loan Bank of Chicago from 1991 to 2004.