GFC Lessons Not Learnt

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Government meddling—not greed or deregulation—caused the GFC and 10 years on we're no safer, warns Competitive Enterprise Institute policy analyst Daniel Press.

This year marks a most unhappy tenth anniversary—the onset of the global financial crisis. What began as a meltdown of the American real estate market quickly turned into a widespread financial crisis that brought the world economy to the brink of collapse.

Over the past decade, hundreds of books have been written on the causes and consequences of the crisis. It involved complex financial instruments, foolish business decisions, and asleep-at-the-wheel regulators.

Its impact was felt around the world, across businesses and governments alike. But while any number of factors played a role in spreading and amplifying the catastrophe, the *sine qua non* of the financial crisis boiled down to one thing—the historic collapse of the US housing market.

Between its peak and trough, the American housing market fell more than 30 per cent—something considered virtually impossible at the time. The boom fuelled the widespread belief that home prices could only go up.

When home values collapsed, the financial instruments built atop of the housing market, such as mortgage-backed securities, plunged.

These losses, along with the erratic government bailouts, fuelled a crisis of confidence in the health of many of the world's largest banks. The financial system ground to a halt and whole national economies teetered on the edge.

So how did the housing market collapse so spectacularly? Many blame the era of deregulation during the 1990s, which allegedly allowed for unchecked risk taking in financial markets. But that story is inaccurate. Between 1990 and 2008, presidential administrations of both political parties led a 20 per cent increase in federal financial regulation.

Further, more than 12,000 people worked full time on regulating the financial markets in Washington, DC, alone—around five times as many as in 1960.

Others blame the unbridled greed of Wall Street, pursuing profit at any cost. But greed on Wall Street did not begin and end with the housing boom. It *always* has been there.

In reality, the real causes of the financial crisis lie deeper; to problems going back a century. In the early 20th century, the American government faced an alarming problem. The Russian Revolution of 1917 terrified government officials. They believed that to deter the rise of communism, more Americans needed to become invested in the system of private property: the best way to make the average American a good capitalist was to make him a homeowner.

The federal government thus began insuring bank mortgage lending, thereby expanding finance available for middle class consumers. But there was a catch: any new housing must be racially segregated to gain federal insurance. No insurance was to be extended to African-American purchasers or to white purchasers moving into African-American neighbourhoods. This practice, known as "redlining" of neighbourhoods, largely provided home ownership for whites while denying it for African-Americans.

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Unable to own their own home and forced into poor quality neighbourhoods, African-Americans missed out on generations of wealth-building opportunities. As house prices rose over time, the gap between minority and white household wealth grew greater. So by the time President Bill Clinton was inaugurated in 1993, he faced a familiar problem—too few low-income and minority Americans owned their home. Clinton was under enormous pressure from housing activists to radically expand homeownership. Activist groups were particularly critical of banks' strict

underwriting standards for home loans, such as requiring high credit scores and solid downpayments. They claimed these higher standards disproportionately hurt low-income earners and minorities. Their answer was to wield the power of the federal government to force the mortgage market to loosen its underwriting standards, so that more and more marginal borrowers could qualify for a home loan. Prominent community activist Gale Cincotta made this clear, testifying before Congress in 1991, that “lenders will respond to the most conservative standards unless [federal government agencies] are aggressive and convincing in their efforts to expand historically narrow underwriting”.

To achieve this, the Clinton administration, and subsequently the George W. Bush administration, made use of two government-sponsored enterprises (GSEs): the Federal National Mortgage Association, or Fannie Mae, and Federal Home Loan Mortgage Corporation, or Freddie Mac. Fannie and Freddie are, in theory, quasi-private entities, but are backed and directed by the government. The two have long dominated the American mortgage market. They buy mortgages from banks and package them into securities to sell to investors, thereby creating a liquid secondary market that enabled banks to lend to more borrowers at reduced rates.

CLINTON DICTATED LENDING

For much of their history, Fannie and Freddie were rather conservative institutions. They only purchased and packaged assets of ‘prime’ quality. But that changed in the 1990s. The GSEs’ traditional underwriting practice did not comport with the government’s new pursuit of expanding homeownership for ‘subprime’ customers. The Clinton administration, therefore, set out various affordable-housing goals for Fannie and Freddie, dictating the number of home loans that the two had to purchase from low income or minority borrowers.

In other words, Fannie and Freddie were forced by the government to dramatically expand the subprime mortgage market.

The initial quota of loans to low-tomoderate income households that Fannie and Freddie had to purchase annually was around 30 per cent. At first, that goal was not too hard for the GSEs to meet, but it was continually raised: to 40 per cent in 1996, then to 50 per cent in 2001, and up to 56 per cent in 2008. This became unsustainable.

There simply were not enough creditworthy borrowers to meet these goals. That meant Fannie and Freddie would have to drastically reduce their underwriting standards. They began buying loans made to borrowers with little or no income documentation, poor credit histories, dangerously low downpayments, and high debt-to-income ratios. Because Fannie and Freddie dominated the mortgage finance system, when they lowered their standards, standards deteriorated throughout the entire mortgage market.

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The result was that, by mid-2008, more than half of the 55 million mortgages in the American financial system were either subprime or of similarly low quality. For comparison, the size of the subprime market in Australia at the time was less than two per cent. The American government, through institutions such as Fannie and Freddie, backed up to 76 per cent of all these mortgages. Many went to their intended targets—low income and minority borrowers—but many more went to wealthy investors who took advantage of low downpayments and debt-toincome requirements to speculate on housing prices, further feeding the housing bubble.

For example, as Johan Norberg describes in his book *Financial Fiasco*, in 2000, only one per cent of subprime mortgages were second mortgages taken out to exploit price rises. By 2006, however, speculative investors took out more than 30 per cent of subprime mortgages.

These mortgages were of such poor quality, with dangerously low downpayments, that it would only take a small drop in housing prices before millions would be underwater, owing more on their mortgage than it was worth. When prices inevitably did plunge, these speculative investors defaulted *en masse* and walked away from their homes. Fannie and Freddie's reckless lowering of mortgage underwriting standards virtually ensured the mortgage market would be riddled with toxic loans. But two other factors drove the housing boom to higher and higher heights: the Federal Reserve's drastic monetary policy, and state and local zoning laws. Worried about a post-September 11 recession, the Federal Reserve kept further inflating the largest house price bubble in American history. While Fannie and Freddie expanded the subprime mortgage market, the Fed pursued the most expansionary monetary policy in 50 years.

In January 2001, the federal funds rate, the interest rate set by the Federal Reserve, was above four per cent. But just two years later, the Fed had driven real interest rates to below zero, where it remained for about two years.

This massive influx of credit helped spur on the housing binge by giving lenders more funds to provide more and more loans. "By imposing this interest rate," one analyst observed, "the Fed invited everyone and his brother and sister-in-law to go out and get a new mortgage and take on more debt." State and local government policies made the situation even worse. Demand for housing, driven by Fannie, Freddie, and the Fed, was skyrocketing. But across the country, many high-growth states severely restricted the supply of new housing. The largest housing bubbles, where prices rose more than 80 per cent at their peak and fell by up to 60 per cent thereafter, were all in states with onerous zoning and land use laws, such as California and Florida. By contrast, in regions with less-stringent regulation, the effect of the bubble was much smaller. For example, house prices increased by only 30 per cent in Texas and Georgia, even though they were two of the fastest growing states by population.

While the federal government was trying to make housing more accessible for working-class people, these state and local regulations put housing further out of reach.

MORTGAGE MEDDLING MAYHEM

In sum, rather than a failure of the free market, government at all levels was directly complicit in the housing market's spectacular ramp-up and eventual collapse. There is no doubt any number of private firms made major mistakes. But the government's meddling in the mortgage market, even with the best of intentions, was what ultimately brought financial devastation to the millions who lost their homes and savings.

One would think such stunning failure would force the US government to wind down its footprint in the housing market.

Yet 10 years after the crisis, the very same problems that caused the financial catastrophe have not been solved. If anything, the government's role in the housing system has become even more entrenched. In response to the financial crisis, Congress passed the longest piece of legislation ever written: the Dodd-Frank financial reform law.

Astonishingly, while Dodd-Frank imposed nearly $40 billion worth of new regulatory costs on the financial services industry, housing issues surrounding Fannie, Freddie, or the Fed were not addressed. Instead, the taxpayer, at a cost of $190 billion, bailed out Fannie and Freddie. Today, taxpayers, through various government agencies, continue to back up to 90 per cent of newly written mortgages and as much mortgage debt as during the crisis. Fannie and Freddie's underwriting standards, just as during the crisis, are becoming dangerously low, with meagre downpayment and credit score requirements. Meanwhile, the Federal Reserve has pursued the longest stretch of monetary easing in American history. For nearly a decade, interest rates have been barely above zero. Only recently has the Fed begun to unwind its enormous balance sheet, slowly raising interest rates again. This unwinding could expose any number of asset classes as overvalued, including housing. Warren Buffet put it well: “you never know who's swimming naked until the tide goes out”.

Government distortions have only grown worse, threatening the whole financial system

State and local zoning regulations also continue to grow. One trade association found an average house costs around $85,000 more due to regulation, an increase of more than 30 per cent since the crisis. That means new housing development is stifled, with fewer homes being built per household today than at almost any time in American history.

We have seen this story play out before. And it should come as no surprise that another housing boom is underway. Since 2012, the American housing market has been on a six-year rise. Housing prices are higher today than before the crisis, and rising faster than any time since 2005. Many of the same states that experienced the largest bubbles are again experiencing the greatest price increases.

Measures of risk in the mortgage market, such as the National Mortgage Risk Index, have been growing dramatically over the years.

An equivalent downturn in the housing market could potentially set off a broader crisis in American

financial markets.

Predicting exactly what will cause the next financial crisis is an impossible task, but it is bewildering that the same policies that caused the last housing bubble have become even further entrenched. The problem is that this time, governments around the world have much less room to deal with another financial shock, as global debt has spiralled out of control. In 2008, the Australian government had a debt-to-GDP ratio of around 11 per cent.

Today, that level is inching above 40 per cent, with little sign of slowing. Further, the Reserve Bank of Australia has little ability to move on the cash rate. Interest rates currently sit around 1.5 per cent, leaving little room for cuts during a time of crisis. With debt levels this high and interest rates already this low, it is reasonable to ask whether our public finances are in good enough shape to survive another global downturn.

A decade on from the financial crisis, far too little has been done to prevent the next one. The real causes of the crisis have not been addressed. The biggest one of all—the American government's meddling in the housing market—carries on as before.

Government distortions have only grown worse, threatening the whole financial system. The problem now for Australia and much of the rest of the world is being woefully unprepared to deal with the next financial meltdown.

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