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THE FINAL REPORT OF THE FINANCIAL CRISIS INQUIRY COMMISSION

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

FEBRUARY 16, 2011

Printed for the use of the Committee on Financial Services

Serial No. 112–6

U.S. GOVERNMENT PRINTING OFFICE

64–556 PDF WASHINGTON : 2011

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

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THE FINAL REPORT OF THE FINANCIAL CRISIS INQUIRY COMMISSION

Wednesday, February 16, 2011

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Spencer Bachus [chairman of the committee] presiding.

Members present: Representatives Bachus, Hensarling, Royce, Lucas, Paul, Biggert, Miller of California, Garrett, McHenry, Bachmann, McCotter, Pearce, Posey, Fitzpatrick, Luetkemeyer, Huizenga, Duffy, Hayworth, Renacci, Hurt, Dold, Schweikert, Grimm, Canseco, Stivers; Frank, Waters, Maloney, Velazquez, Watt, Sherman, Capuano, Baca, Lynch, Miller of North Carolina, Scott, Green, Cleaver, Donnelly, Himes, and Carney.

Chairman BACHUS. Good morning. The hearing will come to order.

In the interest of time, I will reserve my designated 3 minutes to make an opening statement and submit my statement for the record. Without objection, all members' written statements will be made a part of the record.

With that, I would like to recognize the gentleman from Massachusetts, who is recognized for 3 minutes.

Mr. LYNCH. Thank you, Mr. Chairman.

First of all, Mr. Chairman, I would like to thank you and the ranking member, Mr. Frank, for holding this hearing.

I want to thank the members of the Financial Crisis Inquiry Commission for their testimony today, for helping the committee with its work, and for their public service to our country. The Commission's majority report has received a fair amount of praise I think for its honesty and clarity and for the ease with which it explains some very difficult and complex financial issues.

I am pleased that the Commission identified over-the-counter derivatives as one of the nine conclusions offered as the primary cause of the financial crisis. The majority report states that OTC derivatives "fueled the mortgage securitization pipeline by allowing investors to protect themselves against the default of decline in value of mortgage-related securities backed by very risky loans."

Additionally, the report notes that CDs were—credit default swaps were essential to the creation of synthetic CDO, CDO squares, products that I have been very concerned about and which amplified those losses from the collapse of the housing bubble and

were just one example of the interconnectedness that brought down the system.

I realize that the members of the Commission released three reports in total, but many have pointed to the similarities amongst the three rather than their dissenting views. I hope the Commission's findings will help this committee with its work, and Congress with its work, and I look forward to hearing from our witnesses.

I yield back. Thank you, Mr. Chairman.

Chairman BACHUS. I would like to recognize the gentleman from California for 1 minute.

Mr. ROYCE. Mr. Chairman, economists have already pointed out that there is little mention of the major role of the Fed in setting interest rates too low, setting negative real interest rates for 4 years running, causing very cheap money and massive speculation—one out of three homes were being flipped because of those negative real interest rates—nor the role of the politicians. I guess we shouldn't be that surprised.

But for example, the fact that politicians muscled the market for zero downpayment loans to go to 20 percent down to zero down, the politicians backed the GSEs in this effort to allow arbitrage overleveraged at 100 to 1 and thus caused the collapse of the housing market to begin with.

So it is the underlying factors, the other underlying cause here that was hit on by a few members of this Commission but does not end up in the final report.

And I think the Wall Street Journal put it best: So the two companies that dominated the mortgage market, Fannie and Freddie, that bought or insured hundreds of billions in subprime loans that turbocharged the mortgage market with trillions in capital from around the world and that have cost taxpayers more than any other bailed-out bank, they are innocent.

Chairman BACHUS. I will give the gentleman from California an additional minute.

Mr. ROYCE. Was their attorney Johnny Cochran, I ask?

There has been risk-taking and speculation throughout our capital markets for decades but it has not caused a boom-and-bust of this magnitude.

It was the actions taken by the Fed and the GSEs that turned a boom into a bubble and led to the eventual collapse. And I think it is unfortunate that this Commission couldn't produce a more credible report.

But I am glad to see the dissent most notably of Peter Wallison's report, which properly accounts for the government's role in this crisis, and that is what we should be looking at today. Thank you.

Chairman BACHUS. Thank you. Mr. Scott, for 2 minutes.

Mr. SCOTT. Thank you very much, Mr. Chairman, for holding this hearing today on the final report of the Financial Crisis Inquiry Commission.

In its 633-page report, the Commission mentions massive failures of corporate governance and risk management at several important financial institutions. Many entities are deemed responsible for contributing to the crisis, whether through ineffective government policies or by a lack of proper oversight.

The Commission further states in its report that failed policies under President Bush and under President Obama bear some of the blame for the crisis.

In addition, government regulators and corporations are cited for missing key warning signs, including risky subprime lending and securitization and growth in financial firms' trading activities and a steady rise in housing prices.

But perhaps the most troubling is that the report cited that several financial industry figures themselves appear to have acted illegally. Most importantly, the Commission states that the recent financial crisis could have been avoided. It contains to affirm that it occurred as a result of human action and human inaction and that it could happen again if lessons are not learned.

So I find it difficult to disagree with this assertion. If those involved in the financial collapse had responded appropriately to market indicators and had refrained from unsound lending practices, we would not have experienced a crisis so severe. So it is my hope that we could continue to learn from the Commission's report and avoid a similar series of failures in the future.

Thank you, Mr. Chairman.

Chairman BACHUS. Thank you, Mr. Scott. The gentleman from North Carolina, Mr. McHenry.

Mr. MCHENRY. Thank you, Mr. Chairman.

The Financial Crisis Inquiry Commission was entrusted by Congress to conduct the most significant financial investigation since the Pecora investigation of the 1930s, and many were hopeful that it would result in a similar unified report with a unified narrative.

But the FCIC has fallen well short of unity. In fact, it was no Pecora. The fact that 3 different opinions have emerged from a body of only 10 Commissioners brings into question the objectivity of the majority report.

I am also concerned about the lack of new findings provided in the majority report, which reads like a clipping service of already published books, articles, and other works on the financial crisis.

I look forward to speaking with our witnesses today, and I hope that they will be able to shed some light on their process and answer questions that have been left unanswered in this report.

Chairman BACHUS. The gentlelady from California, Ms. Waters, is recognized for 2 minutes.

Ms. WATERS. Thank you very much, Mr. Chairman.

I thank you for holding this hearing today. It is very important that we hear from our Commissioners what they discovered about our financial crisis.

And I am so pleased that we have before us today two persons that I know very well: My former colleague, Mr. Bill Thomas, it is good to see you.

And Phil Angelides, from the State of California, I am very pleased that you are here today.

I appreciate the opportunity to listen to the Commissioners here today and hear the analysis of what caused this catastrophic economic meltdown in 2008. As we get further and further away from this crisis, my fear is that some of my colleagues will try to rewrite history and perhaps some in the public listening to their messages will begin to forget the true cause of how we got here.

Of course, the purpose of trying to rewrite the causes of the crisis I believe could only serve to undermine the Dodd-Frank Act and return the financial services industry to a nostalgic age of unchecked predatory lending, leverage, and risk.

I consider one of my highest priorities during the 112th Congress to continue to reflect on what brought us to the brink in September of 2008 and to protect the work we did under the Dodd-Frank Act, and importantly, I am committed to pursuing what I believe is one of our largest pieces of unfinished business in this Congress, responding forcefully to the foreclosure crisis.

I voted for the legislation that created TARP in 2008 because I believed that the authority would be used to actually buy up toxic paper and in turn provide modifications to homeowners. As we all know, the Treasury plan changed, and that didn't happen.

So I sought the bankruptcy protections for homeowners or loans for unemployed homeowners threatened by foreclosure, then I sought to strengthen and hamper any robosigning and other service abroad. Despite the efforts of many of us, we have never had a sincere robust effort to directly assist homeowners on any scale rivaling what we did for the banks.

As some talk about the need for the market to bottom out or the need to end the few programs we do have, let's remember that so many of these foreclosures were avoidable, as the Commission points out in their report.

Moreover, I believe that many foreclosures continue to be avoidable if we actually take the difficult steps needed to confront this crisis head on.

So I am delighted to hear more about the findings of the Commission, and I look forward to being able to read the entire report at some point. I yield back the balance of my time.

Chairman BACHUS. Thank you, Ms. Waters.

The gentleman from New Mexico, Mr. Pearce, is recognized for 1 minute.

Mr. PEARCE. Thank you, Mr. Chairman.

I appreciate the opportunity to participate in this hearing. It is good to see Mr. Thomas here.

The mortgage crisis that we found here, the banking crisis to me is fairly simple and straightforward. We just poured too much money into a market. We did not run the background checks. We didn't have the documentation for the loans. And then we built securities on those loans, and the whole system was built on thin air and began to collapse very readily.

The fact that we couldn't get a report that actually clarified that completely with agreement among all the members talks about the politicization of that process.

So I will be interested to hear the testimony of the panels. I thank the chairman and I yield back.

Chairman BACHUS. Thank you, Mr. Pearce.

The gentleman from Illinois, Mr. Dold, for 1 minute.

Mr. DOLD. Thank you, Mr. Chairman.

And I certainly want to thank the witnesses for their time, for their effort and service to the Commission and to our Nation.

By my count, we have had 47 economic recessions or downturns since our Nation's first major economic contraction, the panic of

1797. That is an average of 1 economic recession or downturn every 4½ years in the last 214 years.

Throughout our Nation's history, our national economy has regular and inevitable economic expansions followed by economic contractions. This business cycle is how our economy properly allocates resources, evolves and grows.

And while business cycles are certainly inevitable, history proves that normal and necessary and healthy economic contractions are frequently exacerbated by misguided or excessive government regulatory, fiscal, trade, or monetary policies.

We should certainly learn from each and every economic contraction, and we should do so in the most objective and nonpartisan way possible. Our investigation should not be manufactured to support preestablished political philosophies or positions, but instead, we should strive to learn what governments can do and, perhaps more importantly, what governments can stop doing to avoid aggravating otherwise normal and inevitable healthy business cycle contractions.

In response to our most recent financial crisis, we established a financial Commission to investigate the causes. But many months before we even received the financial Commission reports, Congress passed a comprehensive legislation broadly affecting entire industries, including many that indisputably had little or nothing to do with the financial crisis. We should not be manufacturing legislation or regulatory solutions for problems before we adequately assess the actual problems.

So I am concerned that, once again, Congress has overreacted without sufficient information and with a very high risk of creating unintended consequences that could result in a weaker economy, fewer jobs and overly burden some small businesses and diminish Federal competitors.

We need regulation, not more regulation but smarter regulation.

And again, I thank the witnesses for their time and I look forward to receiving their most objective and candid opinions.

I yield back.

Thank you, Mr. Chairman.

Chairman BACHUS. Thank you, Mr. Dold.

And that would—I am going to yield an additional minute to Mr. Dold.

And at this time, I reclaim my time and recognize the gentleman from New York, Mr. Grimm, for 1 minute.

Mr. GRIMM. Thank you, Mr. Chairman.

I thank everyone on the panel today.

I have to say that I am disappointed. I am disappointed that the Commission was really unable to put together a unified report to accurately assess the root cause of the financial crisis. It has cost millions of jobs, and it has done fundamental damage to our economy.

It seems that some members of this Commission were more interested in following an ideological agenda than producing a report that would assist Congress in developing a strong understanding of what occurred so that we can prevent such a grave situation from happening again.

And with that being said, I am interested in hearing what the Commissioners have to say regarding their findings and their assessment of how Dodd-Frank will or will not stop another crisis, specifically noting the irony that Dodd-Frank was passed into law 5 months prior to this Commission's report.

Again, thank you, and I yield back.

Chairman BACHUS. I thank the gentleman from New York.

And I yield 1 minute to the gentleman from Texas, Mr. Canseco.

Mr. CANSECO. Thank you, Mr. Chairman.

The crisis of 2008 resulted in a financial meltdown. Millions of job losses and trillions of dollars of debt piled upon our children and grandchildren. It left Americans wanting to know why it happened.

The American people deserve an answer, not a history lesson. The Financial Crisis Inquiry Commission was created to give the American people that answer. On the 27th of January, the Commission delivered its majority report. However, they failed to provide an explanation for why the financial crisis happened.

It seems that the Commission's report has produced only a step-by-step accounting of the crisis. The American people lived through this crisis. They know what happened. They don't need to be told the story over again. The American people deserve better.

I hope to gather from our panel today some of the reasons for the crisis, and I look forward to hearing from each of you. Thank you.

I yield back my time.

Chairman BACHUS. Thank you.

And for the final minute on our side, I yield to the gentleman from Ohio, Mr. Stivers.

Mr. STIVERS. Thank you, Mr. Chairman.

I would like to thank you for calling this hearing on the Financial Crisis Inquiry Commission's report. I am new to Congress, so I am not sure I understand the process here, because most problem solvers would recognize a problem, study a problem and then find a solution, and it seems only in Congress can we recognize a problem, pass a solution, and then study the problem.

I am also concerned that the report didn't have detailed recommendations of how Congress can avoid a future crisis. In fact, Representative Thomas suggested in his dissent that the majority's report is too broad and provides an account of bad events as opposed to a focused explanation and how we move from here.

Knowing that this report cost the taxpayers $10 million, I have higher expectations. And I look forward to hearing the panelists talk about recommendations of how we can avoid a future crisis and how our solution hopefully can solve the problem.

It is my hope that we can learn from the past so that we don't have to relive it. Thank you so much.

I look forward to hearing from the panelists.

I yield back, Mr. Chairman.

Chairman BACHUS. I thank the gentleman from Ohio.

And I yield the balance of the time on the minority side to the gentleman from Massachusetts, Mr. Frank.

Mr. FRANK. Thank you, Mr. Chairman.

I am pleased to welcome an old friend back, Bill Thomas, who gives me some affirmation that there is life after chairmanship, and I appreciate that. Check his pulse.

We just heard some criticism on the Republican side that the Congress should not have acted on the financial reform until the Commission finished. But the point is one very prominent commentator has argued that a significant part of the Commission's report is a justification of the rationale of the bill and, to some extent, of its substance.

Let me read from Peter Wallison's dissent. We will hear from Mr. Wallison later: "Second, by suggesting that a major cause of the financial crisis was the wholesale failure of bank and financial institution management, this section endorsed a policy foundation for more regulation as well as the underlying rationale for the Dodd-Frank Act. After all, if managements of virtually all the world's financial institutions cannot be trusted to manage their firms, then to protect the public, the government must oversee them."

This commentator thinks that is an implausible position, but he says that is exactly the rationale that Congress used in designing and enacting the Dodd-Frank Act, and unfortunately, it is the implicit policy message of this particular section of the report.

The relevance of that is that the section of the report that is being discussed here is the dissent by the three other Republican Commissioners. In other words, according to Mr. Wallison, the other three Republicans whom he somewhat oddly refers to as the THH dissent—I actually was looking when I first came across that to see what disparaging initials those were; it turns out it is just their last names. But it did seem THH was an odd way to characterize your colleagues. Mr. Wallison says that the dissent went in that same direction.

Obviously, that is I think somewhat unfair to them because there are some differences. But there is one very important point of similarity, and we ought to be clear: Yes, there was a 6–3–1 vote, but on a number of issues, there was a 9–1 vote.

For example, the Community Reinvestment Act: Mr. Wallison has long been a proponent, and there have been some members of this committee who believe that the Community Reinvestment Act is the substantial cause of the problems that have compelled mortgages to be given that shouldn't be. Of course, nothing in the terms of the Act says so. And if you compare mortgages granted by institutions which were not covered by the Community Reinvestment Act, they are far more likely to have failed and to have been inappropriate than those covered by the CRA.

But it is clear that the "THH group", to adopt Mr. Wallison's terminology, his three fellow Commissioners specifically said that the CRA was not a major part of this problem. That is, 9 of the 10 Commissioners repudiate the notion that this was caused in substantial part, or even at all, by the Community Reinvestment Act. And that is very important I think for us to have online.

It is particularly important because we are today continuing the debate on a financial reform bill in which the Republican version of the continuing resolution assaults three particular important aspects of the reform act. One of the things we did in that bill was to say that hedge funds should be covered by a registration require-

ment so that we will know what is going on out there. That is entrusted to the SEC, which under the Republican CR will not have the money to carry that out. Hedge funds will remain uncovered.

We gave the CFTC the mandate to begin to regulate derivatives, including mostly including for end users, making public the price, not for end users in any other way regulating them.

What we did then with both derivatives and with regard to hedge funds and private equity was to get some more information.

People have been talking about the shadow banking system. One of the things we did in the bill was to try to bring that out of the shadows. But as a result of the Republican budget, neither the SEC nor the CFTC will have the money to do that. And so we will go back and from time to time and talk about old radio programs. I think we have another one. Who will know what risk lurks in the heart of the financial system? And the answer is, the shadow will know but nobody else. Because our efforts to put some light on the shadow banking system by having hedge funds register with the SEC and have them be able to calculate what is up and having derivatives regulated by the CFTC, those won't happen.

When AIG needed money from the Federal Reserve, by the way, under a section of the Federal Reserve Act which we unanimously rescinded on both sides, what the Federal Reserve gave to the AIG won't be possible in the future. We have stricken that Section 13(3), but when they gave money to AIG, they came in the first week and told us they were giving them $80 billion and then they needed another $80,000 to $100,000, because no one knew how much they had.

So I welcome 9 of the 10 Commissioners repudiating the notion that it was just the government trying to be nice to poor people and particularly the CRA that caused this problem. And I am regretful that we will be debating later today a budget which will leave hedge funds in the dark, prevent the regulation of derivatives, including price discovery for the end users, and will further reduce the role of the Consumer Protection Bureau. So credit cards, hedge funds, unregulated and unknown and in-the-shadows hedge funds and derivatives will all be the beneficiaries.

And as I said, I do believe Mr. Wallison was right that 9 of the other 10 Commissioners give support to the notion that we should go forward. I think the majority report in particular is a good argument for the bill going forward, and we will be fighting later today to prevent the re-deregulation of the financial economy which the Republican budget represents.

Chairman BACHUS. Thank you.

We will note for the record that you agree with Peter Wallison on those issues.

Mr. FRANK. Yes, I agree with him that the initials of his three fellow Commissioners are in fact "T," "H," and "H."

Chairman BACHUS. All right. Thank you.

I want to introduce the first panel and also acknowledge the second panel and associate myself with Mr. Dold's remarks that we thank you for your service to the Commission and to the country.

Your compensation was very nominal so you did this I think out of a sense of patriotism and duty to your country, so I thank you.

Our first panel consists of: the Honorable Phil Angelides, the Chairman of the Financial Crisis Inquiry Commission; and the Honorable Bill Thomas, the Vice Chairman of the Commission.

Our second panel will consist of four Commissioners of the Financial Crisis Inquiry Commission: Dr. Douglas Holz-Eakin; the Honorable Brooksley Born; Mr. Peter Wallison; and Mr. Bryon Georgiou.

So we thank the second panel.

The first panel will be dismissed at noon.

And without objection, your written statements will be made a part of the record, and you will each be recognized for a 5-minute summary of your testimony.

At this time, Mr. Angelides, I will recognize you.

STATEMENT OF THE HONORABLE PHIL ANGELIDES, CHAIRMAN, FINANCIAL CRISIS INQUIRY COMMISSION

Mr. ANGELIDES. Thank you very much.

Chairman Bachus, Ranking Member Frank, and members of the committee, thank you for the invitation to discuss the report of the Financial Crisis Inquiry Commission.

First of all, I want to thank my colleague, Vice Chairman Bill Thomas, for his service to our country and to this Commission. And I want to thank our dedicated and excellent staff who worked with us.

This committee requested that I address three subjects: the Commission's report; the inability to reach consensus on some conclusions; and the Dodd-Frank Wall Street Reform and Consumer Protection Act.

In 2009, Congress tasked the Commission to examine the causes of the current financial and economic crisis in the United States and to probe the collapse of major financial institutions that failed or would have failed if not for exceptional assistance from the government. We were true to our charge and fulfilled our mandates.

Our task was to determine what happened and how it happened so we could understand why it happened. In doing so, we sought to answer this central question: How did it come to pass that in 2008 our Nation was forced to choose between two stark and painful alternatives—either risk the total collapse of our financial system and economy, or inject trillions of taxpayer dollars into the system and into private companies, even as millions of Americans still lost their jobs, their savings, and their homes?

In the course of the Commission's exhaustive investigation, we reviewed millions of pages of documents, interviewed more than 700 witnesses, and held 19 days of public hearings in New York, Washington, D.C., and communities across the country.

The Commission also drew from a large body of existing work developed by congressional committees, government agencies, academics, and others. The Commission's report contains six specific major conclusions.

First and foremost, we concluded that this crisis was avoidable. The crisis was a result of human action, inaction, and misjudgment, not Mother Nature. Financial executives and public stewards of our financial system ignored warnings and failed to question, un-

derstand, and manage evolving risks within the system so essential to the well-being of the American public.

Second, we found widespread failures in financial regulation that proved devastating to the stability of the Nation's financial markets.

Third, our report described dramatic breakdowns in corporate governance and risk management at many systemically important financial institutions.

Fourth, we detailed the excessive borrowing, risky investments, and lack of transparency that combined to put our financial system on a collision course with catastrophe.

Fifth, we concluded that the key policymakers were ill prepared for the crisis and that their inconsistent response added to uncertainty and panic.

And finally, we documented how breaches in accountability and ethics became widespread at all levels during the run-up to the crisis.

Our report as well as two dissents can be found on our Web site, FCIC.gov. That Web site also contains approximately 2,000 documents, public testimony in our hearings, audios, transcripts and summaries of more than 300 witness interviews, and additional information to create an enduring historical record of this crisis.

In addition to the major causes we identify, the Commission also investigated among other things whether this crisis was caused by excess capital availability, the activities of Fannie Mae and Freddie Mac, and government housing policies. We concluded that excess liquidity by itself did not need to cause a crisis and that Fannie Mae and Freddie Mac contributed to the crisis but were not a primary cause. We determined that government housing policies were not a significant factor in this crisis.

As we undertook our work, all 10 Commissioners were afforded the opportunity to fully participate. While we were not unanimous on all issues or on the emphasis we placed on key causes, there were in fact many areas of agreement among 9 of 10 Commissioners. Importantly, setting aside conclusions and dissents, this report contains a valuable and accurate historical account of the events leading up to the crisis and the crisis itself.

Finally, you have asked me to comment on the Dodd-Frank financial reform law. With our inquiry and report completed and the facts in evidence, I will now speak to this matter. I believe the law's financial reforms are strong and needed and that the law directly and forcefully addresses issues and conclusions identified in our report.

I believe full implementations of its provisions is critical and will help prevent a future crisis. In conclusion, it is my hope that our report will serve as a guide post in the years to come as policymakers and regulators endeavor to spare our country from another catastrophe of this magnitude.

Thank you and I look forward to your questions.

[The prepared statement of Mr. Angelides can be found on page 60 of the appendix.]

Chairman BACHUS. Thank you. Congressman Thomas.

STATEMENT OF THE HONORABLE BILL THOMAS, VICE CHAIRMAN, FINANCIAL CRISIS INQUIRY COMMISSION

Mr. THOMAS. Thank you, Chairman Bachus, Ranking Member Frank, and members of the committee.

You have asked that I address the Commission's findings, the Dodd-Frank Act in light of those findings, and why the Commission was unable to reach unanimous agreement.

I joined a dissent from the majority's report with Commissioners Hennessey and Holtz-Eakin. In our dissent, we describe what we believe are the 10 essential causes of the financial crisis.

Our thesis is that the crisis was at its core a global financial panic precipitated by concentrated correlated housing-related losses at large and midsize financial institutions in the United States and Europe.

Let's examine three areas where our findings and conclusions differ from those of the six-member majority. First, our explanation of the crisis begins with a global credit bubble fueled by international capital flows. We do not think that you can understand what happened in the United States without first understanding what was going on in international capital markets.

There were a series of credit bubbles occurring at the same time in a variety of asset classes around the world. This fact undermines, we think, the thesis that it was something about U.S. capital markets or the U.S. housing market in particular that was the primary cause of the bubble.

We focus on the role that economic forces played in causing the crisis, whereas the majority focused on individual firms and actors. This difference is highlighted in an article by Robert J. Samuelson, entitled, "Rethinking the Great Recession." It is in the winter issue of the Wilson Quarterly. Samuelson's main thesis is, "There is a political, journalistic and intellectual imperative to find out who caused the crisis, who can be blamed, who can be indicted, either in legal courts or the court of public opinion, and, if found guilty, be jailed or politicly humbled. But in embracing a victims-and-villains explanation of the recession, Americans are missing important lessons about the future of the U.S. economy."

Second, as you can see from the chart in my testimony, housing bubbles occurred in a number of large countries with very different systems of housing finance. No two were quite alike, and none looked anything like ours. Therefore, we had a hard time placing too much emphasis on the structure of our mortgage finance system in explaining the boom-and-bust and focused more on factors common to all of the countries, that is the broader credit bubble.

Third, we observed financial firm failures across a variety of different firm organizational structures in the United States and Europe. For us, this supported the conclusion that the organizational form of a financial firm or its specific regulatory regime was secondary in importance to common factors; that is, concentrated exposure to the housing market and poorly managed solvency and liquidity risk.

When we look at the multitude of different types of firm failures in the United States and around the world, it casts doubt on the majority's thesis that a particular feature of the American regulatory regime, a specific type of financial institution or an indi-

vidual firm and the people who ran it was an essential cause of the crisis.

However, when you are looking for villains and victims rather than essential causes, it is easy to examine the same set of facts and arrive at diametrically different conclusions.

This leads me to the central question of why we were unable to reach unanimous agreement among the Commissioners. From the beginning, I thought that the Commission was created for political purposes with a partisan structure and a partisan agenda. It called for six of us to be appointed by Democrats and four by Republicans. And any six votes were all that was needed to transmit the report to the President and the Congress. The math is simple.

Let's be clear, the Commission was not created by Congress to write a 500-plus page commercially produced book. The Commission was created to determine why we had a financial and economic crisis.

In our dissent, we conclude by focusing too narrowly on U.S. regulatory policy and supervision, ignoring international parallels, emphasizing only arguments for greater regulation, failing to prioritize the causes, failing to distinguish sufficiently between causes and effects, the majority's report leads to incorrect conclusions about what caused the crisis.

I think we had the money, the time, the staff, and the resources necessary for our work to have been a success. But when you have the votes, what else really matters?

And finally, regarding the Dodd-Frank Act, I believe our work has shed light on a number of problems in our financial markets that have not been sufficiently addressed, as well as cases of regulatory overreach in the Act where the financial and economic crisis was used as a cover to regulate activities that really had little to do with the financial crisis. I look forward to your questions.

[The prepared statement of Mr. Thomas can be found on page 74 of the appendix.]

Chairman BACHUS. Thank you.

Congressman Thomas, in your testimony, you spoke about the crisis being used as a cover to regulate activities that had little to do with the financial crisis. Can you tell us a little more about the regulatory, what you described as overreach of the Dodd-Frank Act and the use of the financial crisis as a pretext to regulate activities that didn't cause or had nothing to do with the crisis?

Mr. THOMAS. Yes. Thank you, Mr. Chairman.

I am pleased to say that one of the "H's", Douglas Holtz-Eakin, will be on the second panel. He is a professional economist and, some of you may know, was the former head of the Congressional Budget Office. And he is much more conversant with many of the provisions of the Dodd-Frank Act.

However, a couple of things are fairly obvious. One is the whole question that this Congress, at least a portion of the Congress, stressed during the Dodd-Frank Act that the so-called GSEs, Fannie Mae and Freddie Mac, really needed to be dealt with. And I thought it should have been an integral part of the legislation.

The government bailouts, when you look for overreach, the enhanced supervision, I really disagree with the majority that there was information that was available to regulars. In hindsight, it is

always easy to explain what happened, even if it is wrong. And as Samuelson, and I do urge you to read this recent article by Samuelson, because it is so easy to focus on villains and victims, and unfortunately, that is the direction we tend to go politically. And that is why our conclusions looked at we think more fundamental causes, and if we don't focus on those, we are going to be doomed to repeat, notwithstanding a number of regulatory measures that were put in effect, especially a portion of the derivatives legislation.

I am not saying that there weren't certain kinds that were clearly part of the problem, but there are many others, and we are just now discovering as we are getting testimony recently reported in the paper, about firms that use the derivatives to truly hedge against their input costs in producing products. That is a long-time honored procedure for derivatives, in fact, a historical use. And this has to be revisited to be able to allow them to use this in a way that is sound and appropriate and was never a cause, in my opinion, in any way of the financial crisis. Those are a couple of examples.

For example, eating your own cooking, the idea that you are going to hang onto your own stuff, and therefore, you will be more sober. It was rather frightening for me to hear the testimony from Lehman in which a number of the major executives, in fact the top executives actually put into their basic portfolio the derivatives that were synthetic in a way that they thought they were actually worth what they were supposed to be worth because they were Triple A rated. Rating agencies obviously is another area that needs to be dealt with. But that they seemed to be coherent of the fact that they had to make margin calls if in fact the numbers changed relative to what they were holding. That was fairly frightening to some of us who thought that these people, at least in some way, earned the amounts of money that they were receiving. But that was so fundamental as to be shocking.

So I do think there are some areas that were frankly just gathered up, not unlike the stimulus bill, that had been desired regulatory moves for some time and plugged into the Dodd-Frank Act, and there are clearly areas that were left out. Of course, it would have been nice to wait for our report to be able to analyze it, but frankly, that was not of concern to me. I was pleased that we didn't have to come up with solutions, just to try to analyze the cause. If we were supposed to come up with solutions, I wouldn't have volunteered to be on the Commission. And we thought it was important to try to look at the causes.

As I said, with a 6–4 vote, especially near the end, Ranking Member Frank responded to the fact that there were some 9–1 decisions. Yes, those were early on. I would love someone to ask me about all the 6–4 decisions that occurred once it was clear that the former majority was no longer going to be the majority and then, after the election, what occurred in late November and December on a number of 6–4 decisions which wound up producing a rather what I consider to be an unfair and bizarre situation on this Commission as opposed to the many other Commissions that I served on, especially the bipartisan Commission on Medicare and several others.

Chairman BACHUS. Are those Commissions 5–5 or equal numbers?

Mr. THOMAS. I can't hear you, Mr. Chairman.

Chairman BACHUS. Are those Commissions 5–5 as opposed to 6–4?

Mr. THOMAS. No, they were always, well, rather larger. But the point was, look at the President's debt Commission. That is a good example. You require a supermajority; it is very difficult to do. That is what we did, we had as a requirement on the bipartisan Medicare Commission. There were co-chairs, not a chair and a vice chair. Senator Breaux was a co-chair, and I was a co-chair. We worked in an absolutely level relationship. I will say that Chairman Angelides allowed me far more ability to be involved than the Act required. But at the end, when you wind up with a series of 6–4 votes, and I can go into it if somebody wants to ask me the detail, clearly the decision to move forward was I think a function of two things.

Senator Dodd decided to retire. And whenever anyone spends that much time in Congress and wants to move a product, it is very difficult to say no. I am not saying the product was fatally flawed; I am just saying that there was a desire to get it done before he left Congress. That is a pressure that produces a product that perhaps wasn't as well established.

My friend from Massachusetts' name is on it, and I think all of the good parts that are in it are attributed to him. The rest of them are to those who have left the place. And we can agree on that structure.

But when you have a 6–4 structure, and if I might be able to go on for a minute, just to give you a couple of examples, or I will wait for other questions.

Chairman BACHUS. If we have unanimous consent—the ranking member says that is fine as long as you keep complimenting him.

No, he actually didn't say that.

Mr. FRANK. My problem is just with the new deadline. It is okay with me, but there are other members.

Mr. THOMAS. I would just like to say that is not hard to do. We worked as well as could be expected together given the odd fellows that both of us are.

Chairman BACHUS. Thank you.

Mr. THOMAS. Is that a compliment?

Chairman BACHUS. Yes.

Mr. THOMAS. Let me give you a simple example of 6–4 votes. This is a commercially commissioned book. On a 6–4 vote, the whole relationship that I have known for the 28 years that I was in Congress dealing with majority/minority and reports was turned on its head. A congressional report is the majority and the minority's positions. That is the report. What happened here on a 6–4 vote was dissents in the report, i.e., the congressional model, was changed to dissents with the report. Dissents were not part of the report.

And that is why I would say to my friend Mr. Lynch in his description of three reports, no, there was one report; that was the majority. The others clearly were dissents.

I put blue for the Democrats the way all the people—

Mr. FRANK. Mr. Chairman, I am for the other members with a new deadline.

Chairman BACHUS. And the ranking member will let someone else—

Mr. THOMAS. Thirty seconds. The blue is the Commissioner's findings in the report. The red are the minority's dissents. They are separated by 400 pages that could easily have been placed together so that you could judge the two. Those 400 pages are a political decision decided on a 6–4 vote.

Chairman BACHUS. Thank you.

I thank the Congressman.

And Ranking Member Frank will be recognized for an additional minute.

Mr. FRANK. Thank you, Mr. Chairman.

I guess maybe I, based on this example, can look forward to a certain mellowing in retirement. I appreciate the nice words of my former colleague.

I do note that his familiarity with the notion if you have the votes, you go ahead; I don't think this is the first time he encountered that philosophy. I just wanted to begin by saying the typography doesn't seem to me to be very significant. If the material is out there for people to read, whether it is called with the report, or from the report, or over the report, I think is irrelevant; the information is out there.

And I do want to begin with one of the accusations, Mr. Angelides, because I am impressed by what seemed to me the fairness and the openness. In Mr. Wallison's dissent from—the dissent from the majority, he talks about Mr. Pinto and says that you were not fair to Mr. Pinto's information. Will you respond to that? That is a fairly serious charge.

Mr. ANGELIDES. Yes, Mr. Frank.

Yes, Mr. Wallison in his dissent said that Mr. Pinto, who is a housing expert, provided information to the Commission that was never distributed to the Commission, never analyzed, and that Mr. Pinto's testimony was never taken.

Let me just point out that Mr. Wallison distributed that information to all Commissioners, including members of the Housing Working Group. Our staff met 6 times in person and by phone with Mr. Pinto, and his July interview is posted on our Web site. The staff undertook an analysis of Mr. Pinto's work and provided that to the Commission. In fact, Mr. Pinto commented on that analysis. And on pages 219 through 221 of the report, you can find a discussion of Fannie Mae, Freddie Mac, Mr. Pinto's analysis, and the staff's analysis. And if someone would like to read the staff's analysis of Mr. Pinto's work, it is footnoted, Chapter 11, footnotes 17, 13, and 19 and posted on the Web, so I am a little surprised by that.

Mr. FRANK. Thank you. Let me just say with regard to the scope of the bill that came up, I don't just acknowledge, I am inclined to brag about the fact that the Financial Reform Act included more than what we thought were the causes of the crisis. It would have been irresponsible not to have dealt with other issues.

I don't understand when the philosophy came that when Congress is legislating, it should only look backwards; it should not an-

ticipate potential future problems. Of course, we did things that were not necessarily part of the past problem. We tried to take a comprehensive view, and we looked at things that might be happening in the future or other factors.

So I am stunned that it is a criticism that the bill on financial reform, and you don't do those very often, did more than simply respond to the crisis.

I will say, I will dissent from one thing Mr. Thomas said. No, this wasn't hurried because of Chris Dodd; this was hurried because a whole range of people, beginning with Hank Paulson and Ben Bernanke, the Bush appointees who initiated our efforts here, said you really need to get this done quickly; because we were told by the financial community correctly that uncertainty was a problem and to prolong this for another year or so would have added to that uncertainty. So, yes, those were the reasons why we did more.

Finally, as to not including Fannie Mae and Freddie Mac, my view is that we were not ready at that point to do that, that the responses hadn't been formulated. And I now accept graciously—people say you should take "yes" for an answer. I have learned how to do that, because last year the Republicans offered what they said was the solution to the Fannie Mae and Freddie Mac problem in the conference. We did not accept it. And they said, this is a big mistake.

Now that the Republicans are in power, that solution appears to have become a dissolution. It is dissolved. It is not here anymore. We had a hearing on Fannie Mae and Freddie Mac, and that wasn't even the subject of the hearing. So what we now have is retroactively the Republicans acknowledging that while we had put them in the receivership, the conservatorship, we had stopped the bleeding; we were not yet at a consensus as to how to replace them. And indeed, I was struck that the Republicans, oddly to me, criticized President Obama's Administration for not giving them more specific advice about how to fix Fannie Mae and Freddie Mac. I was not aware that they were in the habit of waiting for the President to tell them what to do.

So they have in fact acknowledged by their action or inaction that we are now in the process of trying to figure out what to do next, and that is why we hadn't moved on it.

The last point I want to say is, I will go back to Mr. Thomas, and I do think there were some who blamed Fannie Mae, Freddie Mac, and the CRA; others who blamed other aspects of the American situation. I am struck by the three-member dissent disagreeing with both. But I do, particularly for those who thought it was Fannie Mae and Freddie Mac or people who thought it was the American system in general, Mr. Thomas I will just ask you to comment briefly as I read from your testimony: "This fact undermines the thesis that it was something about U.S. capital markets or the U.S. housing market in particular that was the primary cause of the bubble. It undermines that thesis. That is a repudiation of the notion that it was the U.S. housing market in particular that was a primary cause."

And then you say two pages later, "We observed financial firm failures through a variety of different firm organizational struc-

tures in the United States and Europe. This fact supported the conclusion that the organizational form of a financial firm or its specific regulatory regime was of secondary importance to common factors that concentrated exposure to the housing market and poorly managed salvage and liquidity risk."

Now, I realize that is a difference from both what had been the majority view, but it is also very much a difference from the view that it was Fannie Mae, Freddie Mac, and the CRA because those were particular American institutions managed in a particular way. Is that an inaccurate summation of your view?

Mr. THOMAS. No. I thought the Commission was charged with looking at the fundamental causes of the crisis. I really want to recommend to you the Samuelson article that has just been written.

Mr. FRANK. I thank you. And let me just say—

Mr. THOMAS. Because he is worried that we are going to go off on the tangent of investigating villains and victims and not understand the fundamental lesson of what happened, international capital, its interrelatedness, lack of transparency. The CRA was a cause. Fannie Mae and Freddie Mac were causes. There were multiple causes, but they weren't the reason for what happened.

We can look at the loosening up of credit under Greenspan, the area of moderation. You can look at all of the sovereign funds that came in. There are a lot of reasons, and a lot of them have been written about. But if our job was to go to the court and try to explain what happened, that is what we thought—

Mr. FRANK. Okay. Let me interrupt you. Let me emphasize again, and that is true for the Commission. I do want to differentiate, that was not the mandate of the legislation. So the fact that we consciously included in the legislation things that were not necessarily the cause or not the cause is not a criticism of legislation. Our mandate is to go beyond that.

The other thing I would say is that I did appreciate it, so on this question, the notion that it was Fannie Mae and Freddie Mac and CRA that were causal, it is one thing to say they were exacerbating factors once the problem started, and I think that is a very important—

Mr. THOMAS. And are they a problem and a problem today? Yes.

Mr. FRANK. Yes. And I await the Republican solution now that they are in the majority. I yield back.

Chairman BACHUS. Thank you.

Mr. Royce.

Mr. ROYCE. Thank you, Mr. Chairman.

I think in response maybe to this argument about primary causes and factors, clearly, one of the underlying factors I think was missed in this report. And I remember the British magazine, The Economist, making the argument in 2002 that our Federal Reserve had set an interest rate that effectively was below zero if you included inflation into the calculation.

Mark Zandi, in his book, "Financial Shock", and I see, Barney, you have had a quote in support of some of his conclusions—but I had a chance to have dinner with him and talk to him about this particular factor and how, in my view, and I think in the view of many economists, the fact that for 4 years in a row you had inter-

est rates which were below zero. And every time that that has happened—and here is what The Economist said at the time, they said you are going to have asset bubbles in real estate. And because the Fed has done this in the United States, other central banks are going to follow.

I just want it understood that when you eliminate or erase market discipline—as clearly we did with government intervention into the market, with the pressure to get those 20 percent downpayments down to zero, Congress did that with what we did with the GSEs—all of that helps create a bubble. Underlying that is this massive infusion of credit. And he goes through the argument, the extraordinarily easy money policies pursued by the globe's central banks helped pump up the U.S. credit and housing market.

As I read the report, yes, there is a mention on page 5—there are maybe three different mentions through the report—about interest rates being low. But I think what you missed is something that the Federal Reserve and Mark Zandi—at least in the majority report here, the thing that you missed was the crucial role it played. And I wanted to ask you about that and how you have been criticized. This argument has been made by many journalists and economists since the report came out. I wanted to ask you about that.

And the other point I think is that I don't think you can debate the issue with respect to the role of the GSEs, given the losses, which are probably going to be $350 billion to the taxpayers, and given the fact that those institutions were at the heart of the collapse of the housing market. More importantly, the Federal Reserve came here in 2004 and 2005 and warned us that unless we regulated the GSEs for systemic risk and gave the regulator the ability to bring down those mortgage portfolios, that this would create a systemic financial crisis, and here we are.

And so I wanted to ask you, Mr. Angelides, about those two points.

Mr. ANGELIDES. Great. Thank you very much. I appreciate the questions.

First of all, we did look at international capital flows. We looked at excess liquidity. We looked at monetary policy. In fact, in the book, I think it is on page 83, there is a whole section on credit expansion. We also have parts in the book where we discuss what happened in terms of other countries' housing bubbles. But let me say this: On that issue, the Commission concluded that, yes, there was excess liquidity, but in and of itself, that need not have caused a crisis, that there could have been—recognizing that excess liquidity, regulators, market participants should have exercised discipline.

And in particular, let me just give you the example of the Federal Reserve. Knowing that there was that kind of excess liquidity in the global economy, it was incumbent on the Federal Reserve to use its power under HOEPA to set reasonable, prudent mortgage lending standards.

And by the way, as someone who comes out of the real estate business, we should have recognized those asset bubbles. We should have had tighter mortgage lending standards. And I think

that was at the heart. It was our failure to grapple with those capital flows. I think if we take the position that international capital flows are detrimental to this country, that is very damaging. We want to have capital flowing, and we want to put it to productive uses, not merely—

Mr. ROYCE. You cannot regulate the idea that you are going to make money so cheap that it is less than zero, that for 4 years you are going to flood the market with that, and that somehow you are going to be able—this is what economists would call the fatal conceit—that somehow you are going to be able to overcompensate for the fact that that much money is flooded into the market. And on top of it, you have erased market discipline by what you have done with government intervention with Fannie and Freddie and gone to zero downpayment loans, the idea that some regulator is going to be able to tamp all that down or keep that under control when the government has unleashed, by bad decisions, all of that liquidity into the market I think is a fantastic belief.

I can't understand in this day and age how people, unless you have central planning able to control every aspect of decisions made by people, how could you possibly undo the damage that those kinds of decisions create in an economy?

Mr. ANGELIDES. I am sorry, I don't mean to interrupt you, sir.

Mr. ROYCE. But even if we concede that some way you could overregulate for all of what has been unleashed, why not a real discussion on Fed policy in the majority report in terms of how this underlies the problem. And I have read the report, and—

Mr. ANGELIDES. I would urge everyone to read—I am sorry, sir.

Chairman BACHUS. Let me say this, let the gentleman respond and then—

Mr. ANGELIDES. Quickly. I would urge everyone to read—and I hope as many Americans as possible—the report. We do detail monetary policy. We do detail the excess liquidity in the marketplace. But I will say that when you take degrading lending standards, when you take leverage ratios of 40–1, when you take a shadow banking market of $13 trillion that exceeds the regular banking system with no transparency, the combination of cheap money and excesses in the marketplace and dramatic failures of regulatory control, I think you have a formula for disaster.

Mr. ROYCE. The GSE ratios were 100–1.

I yield back.

Mr. ANGELIDES. In fact, they were the kings of leverage, yes, sir.

Chairman BACHUS. The gentlelady from California is recognized.

Ms. WATERS. Thank you very much, Mr. Chairman.

I would like to thank the co-chairs of the Commission. I take to heart the recommendation that Mr. Thomas is making about Samuelson and what he is explaining about Samuelson, villains and victors.

There is a fundamental debate that is going on in the Congress of the United States today. This fundamental debate is about regulation. On this side of the aisle, we believe that we understand and recognize the cause of the meltdown and what brought us to the brink of a depression. And we have also heard from our regulators who are agreeing that they need to be supported, they need more

funds, they can do a better job, and the Dodd-Frank bill helps to do that.

On the opposite side of the aisle, we are hearing we need less regulation. My colleagues on the opposite side of the aisle are claiming that regulation is a job killer. And so this debate is so important because it is about which way America—are we going to have regulatory agencies that turn a blind eye or that are not supported with their technological capability, or are going to be intimidated? Or are we going to have a regulatory system that is going to do the job that they expect it to do, not only to protect the public and the consumers, but to help regulate what happens in this economy? That is what it is all about.

Now Mr. Angelides, you said in your statement that the crisis was a result of human inaction and misjudgment, not Mother Nature. Financial executives and the public stewards of our financial system ignored warnings and failed to question, understand, and manage evolving risk within a system so essential to the well-being of the American public. You found widespread failures in financial regulation that proved devastating to the stability of the Nation's financial markets, and on and on and on. And basically, that is the conclusion that some of us have come to.

In your discussion, did you find that there was indeed a consensus about what you have just identified here in some shape, form or fashion about the failure of our regulatory agencies to do their job?

Mr. ANGELIDES. Let me just say that, certainly speaking for the Commission's conclusions, we really found there was a—first of all, that we believe this was avoidable. There were plenty of warning signs along the way. You don't create $13 trillion worth of mortgage securities and have no one notice. You don't have the FBI warn about rampant mortgage fraud in 2004 and 2005 and have no one notice. You don't have unprecedented escalation—and I guess Mr. Royce talked about in terms of asset bubbles and housing prices. And there were plenty of warnings, for example, at the Federal Reserve about egregious and predatory lending practices. Mr. Greenspan said regulation was not the answer; the answer was law enforcement, but from 2000 to 2006, the Federal Reserve made only three referrals to the Department of Justice.

But there was a twin phenomenon here. There was a breakdown in regulation, and we detail that. And I might add—I don't want to speak for my other members, but I think there was an acknowledgement, we may differ on the cause, but the SEC had the ability to curb excesses at the investment banks; they did not. The Federal Reserve Bank of New York had chances to curb the excesses at Citigroup; they did not. The Office of Thrift Supervision, which oversaw AIG, didn't even understand that its mandate—and it had signed a directive with the European Union to oversee the whole company.

So there were dramatic breakdowns, but they were also accompanied by dramatic corporate governance and risk-management breakdowns at companies. At Citigroup, this was an organization that did not know that it had $55 billion worth of exposure to subprime mortgages. They represented to the public all through 2007 that they had $13 billion. They had about $25 billion in what

are called liquidity puts off balance sheet that executives themselves did not learn until the fall. And they represented still to the public that they had $13 billion on the same day that their board was being told our exposure is $55 billion.

At AIG, they wrote $79 billion of credit default swaps protection on subprime securities. The CEO, Mr. Sullivan, the CFO, Mr. Bensinger, the chief risk officer, none of them knew that there would be collateral calls made on AIG if the market value of those securities fell. So when Goldman Sachs makes their first collateral call in July of 2007, they were shocked. And of course, as everyone knows, what happened after that is the collateral calls accelerated, ultimately leading to the collapse and the taxpayer bailout.

So it was a twin phenomenon of deregulation, gaps in regulation, and failures of regulators to use the powers they had. And I want to be clear to all members here of both parties, there were a lot of powers that went unused. I believe Dodd-Frank has helped close a lot of the gaps that existed, but the fact is there was a twin phenomenon here where there were clear breakdowns in corporate governance and management.

Chairman BACHUS. Thank you.

Ms. WATERS. Thank you very much.

I yield back the balance of my time.

Chairman BACHUS. Mr. Garrett.

Mr. GARRETT. I thank the chairman.

And to the Congressman, it is interesting that the ranking member says that this is what he has to look forward to in retirement, the mellowing that we see here, so I don't know whether we hear some pronouncement from the ranking member with regard to his retirement. If not, I guess we will proceed. I thought this would be the committee hearing of the week then, in which case—in any event, to the Congressman, you began your issue with regard to the lack of bipartisanship nature of the committee.

I am thinking back a couple of years ago when we had the 9/11 Commission. You mentioned some other Commissions where it was done in a truly bipartisan manner. So can you just comment very briefly if you will, did the majority give you complete bipartisanship with regard to the staff and to the resources, and also to the areas that you were going to, as a Commission, study and investigate and file a report upon? I guess that is one or two questions.

And third, you had some sort of comment you wanted to make with regard to the final vote as well.

Mr. THOMAS. I thank the gentleman.

Mr. GARRETT. Sure.

Mr. THOMAS. I thought it was pretty obvious, when the move was made at the beginning of the Congress to create a committee which was structured along partisan lines—six and four—the Democrat side got the chairman and the minority side got the vice chairman, rather than co-chairman, that my friend from Massachusetts' argument that I am very familiar with the partisan environment was one of the reasons I decided to go into this because it was clear from the beginning it was a partisan environment. I was going to try to make sure that it didn't wind up a partisan environment. And as we began, it was clear that there was an attempt to try to get a broader base.

However, as the Commission went on and decisions needed to be made—and more importantly, the use of the Commission started to shift, I have no question that this body and the Congress should not have held up in passing legislation. I just think a lot of the legislation was off-the-shelf stuff that people wanted to do with derivatives in general, they hadn't been able to do—as I said, a lot like the stimulus bill, here is a chance to dump some stuff in that we wanted to do for a while—and became part of the Dodd-Frank fresh and new movement.

What can you do with a Commission that is created, and less than a month after it was created, the President offers his solutions and the Congress moves forward with their solutions? There are a lot of things you can do with it, especially, I believe, because the former majority thought they were going to be a majority in this Congress as well. It is very difficult. I will tell you, when Republicans were in power and the Administration was Republican, we could not go back to the Dingell playbook and go after the Administration because they were Republican, and we were Republican. Democrats did a great job of oversight for decades because the Republicans were in the Presidency and the Democrats were in the Congress.

So when you look at what you can do with this Commission, one, you can use it to go after the villains and help the victims if that is the result and you are in the majority. You can use it, even if you are in the minority, to hold hearings about those issues. And so when you wind up with a series of 6–4 votes that literally, in my opinion, split the Commission on a partisan basis, the result is a partisan conclusion. And I have no qualms about that. I thought that was what it was going to be to begin with. I just was trying to overcome it.

Mr. GARRETT. So let's go into a little bit of detail. As far as the things that were done and that were not done—and both of you can answer this—what was done, I guess, is case studies of 10 specific financial institutions and finding the problems or lack thereof in the financial institutions but not, I understand, any specific case studies with regard to the regulatory failures. Can you comment on why it wasn't done? And how then can you come up with the conclusions if you are not going to do it in that same fashion, the conclusions that you came up with?

Mr. THOMAS. Is that a question for me or the chairman?

Mr. GARRETT. I will go first to the chairman, and then you can respond as well.

Mr. ANGELIDES. Yes, we did the following, and this is important to understand.

First of all, let me just say very quickly that I really do stand on the report and the integrity of the report. The facts are in it. The facts themselves have not been challenged. And everyone can draw their own conclusions, but that 400-some pages Mr. Thomas talked about—

Mr. GARRETT. We were looking at you for the conclusion really.

Mr. ANGELIDES. And we laid them out. But I want to say that every member had a full opportunity to participate. All members had an opportunity to attend hearings all over the country. In fact, I went to Bakersfield. I had a great chance to go with the vice

chairman to Bakersfield for a very informative hearing about what had happened at the community level. All materials and interviews were made available to all Commissioners. All drafts of all the reports and all the chapters were made available to Commissioners for comments; some chose to, some did not. And all staff were jointly approved by Mr. Thomas and me.

What we did as a general kind of approach to our work is we did a look at overall research, the large picture. And because of our timeframe, we then did 10 case studies of financial institutions, including a very deep scrub on Fannie Mae. We also looked at other institutions at a lesser level, but we looked very specifically at the roles of policymakers and regulators. We looked at the FDIC, the Federal Reserve, the Federal Reserve Bank of New York.

And let me just speak to the nonpartisan nature of this. If you look at this report, sir, we were very critical of the Federal Reserve Bank of New York's oversight of Citigroup when Mr. Geithner was in charge of the Federal Reserve Bank of New York. We looked at HUD, its affordable housing goals. We looked at the role of the Office of the Comptroller of the Currency and the Office of Thrift Supervision.

So we looked at both financial institutions and regulators, and I think you will find that we found, without regard to party, without regard to private sector or public sector, that this crisis was avoidable, both in failures of regulation and failures in corporate risk management.

Chairman BACHUS. Thank you.

The gentlelady from New York.

Mr. GARRETT. Did Mr. Thomas want to respond?

Chairman BACHUS. Thirty seconds. It is hard to get Congressman—

Mr. THOMAS. Look, Warren Buffett came before us in New York and said he didn't think housing prices would go down the way they did. People who are supposed to be gurus in this said they weren't aware of it.

You have to read a clever book by Michael Lewis if you haven't, "The Big Short," because he winds up writing a book about those three or four people who actually made money on it. I asked him, well, what about John Paulson? And he said, "John Paulson has been around for a long time; he was a joke." We all laughed at him. He had this view of what was going on.

It turns out he was right, but it was after the fact. If Warren Buffett didn't know it was coming, how can you say very nonchalantly that it all could have been avoidable?

Chairman BACHUS. Thank you.

Mrs. Maloney is recognized for 5 minutes.

Mrs. MALONEY. Thank you very much.

And I welcome the panelists, particularly my former colleague, Congressman Thomas; it is very good to see you again.

I would like to mention that one of my constituents is here—Brooksley Born. We are very proud of her and I thank her for her public service and her courageous leadership in pointing out reforms that need to take place.

I would like to say, first of all, that I thought it was an excellent report, and my biggest disappointment in it was that it was not

more bipartisan. I truly believe one of the best actions of this Congress was the 9/11 Commission report that was totally bipartisan, and we worked together to implement their charges and their suggestions of how to make this country safer.

Republicans and Democrats lost their jobs. Republicans and Democrats lost their savings. Republicans and Democrats lost their homes. And they are both suffering, Republicans and Democrats, in the worst recession that we have ever had in this country. So when a house is burning down, it would have been helpful if everybody could have come together and worked together in a positive way with concrete solutions and analysis.

I would like to begin by asking Mr. Angelides, can you elaborate on the role of unprecedented liquidity and your response that it doesn't have to be a problem; in fact, we should welcome it if it is used responsibly?

Mr. ANGELIDES. Yes. And this is a follow-up to Mr. Royce's question.

Clearly, as we detail in the report, there is monetary policy made for cheap money; there are capital inflows into this country. But in the end, the availability of capital need not be the maker of a crisis. The fact is that, as I said earlier, the Federal Reserve could have set tougher mortgage lending standards. They allowed a tragic deterioration of mortgage lending standards, notwithstanding all the information they had.

Companies levered themselves up. The investment banks were levered to about 40–1. Take Bear Stearns, for example, they had about, in 2007, $11 billion in equity; about $380 billion in liabilities; and they were borrowing up to $70 billion in the overnight markets. That is like a small business that has 50,000 equities borrowing $1.6 million, with about $300,000 due every day. So, in this environment, you have to be careful for excesses.

But this idea that reasonably priced capital is necessarily the maker of the crisis I think is a flawed one. It can be channelled into productive uses. Unfortunately, where the money went was to create $13 trillion in mortgage securities, many of which were wholly defective. Institutions either didn't care to know, didn't examine, or knew they were defective but still moved them in the marketplace. And instead of building the economy, we built a house of cards built on financial engineering.

As to the matter of consensus, I do want to say that there were a number of areas, if you look, where in fact 9 of the 10 Commissioners did find common ground. And the dissent, which I would say by Mr. Thomas, Mr. Holtz-Eakin, and Mr. Hennessy noted that we find areas of agreement with the majority's conclusions: Fannie Mae and Freddie Mac did not by themselves cause the crisis, but they contributed significantly, and that is our view also. These organizations were poorly managed. They were seeking market share. They were seeking profits and big compensation for their executives. But I want to point out, yes, they added helium to the housing balloon, but they never represented a majority of the purchase of mortgage securities, they followed Wall Street. They didn't lead it.

And finally, this is important to note, the value of GSE-backed mortgage securities from January of 2007 to the day before con-

servatorship never dropped, so they did not cause the financial losses at the big financial firms. They caused huge losses to the taxpayers, that is a fiscal issue, but they were not the cause of the big financial losses that happened at Merrill Lynch, at Citigroup, that began the cascade that led to the bailouts in September.

Mrs. MALONEY. Could you comment on the lack of knowledge or understanding in AIG? You touched on it, but I recall the hearing we had here and Treasury and many others came, and they asked first for $50 billion; that is all they needed—$80 billion, that is all they needed, then they came back 2 days later, they needed $50 billion, and they kept coming back, showing that they clearly did not understand the exposure or the problem. There was no understanding. And the head of AIG didn't understand the exposure for the $79 billion in credit protection. And furthermore, the Office of Thrift Supervision didn't understand. Even the chief credit default swap salesman at AIG did not know about the terms he was selling with. No one seemed to understand anything about it except for the counterparties when they started calling it in.

Can you discuss the extent to which this lack of knowledge by regulators, by leaders, by salespersons, by everyone contributed to this? I believe it is astonishing. Some were saying, buy the product, others were saying—within the same company—that it was a problem. There was a total lack of knowledge. And could you comment on it and what you think—

Chairman BACHUS. Mrs. Maloney, your time is up. But I will—

Mr. ANGELIDES. I will try to deal with it in 1 minute. I will be very quick.

Chairman BACHUS. Absolutely.

Mr. ANGELIDES. I will try my best.

Three items. First of all, as I noted earlier, AIG sold $79 billion worth of credit protection to holders of subprime-related securities. There are conditions in those contracts that said that AIG would have to post collateral—by the way, AIG had no cash reserves. They had nothing set aside, no reserves. They had a model that showed that there was a 99.75 percent chance they would never lose a dime. The contract said that they would have to post collateral if AIG was downgraded, if there was an actual economic loss on those subprime securities, or if the market value declined. The market value of those securities started plummeting in 2007. Not the CEO, the CFO, or the chief risk officer knew anything about these collateral provisions related to market value. They were stunned.

Second, in about 2006, the people actually writing credit protection began to look at the quality of these subprime loans, and they start to stop writing. They kept writing a few more new protection. At the same time, though, AIG ramps up its securities lending program and starts buying tens of billions of dollars more of subprime securities on behalf of their insurance subsidiaries.

Finally, as to regulation, the Office of Thrift Supervision signed an agreement with the European Union to become a consolidated supervisor. Mr. Reich, who was the head of OTS, told us that he wasn't aware that they had the authority over the holding company. He said they had no understanding of these credit default

swap provisions, and in fact, he said, having the OTS regulate AIG was like having a gnat on an elephant.

Mrs. MALONEY. Thank you.

Chairman BACHUS. Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman. And thank you for calling this hearing.

I certainly think the establishment of this Commission was an important act.

I do still find it somewhat ironic, somewhat perplexing, and somewhat amusing that we ended up passing the entire Dodd-Frank Act before we even had the conclusions of the Commission in the first place. So the whole reason for being I am not sure if it hasn't passed.

Having said that, before I get into the conclusions of the majority, I did have a couple of process questions, something I am somewhat sensitive to since I served on the Congressional Oversight Panel for the TARP Commission. I know that one of the minority members held the 9/11 Commission up as a model of bipartisanship. If I recall right, there were an equal number of Democrats and Republicans that served on that Commission, and I believe the resources were equally shared.

So I would like to ask you, Mr. Mayor, a couple of questions under your chairmanship. Number one—or actually, Chairman Thomas, let me go to you first. And welcome, it is good to see you, sir.

Were the minority representatives of the Commission, what type of access to the resources of the Commission were they granted?

Mr. THOMAS. As I said—

Mr. HENSARLING. I am sorry, I missed your testimony. I was not here.

Mr. THOMAS. As I said, I don't think the problem was a lack of money. I don't think it was the staff. I think we reached a point—and it is very easy to do when you have the kind of makeup that you have. And remember, the charge to the Commission were 22 specific agenda items which were reached in a partisan way in this committee. I, early on, was contacted by folks who said we wanted to get these particular items on the list and we weren't allowed to. So that what we were guided to look at was structured from a partisan point of view.

Now why in the world would I, if I know anything about that, go into this situation with my eyes wide open? I went into it with my eyes wide open. We were asked to get to the fundamental causes, and I thought that was really, really important. And I was concerned about this business, as Samuelson calls it, looking at villains and victims.

Just let me run a quick analogy. It is like this budget right now. We are spending all this time on discretionary spending; it is a dime. Nobody is moving to the fundamentals, which is the entitlement reform area. I was hopeful we could move as a Commission to the fundamental causes and understand them. We got sidetracked in a partisan, political way.

I will tell you that the chairman says, well, we shared leadership. Of course, we did. Look at the early agendas, there is the chairman's report, and the vice chairman's report. Look at the last

few agendas; there wasn't even a vice chairman mentioned on the agendas. It turned partisan at the end on a 6–4 vote—multiple 6–4 votes that drove the structure.

Mr. HENSARLING. Mr. Chairman, I think I get that.

I also heard, in this vein—I just want to ask you, Mr. Mayor, if this is true or not. Was it true that the majority—

Chairman BACHUS. The mayor? Who is the mayor?

Mr. ANGELIDES. I was treasurer, but—

Mr. HENSARLING. I am sorry.

Mr. ANGELIDES. That is okay, don't worry about. I don't think my own town would elect me mayor, Mr. Hensarling.

Mr. HENSARLING. Mr. Treasurer, Mr. Chairman—whatever the appropriate title is—I understand the majority report is 400 pages long. I have read summaries. I have not read the entirety of the report. Is it true that in the authorized addition, the dissenters were limited to 9 pages apiece; is that correct?

Mr. ANGELIDES. Sir, first of all, let me comment. The 400-and-some pages is actually the report of our investigation. Our conclusions, the Commission's conclusions, are actually shorter than the published dissent, and here is how it worked. I think our conclusions are about 20-some pages, it reminds me of the Mark Twain line—

Mr. HENSARLING. Weren't the minority limited in their dissent in the authorized addition?

Mr. ANGELIDES. In the authorized addition, any Commissioner could give an additional or dissenting view of up to 9 pages, people could combine. But let me add, in the government report and on the Web, folks were unlimited. Mr. Thomas, Mr. Holtz-Eakin and Mr. Hennessy chose not to use that additional space.

Mr. HENSARLING. If I could, I see, unfortunately, my time is running out here.

You did say in the report you determined government housing policies were not a significant factor in the crisis.

Mr. ANGELIDES. Correct.

Mr. HENSARLING. Clearly, there was strong dissent. So be it the affordable housing goals of Fannie and Freddie, HUD's best practices, CRA, you found no significant factor in the crisis.

Mr. ANGELIDES. Sir, let me talk about each of these very quickly.

Let me tell you about Fannie and Freddie. And I just want to say very quickly that a deeply flawed business model, this publicly traded corporation with the implicit backing of the government, was a bad model. The fact is that those entities used their political power to ward off effective regulation. We conclude that they did contribute to the crisis, but they were not primary.

They did add helium to the housing balloon, but keep in mind, they never represented a majority of the purchases of subprime securitizations that were emanating out of Wall Street. They did ramp up dramatically their purchases and guarantees in 2005, 2006, and 2007, but one of the most—

Mr. HENSARLING. I am sorry; I am running out of time.

Can I get a quick comment out of you, Chairman Thomas?

Mr. ANGELIDES. There is one important point I would like to add if we have time.

Mr. THOMAS. Look, the majority, six votes, owned over 400 pages. At the end of each chapter, our Commission conclusions on chapter 14, Commission conclusions on chapter 15, they owned the 400 pages. We were given, on a 6–4 vote, 9 pages each total out of this entire document. They had 400 pages to do whatever they wanted with. What they did was what they wanted. You can't explain away the fact that on a 6–4 vote, I was given 9 pages. That is why the three of us came together so we could have almost 30 pages to try to explain our fundamental concerns. That is partisan.

Mr. HENSARLING. Mr. Chairman, I will yield back just on this note: I think it is sad that such an important work is hard to take seriously when it was conducted on such a partisan basis. It is going to be hard to take the nature of this work seriously.

I yield back my time.

Mr. ANGELIDES. Sir, could I make one comment very quickly? I just would say that I would stand on the facts of the report. And the facts are truthful. They have withstood scrutiny. I guarantee you every financial institution, every—

Mr. HENSARLING. Apparently, not the scrutiny of several of the dissenting opinions.

Mr. THOMAS. Could I briefly respond, just 25 seconds? Because I have been sitting here very quietly—for me.

Mr. Congressman, again, in my opening statement, I said when you are looking for victims and villains rather than essential causes, it is easy to examine the same set of facts and arrive at diametrically different conclusions. It isn't the facts; it is the conclusions that we should be focusing on.

Thank you.

Chairman BACHUS. Thank you.

I will say that this has been a very informative hearing. It has been rather loose, but I think we have learned quite a lot. And I think it has been very thought-provoking.

With that, Mr. Lynch, what we are going to do now, with your permission, the panel's permission, is we are going to extend your panel 30 minutes, which will take care of all the 27 minutes that we have gone over and give some of our very talented younger members an opportunity to ask questions.

Mr. WATT. Does that exclude me, Mr. Chairman?

Chairman BACHUS. I was talking about the talented members.

Mr. WATT. I am neither talented nor young. I think I have just been excluded on both criteria.

Chairman BACHUS. You would be included under talented, but probably excluded under new.

Mr. MILLER OF CALIFORNIA. We are matching ends of the dais.

Chairman BACHUS. Mr. Watt, you are recognized.

Mr. WATT. Oh, I am both talented and young now. Hey, I got in at a good time.

I am not sure I want to take time to ask a lot of questions. I actually have looked at the report and will look at it more thoroughly.

I want to use my time really to comment more on a couple of things that I thought were important because it is ironic that I got beat up a lot back in 2007 because I was the chairman of the Oversight Subcommittee of this full committee. I got beat up by people

who said the Oversight Subcommittee ought to be doing what you all ultimately got tasked to do. And it was bipartisan because a lot of folks wanted me to have hearings that would blame the meltdown on the past Administration; a lot of folks wanted me to—and I just said, look, I think it is more important for this committee to be focusing on how do we get out of this mess, rather than spending the resources of our committee looking backwards trying to figure out how we got into it.

That doesn't mean, and I didn't mean at that point, that it was not an important undertaking to look retroactively at it, but we were trying to focus more attention on how to move forward. And I am glad we did, but now we can take a look back.

To the extent that the report contradicts anything we did in Dodd-Frank, I think it is worthwhile for us to do that. To the extent that it reaffirms some of the things we did in Dodd-Frank, I think that is important.

But what is most important is we need to try to avoid this kind of economic meltdown in the future. And I heard one of the opening statements over there saying we go through these cycles periodically, that cycles are inevitable. They may be inevitable, but they are incredibly painful. And if there is anything we can do to avoid them, I think we need to be trying to avoid them. I think you all's work perhaps will have a very important salutary effect in that, and I appreciate all of the work that all of the Commission has done.

My good friend, Mr. Thomas, who wasn't always my good friend when he was here, but—

Mr. THOMAS. No, we were good friends; we just disagreed on a lot of things, but that is how it works.

Mr. WATT. You know I am joking.

Mr. THOMAS. I hate to keep repeating this on a small article in the winter addition of the Wilson—

Mr. WATT. Yes, I heard that part of your testimony. I will go back, and I will look at the article. You know I will.

Mr. THOMAS. No, this is on a different point. That is, he said that in looking back at what has happened, where we got complacent because we thought we did control the universe—which was one of our problems—that maybe—no one could get elected standing up and saying I think we should have a lot of little recessions, but had we had a few more little recessions, we wouldn't have necessarily had the great big one that we had. And he wants us to focus on the belief that if you can control—just need a few more regulations, just need more this, more that—that you are kidding yourself about some of the dislocations, not just in this country, but in the international—

Mr. WATT. I understand that, but you can have a bubble in the international capital market and still people have to make decisions about how to use that capital.

That is why I had a major disagreement with what you were saying. Maybe that did create the environment for this to happen, but somebody had to make some decisions. And the industry made some bad decisions. The regulators made some bad decisions, and to the extent that we can incentivize people to avoid those decisions in the future, we need to do it.

Mr. Angelides.

Mr. ANGELIDES. Yes, very quickly. We do not believe you can repeal the business cycle, but we don't think you need to end up with 26 million Americans out of work, who can't find full-time work, who stopped looking for work. We don't think we needed to end up with 4 million families losing their homes—that may go to 13 million—or $11 trillion worth of life savings and retirement wiped away.

As to where we go from here, again, I hope our report—I hope everyone has a chance to read it, and draw their own assessments. If we stir a healthy debate, that is healthy. But where we go from here is an important question. I very studiously with Mr. Thomas focused on the work in front of us, but my belief is we need to fully implement the new law and provide the resources to do it. We need regulators with backbone, will, and capacity. One of the things I talked to Federal Reserve Chairman Ben Bernanke about is, Wall Street is a little like a greased pig; they keep moving fast. We need regulators. We need to give them the resources. We need to have the talent there. I believe we need to stay vigilant because the financial system is constantly evolving very, very quickly.

I do think there has been an absence of self-reflection on Wall Street, partly because the U.S. taxpayers bailed out Wall Street, but I do think the—

Mr. HENSARLING. [presiding.] The time of the gentlemen has expired. If you could wrap up the answer in 30 seconds, please.

Mr. ANGELIDES. I will.

A new ethos of responsibility, and if laws have been broken, prosecutors should pursue where civil and criminal violations have occurred. There ought to be a sense of fairness.

Mr. HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from North Carolina for 5 minutes.

Mr. MCHENRY. Thank you, Mr. Chairman.

Mr. Angelides, the accusation has been made that the Commission failed to conduct an objective investigation. And I know you discussed this immediately with Mr. Frank, his question to you about Edward Pinto's report on housing. And you referenced page 219 to page 221. You are being a bit generous. You used three paragraphs to rebut—to explain Mr. Pinto's report.

And the crux of what Mr. Pinto is saying is that there were—49 percent of the mortgages out in 2008 in America were Alt-A or subprime or equivalent to that. Of these, Mr. Pinto counts 11.9 million or 45 percent that were purchased or guaranteed by GSEs. In contrast, the GSEs categorized fewer than 3 million of their loans as subprime or Alt-A.

Did you verify Mr. Pinto's work?

Mr. ANGELIDES. Yes. And let me just say one more—

Mr. MCHENRY. Why is that not included in the report?

Mr. ANGELIDES. First of all, it is discussed in the report, and the staff's analysis of Mr. Pinto's work, full analysis—

Mr. MCHENRY. Where is that?

Mr. ANGELIDES. —was placed on the Web. It is footnote numbers 17, 13, and 19 in this chapter. So you can see—first of all, everyone can see—first of all, the staff did an analysis. The staff put to-

gether a database of 25 million loans to see how loans purchased and guaranteed by the GSEs performed, how those guaranteed by the FHA performed, how those created by Wall Street and other private lenders performed. And the fact is that we did that analysis and an analysis of Mr. Pinto's work. And here is something that is very important: You can't just lump all those loans together; they perform differentially.

Mr. MCHENRY. Obviously, sure.

Mr. ANGELIDES. Look, the GSEs were a disaster, but can I point something out, sir?

If you take, for example, loans purchased and guaranteed by the GSEs versus those created by Wall Street and private lenders, for similar loans to borrowers with FICO scores below, credit scores below 660, by the end of 2008, the default rate in GSE-guaranteed or purchased loans was 6.3 percent; for the Wall Street or other private firms it was 28 percent.

Mr. MCHENRY. Okay. Reclaiming my time, I certainly appreciate that.

Mr. ANGELIDES. But the information is more fully available.

Mr. MCHENRY. I read that in your report, and you outline that very well. But the GSEs are saying that it is 3 million; Mr. Pinto is saying it is closer to 12 million that are at these lower quality. Did you analyze the GSEs' portfolio?

Mr. ANGELIDES. Yes, we did.

Mr. MCHENRY. And where is that?

Mr. ANGELIDES. We had a staff analysis, a high-quality staff analysis prepared for the full Commission, and again, on the Web. I don't have it handy at this moment.

Mr. MCHENRY. Sure. Okay. I have a brief amount of time. I will say you two gentlemen are fantastic at filling the time, so I do want to ask short questions here.

Can you give me a specific example, Mr. Angelides, where you changed your mind after doing research, after a lot of input and looking at the facts, where you changed your mind about this financial crisis? Give me an example. Is there one?

Mr. ANGELIDES. Yes. I didn't come in with a predisposition about Fannie and Freddie's role, and frankly, when I looked at Fannie, their management practices, how they operated, I was taken aback.

Mr. MCHENRY. Is there a preconceived notion that you had that was changed?

Mr. ANGELIDES. The other was that I did not necessarily assume that this crisis was avoidable, but when I looked at all the facts—because a lot of the narrative is, no one saw it coming. What changed my mind was when I saw the full record, for example, of what was before the Federal Reserve, what they knew about predatory lending, what they knew about lending standards from the late 1990s, and yes, I changed my mind and I came to the conclusion that the Federal Reserve fell down badly on the job.

Mr. MCHENRY. Reclaiming my time.

Congressman Thomas, look, there is this sort of notion that you were there just to sort of battle it out, that at the end of the day, they were going to go their own path and it was going to be a 6–4 vote. Walk us through this. At what point did things turn where

you realized that you were not going to have a unified narrative, that they didn't really care about that?

Mr. THOMAS. To me, it was very difficult from the beginning because I chaired a number of conference committees in my 28 years in the House, and the only way you can get to almost a near unanimous or unanimous position is frankly accommodation and compromise, and there virtually was no real accommodation and compromise.

There will be any number of indications where we were able to do this or do that. I invite you to listen to Peter Wallison in terms of his level of frustration—and frankly, my level of frustration—in trying to direct where we might be going in terms of the investigation.

This was a top-down structure from day one. He was the chairman. I was the vice chairman. So I tried to deal with it as best I was able to create a broader willingness to share. Early on, it was easy. It is easy to share on all the easy stuff.

Mr. HENSARLING. Chairman Thomas, the time of the gentleman has expired.

Mr. THOMAS. But when it came down to the crunch, all the votes were 6–4.

Mr. HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Massachusetts, Mr. Lynch, for 5 minutes.

Mr. LYNCH. Thank you, Mr. Chairman.

I don't find the lack of unanimity in this report as troubling. I find it as a strength, especially with respect to the position of the dissent that asserts that derivatives were not a major factor. I don't want the majority to cave on that issue. I don't want you to. I don't believe it. And the reason I don't believe it is because I have been sitting here for the past 10 years.

I had an opportunity to listen to Secretary Paulson and Chairman Bernanke sit at that same table you are sitting at right now, and they were unable to tell us when the meltdown started to occur—the first meeting they had with us, they said, we have a problem; it is not a major problem. We have a good sense of the size of it, and we are going to take the necessary steps to stop this meltdown. Then, 3 weeks later, after the meltdown continued to occur, they would come back in, and they would say, well, we have it contained; it is worse than we thought, but we have it contained. And then we would have them in 3 weeks later or a month later.

The problem they had, as brilliant as they are, we had a completely dark market for derivatives. They could not tell the exposure. They could not tell the range of counterparties that were out there. At one point, if it wasn't so disastrous, it would be laughable. We had E. Stanley O'Neill come out and report a $4 billion loss. Then, 9 days later, he comes out and says, sorry, it is a $14 billion loss. And then 20 days later, he comes out and says it is a $21 billion loss. The reason that he couldn't tell us or the markets was because he didn't know his exposure because the markets were so dark. There was no need to register. We didn't know who the counterparties were.

Derivatives, if you read—and I am not just—although I have read everything that is out there in terms of, including your report,

on this crisis, you listen to Warren Buffett, someone that both sides respect, calls derivatives "financial weapons of mass destruction." You read Michael Lewis' excellent book, "The Big Short." Gretchen Morgenson, another writer whom I greatly respect; Hank Paulson; Alan Greenspan who said, sitting here before the committee, he made a mistake.

So there is an abundance of consensus out there about the danger that derivatives presented, not only because of the opacity there, a dark market, but also the leverage. It allowed us to have this massive leverage. It allowed banks to reduce their capital requirements. And it provided the impact for this financial crisis. I liken it to the economy being the Titanic and derivatives being the iceberg. That is what brought this economy to the bottom because of the uncertainty it created, the leverage, the impact, and because it was beyond the ability of our leaders in the financial industry to understand the impact and the implications that were at hand. So I am glad in this report that we have a difference between the majority and the minority as to the play of derivatives here.

And Mr. Angelides, I know you cited the $79 billion in credit default swaps in your report. There was also $150 billion that the U.S. taxpayer had to contribute to AIG to cover collateral calls on AIG's derivatives, collateral debt obligations. A lot of that money went over to—direct pay over to Goldman Sachs at 100 cents on the dollar. But I just wanted to hear from you as to the majority's assessment regarding the impact of derivatives on this crisis.

Mr. ANGELIDES. Yes. Very quickly, let me just say that Ms. Born, of course, can speak in more detail on this, but we found that there were three principal impacts. First of all, credit default swaps enabled the creation of a lot of the mortgage-backed securities. So that is one way in which they contributed. And of course, AIG and others wrote those with no capital behind them, and so when that market went south, it created a huge wave of collateral calls.

Second, they allowed for the creation of synthetic mortgage securities, which were merely bets, as you know, on real mortgage securities. So, instead of having one investor investing or betting, so to speak, on a mortgage security, this was amplified many times over. The bets on the housing market were multiple-fold because you had synthetic securities.

Mr. HENSARLING. The gentleman's time has expired.

Could you please wrap up your answer in 30 seconds?

Mr. ANGELIDES. Yes. Finally, at the end, there was such confusion and chaos and lack of knowledge about derivative positions. It is only 4 weeks before the crash of Lehman that the Federal Reserve and the Federal Reserve Board of New York are trying to figure out what exposure is created by 900,000 Lehman derivatives contracts. This was a completely opaque market and therefore contributed to the panic.

Mr. HENSARLING. The time of the gentleman from Massachusetts has expired.

The Chair now recognizes the gentleman from New Mexico for 5 minutes.

Mr. PEARCE. Thank you, Mr. Chairman.

Mr. Angelides, I am trying to get some understanding. You are saying that CDS's pushed through, the MBS's, mortgage-backed se-

curities, that was a key to the problems that were going on; is that correct? I just want a yes or no answer because we really have a long way to go on that.

Mr. ANGELIDES. Yes. I believe that they helped create the collateralized debt obligations that made it possible for senior—

Mr. PEARCE. So you have mortgage-backed securities that don't have much value. Those mortgage-backed securities that don't have much value are based on a combination of individual loans that have very little value; is that correct? Just yes or no.

Mr. ANGELIDES. What the CDS did is give the purchasers the "assurance" that if these things went bad—

Mr. PEARCE. No, I understand. But mortgage-backed securities were basically packages of loans that had almost no capability to repay. They were worthless.

Mr. ANGELIDES. They were highly defective, yes, sir.

Mr. PEARCE. And they were worthless because we had reduced the underwriting standards for the loans.

Mr. ANGELIDES. Terribly.

Mr. PEARCE. And the underwriting standards that were reduced were accelerated by the Federal Reserve trying to prop the system up. In other words, the ability to repay is based on our income and the price of the house combined. And so the Federal Reserve was driving the price of interest down to where people could dedicate a larger stream to the principal payment and keep the illusion alive, so we are moving lower and lower. And Mr. Greenspan, in testimony, said we are having a little bit of a problem with this housing bubble, but we are going to work it out.

And so I am seeing this sequence where underwriting standards generated bad mortgages, which generated bad bonds, which generated bad CDS's. At the heart of it is the decline in underwriting standards. And when I pursue that upstream, then I find an aggressive affordable housing policy to be a culprit. And I am amazed then that you draw the conclusion on page 3 that says, "We determined that government housing policies were not a significant factor in the crisis." I am amazed at that conclusion. Can you help me understand why the government's position—they could—the government as the regulators, they are achieving a position right now that is not allowing bad loans to be made. And the government, therefore, could have done this 2 years ago. We didn't pass any new law saying that you can't do this. It was an option on the part of the government. And for you to draw that conclusion is amazing.

Mr. ANGELIDES. Yes. So we were speaking here about the Community Reinvestment Act and the affordable housing goals at HUD. I agree with you that the Federal Reserve fell down on mortgage standards.

Mr. PEARCE. I am glad you said that. But I am asking about the policy that says we are going to lower the underwriting standards and—

Mr. ANGELIDES. Let me just take, for example, the one reason we found the Community Reinvestment Act didn't have an impact. Most of these lenders or many of the subprime lenders, the Ameriquests of the world, the New Centurys of the world, many of those lenders, they were not regulated thrifts or commercial banks, they were not governed by government housing policy, they weren't

Fannie, they weren't Freddie. The most aggressive loans, the worst loans in the marketplace were being made by nonbank financial institutions. They were supported by bank financial institutions.

Mr. PEARCE. Just reclaiming my time, isn't it correct that eventually most of those loans were repurchased by someone, and about 50 percent of the Community Reinvestment Act loans were purchased by Fannie and Freddie who were getting a wink and a nod from the regulators saying it is okay? And so, again, I drive at the point of your conclusion that the government policies had nothing to do—they didn't get in your top six. You write out your top six complaints, but government policies didn't make the top six list, and I find that amazing.

Mr. Thomas, do you have a comment?

Mr. THOMAS. Yes. You are right.

Mr. PEARCE. Thank you. That is enough. If I get that from you, I am ready to go.

Mr. THOMAS. But I still have 30 seconds. When I talked about the overreach in Dodd-Frank, I didn't mean that there wasn't a need to deal with some derivatives. The synthetic CDOs absolutely were a major problem. The move in terms of originate to hold as a mortgage pattern, to originate to sell was a major problem. Transparency was a major problem. Through Republican and Democratic Administrations, the desire to get people into houses as part of the American dream definitely was part of the problem. The cheap money from the Fed was part of the problem.

But if you go out looking for villains and victims, you miss some of those fundamental shifts that we ought to be focusing on. I spent more than 3 decades in government. I will tell you, if you want to bet on conspiracy versus incompetency, incompetency wins every time. We need to look at the fundamentals and not point fingers at various folks. Yes, some derivatives too much.

Mr. HENSARLING. The time of the gentleman has expired.

Mr. PEARCE. Mr. Chairman, I yield back the rest of my time.

Mr. HENSARLING. The rest of your nonexistent time. The Chair now recognizes the gentleman from Calilfornia, Mr. Sherman, for what I hope will be 5 minutes.

Mr. SHERMAN. Thank you, Mr. Chairman. I think you have produced a high-quality report in both sections. I realize there are some differences, and that is what the press is focused on. And they focused on arguments amongst the members. Whether you guys had a good time preparing this report is an absolute irrelevancy to anyone other than yourselves. My own belief is, if I was writing this report, it would have been much shorter, because I focus on one thing as the ultimate cause and that is the credit rating agencies.

Senator Franken and I were able to get something in the bill which is not as artfully drafted, but, if properly interpreted, I think will solve the problem within a year or two. And perhaps one of the more brilliant aspects of the report is that both the dissent and the report in chief say pretty much the same thing. The report in chief says: "We conclude that the failure of the credit rating agencies were essential cogs in the wheel of financial destruction and point out that Moody's was giving its Triple A stamp to 30 mort-

gage-related securities every working day and had to downgrade 83 percent."

And I see our friend, Mr. Thomas, nodding his head. I don't know if he embraced those exact words, but his part of the report said much the same thing by saying: "The credit rating agencies assigned overly optimistic ratings and this contributed to the creation of toxic financial assets."

One thing I didn't spot in the report is that not only did it create the toxic assets, but it created a housing bubble. Providing all this "no questions asked" capital to anybody who would sign the papers to move into a home greater than they had ever dreamed of, let alone could afford, creates a housing bubble such that good mortgages become bad mortgages.

Now, the credit rating agencies gave Triple A to Alt-A. And we have had testimony here that says, it is up to the investor, it is up to the portfolio manager, to see through the false ratings. What happens to a portfolio manager short term if he or she gets 20 or 30 fewer basis points on their portfolio investing in bonds with a lower rating than the portfolio manager down the street? Can a portfolio manager be highly respected getting a lower rate of return on lower-rated instruments and expect to attract additional capital? Mr. Angelides.

Mr. ANGELIDES. Could you just repeat the last part of that, Mr. Sherman, very quickly?

Mr. SHERMAN. Can a portfolio manager who had the brilliance to recognize that the credit rating agencies are wrong, and therefore invests in different instruments, instead of seeking the best rating with the best return says, the ratings aren't worth anything, I am just going to try to get the best return investing in things that may be lower rated by the credit rating agencies but in my own analysis are better, and then presents to the investors saying, instead of investing in Triple As, I invested in Double As and I am getting 30 basis points less than the guy across the street, but trust me, it is a better portfolio.

Mr. ANGELIDES. Certainly, investors have a responsibility to do their own due diligence. And I think one of the important things about Dodd-Frank is it removes a lot of the statutory requirements that people have to rely on rating agencies. It makes the rating agencies produce for public view their models.

Mr. SHERMAN. But let me interrupt. Let's say I have $50,000 to invest and you would advise me to diversify that by investing in a portfolio of 100 different debt instruments, perhaps through a mutual fund. How many minutes am I supposed to spend of my life to invest that $50,000 looking at the 100 different debt instruments, not to mention the 400 or 500 that I reject and don't include in my pool of 100? Is there any way I can invest $50,000 except by relying on the credit rating agencies?

Mr. ANGELIDES. On financial advisors who have fiduciary duties to you. The ratings are important, and therefore the oversight, the exposure of models in Dodd-Frank, the provisions that you worked out with Mr. Frank to take away issuer pay, so that these aren't biased, these are all important reforms.

Mr. SHERMAN. It is not so much issuer pay, it is issuer select.

Mr. ANGELIDES. Yes.

Mr. HENSARLING. The time of the gentleman has expired. If the witness has completed the answer, the Chair will note that there are five remaining members in the room who have not had a chance to question. It will be the Chair's intent to allow—

Mr. SHERMAN. Mr. Chairman, is there a way that our former colleague could have 20 seconds?

Mr. HENSARLING. Yes, after I finish my announcement that we will allow the five members who haven't asked questions to question the witnesses so that we may dismiss this panel at approximately 12:30. We will give Chairman Thomas 30 seconds before going on to the next member. Chairman Thomas.

Mr. THOMAS. Thank you very much. Big, big, big problem. In our New York testimony, we had people who were former participants in the ratings tell us that they changed their business model or they were going to lose business. We haven't focused on the short-term financing, the commercial paper, the repo paper, repurchase paper, overnight financing. Based on the ratings, people would accept or they wouldn't.

What scared me was the first regulation coming out of Dodd-Frank was on the rating agencies, and they said they wouldn't do it and you guys blinked. And it scares me to death in terms of getting on top of what I think, as we said in our dissent, one of the major problems—transparency, the rating agencies, and the willingness to accept three letters versus factual investigation of what happened.

Mr. HENSARLING. The Chair now recognizes the gentleman from Missouri for 5 minutes.

Mr. LUETKEMEYER. Thank you very much. In your report and in the summaries that I read, you talk about the different causes. I have yet to see in there community banks, credit unions, insurance companies, household lenders were the cause of this debacle.

Mr. ANGELIDES. I do not believe that community banks were a driving cause of this. They had large real estate portfolios. But the primary losses that set off the cascade in 2007 were driven by the larger, first of all, nonbank financial institutions; then it went into other areas of the shadow banking. But they have suffered greatly, I might add, tons of community banks and—

Mr. LUETKEMEYER. Let's just run then with the question. Mr. Thomas.

Mr. THOMAS. Community banks, basically when you move from that model of originate to hold to originate to sell, got pushed out of the home mortgage market pretty significantly. They wound up in the commercial market. And although a number of local community banks have failed hanging on to that, it was the depreciation of property and not the similar problem with synthetic CDOs and that sort of thing.

Mr. LUETKEMEYER. So basically you agree that the list that I gave you, they were not the root causes of what happened.

Mr. THOMAS. Certainly not root causes or fundamental.

Mr. LUETKEMEYER. Even though they were, as a result of Dodd-Frank, more grafted into that and other regulations put onto them.

Mr. THOMAS. Yes. That is a prime example of overreach, in my opinion.

Mr. LUETKEMEYER. Okay. That is where I am headed. One of the things, as a former regulator myself, to me as I go through this process, what you detailed, the number of things that you listed here as causes over and over again, it is not necessarily the lack of regulation, of a regulation that is there; it is the lack of enforcement of the regulation. And then when we go to Dodd-Frank, we create a new bureaucracy of the Consumer Financial Protection Board, which, in my mind, it is kind of like at home if you have a fire department that doesn't work, is not answering your fires, instead you have a chain of firing everybody and putting a new group in charge who will do the job. We put another fire department in place, so we got it paid for, that actually unless we give them the right tools and the right job and do the job they are supposed to do, we are not going to improve ourselves.

And so I guess I ask the question, in Dodd-Frank do you see solutions to our problems not from the standpoint of more regulation but from the standpoint that we will enforce—do you see a reason to believe that this is a true solution from the standpoint that you see a willingness to enforce from all the different agencies that you haven't seen before?

Mr. ANGELIDES. Very quickly, in our conclusions we did say that there were powerful regulations on the books that were not enforced. And I would hope that the regulators would have the backbone, political will and your backing to enforce.

But I do believe that there were big gaps that Dodd-Frank does fill. It cuts off regulatory shopping, it does create oversight over nonbank financial institutions that kind of escape scrutiny. So I think it filled some important holes. But I will say that there were powers there. Dodd-Frank helps make sure that the gaps were closed, derivatives, shadow banking markets, credit rating agencies.

Mr. LUETKEMEYER. Very good. Thank you, Chairman Thomas, and if you could add to that, do you see some gaps of things that we need to put in there as well? Very quickly.

Mr. THOMAS. Yes. We can fill every gap. And the next time it will be something we hadn't anticipated. So when you talk about overregulation, I think this Commission especially, and others in the Congress, have an enormous responsibility in the oversight.

Yes, Dodd-Frank has become law. But as the Administration begins to move in the direction of regulations, you ought to bring them in and examine it again, because I think many of them overreach. I think some of them were off-the-shelf concerns that people have been worried about, literally for decades, that may not directly apply to the concerns that you might have. Yes, you do need to have oversight and regulation. But if you have so much that nothing bad goes on, you don't get the dynamic financial flow which has made this country what it is. And it is always going to be a judgment question.

Mr. LUETKEMEYER. I apologize here. I have one more question to ask. With regards to all the hearings we have had so far, and as we go through the review of Dodd-Frank, I have yet to see anything that says something about pre-approval of any of the new financial products.

Through the last 20 years, we have had a whole lot of new financial products that have come to the marketplace, most of them without regulation, most of it beyond, in fact, with the derivatives market, beyond regulations we found out.

Do you believe in your discussions in 3-year findings that we need to have some sort of mechanism in place to pre-approve new financial products, or are you going to allow the market to continue to develop all these new products and then, after the fact, regulate them?

Mr. HENSARLING. Thirty seconds please.

Mr. THOMAS. I think the most valuable thing, rather than try to set up pre-approval, is to have transparency, to let the marketplace see what the upside and the downside is, and then make sure people can get the information. So that if you have full disclosure and transparency, I do believe most of the problems that we face will be at least moved to minor items.

Mr. LUETKEMEYER. Thank you.

Mr. HENSARLING. The Chair now recognizes the gentleman from North Carolina for 5 minutes.

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Chairman. Mr. Angelides, just one quick question in response to Mr. Pearce's questions just a few minutes ago.

Did you compare how well mortgages perform that were originated by depository institutions, subject to the CRA, to the kind of borrowers that the CRA would encourage lending to that were purchased by Fannie and Freddie, versus mortgages to the same kind of borrowers originated by nondepository institutions, not subject to CRA, bought by investment banks, private label securities, government policy, having nothing to do with that?

Mr. ANGELIDES. So do we compare the performance of loans made under CRA?

Mr. MILLER OF NORTH CAROLINA. Bought by Fannie and Freddie versus loans of the same kind of borrowers.

Mr. ANGELIDES. I can't speak to that specifically. I will have to get back to you. I do know that we looked at studies that showed that of the high-cost loans under HMDA, which is a good proxy for CRA, approximately 6 percent of the high-cost loans were made under CRA. And they looked at neighborhoods and found that to similar borrowers, CRA loans performed better than those loans made by non-CRA-regulated institutions. But as to your specific question, I will have to get back to you, sir.

Mr. MILLER OF NORTH CAROLINA. I don't have much time, but if you have a quick answer.

Mr. THOMAS. Just a quick response to that. The overall portfolio wasn't all that bad for a period of time compared to some of the newer stuff coming on. But once Freddie and Fannie became actually market commercial structures, there was a drive to please their shareholders and they had to maintain not only the government number but a high enough number in terms of mortgages. So in essence, they were partially forced to go into some of these other areas. And they were the insurer of last resort.

And frankly, when you look at the relationship between Countrywide and its willingness to provide Fannie and Freddie, and Fannie and Freddie's willingness to use Countrywide, that really pulled

that whole structure down. They were still buying even after we realized the market was as bad as it was.

Mr. MILLER OF NORTH CAROLINA. Mr. Thomas, you mentioned Michael Lewis earlier and his book, "The Big Short", but Mr. Lewis has actually been pretty complimentary of the Commission. He said it did an excellent job. He said it found some nuggets of facts that were not available earlier because you had subpoena power, but he said really to have a complete story you needed not just subpoena power but waterboarding power. So he thought there were some natural limitations to what could be gained voluntarily.

Mr. THOMAS. As a Republican, I assume that is a positive comment.

Mr. MILLER OF NORTH CAROLINA. Without getting into that whole debate, allow me to move on. One thing that most people, and certainly the rules of evidence allow you to consider in whether to believe a witness is, is it consistent with what they said before? And we are now hearing or have been hearing since September of 2008 that government policies made banks make all these bad loans, and the banks would never have made those.

I was right here as part of that debate. I remember very clearly what everybody said. I don't remember anybody saying a word about that before September of 2008. I don't remember banks sitting in our office or sitting at that table or saying in the popular press, we shouldn't be making these loans; please, please, let us stop. Do any of you remember—what I heard from the banks, from the industry, was that subprime mortgages were a great thing.

Mr. THOMAS. One of the real values of this Commission, notwithstanding any differences we might have, is that we agreed early on to create a repository of all the information that we gathered. It is now going to be held at Stanford, and there is going to be an interactive relationship. And my hope is that we use it as a resource and expand it so we can do exactly that; this is what was said back then in terms of the in-depth testimony. And Congress needs to realize that there is help in getting data that will lead you to the best conclusions, and one of those resources will be the Commission's Web site location is going to be located at Stanford University.

Mr. MILLER OF NORTH CAROLINA. Mr. Angelides, do you remember anything like that?

Mr. ANGELIDES. I was a private citizen at the time, but I will say this. We did look at, for example, the affordable housing goals set by HUD. We interviewed I believe 46 people on this subject. Only two folks said that the affordable housing goals is what pushed Fannie and Freddie to do what they did. The overwhelming majority of evidence we gathered—documents, witness testimony—said it was their drive for profit, therefore compensation, regaining market share, catching up to Wall Street, that drove their activities.

But we did conclude that the affordable housing goals that went up above 50 percent, I believe in 2005, did marginally contribute to Fannie and Freddie, was called their targeted loans, that they did contribute to some of their losses; that, in fact, when you did move the goals above 50 percent it did have a marginal impact.

Mr. HENSARLING. The time of the gentleman has expired. The Chair now recognizes the gentleman from Ohio for 5 minutes.

Mr. STIVERS. Thank you, Mr. Chairman.

I thought Mr. Thomas' comments on transparency were a very important lesson. And I assume Mr. Angelides agrees that transparency was an important cause here. I think a lesson that we can take in any market is that investors need transparency about what is going on with—whether it is counterparties or what is going on in the marketplace. Is that correct, Mr. Angelides?

Mr. ANGELIDES. I absolutely concur, and to have transparency, you can't have dark markets; you have to have reporting. And that didn't exist for the repo market, the derivatives markets. And so there is a correlation between regulation derivatives. You have to start by asking for disclosure. That is very important. Yes, I think we agree on transparency is a very key factor here.

Mr. STIVERS. Thank you. Mr. Thomas?

Mr. THOMAS. And with the rating agencies, who today would design someone to provide a gold standard or a Good Housekeeping Seal of Approval in which they earn their money by having people pay them for those ratings.

Mr. STIVERS. I am glad you went there. That is my next question, actually.

Mr. THOMAS. And a failure to appreciate how little they were worth.

Mr. STIVERS. I think that is something we still haven't addressed, and it kind of takes off on what Mr. Sherman talked about.

But I do have a concern about issuers being able to pick their own credit rating agency. And in fact, I prefer a blind draw. I don't prefer the method that the Senator from Minnesota proposed, which creates a big-government structure. I would just create a trust essentially, and they pay into the trust and there is a blind draw. It doesn't create more government, it is a more efficient system.

But I do want to ask both of you, quickly, about the current rating agencies, because I think that there is a view on some in this committee, and I think other places, that we need to reduce our dependence on the credit rating agencies. And while I believe that is partially true, I think it is also we can't go too far with that because so many things in our investment structure in this country and worldwide are based on credit rating.

So if we took away the conflict of interest and created something like a blind draw, how would both of you view that as creating a system that would work better? And please be brief, because I have one more question.

Mr. ANGELIDES. Okay. One quick question. I think one of the most important things—and Dodd-Frank is exposing the methodology—we had to play, "Where's Waldo?" We had a whole team trying to figure it out. It wasn't until 2006 that Moody's actually had a model to analyze subprime lending. I will tell you, having sat on two pension boards, that a lot of pension boards don't have the capacity, so ratings will be around.

Mr. STIVERS. And they always will be.

Mr. THOMAS. Ratings are easy and they had a history. And what they gained, that positive history, overlooked nothing like what they were rating at the time that the world fell apart.

I don't think you can create a government structure. I happen to agree with you. It will always be a dollar short and a day late in trying to cover it. But creating a system where people can't link up on their payment versus their rating is fundamental, and you can do that fairly easily.

Mr. STIVERS. And I believe that, too. Thank you.

I have just one more question for Mr. Angelides. How is the book selling?

Mr. ANGELIDES. I think there is—let me just say something. Here is what has been surprising. There has been a tremendous hunger in this country to have answers. And while we have a debate going on, I don't say this as a matter of hubris for this Commission, but I guess this weekend it will be listed as number 10 on the New York Times best seller nonfiction paperback. But I think what that speaks to is still a lot of anger, confusion, people in this country wanting to know why so many people are out of work, why they lost their homes. I think that is really a credit to all the Commission's work that we put forward facts and we have put forward a debate.

Mr. STIVERS. Thank you.

Mr. THOMAS. I have been told by a number of people that the 36 pages, 400 pages in, are definitely worth the price of the book.

Mr. ANGELIDES. Yes, I always go to the back.

Mr. STIVERS. I do hope the taxpayers get their $10 million back, so that is why I asked about—

Mr. ANGELIDES. Very quickly, though. From the day we announced this report to 2 weeks after, there were 330,000 unique visits to the Web site, so people are going there.

Mr. STIVERS. That kind of access is important, too. And I do want to thank both of you. I think the fact that even though there is competing ideology in the report, there is always going to be that. And I think people get to see both and choose for themselves. So it doesn't bother me that it was a partisan system, our country is a partisan system. But I appreciate the fact that both of you were willing to be involved, and that the taxpayers and the citizens of this country are getting more information.

Thank you, Mr. Chairman. I yield back the balance of my time.

Mr. HURT. [presiding.] I thank the gentleman. The gentleman from Texas, Mr. Green, is recognized for 5 minutes.

Mr. GREEN. Thank you, Mr. Chairman. I thank the chair and the vice chair for the service that you have rendered. I would also like to thank the other members of the committee because they, too, labored long and hard. And I think it is worthy to note that they should be appreciated as well.

I would like to for just a moment peer through the vista of time and harken back to that era before 1977 when we had in this country something known as redlining. Redlining, for edification purposes, simply means that there were areas in the country wherein lending institutions would not lend, notwithstanding credit worthiness, they would not lend to people simply because of perhaps the location and, to a greater extent, who they were. Redlining was a dastardly, ugly thing to have perpetrated upon you. It usually happened to people of color. Usually. My suspicion is that it happened to some others as well.

But in 1977, the CRA was enacted, and the purpose of the CRA was to address redlining. For some of us, when we talk of the CRA, there is a much deeper meaning because of how it impacted us directly or indirectly.

And so today, I approach the CRA from the perch of a person who saw the actual devastation that was created by virtue of something known as redlining. And I do not believe any other persons who are antithetical to the position that I approach, I don't believe that any of them occupy their positions with malice aforethought. I believe them to be honorable people who have a different opinion.

But I know why my opinion exists, because I saw the devastation. So when I hear people make an effort to blame the CRA for the crisis, it has a greater impact on me than it may have on some others, because I knew what the CRA meant when it was enacted, and I know now what it means to people of color who try to have equality of opportunity: Not to get more than you deserve, but to do what others do, to succeed on their merits or fail on their demerits and have their creditworthiness be appraised just as everybody else's creditworthiness is appraised.

So I ask now this simple question: Was the CRA the major cause of the crisis?

Mr. THOMAS. A large part of the debate, or one of the fundamental causes, in my opinion it clearly was one of the causes, but not a fundamental cause. And let me hasten to tell you that I agree completely with those early days.

Mr. GREEN. Permit me for just a moment, Mr. Vice Chairman, because time is of the essence. And I do beg that you forgive me. I don't mean to be rude, crude, and unrefined, but I do have to move forward and ask this. Given what you said about it not being a fundamental cause, would you eliminate the CRA because of what happened with this crisis?

Mr. THOMAS. I would talk about going back to what the CRA was earlier. What happened between both—

Mr. GREEN. My question, though, is—I do have to intercede because my question is, would you eliminate it? And I have the yellow light. Would you eliminate it, would you do away with it completely?

Mr. THOMAS. I would modify it.

Mr. GREEN. Okay, thank you.

Now, let's move to the chairman, if I may. Mr. Chairman, do you believe that the CRA was the cause of the crisis?

Mr. ANGELIDES. No, I do not believe it was. We found that it was not significant in subprime lending. We found, therefore, it was not significant with the crisis. Many of the subprime lenders were not even regulated by the CRA. Only 6 percent of the high-cost loans, which is a proxy, those are under HMDA data, were even originated by CRA lenders. And studies show that CRA loans, loans made by CRA-regulated institutions in neighborhoods to similar borrowers, the non-CRA-regulated institutions performed better. So the answer from my perspective is no.

Mr. GREEN. Thank you, Mr. Chairman.

Mr. THOMAS. Mr. Chairman, can I ask unanimous consent for 30 seconds to respond outside the question structure?

Mr. HURT. Thirty seconds.

Mr. THOMAS. One of the reasons I would talk about modifying it, Mr. Green, is that we have a fundamental problem with our Tax Code, that if you are able to own a home you have many, many advantages under the Tax Code. We need to change the relationship between renting and ownership.

There was much political thrust, both Republicans and Democrats, to get people into their own home for the tax advantages, and that shouldn't be the case. That is how I would change it in terms of modification.

Mr. GREEN. Mr. Chairman, if I may, Mr. Chairman, may I be recognized, please, for a question?

Mr. HURT. Thirty seconds.

Mr. GREEN. May I please ask that the chair respond to the comment that was made by the vice chair? Thank you.

Mr. ANGELIDES. This comment?

Mr. GREEN. Yes, sir.

Mr. ANGELIDES. First of all, I started my career in the affordable housing arena. And I do think we have to pay attention to the needs of renters in this country. And I want to say one important thing. Here is the tragedy of this crisis. It was supposed to be about creating new homeownership. The homeownership rate peaked in this country in the spring of 2004. From then on, it was all about financial engineering, mortgage-backed securities, CDOs, not about putting Americans in homes. That is the real tragedy of this crisis.

Mr. HURT. I now recognize myself for 5 minutes. The question I would like to ask—and let me first thank you all for being here, and I appreciate your testimony today—but it goes to the heart, I think, of what has been discussed. I think Mr. Miller from North Carolina was talking about this as well.

It seems to me that irresponsible lending certainly has played a role in where we are, for sure. And so, I find it interesting that in your report and in your testimony, Mr. Angelides, that you say that government housing policies were not a significant factor in the crisis.

And so my question is: Are there any housing, government housing policies that you think should be changed? And how do you defend that statement in light of what I think we would all agree, at least a significant—I think a significant part was caused by irresponsible lending. And so I would like to ask that question to you, and then I would like to have a comment from Mr. Thomas and then another question.

Mr. ANGELIDES. Let me be very specific. We looked at the affordable housing goals of HUD and believe they contributed only marginally to Fannie Mae and Freddie Mac's massive losses. We looked at the Community Reinvestment Act and found that it was not a significant factor in subprime lending, therefore the crisis. Clearly, Fannie and Freddie were publicly traded corporations but with an implicit government guarantee which became explicit with many subsidies from the Federal Government, and clearly that model is flawed and broken and ought not to be returned to. And we did say, I will say majority of the Commission, and the dissent by Mr. Thomas et al., that they did contribute significantly. We say that and we say it clearly.

Mr. HURT. But are there any specific housing policies that you can recommend to this committee that we look at to help prevent this from happening again? You said that this was avoidable, and I think we want to avoid this in the future.

Mr. ANGELIDES. I think the most important, at least homeownership policies, is to make sure we are always studying reasonable mortgage lending standards. And anything that the government backs ought to be on strongly underwritten loans in terms of quality. That was a major failure and we should never let that happen again. I believe Dodd-Frank helps in that regard.

I would have to give some thought—I spent a lifetime on this, but I agree with Mr. Thomas that we do have to pay attention also to rental housing as an option, so that we are not stretching to put people in homeownership who can't quite reach it by virtue of income. I think that is a very legitimate comment by Mr. Thomas.

Mr. HURT. Just briefly, Mr. Thomas.

Mr. THOMAS. Government housing policies did contribute to the problem. Government tax positions also contributed to the problem. The real difficulty is that owning a home was "the American dream." But it was also the source of what people believed were their primary savings by virtue of the inflation associated with the value of the home and the so-called equity. We failed in the Tax Code to not let them cash in on that equity.

So for someone who had been in a home for 20 years and you had the downturn, they had virtually no equity in it because of the tax structure. But ultimately everyone contributed, because it had been so long since we had a difficult time and it was easy to make money. But there is no question that a number of government policies, including the drive at all costs to get everybody in a home of their own, was one of the contributors.

Mr. HURT. Thank you, Mr. Thomas.

I would like to yield the balance of my time to the gentleman from New York, Mr. Grimm.

Mr. GRIMM. Thank you, Mr. Chairman. I will be very brief. Chairman Angelides, you mentioned earlier that the Federal Reserve could have done things; they had the power and authority, but they didn't act, specifically, relating to overleverage. What could they have done?

Mr. ANGELIDES. First of all, I was commenting specifically on their failure to adopt mortgage lending standards, which they have the full authority to do, that would apply to all institutions, and in that regard they failed miserably.

In 2001, they adopted some regulations. Our regulatory bodies had the ability, bank holding companies, other institutions, to control leverage and didn't. And as you know, these institutions levered up tremendously such that, for example, the investment banks—which, of course, was the SEC's purview—a 2 or 3 percent drop in values could wipe out all equity.

Mr. GRIMM. But isn't it—and I understand there are multiple reasons that lead to this crisis—but would it be fair to say that an absolute major part of this crisis was overleverage?

Mr. ANGELIDES. Absolutely. Oh, yes.

Mr. GRIMM. So doesn't that beg the question, then, that it really is not a complete lack of regulation but a lack of enforcement and

proper oversight? And that is why I am a little perplexed by the overreaching of Dodd-Frank, because a lot of this could have been avoided simply by enforcing rules we have had on the books for years.

Mr. ANGELIDES. But here is what we said in our conclusions. We said there was a lot of power and it wasn't used. However, we also note that there were significant gaps that were opened up, and there was regulatory shopping. Take Countrywide. You can read here how they decide. They don't want to be regulated by the Fed, they don't want to be regulated by the OCC, they want to go to the OTS because they are the weakest.

Mr. GRIMM. My time is up, so I just want to make a point, and I concede. However, doesn't prudence and common sense—let's forget we are in the government now and let's actually try to apply common sense. Doesn't it make sense to first fix the problem where rules and regulations exist, so that we enforce that before we go ahead and go to the next step, which I would think would be logically, then add any additional rules or regulations that are needed at that point? But to have a set of rules we didn't listen to because of for whatever reasons, and then add more on top of that, I would think they are not going to listen to the new rules either.

Mr. ANGELIDES. Quickly, I think you need both. And I will just say that more than most of my career has been in the private sector, and so I come at this with a belief in free markets. But the financial sector is so central, it is like the heart of our system; we don't want arrhythmia, we want to make sure there is—you don't want to kill innovation, but I think there are two problems. We said very clearly here, by the way, that we don't accept the view that regulators didn't have power, but we also say there were big gaps open. I think it was a dual problem.

Mr. HURT. Mr. Thomas, just very briefly.

Mr. THOMAS. I think there is a real opportunity because, clearly, Dodd-Frank was passed in a very partisan environment. And we have an opportunity, you folks do in the House, to review the proposed regulations in another partisan environment and make sure that some of the clear overreaching is tempered.

So I really think this committee is absolutely fundamental to getting it right. Because yes, there were regulations that should have been carried out. Have we gone overboard in dealing with them? You are seeing testimony now about certain types of derivatives. Some derivatives need to be transparent and regulated. Some are going to be killed, a useful financial tool.

You folks now in the majority have the chance to go back and revisit those proposed regulations, bring them in here, make them explain why they need all the bells and whistles, because, frankly, my bigger concern is going to be a choking up of the financial structure in various ways. It is going to force creativity, because creativity will move to areas that you haven't anticipated. It is best to keep them comfortable but under a structure. Thank you very much.

Mr. HURT. Mr. Thomas, thank you. The Chair notes that some members may have additional questions for this panel which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written

questions to these witnesses and to place their responses in the record.

I want to thank Mr. Angelides and Mr. Thomas for being here. We appreciate the dialogue. With that, the first panel is dismissed. And the second panel will quickly take their place at the table.

Mr. ANGELIDES. And by the way, I want to thank the committee for your courtesy, and thank my colleagues, all my colleagues on the Commission and the staff, who did an excellent job. So thank you very much, Mr. Chairman.

Mr. THOMAS. And I want to echo my comments as well. Thank you very much for your leniency.

Chairman BACHUS. Mr. Wallison, you are recognized for 5 minutes for your opening statement.

STATEMENT OF PETER J. WALLISON, COMMISSIONER, THE FINANCIAL CRISIS INQUIRY COMMISSION

Mr. WALLISON. Thank you, Mr. Chairman. Chairman Bachus, Ranking Member Frank, and members of the committee, by June of 2008, there were 27 million subprime and Alt-A mortgages in the U.S. financial system. That was half of all mortgages. These weak and risky loans had begun to default in unprecedented numbers when the 1997–2007 bubble began to deflate. And by 2008, many financial institutions that held these mortgages, or mortgage-backed securities based on them, were in trouble.

No one doubts that it was the failure of these mortgages, what was known at the time as the mortgage meltdown, that caused the financial crisis. Nothing like this had ever happened before. In previous bubbles, the number of subprime loans was very small and losses, when they deflated, were generally confined to local areas. In this bubble, the mortgage losses were large and the losses were international.

In light of these facts, the question the Commission should have answered—and did not—was why there were so many bad mortgages outstanding in 2008. Obviously, there had been a serious decline in underwriting standards, something else that had never happened before. Neither the Commission nor the other dissenters advanced a plausible explanation for the decline in underwriting standards. Both seemed to assume that easy credit automatically produces subprime loans, but this is far from obvious.

Before the 2008 crisis, the United States had frequently experienced periods of low interest rates, large flows of funds from abroad, and housing bubbles. We also had the same regulatory structure and relied on financial institution management to anticipate risks. None of these conditions or factors, separately or together, had ever before resulted in a mortgage-based international financial crisis.

Under these circumstances, it is logical to focus on the one unprecedented element in the U.S. financial system before the crisis: the large number of subprime and other risky loans.

My dissent focuses on the only plausible explanation for the buildup of these loans, and that is U.S. Government policies, specifically housing policies. Beginning in 1992, with the imposition of affordable housing requirements on the GSEs, mortgage underwriting standards began to erode. HUD caused this erosion by rais-

ing the affordable housing goals through the Clinton and Bush Administrations, until more than half of all loans the GSEs had to buy were required to be made to borrowers at or below the median income where they lived.

In addition, the GSEs were put into competition with FHA, with insured banks under the Community Reinvestment Act, and with subprime lenders, all of whom were looking for borrowers who were also at or below the median income. Prime loans were difficult to find among these borrowers, so to acquire the loans the government was demanding, underwriting standards had to be reduced.

By 2000, for example, Fannie was offering to buy mortgages with no downpayment. My dissent details how these weak government-mandated loans caused the growth of the bubble, how the bubble created the private label market for securities backed by subprime loans, and how the failure of all these weak loans destroyed the value of the mortgage-backed securities and thus weakened financial institutions around the world.

Finally, the Commission's majority report propagates the false idea that the GSEs bought these risky loans not because of the affordable housing requirements but to regain market share, or for profit.

My dissent documents that this is not true. For example, this quote from Fannie's 2006 10–K report: "We 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 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."

Fannie and Freddie are deeply insolvent, and will cost the taxpayers almost $400 billion as a result of the kinds of decisions they made to comply with the affordable housing goals.

Now, could anything be clearer than that statement in their 10–K? I don't think so. The deterioration in underwriting standards was caused by U.S. Government policy, and this caused the financial crisis, not a lack of regulation or a failure of risk management. In my view, then, the Dodd-Frank Act was not soundly based and will not prevent a future financial crisis. Thank you.

[The prepared statement of Mr. Wallison can be found on page 122 of the appendix.]

Chairman BACHUS. I don't mean to rush anybody, but we will have votes at about 1:00. And I enjoyed your testimony. I wasn't trying to cut you off, but I would like to get to, as rapidly as possible, the questions.

Ms. Born, I recognize you for 5 minutes.

STATEMENT OF THE HONORABLE BROOKSLEY BORN, COMMISSIONER, THE FINANCIAL CRISIS INQUIRY COMMISSION

Ms. BORN. Thank you, Chairman Bachus, Ranking Member Frank, and members of the committee. Thank you for inviting me

to appear before you to discuss the report of the Financial Crisis Inquiry Commission. As a member of that Commission, I voted to adopt the report and I agree with its conclusions which have been discussed by former Chairman Angelides in his testimony.

In my testimony, I will describe several conclusions of the Commission about three specific components of the financial system that contributed significantly to the financial meltdown. First, the Commission concluded that collapsing mortgage lending standards and the mortgage securitization pipeline lit and spread the flame of contagion and crisis. Many mortgage lenders became so eager to originate loans that they took borrowers' qualifications on faith, often with a willful disregard of the borrower's ability to repay.

The Federal Reserve and other regulators were aware of the increase in irresponsible lending, including predatory and fraudulent practices, but failed to act effectively to restrict such behavior. The securitization process led lenders and securitizers to believe that they were able to pass the risk of these toxic mortgages to investors in mortgage-backed securities and collateralized debt obligations. However, the financial crisis revealed that in fact a number of systemically important institutions remained significantly exposed to them.

Second, the Commission concluded that over-the-counter derivatives contributed significantly to the crisis. After being deregulated by Federal statute in 2000, the OTC derivatives market grew exponentially to almost $673 trillion in notional amount on the eve of the crisis in June 2008. This unregulated market was characterized by uncontrolled leverage, lack of transparency, lack of capital and margin requirements, rampant speculation, interconnections between firms, and concentration of risk in systemically important institutions.

Derivatives known as credit default swaps fueled the securitization frenzy by encouraging investors in mortgage-related securities to believe that they were protected against default. Credit default swaps were also used to create synthetic collateralized debt obligations, or CDOs, which were merely bets on real mortgage securities. Such bets significantly amplified the losses from the collapse of the housing bubble.

Insurance giant AIG's sale of these credit default swaps without adequate capital reserves brought it to the brink of failure and necessitated its rescue by the government, which ultimately committed more than $180 billion because of concerns that AIG's collapse would trigger cascading losses throughout the financial system.

In addition, the existence of millions of contracts of other kinds of OTC derivatives created interconnections among a vast web of financial institutions through counterparty credit risk, exposing the system to contagion and helping to precipitate the government bailouts.

Third, the Commission concluded that the failures of the credit rating agencies were essential cogs in the wheel of financial destruction. Without the high ratings issued by credit rating agencies, the mortgage-related securities at the heart of the crisis could not have been marketed and sold in such vast quantities. The credit rating agencies issued top ratings to tens of thousands of mort-

gage securities, which reassured investors and allowed the market to soar, and then downgraded them wreaking havoc across markets and firms.

The agencies' rating failures resulted from pressures by financial firms that paid for the ratings, the use of faulty computer models, the desire to increase or maintain market share, and the absence of meaningful public oversight.

Thank you.

[The prepared statement of Ms. Born can be found on page 62 of the appendix.]

Chairman BACHUS. Thank you.

Mr. MILLER OF CALIFORNIA. [presiding.] Dr. Holtz-Eakin.

STATEMENT OF DR. DOUGLAS HOLTZ-EAKIN, COMMISSIONER, THE FINANCIAL CRISIS INQUIRY COMMISSION

Mr. HOLTZ-EAKIN. Acting Chairman Miller, Acting Ranking Member Green, thank you for the chance to be here today. I want to begin by acknowledging and thanking the staff of the FCIC for their superb work throughout the Commission. And the fact that the Commissioners failed to come to a consensus report should not diminish their efforts in any way.

The committee asked me to discuss three things: the findings of the majority and minority reports; the issue of lacking the ability to come to consensus; and the implications for Dodd-Frank. Let me briefly discuss each of those.

In the dissent that I filed with Vice Chairman Thomas and with Commissioner Hennessey, we differed in three important ways:

First, we felt that you could not describe the causes of the financial economic crisis, the mandate which Congress gave to us, through a simple narrative that relied either on the greed of Wall Street or the failure of government policy but, instead, there would be 10 specific and essential pieces that led to the crisis. And we detailed those in our report and would be happy to expand on those.

Second, it is is not U.S.-centric. Much of the evidence about the cause of the financial crisis can be gleaned by looking around the globe. This was a global phenomenon. We had housing bubbles and a credit bubble around the globe, in Australia, the United Kingdom, Spain, and other places, even though they had very different mortgage finance systems and very different regulatory structures. And we had large financial institutions fail around the globe, again, in the presence of very large differences in regulatory structure. So it struck us that focusing on U.S.-centric regulatory phenomenon missed the point.

And third, we tried to focus on deep underlying causes, without an emphasis on institutions and individuals, as we saw in the majority's report. In particular, again, we did that because we thought it was closer to answering the truth.

On the second point of a failure to come to agreement, I think in many ways this isn't surprising. I have been studying economics since 1978, and among my professional colleagues, we have yet to agree on the causes of the Great Depression.

I believe we will continue to disagree on the causes of the financial crisis of 2008. Particularly given the scope and the timetable the Commission was handed, I think it is in many ways an

unsurprising outcome, and I don't feel that it enhances the report for us to disagree, but it is not entirely a shock. And I am disturbed that late in the game, it appeared to become partisan in nature when, in fact, what I saw during the vast majority of the Commissioners' deliberations were 10 individuals with views that did not agree and a willingness to look at the data and try to work that out.

Finally, in terms of implications for the legislation that was ultimately passed, if you look at our dissent, we found around the globe credit in housing bubbles in these various regulatory environments. While we certainly acknowledge that bad people did bad things, and there is tremendous evidence that mortgage organization standards declined in the United States, we don't find the broad mandate for erecting, for example, a Consumer Financial Protection Agency. There was never any quantitative evidence brought to bear by the majority in the Commission about the extent of fraud or its contribution to the crisis, and outside of mortgages there is no evidence whatsoever.

The second is that we found no real role for the repeal of Glass-Steagall or proprietary trading in the crisis. And so efforts to impose, for example a vocal role, appear to be misguided.

And then in the interest of time, let me just close with the last I think implication, which is the crisis itself was a tribute to the financial sector spilling over into the real economy, the Main Street economy, and it doesn't exist in isolation. And as this committee and the framers of the legislation go forward, it is useful to remember that the costs imposed by that legislation are going to spill over to the real economy as well.

The scale of the rulemaking is enormous. It takes place at a time when the Affordable Care Act and the EPA's activities are also leading to record Federal Register pages for regulations, and I have a deep concern that this will inhibit the growth that is necessary for the 8 million Americans who are out of work. Thank you.

[The prepared statement of Dr. Holtz-Eakin can be found on page 70 of the appendix.]

Mr. MILLER OF CALIFORNIA. Thank you, Doctor, for your testimony.

Mr. Georgiou.

STATEMENT OF BYRON GEORGIOU, COMMISSIONER, THE FINANCIAL CRISIS INQUIRY COMMISSION

Mr. GEORGIOU. Thank you, Acting Chairman Miller and Acting Ranking Member Green. I am pleased to join my colleagues today. I would like to join Dr. Holtz-Eakin's commendation of our staff who worked under incredibly strenuous circumstances and extraordinary hours and contributed enormously to this process, and thank my fellow Commissioners.

We concluded that the financial and economic crisis was caused by widespread failures of financial regulation, breakdowns in corporate governance, a volatile mix of excessive borrowing and risk-taking, key policymakers who were ill prepared for the crisis, and systemic breaches in accountability and ethics at many levels in the private sector. There were many warnings, and the Commission concluded that the crisis could have been avoided.

I will address three key areas we investigated. These matters included: the roles of excess capital availability and liquidity; the Government Sponsored Entities Fannie Mae and Freddie Mac; and government housing policies.

First, the Commission agreed that the availability of well-priced capital, both foreign and domestic, is an opportunity for economic expansion and growth if encouraged to flow in productive directions. Excess liquidity by itself did not need to cause a crisis.

The Commission determined that low interest rates, widely available capital, and international investment were prerequisites for the creation of the credit bubble, creating increased risk that should have been recognized by market participants, policymakers, and regulators. However, with proper safeguards in place, such as prudent lending standards and adequate attention to risk in the private sector, excess liquidity need not have led to a crisis.

Second, the Commission investigated the role of Fannie Mae and Freddie Mac, using Fannie Mae as its in-depth case study. We concluded that they contributed to the crisis but they were not a primary cause. These Government Sponsored Enterprises had a deeply flawed business model. As publicly traded corporations with the implicit backing of and subsidies from the Federal Government and with the public mission, their $5 trillion mortgage exposure and market position were significant. And they used their political power for decades to ward off effective regulation oversight, spending $164 million on lobbying from 1999 to 2008.

As you know, through the third quarter of 2010, the Treasury Department had provided $151 billion in financial support to keep them afloat. Still, GSE mortgage securities essentially maintained their value throughout the crisis and did not contribute to the significant losses seen at other financial institutions that were central to the financial crisis. The Commission report explains how prices of Fannie Mae mortgage-backed securities actually increased slightly in the 2007–2008 time period while the prices of private label mortgage-backed securities have dramatically declined. And the purchases of non-GSE mortgage-backed securities added helium to the housing balloon, but their purchases never represented a majority of the market. The GSEs participated in the expansion of subprime and other risky mortgages, but they followed rather than led Wall Street and other lenders.

In 2005 and 2006, they ramped up their purchase and guarantee of risky mortgages in order to meet stock market analysts' expectations for growth. The evidence shows that they did so to regain market share and to ensure generous compensation for executives and employees.

We sampled about 25 million mortgages. Some of our data indicated that subsets of borrowers with credit scores less than 660, those GSE mortgages were far less likely to become seriously delinquent than were private label securitized mortgages to the same types of lenders, 6 percent on the part of the GSEs, 28 percent on the private label.

Third, the Commission studied government housing policies and concluded that they did not cause the crisis. Based on the evidence and interviews with dozens of individuals, the report describes how the Department of Housing and Urban Development's affordable

housing goals for Fannie and Freddie contributed only marginally to the GSEs' participation in risky mortgages. And we concluded that the Community Reinvestment Act, enacted in 1977 to expand safe and sound lending to creditworthy borrowers in certain neighborhoods, was not a significant factor in subprime lending or the crisis.

On the matters of Fannie Mae, Freddie Mac, and the CRA, there was considerable common ground among the Commission's conclusions and the so-called "dissent"—which I would characterize really more as a concurring opinion authored by Commissioners Hennessey, Douglas, Holtz-Eakin, and Thomas.

As to the Dodd-Frank law, I haven't studied it in considerable depth, but I do think that its full and effective implementation is important to helping this country avert a future crises.

Thank you for your courtesy.

[The prepared statement of Mr. Georgiou can be found on page 68 of the appendix.]

Mr. MILLER OF CALIFORNIA. Thank you. I have really enjoyed the testimony. Even my good friend, Mr. Thomas, who has come back, I served with him for a number of years and he has always been a lot of fun.

I really enjoyed the testimony. The problem I have had in recent years is who is getting blamed for this problem out there. Everybody keeps pointing to Fannie and Freddie. And yes, they have been involved in some problematic issues. I remember when Secretary Jackson first took over. The first meeting I had with him, I was concerned about their raising requirements on their affordable housing goals; I thought they were problematic and could lead to trouble. It didn't do any good at the meeting. I remember introducing amendments in 2000 and 2001 to define "predatory" versus "subprime." I got it to the Senate numerous times, but couldn't get it back.

But the data I received, and it is bothersome, is that we are pointing just to Fannie and Freddie. I think it is much broader than that; I think it is global, too, but definitely systematic and industry-wide in the United States.

Between 2002 and 2006, Freddie's mortgage-backed securities share of the marketplace dropped from 70 to 40 percent. Only in effect, non-agencies went from 20 to 60 percent. At that point in time you had a lot of groups like Countrywide and Washington Mutual and Ameriquest HSB Finance putting out a lot of predatory subprime loans, I believe, and then backing them into mortgage-backed securities and selling them off. In fact, I believe that what took Countrywide down was the inability to basically bundle those and sell them off to the marketplace.

But when you look at the current numbers out there and default rates, I think we have a systematic problem. And Dr. Holtz-Eakin, I think you addressed that. Non-agency loans in the subprime ARMs, serious delinquent, are 38.7 percent today. Subprime loans, seriously delinquent, are 26.5 percent today. Prime loans, seriously delinquent, are 5.4 percent. On GSEs Freddie and Fannie, serious delinquency is 4.2 percent. Freddie Mac's serious delinquency is 3.1 percent. Now, those are both high, but when you compare them to the industry, you think they are performing better than the rest of

the industry. So to shine a light on them and just say they are the problem, I think we are missing a lot in what is going on out there. And I think that is a problem.

A lot of the losses that Fannie and Freddie have taken are because of the way they bundle their mortgage-backed securities. If you have a nonperforming loan, they take it back, they eat the loss, and replace it with a performing loan, where in the private sector and all these other groups, many of which are not in business today, they are bundling them to where you can't debundle those loans. And if anybody loses money, it is the person who invested in the mortgage-backed security. That is basically where the loss is today, because the GSE mortgage-backed securities are very safe and sound, investors are making the return they were promised.

So I am looking at that and I am hearing some say that it is just the GSEs. Now, yes, there is a problem. And a lot of the problem I believe was being encouraged to change your underwriting standards to be able to make more loans and broader-based loans. But the question has never been answered.

The last time I think Fannie Mae lost money was 1995; Freddie Mac has never lost money. From 1986 to 2005, the only years I can see that they were making bad loans that were really causing the problems were from mid-2005, 2006, and 2007. Does anybody have any data different than that showing how the loans in previous years performed when the downturn occurred? And I open it to anybody.

Mr. WALLISON. I would just add that up until 2002, Fannie and Freddie made subprime and Alt-A loans or bought private label securities that were backed by such loans, equal to $1.2 trillion. That is far more than the private market did after that point. The private market in 2002 exceeded $100 billion for the first time that year. So Fannie and Freddie were 10 times the size of the private market before that. This is very significant.

Now, what you can't do exactly is tell when those particular loans were purchased and what their particular delinquency rates were. We know what the delinquency rates were at the end, but we don't know the vintages of those particular loans so we can't really pinpoint what the losses were for those particular years.

Mr. MILLER OF CALIFORNIA. But your current subprime loans make up about $1 trillion to $1.5 trillion of an $11 trillion market is all, and much of that is the private sector.

Mr. WALLISON. I am sorry, I couldn't hear—

Mr. MILLER OF CALIFORNIA. The subprime loans make up about $1 trillion to $1.5 trillion total of an $11 trillion mortgage market today. And Freddie and Fannie did not own the bulk of those.

Mr. WALLISON. Right.

Mr. MILLER OF CALIFORNIA. The bulk of those were in the private sector.

Mr. WALLISON. No, I don't think that is correct.

What I was saying was the number of subprime loans that were bought—subprime and Alt-A loans that were bought between 1992 and 2002 were $1.2 trillion. Now, the point here is simply that they were buying subprime and Alt-A loans all along.

Mr. MILLER OF CALIFORNIA. My time is up, so I will let one of the witnesses respond.

Mr. GEORGIOU. Mr. Acting Chairman, let me just say one thing. Nobody, I think, can defend entirely the activities of Fannie Mae and Freddie Mac in these circumstances, and I certainly would not do so. But I think it would be an enormous mistake if we came out of this crisis and attributed the crisis exclusively to the problems with those institutions. It would let the major difficulties of failure of accountability in the private sector completely off the hook.

In the private sector we had mortgage brokers who were incentivized and paid at the front end to originate mortgages which they knew were not likely to be paid back, and they had no economic consequence when they weren't paid back. We had financial institutions—

Mr. MILLER OF CALIFORNIA. I am going to have to have you conclude because my time has run out. But my whole statement was, based on default rates today, the GSEs are outperforming the private sector by—

Mr. GEORGIOU. They are outperforming them extraordinarily.

Mr. MILLER OF CALIFORNIA. But that is not an excuse.

Mr. GEORGIOU. Right.

Mr. MILLER OF CALIFORNIA. And the former chairman, Mr. Frank, is recognized.

Mr. FRANK. I thank you.

I would like, on the GSEs—and I appreciate that because there has been a lot of talk about the urgency of GSEs, but the point is, as a result of the legislation that passed this committee in 2007 and in the Senate in 2008, putting them under conservatorship, the GSEs today are very different institutions than they were before. In fact, there is some hope that we may even be able to recover some money.

So we ought to be clear. And I only say that because obviously we need to reform that, but I think the urgency is not as great, they are not now bleeding, and we need to figure out how to replace the function. But it is important to note that as of today, these are very different institutions.

Mr. Wallison, I just wanted to ask a couple of questions. I noticed in your testimony—and I appreciate this—you talk about HUD's role and you state that HUD was part of the problem. And you list three statements from HUD in which you say they are in effect saying it is a good thing what happened. But I did want to note, of the three—and to make clear that this is an across-the-board problem—the first statement came in 2000 under the President Bill Clinton. The second two that you quote come in 2004 and 2005 under President Bush.

Mr. WALLISON. Right.

Mr. FRANK. And I would note in 2004, it was under the Bush Administration that Fannie Mae and Freddie Mac were instructed by the regulators to increase the percentage of loans they bought from people below median income. And I criticized that at the time. I thought that was a bad idea. But I did want to get back to efforts to deal with that.

The gentleman from California mentioned that in 2004 and 2005, the Federal Reserve came to the Congress and they asked for action and were pointing out the problems with Fannie Mae and Freddie Mac. Of course at the time, the Republicans were in the

majority. And in 2004, Mr. Oxley began an effort to do legislation. And in 2005, the House actually passed a bill—I voted for it in committee; I voted against it on the Floor because of things that they did with regard to the Low Income Housing Trust Fund, not Fannie and Freddie. But there was an effort, under Republican majority rule, under the chairmanship of Mr. Oxley, to respond.

What is your evaluation of what the House produced in 2005 in this committee of that bill which actually did pass the House?

Mr. WALLISON. Let me go back first, if I may, to the point you made, which is that HUD was responsible for the deterioration in mortgage underwriting standards beginning in 1992 when they took over authority for the affordable housing requirements. Those three quotes are only three of many, many statements by HUD as they gradually increased the affordable housing requirements over time. And they were very pleased with the fact—

Mr. FRANK. I understand that, and that is in the record. But Mr. Wallison, we only have a limited amount of time. You are simply repeating what we all agree to. Please get to the point.

Mr. WALLISON. I want to get into the point you were, I think, trying to make, which is that somehow the Republicans—I am trying to excuse the Republicans for something. In fact, I am not. I think HUD, through both the Clinton Administration and the Republican Bush Administration, was—

Mr. FRANK. I understand that. I was acknowledging your doing that and I appreciated that, but I am now talking about the legislative history because that was the executive history.

In 2005, I asked specifically for your evaluation of the bill that this committee passed under Mr. Oxley, and the House then passed, that was a response to this notion that we needed to do something.

Mr. WALLISON. I am happy to do that. That bill was very weak, and the Bush Administration opposed it because it was so weak. And in one respect, it was weak because it did not deal with the holdings, the portfolios that mortgage companies—that is, Fannie Mae and Freddie Mac—were acquiring at that point. They had over $1 trillion in mortgages in their portfolio. That was the danger, and that bill didn't deal with it.

The Senate bill did deal with that, but that Senate bill never got anywhere because of the failure to get the 60 votes that you need—

Mr. FRANK. Right. At that point, the Senate Democrats were supporting the House bill and the Senate Republicans were supporting the Administration bill, but it was Republican control of both Houses.

Mr. WALLISON. This was not a partisan issue.

Mr. FRANK. Mr. Wallison, please, I am asking you specific questions and I appreciate your answers.

Now, we then passed a bill in 2007 that was then modified and adopted in 2008. What is your evaluation of the bill?

Mr. WALLISON. I thought that was an excellent bill. In fact, when I have been asked by the media about your activities in that connection, Mr. Frank, I supported them wholly. I said that you made a wonderful compromise with Secretary Paulson, and as a result of that we got a bill that we needed very badly.

Mr. FRANK. I thank you, Mr. Wallison, I appreciate that. I have been told there are 4 minutes left on the vote, and that isn't a bad note to end on.

Chairman BACHUS. I recognize Mr. Schweikert for as long as he can try. We have 4 minutes left on the vote.

Mr. SCHWEIKERT. Great. Give the freshman the opportunity. Thank you, Mr. Chairman.

Commissioners, first, thank you for what you have done. Congratulations. Rumor has it you may have almost a best seller, though now I am really questioning Americans' reading habits.

One of the things—and this may be a conversation we are going to have to have later, if we get beyond the typical repartee back and forth of who sinned, who didn't, which Administration was this. I am new, but when I read through the dissents, when I read through everyone giving me the history of what went wrong, I keep coming back to, okay, systemically—

Chairman BACHUS. The gentleman, you have 5 minutes, but there are 2 minutes left in the vote. You can take as long as you want.

Mr. SCHWEIKERT. Price of money, price of risk. Isn't the ultimate failure we have seen up and down the system that, whether it be through regulations, whether it be through incentives, whether the way it has been done, we are failing to price risk; and because of that we are now trying to regulate mechanics to create risk pricing? And those who have incentives are always going to find a way around that.

Mr. GEORGIOU. I think you are absolutely right. But one of the problems, of course, is that in our financial system, as a general rule, when you take excessive risk with inadequate capital and you fail, then you go bankrupt and your assets are distributed and you get to go on. The problem here is that we had systemically important institutions, so that when they took extraordinary risk, they put themselves in a situation where they had the upside to themselves and they had the possibility of turning to the taxpayers for protection on the downside. And that was—

Mr. SCHWEIKERT. Mr. Chairman, I am about to do something horribly rude. I am going to get up because I need to go vote, but really I think there may be a much simpler way to get what we need to protect ourselves in the future than some of the things we are doing right now.

Chairman BACHUS. Mr. Schweikert, thank you. I apologize for the lack of time.

The Chair notes that some members may have additional questions for this panel which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions for these witnesses and to place their responses in the record.

I want to thank each of you for your testimony. We had a tremendous number of questions that we were not able to ask, and I know you had the answers for each of them, but thank you for your testimony. The hearing is adjourned.

[Whereupon, at 1:15 p.m., the hearing was adjourned.]

A P P E N D I X

February 16, 2011

Testimony before the
House Committee on Financial Services
2129 Rayburn House Office Building
by
Chairman Phil Angelides,
Financial Crisis Inquiry Commission
February 16, 2011

Chairman Bachus, Ranking Member Frank, members of the Committee, thank you for the invitation to discuss the report and conclusions of the Financial Crisis Inquiry Commission. It was my honor to chair the panel, which officially disbanded three days ago. I want to thank my colleague, Vice Chairman Bill Thomas, for his service.

This Committee requested that I address three subjects today: the Commission's report; the inability to reach consensus on some conclusions; and the Dodd-Frank Wall Street Reform and Consumer Protection Act in light of the Commission's report.

Let me describe our inquiry. In 2009, Congress tasked the Commission to examine "the causes of the current financial and economic crisis in the United States," and to probe the collapse of major financial institutions that failed or would have failed if not for exceptional assistance from the government. We were true to our charge and we fulfilled our mandates.

Our task was to determine what happened and how it happened so we could understand why it happened. In doing so, we sought to answer this central question: How did it come to pass that in 2008 our nation was forced to choose between two stark and painful alternatives – either risk the total collapse of our financial system and economy -- or inject trillions of taxpayer dollars into the system and into private companies -- even as millions of Americans still lost their jobs, their savings, and their homes?

In the course of the Commission's more than year-long investigation, we reviewed millions of pages of documents, interviewed more than 700 witnesses, and held 19 days of public hearings in New York, Washington, D.C., and in communities across the country that were hard hit by the crisis. The Commission also drew from a large body of existing work developed by congressional committees, government agencies, academics and others.

The Commission's report contains six major conclusions:

First and foremost we concluded that this financial crisis was avoidable. The crisis was the result of human action, inaction and misjudgment, not Mother Nature. Financial executives and the public stewards of our financial system ignored warnings and failed to question, understand, and manage evolving risks within a system so essential to the well-being of the American public.

Second, we found widespread failures in financial regulation that proved devastating to the stability of the nation's financial markets. Third, our report describes dramatic breakdowns in corporate governance and risk management at many systemically important financial institutions. Fourth, we detail the excessive borrowing, risky investments, and lack of transparency that combined to put our financial system on a collision course with catastrophe. Fifth, we concluded that key policy makers were ill prepared for the crisis, and that their inconsistent responses added to uncertainty and panic. And sixth, we documented how breaches in accountability and ethics became widespread at all levels during the run-up to the crisis.

Our report, as well as the two dissents, can be found at our website, *www.FCIC.gov*. That website also contains approximately 2,000 documents; public testimony at our hearings; audio, transcripts and summaries of more than 300 witness interviews; and additional staff reports and data to create an enduring historical record of this crisis.

In addition to the major causes we identify, the Commission thoroughly investigated some important mechanisms of the financial system. We determined that collapsing mortgage-lending standards, the flawed mortgage securitization pipeline, over-the-counter derivatives, and the actions of the credit rating agencies contributed significantly to the financial meltdown.

The Commission also investigated whether the crisis was caused by excess capital availability and liquidity; the activities of Fannie Mae and Freddie Mac; and government housing policies.We concluded that excess liquidity, by itself, did not need to cause a crisis, and that Fannie Mae and Freddie Mac contributed to the crisis but were not a primary cause. We determined that government housing policies were not a significant factor in the crisis.

As to the lack of consensus, let me first say all 10 Commissioners were afforded the opportunity to provide extensive input as we undertook our work. While commissioners were not unanimous on all issues or on the emphasis we placed on key causes of the crisis, there were, in fact, many areas of agreement. Importantly, setting aside the conclusions and dissents, this report contains a valuable and accurate historical account of the events leading up to the crisis and the crisis itself.

Finally, you have asked me to comment on the Dodd-Frank financial reform law. With our inquiry and report completed and the facts in evidence, I will now speak to this matter. I believe that the law's financial reforms are strong and needed, and that the law directly and forcefully addresses issues and conclusions identified in our report. I believe full implementation of its provisions is critical and will help prevent a future crisis.

In conclusion, it is my hope that our report will serve as a guidepost in the years to come as policy makers and regulators endeavor to spare our country from another catastrophe of this magnitude.

Thank you. I look forward to your questions.

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Testimony
of
Brooksley Born

Former Commissioner,
Financial Crisis Inquiry Commission

Concerning the Final Report
of the
Financial Crisis Inquiry Commission

Before the
United States House of Representatives
Committee on Financial Services

February 16, 2011

Chairman Bachus, Ranking Member Frank and Members of the Committee:

Thank you for inviting me to appear before you to discuss the Report of the Financial Crisis Inquiry Commission. As a member of that Commission, I voted to adopt the Report and agree with its conclusions, which have been discussed by former Chairman Angelides in his testimony.

In my testimony, I will describe several conclusions of the Commission about specific components of the financial system that contributed significantly to the financial meltdown.

1. The Commission concluded that collapsing mortgage-lending standards and the mortgage securitization pipeline lit and spread the flame of contagion and crisis.

Many mortgage lenders became so eager to originate loans that they took borrowers' qualifications on faith, often with a willful disregard of the borrowers' ability to pay. The Federal Reserve and other regulators were aware of the increase in irresponsible lending, including predatory and fraudulent practices, but failed to act effectively to restrict such behavior. The securitization process led lenders and securitizers to believe that they were able to pass the risk of these toxic mortgages to investors in mortgage-backed securities and collateralized debt obligations (CDOs). However, the financial crisis revealed that in fact a number of systemically important institutions remained significantly exposed to them.

2. The Commission concluded that over-the-counter (OTC) derivatives contributed significantly to this crisis.

After being deregulated by federal statute in 2000, the OTC derivatives market grew exponentially to almost $673 trillion in notional amount on the eve of the crisis in June 2008. The unregulated market was characterized by uncontrolled leverage, lack of transparency, lack of capital and margin requirements, speculation, interconnections between firms, and concentration

of risk in systemically important institutions. Derivatives known as credit default swaps fueled the securitization frenzy by encouraging investors in mortgage-related securities to believe they were protected against default. Credit default swaps were also used to create synthetic CDOs which were merely bets on real mortgage securities. Such bets significantly amplified the losses from the collapse of the housing bubble. Insurance giant AIG's sale of credit default swaps without adequate capital reserves brought it to the brink of failure and necessitated its rescue by the government, which ultimately committed more than $180 billion because of concerns that AIG's collapse would trigger cascading losses throughout the financial system. In addition, the existence of millions of OTC derivatives of all types created interconnections among a vast web of financial institutions through counterparty credit risk, exposing the system to contagion and helping to precipitate the massive government bailouts.

3. The Commission concluded that the failures of credit rating agencies were essential cogs in the wheel of financial destruction.

Without the high ratings issued by credit rating agencies, the mortgage-related securities at the heart of the crisis could not have been marketed and sold in such vast quantities. The credit rating agencies issued top ratings to tens of thousands of mortgage securities, which reassured investors and allowed the market to soar, and then downgraded them, wreaking havoc across markets and firms. The agencies' rating failures resulted from pressure by financial firms that paid for the ratings, the use of flawed computer models, the desire to increase or maintain market share and the absence of meaningful public oversight, among other things.

* * *

The Committee has asked for my assessment of the Dodd Frank Act in light of the Commission's conclusions. As we have testified, the Commission found that widespread

failures in financial regulation and supervision along with dramatic breakdowns in corporate governance and risk management were key causes of the financial crisis. In my view, the Dodd Frank Act is an important response to those problems, and its full and speedy implementation should reduce risks to the financial system. I urge policy makers and regulators to examine the Commission's Report to ensure that the causes of the crisis are adequately addressed in order to protect the American public.

Thank you very much.

BROOKSLEY ELIZABETH BORN
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Born: San Francisco, California
August 27, 1940

Education: San Francisco public schools;
A.B. Stanford University 1961;
J.D. Stanford Law School 1964.

Academic Honors, Awards, Etc.:

Intelligence and Courage Award, Frances Perkins Center, 2010;
Margaret Brent Women Lawyers of Achievement Award, American Bar Association Commission on Women in the Profession, 2010;
Outstanding Service Award, Fellows of the American Bar Foundation, 2010;
Breaking Down Barriers Award, National Women's Law Center, 2009;
Pioneer of the Bar, Washington's Top Lawyers, Washingtonian, 2009;
Profile in Courage Award, John F. Kennedy Library Foundation, 2009;
Champion, Legal Times, 2008;
Lifetime Achievement Award, American Lawyer, 2005;
Stars of the Bar Honoree, Women's Bar Association of the District of Columbia, 2002;
Woman of Genius Award, Trinity College, 2000;
Outstanding Public Interest Advocate of the Year, National Association of Public Interest Law, 1994;
Allies for Justice Award, National Lesbian & Gay Lawyers Association, 1993;
Honoree, National Legal Aid and Defender Association, 1992;
Honoree, National Women's Law Center, 1986;
Woman Lawyer of the Year Award, Women's Bar Association of the District of Columbia, 1981;
Outstanding Senior Award, Stanford Law School, 1964;
Order of the Coif, 1964;
President, Stanford Law Review, 1963-1964.

Admitted to Practice: District of Columbia, 1966.

Employment:

Law Clerk, Judge Henry W. Edgerton, U.S. Court of Appeals for the District of Columbia Circuit, 1964-1965;
Legal Researcher, Harvard Law School, 1967-1968;
Lecturer at Law, Columbus School of Law, Catholic University of America, 1972-1974 (teaching Women and the Law);
Adjunct Professor, Georgetown University Law Center, 1972-1973 (teaching Women and the Law);
Chairperson, U.S. Commodity Futures Trading Commission, 1996-1999;

Associate and then Partner, Arnold & Porter, Washington, D.C.,
1965-1967, 1968-1996, 1999-2002;
Commissioner, Financial Crisis Inquiry Commission, 2009 - 2011.

Affiliations:

American Bar Association
House of Delegates, State Delegate for the District of Columbia, 1994-2005;
Council of the Fund for Justice and Education (formerly
Resource Development Council), Chair, 1993-1996;
Board of Governors, 1990-1993, Program Committee, Chair, 1992-1993;
Consortium on Legal Services and the Public, Chair, 1987-1990;
Standing Committee on Federal Judiciary. Chair, 1980-1983;
Section of Individual Rights & Responsibilities, Chair, 1977-1978;
American Bar Foundation, Board of Directors, 1989-1999;
District of Columbia Bar
Secretary, 1975-1976;
Board of Governors, 1976-1979;
National Women's Law Center, Board of Directors, 1981-, Chair, 1981-1996, 2003-;
District of Columbia Judicial Nomination Commission, 2005-2009;
ALI-ABA Continuing Professional Education, Board of Directors, 2005-2009;
President's Working Group on Financial Markets, 1996-1999;
International Organization of Securities Commissions,
Technical Committee, 1996-1999;
Small Agency Heads, 1997-1999;
Center for Law & Social Policy, Board of Trustees, 1977-1996;
Lawyer's Committee for Civil Rights Under Law, Board of Directors, 1993-1996;
Washington Lawyers' Committee for Civil Rights and Urban Affairs,
Board of Directors, 1992-1996;
Historical Society of the District of Columbia Circuit,
Board of Directors, 1990-1996;
Consortium for the National Equal Justice Library,
Board of Directors, 1992-1996;
Southwestern Legal Foundation, Board of Trustees, 1993-1996;
Washington Legal Clinic for the Homeless, Inc.,
Board of Directors, 1993-1996;
Stanford Law School, Board of Visitors, Chair, 1987;
American Judicature Society, Board of Directors, 1984-1988;
Women's Bar Foundation, Board of Directors, 1981-1986;
National Legal Aid and Defenders Association,
Board of Directors, 1972-1979.

Prepared Testimony before the
House Committee on Financial Services
2129 Rayburn House Office Building
by
Commissioner Byron Georgiou,
Financial Crisis Inquiry Commission
February 16, 2011

Chairman Bachus, Ranking Member Frank, members of the Committee, thank you for the invitation to discuss the report and conclusions of the Financial Crisis Inquiry Commission. I am pleased to join my colleagues today.

The Commissionconcluded that the financial and economic crisiswas caused by widespread failures of financial regulation; breakdowns in corporate governance; a volatile mix of excessive borrowing and risk-taking; key policy makers who were ill prepared for the crisis; and systemic breaches in accountability and ethics at many levels. There were many warnings, and the Commission concluded that the crisis could have been avoided.

I will address three key areas we investigated as possible causes of the crisis.These matters include the roles of excess capital availability and liquidity; the government-sponsored entities, Fannie Mae and Freddie Mac; and government housing policies.

First, the Commission agreed that the availability of well-priced capital – both foreign and domestic – is an opportunity for economic expansion and growth if encouraged to flow in productive directions. Excess liquidity, by itself, did not need to cause a crisis. The Commission determined that low interest rates, widely available capital, and international investment were prerequisites for the creation of the credit bubble, creating increased risks that should have been recognized by market participants, policy makers, and regulators. However, with proper safeguards in place, such as prudent lending standards, excess liquidity need not have led to a crisis.

Second, the Commission investigated the role of Fannie Mae and Freddie Mac, using Fannie Mae as its in-depth case study. We concluded they contributed to the crisis, but they were not a primary cause. These government-sponsored enterprises had a deeply flawed business model as publicly traded corporations with the implicit backing of and subsidies from the federal government and with a public mission. Their $5 trillion mortgage exposure and market position were significant.

They used their political power for decades to ward off effective regulation and oversight—spending $164 million on lobbying from 1999 to 2008. As you know, through the third quarter of 2010, the Treasury Department had provided $151 billion in financial support to keep them afloat.

Still, GSE mortgage securities essentially maintained their value throughout the crisis and did not contribute to the significant losses seen at other financial institutions that were central to the financial crisis.The Commission report explains how prices of Fannie Mae mortgage-backed securities actually increased slightly in the 2007-2008 time period, while the prices of private-label mortgage-backed securities dramatically declined.

Their purchases of non-GSE mortgage-backed securities added helium to the housing balloon, but their purchases never represented a majority of the market. The GSEs participated

in the expansion of subprime and other risky mortgages, but they followed rather than led Wall Street and other lenders. In 2005 and 2006, they ramped up their purchase and guarantee of risky mortgages in order to meet stock market analysts' and investors' expectations for growth. The evidence shows that they did so to regain market share, and to ensure generous compensation for executives and employees.

Using a sample of 25 million mortgages, the Commission examined the performance of the loans securitized, purchased or guaranteed by the GSEs and other institutions. Delinquency rates for Fannie and Freddie loans were substantially lower than loans securitized by other financial firms. For example, data compiled by the Commission for a subset of borrowers with similar credit scores—scores below 660—show that by the end of 2008, GSE mortgages were far less likely to be seriously delinquent than were private-label securitized mortgages: 6 percent versus 28 percent.

Third, the Commission studied government housing policies and concluded they did not cause the crisis. Based on the evidence and interviews with dozens of individuals, the report describes how the Department of Housing and Urban Development's affordable housing goals for Fannie Mae and Freddie Mac contributed only marginally to the GSEs' participation in risky mortgages. And we concluded that the Community Reinvestment Act -- enacted in 1977 to expand safe and sound lending to creditworthy borrowers in certain neighborhoods -- was not a significant factor in subprime lending or the crisis.

On the matters of Fannie Mae, Freddie Mac, and the CRA, there was considerable common ground among the Commission's conclusions and the dissentauthored by Commissioners Keith Hennessey, Douglas Holtz-Eakin and Bill Thomas.

Finally, as to the Dodd-Frank law -- I think Chairman Angelides said it best this morning. The law directly addressed concerns about our financial system posed as a result of the financial crisis and its economic aftermath. Our report included in-depth explanations of these issues. The Act's full and effective implementation is important to helping this country avert a future crisis like this one.

Thank you for your interest in the Commission'svaluablereport. I am happy to try to answer any questions you may have.

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The Financial Crisis Inquiry Commission

Douglas Holtz-Eakin
Commissioner, Financial Crisis Inquiry Commission
President, American Action Forum*

February 16, 2011

Introduction

Chairman Bachus, Ranking Member Frank and Members of the Committee, I am pleased to have the opportunity to appear today. In your invitation, you asked that I address three areas:

- The findings of the FCIC's Majority and Minority final reports;
- My assessment of the Dodd-Frank Act in light of these findings; and
- The reasons for the Commission's inability to reach consensus on a single set of findings with regard to the causes of the financial crisis.

I am pleased to have the opportunity to comment on all three aspects of this hearing.

FCIC Findings

No abridged version of the Majority or Minority reports can substitute for a reading of the full documents. In particular, the dissent authored by Vice-Chairman Thomas, Commissioner Hennessey, and myself is concise enough that I encourage Members to read it in its entirety. (See http://americanactionforum.org/sites/default/files/Dissent%20-%20Hennessey%2C%20Holtz-Eakin%20and%20Thomas.pdf.)

Our conclusions differ from those of the majority and the dissent of Commissioner Wallison in three important ways. First, we depart from the other statements' simplistic narratives – either "it's the fault of Wall Street greed" or "it's only about

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* The opinions expressed herein are mine alone and do not represent the position of the American Action Forum. I am grateful to Cameron Smith, Michael Ramlet, and Matt Thoman for assistance.

government housing policy" – in favor of a more precise, if less media-friendly, identification of 10 specific causes of the crisis:

1. A Credit bubble.
2. A Housing bubble.
3. Nontraditional mortgages.
4. Credit ratings and securitization.
5. Financial institutions concentrated correlated risk.
6. Too much leverage and liquidity risk.
7. Risk of contagion.
8. Exposure to a common housing shock.
9. Financial shock and panic.
10. Transmission of financial crisis to an economic downturn.

I would be happy to elaborate on any of these 10 factors.

A second key difference among the findings is our global orientation instead of the U.S.-centric approaches in the other reports. We believe that the bursting of a global credit and housing bubble was the triggering event that started this nation toward its financial crisis. Because those bubbles had a global scope, they belie an exclusive focus on either U.S. housing policy, U.S. monetary policy, or the motivations of U.S. financial sector executives. More generally, we think that to meet the mandate Congress set for the Commission – a full understanding of the causes of the financial and economic crisis – one must think more broadly than evidenced in the other reports.

Similarly, in the United Kingdom the government was forced to bail out Northern Trust in a manner reminiscent of U.S. financial intervention, despite the fact that the Financial Services Authority constituted a wholly different regulatory regime than in the United States. This global episode is important evidence that argues against the notion that it was the U.S. regulatory regime that was at fault. Our report and reasoning is heavily influenced by this kind of reasoning.

Finally, our dissent places the focus more on broad economic forces and financial structures, and less on specific institutions or individuals. Again, we did so because we felt it best met the mandate Congress set for us.

Reasons for Inability to Find Consensus

The failure to reach agreement on a consensus report has garnered an outsized amount of attention. Let me begin by noting that the FCIC was given a mandate of extraordinary scope and a very short timetable. Even had all 10 Commissioners agreed on every issue each and every day, we would have run the risk of not satisfying Congress in our response to its charge. And it is not surprising that there

existed disagreements. After all, experts continue to investigate, argue about, and disagree over the causes of the Great Depression seven decades after it ended.

However, a review of the key differences in the three reports is an insight into the failure to reach consensus. Simply put, we were unable to bridge the differences with our colleagues in their desire for simple narratives; focus on specific institutions, individuals, or policies; and a U.S.-centric approach to the evidence.

Implications for the Dodd-Frank Legislation

Taken at face value, a purpose of the FCIC was to provide a roadmap for the statutory changes needed to address, at least in part, the causes of the financial crisis. And despite the fact that its passage preceded the final reports of the FCIC by several months many have interpreted the Dodd-Frank legislation as the response to the financial crisis. However, there is no neat one-to-one correspondence between the crisis, the FCIC, and the law.

There are areas that have nothing to do with the financial crisis that might merit reforms in financial regulation. For example, only a handful of derivatives (complex mortgage-based securities and credit-default swaps at AIG) were involved in the crisis, leading me to disagree with the notion that "derivatives caused the financial crisis" that pervades the majority reasoning. The vast majority of index futures, oil futures, interest rate swaps, currency futures, and the myriad other financial derivatives had *nothing* to do with the crisis in 2008. Nevertheless, I have agreed with the notion that it would be an improvement to trade some of these instruments through the use of clearinghouses or exchanges. Similarly, the continued failure to merge the Securities and Exchange Commission and the Commodity Futures Trading Commission is a baffling affront to regulatory common sense. The former was done (and, perhaps, overdone) in Dodd-Frank while the latter continues forward. But neither would be a response to the financial crisis.

However, there are a few areas in which consideration of the findings of the FCIC (or at least *my* findings) do shape one's view of Dodd-Frank. To begin, we found that origination of nontraditional mortgages was a contributing cause to the financial crisis. And, as we stress in our report, there were unquestionably bad mortgages made with bad intent by bad people. But other countries had housing bubbles without the same array of sub-prime, alt-A, negative amortization, and other exotic mortgages that have been the focus in the United States. And, despite repeated public comments about the importance of fraud, the FCIC majority was never able to provide a single piece of evidence about its quantitative contribution to mortgage origination.

Accordingly, one has to downgrade claims of a massive regulatory failure regarding mortgage origination, and be skeptical of broader claims regarding the need for different regulation of consumer transactions. For this reason, I do not support the creation of the Consumer Financial Protection Agency included in Dodd-Frank. And

I am surprised that Congress would choose to create such an agency and place it beyond the standard oversight provided by funding through the budget process.

Similarly, our investigation showed no contribution from the repeal of Glass-Steagall to the financial crisis. For this reason, I do not think that rulemaking to impose the so-called Volcker will generate a valuable contribution to the regulatory environment.

Next, our investigation delved at length into the issue of "too-big-to-fail" institutions. One fact that seems to have been largely overlooked is that institutions were deemed too-big-too-fail around the globe and not just in the United States. Thus, for example, even in the United Kingdom, which had both an integrated regulatory body and a mandate for systemic risk regulation, the phenomenon prevailed. Accordingly, I do not believe that the array of features in Dodd-Frank effectively resolves the large amount of moral hazard in the U.S. financial system.

Lastly, one of the strong, if obvious, lessons is that financial markets interact with the real, Main-street economy. The crushing financial crisis of 2008 drove a weak economy into a deep recession. As the macroeconomy struggles to reach a robust recovery, the same lesson should be remembered. The hundreds of new rules that must be promulgated in Dodd-Frank are a lingering uncertainty that cannot be anything but a drag on the financial sector. The scope and haste of the rule-making will inevitably yield rules that would fail a true benefit-cost test. And when combined with the regulatory expansions in the Environmental Protection Agency and under the Patient Protection and Affordable Care Act, the result is a massive regulatory expansion that will burden businesses large and small, harm job creation and slow the recovery from this painful recession.

Conclusion

Thank you for the chance to offer this brief written statement. I would be happy to elaborate in areas that you find interesting and look forward to answering your questions.

Statement of Bill Thomas

Vice-Chairman, Financial Crisis Inquiry Commission

Testimony before the House Committee on Financial Services

February 16, 2011

Chairman Bachus, Ranking Member Frank and members of the Committee, my name is Bill Thomas. I was appointed as Vice-Chairman of the Financial Crisis Inquiry Commission by the Republican leaders of the 111th Congress. Thank you for having me here today to speak about the report of the Financial Crisis Inquiry Commission. You have asked that I address the Commission's findings, to assess the Dodd-Frank Act in light of those findings, and to discuss why the Commission was unable to reach unanimous agreement.

I joined a dissent from the majority's report with Commissioners Keith Hennessey and Douglas Holtz-Eakin. In our dissent, we describe what we believe are the ten essential causes of the financial crisis – that is, the ten causes which were individually necessary and together sufficient to cause the financial and economic crisis that we were tasked to investigate. Our thesis is that the crisis was, at its core, a global financial panic precipitated by concentrated, correlated housing-related losses at large and midsize financial institutions in the United States and Europe.

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THE TEN ESSENTIAL CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS

The following ten causes, global and domestic, are essential to explaining the financial and economic crisis.

I. **Credit bubble.** Starting in the late 1990s, China, other large developing countries, and the big oil-producing nations built up large capital surpluses. They loaned these savings to the United States and Europe, causing interest rates to fall. Credit spreads narrowed, meaning that the cost of borrowing to finance risky investments declined. A credit bubble formed in the United States and Europe, the most notable manifestation of which was increased investment in high-risk mortgages. U.S. monetary policy may have contributed to the credit bubble but did not cause it.

II. **Housing bubble.** Beginning in the late 1990s and accelerating in the 2000s, there was a large and sustained housing bubble in the United States. The bubble was

characterized both by national increases in house prices well above the historical trend and by rapid regional boom-and-bust cycles in California, Nevada, Arizona, and Florida. Many factors contributed to the housing bubble, the bursting of which created enormous losses for homeowners and investors.

III. **Nontraditional mortgages.** Tightening credit spreads, overly optimistic assumptions about U.S. housing prices, and flaws in primary and secondary mortgage markets led to poor origination practices and combined to increase the flow of credit to U.S. housing finance. Fueled by cheap credit, firms like Countrywide, Washington Mutual, Ameriquest, and HSBC Finance originated vast numbers of high-risk, nontraditional mortgages that were in some cases deceptive, in many cases confusing, and often beyond borrowers' ability to repay. At the same time, many homebuyers and homeowners did not live up to their responsibilities to understand the terms of their mortgages and to make prudent financial decisions. These factors further amplified the housing bubble.

IV. **Credit ratings and securitization.** Failures in credit rating and securitization transformed bad mortgages into toxic financial assets. Securitizers lowered the credit quality of the mortgages they securitized. Credit rating agencies erroneously rated mortgage-backed securities and their derivatives as safe investments. Buyers failed to look behind the credit ratings and do their own due diligence. These factors fueled the creation of more bad mortgages.

V. **Financial institutions concentrated correlated risk.** Managers of many large and midsize financial institutions in the United States amassed enormous concentrations of highly correlated housing risk. Some did this knowingly by betting on rising housing prices, while others paid insufficient attention to the potential risk of carrying large amounts of housing risk on their balance sheets. This enabled large but seemingly manageable mortgage losses to precipitate the collapse of large financial institutions.

VI. **Leverage and liquidity risk.** Managers of these financial firms amplified this concentrated housing risk by holding too little capital relative to the risks they were carrying on their balance sheets. Many placed their firms on a hair trigger by relying heavily on short-term financing in repo and commercial paper markets for their day-to-day liquidity. They placed solvency bets (sometimes unknowingly) that their housing investments were solid, and liquidity bets that overnight money would always be available. Both turned out to be bad bets. In several cases, failed solvency bets triggered liquidity crises, causing some of the largest financial firms to fail or nearly fail. Firms were insufficiently transparent about their housing risk, creating uncertainty in markets that made it difficult for some to access additional capital and liquidity when needed.

VII. **Risk of contagion.** The risk of contagion was an essential cause of the crisis. In some cases, the financial system was vulnerable because policymakers were afraid of a large firm's sudden and disorderly failure triggering balance-sheet losses in its

counterparties. These institutions were deemed too big and interconnected to other firms through counterparty credit risk for policymakers to be willing to allow them to fail suddenly.

VIII. **Common shock.** In other cases, unrelated financial institutions failed because of a common shock: they made similar failed bets on housing. Unconnected financial firms failed for the same reason and at roughly the same time because they had the same problem: large housing losses. This common shock meant that the problem was broader than a single failed bank – key large financial institutions were undercapitalized because of this common shock.

IX. **Financial shock and panic.** In quick succession in September 2008, the failures, near-failures, and restructurings of ten firms triggered a global financial panic. Confidence and trust in the financial system began to evaporate as the health of almost every large and midsize financial institution in the United States and Europe was questioned.

X. **Financial crisis causes economic crisis.** The financial shock and panic caused a severe contraction in the real economy. The shock and panic ended in early 2009. Harm to the real economy continues through today.

***

I will highlight three areas where our findings and conclusions differ from those of the six-member majority:

First, our explanation of the crisis begins with a global credit bubble fueled by international capital flows. We do not think that you can understand what happened in the United States without first understanding what was going on in international capital markets. There were a series of credit bubbles occurring at the same time in a variety of asset classes around the world. This fact undermines the thesis that it was something about U.S. capital markets, or the U.S. housing market in particular, that was the primary cause of the bubble. This difference in emphasis is also indicative of a general divergence in approach: we focused more heavily on the role that economic forces played in causing the crisis where the majority focused on individual firms and actors.

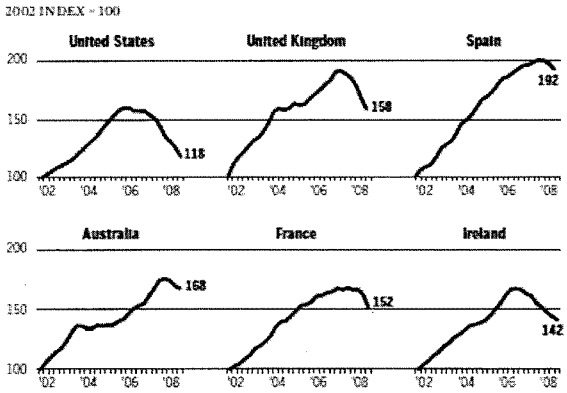
This divergence in approach is highlighted in an important and timely article by Robert J. Samuelson entitled "Rethinking the Great Recession" featured in the Winter 2011 issue

of the *Wilson Quarterly*.[1] Samuelson's main thesis is that "there's a political, journalistic, and intellectual imperative to find out who caused the crisis, who can be blamed, and who can be indicted (either in legal courts or the court of public opinion) and, if found guilty, be jailed or publicly humbled," but "in embracing a victims-and-villains explanation of the recession, Americans are missing important lessons about the future of the U.S. economy."

Second, housing bubbles occurred in a number of large countries with very different systems of housing finance. Some had a lot of subprime mortgages; others did not. Some had mortgages primarily originated by centrally regulated banks; others were dominated by independent mortgage originators. Some had little mortgage securitization; others had much more securitization. No two were quite alike, and none looked anything like ours. Therefore, we had a hard time placing too much emphasis on the structure of our mortgage finance system in explaining the boom and bust, and focused more on factors common to all of these countries, e.g. the broader credit bubble.

House Price Appreciation in Selected Countries, 2002-2008

The United States was one of many countries to experience rapid house price growth



SOURCES: Standard and Poors, Nationwide, Banco de España, AusStats, FNAIM, Permanent TSB

[1] The article has been included as Appendix C. Robert Samuelson (2011) "Rethinking the Great Recession," *The Wilson Quarterly*, Winter. http://www.wilsonquarterly.com/article.cfm?AID=1768.

Third, we observed financial firm failures across a variety of different firm organizational structures in the United States and Europe. For us, this fact supported the conclusion that the organizational form of a financial firm or its specific regulatory regime was secondary in importance to common factors, e.g. concentrated exposure to the housing market and poorly managed solvency and liquidity risk. When we look at the multitude of firm failures – banks, thrifts, investment banks, insurance companies, credit unions, hedge funds, pension funds, the list goes on and on – in the United States and around the world, it casts doubt on the majority's thesis that a particular feature of the American regulatory regime, a specific type of financial institution, or an individual firm and the people that ran it was an essential cause of the crisis. However, when you are looking for victims and villains, rather than essential causes, you can examine the same set of facts and arrive at diametrically different conclusions.

This leads me to the central question of why we were unable to reach unanimous agreement among the Commissioners on the causes of the crisis. I will not deny that there were substantive differences of opinion, but I do not believe that these differences were so large as to make a bipartisan final report impossible. From the beginning, I thought that the Commission was created for political purposes, with a partisan structure and a partisan 22-point agenda. It called for six of us to be appointed by Democrats and four by Republicans, and only six votes were needed to transmit the report to the President and the Congress – the math was simple. Further, we were created for a number of political purposes which depended on what unfolded following the Commission's creation, which made bipartisan agreement next to impossible.

Let's be clear: the Commission was not created by Congress to write a 500-plus page commercially-produced book. The Commission was created to determine why we had a financial and economic crisis. When inordinate hours of staff time are being used to find 'gotcha' documents to support provocative headlines rather than to produce material relevant to Commissioner deliberations; when the proceedings of private Commission meetings are inaccurately leaked again and again in an attempt to embarrass the minority

and create artificial hype for a commercial book; when the minority is forced to vote on potentially illegal motions presented to them just one day prior; when the final findings and conclusions of the majority are first presented to the minority four days before the final vote; and when minority views are then excluded by a 6-4 vote from the report[2] and suppressed in the commercial book[3], in the event presenting the report, and on the Commission's website, it becomes abundantly clear that consensus is not a primary goal.

In our dissent, we conclude: "By focusing too narrowly on U.S. regulatory policy and supervision, ignoring international parallels, emphasizing only arguments for greater regulation, failing to prioritize the causes, and failing to distinguish sufficiently between causes and effects, the majority's report is unbalanced and leads to incorrect conclusions about what caused the crisis." I think we had the money, the time, the staff, and the resources necessary for our work to have been a success. I believe this disappointing result was as much a product of the political motivation in our creation as it was an inability to reach agreement on substantive issues. When you have the votes, what else really matters?

Regarding the Dodd-Frank Act, I do believe that our work has shed light on a number of problems in our financial markets that have not been sufficiently addressed, as well as cases of regulatory overreach where the financial and economic crisis was used as cover to regulate activities that had little to do with the financial crisis

I look forward to your questions.

Thank you.

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[2] In the December 6, 2010 business meeting, the majority decided by 6-4 vote to change the Commission's rules from stating that dissents would be published "in the report" to stating that dissents would be published "along with" the report.

[3] In the December 6, 2010 business meeting, the majority decided by 6-4 vote that "Additional or dissenting views of up to nine typeset pages in length, including charts and footnotes, may be submitted by any Commissioner for publication in the Commission's commercially published report." No limits were placed on the length of the majority's views.

Appendix A:

"What Caused the Financial Crisis"

By Bill Thomas, Keith Hennessey and Douglas Holtz-Eakin

The Wall Street Journal
January 27, 2011

January 27, 2011

What Caused the Financial Crisis?

Congress's inquiry commission is offering a simplistic narrative that could lead to the wrong policy reforms.

By BILL THOMAS, KEITH HENNESSEY AND DOUGLAS HOLTZ-EAKIN

Today, six members of the Financial Crisis Inquiry Commission—created by the last Congress to investigate the causes of the financial crisis—are releasing their final report. Although the three of us served on the commission, we were unable to support the majority's conclusions and have issued a dissenting statement.

In a November 2009 article, Brookings Institution economists Martin Baily and Douglas Elliott describe the three common narratives about the financial crisis. The first argues that the primary cause was government intervention in the housing market. This intervention, principally through Fannie Mae and Freddie Mac, inflated a housing bubble that triggered the crisis. This is the view expressed by one of our co-commissioners in a separate dissent.

The second narrative blames Wall Street and its influence in Washington. According to this narrative, greedy bankers knowingly manipulated the financial system and politicians in Washington to take advantage of homeowners and mortgage investors alike, intentionally jeopardizing the financial system while enjoying huge personal gains. That's the view of the six majority commissioners.

We subscribe to a third narrative—a messier story that emphasizes both global economic forces and failures in U.S. policy and supervision. Though our explanation of the crisis doesn't fit conveniently into the political order of Washington, we believe that it is far superior to the other two.

We recognize that the other two narratives have popular appeal: They each blame a clear entity, and thus outline a clear set of reform proposals. Had the government not supported housing subsidies (the first narrative) or had policy makers implemented more restrictive financial regulations (the second) there would have been no calamity.

Both of these views are incomplete and misleading. The existence of housing bubbles in a number of large countries, each with vastly different systems of housing finance, severely undercuts the thesis that the housing bubble was a phenomenon driven solely by the U.S. government. Likewise, the multitude of financial-firm failures, spanning varied organizational forms and differing regulatory regimes across the U.S. and Europe, makes it implausible that the crisis was the product of a small coterie of Wall Street bankers and their Washington bedfellows.

We believe the crisis was the product of 10 factors. Only when taken together can they offer a sufficient explanation of what happened:

Starting in the late 1990s, there was a broad credit bubble in the U.S. and Europe and a sustained housing bubble in the U.S. (factors 1 and 2). Excess liquidity, combined with rising house prices and an ineffectively regulated primary mortgage market, led to an increase in nontraditional mortgages (factor 3) that were in some cases deceptive, in many cases confusing, and often beyond borrowers' ability to pay.

However, the credit bubble, housing bubble, and the explosion of nontraditional mortgage products are not by themselves responsible for the crisis. Our country has experienced larger bubbles—the dot-com bubble of the 1990s, for example—that were not nearly as devastating as the housing bubble. Losses from the housing downturn were concentrated in highly leveraged financial institutions. Which raises the essential question: Why were these firms so exposed?

Failures in credit-rating and securitization transformed bad mortgages into toxic financial assets (factor 4). Securitizers lowered the credit quality of the mortgages they securitized, credit-rating agencies erroneously rated these securities as safe investments, and buyers failed to look behind the ratings and do their own due diligence. Managers of many large and midsize financial institutions amassed enormous concentrations of highly correlated housing risk (factor 5), and they amplified this risk by holding too little capital relative to the risks and funded these exposures with short-term debt (factor 6). They assumed such funds would always be available. Both turned out to be bad bets.

These risks within highly leveraged, short-funded financial firms with concentrated exposure to a collapsing asset class led to a cascade of firm failures. The losses spread in two ways. Some firms had large counterparty credit risk exposures, and the sudden and disorderly failure of one firm risked triggering losses elsewhere. We call this the risk of contagion (factor 7). In other cases, the problem was a common shock (factor 8). A number of firms had made similar bad bets on housing, and thus unconnected firms failed for the same reason and at roughly the same time.

A rapid succession of 10 firm failures, mergers and restructurings in September 2008 caused a financial shock and panic (factor 9). Confidence and trust in the financial system evaporated, as the health of almost every large and midsize financial institution in the U.S. and Europe was questioned. The financial shock and panic caused a severe contraction in the real economy (factor 10).

We agree with our colleagues that individuals across the financial sector pursued their self-interest first, sometimes to the detriment of borrowers, investors, taxpayers and even their own firms. We also agree that the mountain of government programs supporting the housing market produced distorted investment incentives, and that the government's implicit support of Fannie Mae and Freddie Mac was a ticking time bomb.

But it is dangerous to conclude that the crisis would have been avoided if only we had regulated everything a lot more, had fewer housing subsidies, and had more responsible bankers. Simple narratives like these ignore the global nature of this crisis, and promote a simplistic explanation of a complex problem. Though tempting politically, they will ultimately lead to mistaken policies.

Mr. Thomas is a former Republican congressman from California. Mr. Hennessey served as director of the White House National Economic Council in 2008. Mr. Holtz-Eakin is a former director of the Congressional Budget Office.

Appendix B:

Dissenting Statement of Commissioner Keith Hennessey, Commissioner Douglas Holtz-Eakin and Vice Chairman Bill Thomas

January 27, 2011

Dissenting Statement of

Commissioner

KEITH
HENNESSEY

Commissioner

DOUGLAS
HOLTZ-EAKIN

Vice Chairman

BILL
THOMAS

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CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS

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INTRODUCTION

We have identified ten causes that are essential to explaining the crisis. In this dissenting view:

- We explain how our approach differs from others';
- We briefly describe the stages of the crisis;
- We list the ten essential causes of the crisis; and
- We walk through each cause in a bit more detail.

We find areas of agreement with the majority's conclusions, but unfortunately the areas of disagreement are significant enough that we dissent and present our views in this report.

We wish to compliment the Commission staff for their investigative work. In many ways it helped shape our thinking and conclusions.

Due to a length limitation recently imposed upon us by six members of the Commission,[1] this report focuses only on the causes *essential* to explaining the crisis. We regret that the limitation means that several important topics that deserve a much fuller discussion get only a brief mention here.

HOW OUR APPROACH DIFFERS FROM OTHERS'

During the course of the Commission's hearings and investigations, we heard frequent arguments that there was a single cause of the crisis. For some it was international capital flows or monetary policy; for others, housing policy; and for still others, it was insufficient regulation of an ambiguously defined shadow banking sector, or unregulated over-the-counter derivatives, or the greed of those in the financial sector and the political influence they had in Washington.

In each case, these arguments, when used as single-cause explanations, are too simplistic because they are incomplete. While some of these factors were essential contributors to the crisis, each is insufficient as a standalone explanation.

The majority's approach to explaining the crisis suffers from the opposite problem–it is too broad. Not everything that went wrong during the financial crisis caused the crisis, and while some causes were essential, others had only a minor impact. Not every regulatory change related to housing or the financial system prior to the crisis was a cause. The majority's almost 550-page report is more an account of bad events than a focused explanation of what happened and why. When everything is important, nothing is.

As an example, non-credit derivatives did not in any meaningful way cause or contribute to the financial crisis. Neither the Community Reinvestment Act nor removal of the Glass-Steagall firewall was a significant cause. The crisis can be explained without resorting to these factors.

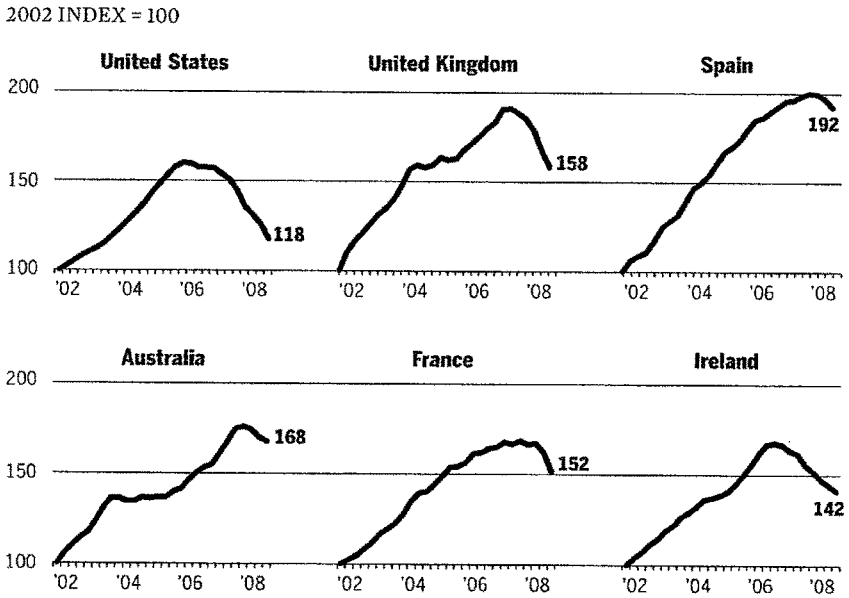
We also reject as too simplistic the hypothesis that too little regulation caused the crisis, as well as its opposite, that too much regulation caused the crisis. We question this metric for determining the effectiveness of regulation. The *amount* of financial regulation should reflect the need to address particular failures in the financial system. For example, high-risk, nontraditional mortgage lending by nonbank lenders flourished in the 2000s and did tremendous damage in an ineffectively regulated environment, contributing to the financial crisis. Poorly designed government housing policies distorted market outcomes and contributed to the creation of unsound mortgages as well. Countrywide's irresponsible lending and AIG's failure were in part attributable to ineffective regulation and supervision, while Fannie Mae and Freddie Mac's failures were the result of policymakers using the power of government to blend public purpose with private gains and then socializing the losses. Both the "too little government" and "too much government" approaches are too broad-brush to explain the crisis.

The majority says the crisis was avoidable if only the United States had adopted across-the-board more restrictive regulations, in conjunction with more aggressive regulators and supervisors. This conclusion by the majority largely ignores the global nature of the crisis. For example:

- A credit bubble appeared in both the United States and Europe. This tells us that our primary explanation for the credit bubble should focus on factors common to both regions.

House Price Appreciation in Selected Countries, 2002-2008

The United States was one of many countries to experience rapid house price growth



SOURCES: Standard and Poors, Nationwide, Banco de España, AusStats, FNAIM, Permanent TSB

- The report largely ignores the credit bubble beyond housing. Credit spreads declined not just for housing, but also for other asset classes like commercial real estate. This tells us to look to the credit bubble as an essential cause of the U.S. housing bubble. It also tells us that problems with U.S. housing policy or markets do not by themselves explain the U.S. housing bubble.
- There were housing bubbles in the United Kingdom, Spain, Australia, France and Ireland, some more pronounced than in the United States. Some nations with housing bubbles relied little on American-style mortgage securitization. A good explanation of the U.S. housing bubble should also take into account its parallels in other nations. This leads us to explanations broader than just U.S. housing policy, regulation, or supervision. It also tells us that while failures in U.S. securitization markets may be an essential cause, we must look for other things that went wrong as well.
- Large financial firms failed in Iceland, Spain, Germany, and the United Kingdom, among others. Not all of these firms bet solely on U.S. housing assets, and

they operated in different regulatory and supervisory regimes than U.S. commercial and investment banks. In many cases these European systems have stricter regulation than the United States, and still they faced financial firm failures similar to those in the United States.

These facts tell us that our explanation for the credit bubble should focus on factors common to both the United States and Europe, that the credit bubble is likely an essential cause of the U.S. housing bubble, and that U.S. housing policy is by itself an insufficient explanation of the crisis. Furthermore, any explanation that relies too heavily on a unique element of the U.S. regulatory or supervisory system is likely to be insufficient to explain why the same thing happened in parts of Europe. This moves inadequate international capital and liquidity standards up our list of causes, and it moves the differences between the regulation of U.S. commercial and investment banks down that list.

Applying these international comparisons directly to the majority's conclusions provokes these questions:

- If the political influence of the financial sector in Washington was an essential cause of the crisis, how does that explain similar financial institution failures in the United Kingdom, Germany, Iceland, Belgium, the Netherlands, France, Spain, Switzerland, Ireland, and Denmark?
- How can the "runaway mortgage securitization train" detailed in the majority's report explain housing bubbles in Spain, Australia, and the United Kingdom, countries with mortgage finance systems vastly different than that in the United States?
- How can the corporate and regulatory structures of investment banks explain the decisions of many U.S. commercial banks, several large American university endowments, and some state public employee pension funds, not to mention a number of large and midsize German banks, to take on too much U.S. housing risk?
- How did former Fed Chairman Alan Greenspan's "deregulatory ideology" also precipitate bank regulatory failures across Europe?

Not all of these factors identified by the majority were irrelevant; they were just not essential.

The Commission's statutory mission is "to examine the causes, domestic and global, of the current financial and economic crisis in the United States." By focusing too narrowly on U.S. regulatory policy and supervision, ignoring international parallels, emphasizing only arguments for greater regulation, failing to prioritize the causes, and failing to distinguish sufficiently between causes and effects, the majority's report is unbalanced and leads to incorrect conclusions about what caused the crisis.

We begin our explanation by briefly describing the stages of the crisis.

STAGES OF THE CRISIS

As of December 2010, the United States is still in an *economic slump* caused by a *financial crisis* that first manifested itself in August 2007 and ended in early 2009. The primary features of that financial crisis were a *financial shock* in September 2008 and a concomitant *financial panic*. The financial shock and panic triggered a severe contraction in lending and hiring beginning in the fourth quarter of 2008.

Some observers describe recent economic history as a recession that began in December 2007 and continued until June 2009, and from which we are only now beginning to recover. While this definition of the recession is technically accurate, it obscures a more important chronology that connects financial market developments with the broader economy. We describe recent U.S. macroeconomic history in five stages:

- A series of foreshocks beginning in August 2007, followed by an economic slowdown and then a mild recession through August 2008, as liquidity problems emerged and three large U.S. financial institutions failed;
- A severe financial shock in September 2008, in which ten large financial institutions failed, nearly failed, or changed their institutional structure; triggering
- A financial panic and the beginning of a large contraction in the real economy in the last few months of 2008; followed by
- The end of the financial shock, panic, and rescue at the beginning of 2009; followed by
- A continued and deepening contraction in the real economy and the beginning of the financial recovery and rebuilding period.

As of December 2010, the United States is still in the last stage. The financial system is still recovering and being restructured, and the U.S. economy struggles to return to sustained strong growth. The remainder of our comments focuses on the financial crisis in the first three stages by examining its ten essential causes.

THE TEN ESSENTIAL CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS

The following ten causes, global and domestic, are essential to explaining the financial and economic crisis.

I. **Credit bubble.** Starting in the late 1990s, China, other large developing countries, and the big oil-producing nations built up large capital surpluses. They loaned these savings to the United States and Europe, causing interest rates to fall. Credit spreads narrowed, meaning that the cost of borrowing to finance risky investments declined. A credit bubble formed in the United States and Europe, the most notable manifestation of which was increased

investment in high-risk mortgages. U.S. monetary policy may have contributed to the credit bubble but did not cause it.

II. **Housing bubble.** Beginning in the late 1990s and accelerating in the 2000s, there was a large and sustained housing bubble in the United States. The bubble was characterized both by national increases in house prices well above the historical trend and by rapid regional boom-and-bust cycles in California, Nevada, Arizona, and Florida. Many factors contributed to the housing bubble, the bursting of which created enormous losses for homeowners and investors.

III. **Nontraditional mortgages.** Tightening credit spreads, overly optimistic assumptions about U.S. housing prices, and flaws in primary and secondary mortgage markets led to poor origination practices and combined to increase the flow of credit to U.S. housing finance. Fueled by cheap credit, firms like Countrywide, Washington Mutual, Ameriquest, and HSBC Finance originated vast numbers of high-risk, nontraditional mortgages that were in some cases deceptive, in many cases confusing, and often beyond borrowers' ability to repay. At the same time, many homebuyers and homeowners did not live up to their responsibilities to understand the terms of their mortgages and to make prudent financial decisions. These factors further amplified the housing bubble.

IV. **Credit ratings and securitization.** Failures in credit rating and securitization transformed bad mortgages into toxic financial assets. Securitizers lowered the credit quality of the mortgages they securitized. Credit rating agencies erroneously rated mortgage-backed securities and their derivatives as safe investments. Buyers failed to look behind the credit ratings and do their own due diligence. These factors fueled the creation of more bad mortgages.

V. **Financial institutions concentrated correlated risk.** Managers of many large and midsize financial institutions in the United States amassed enormous concentrations of highly correlated housing risk. Some did this knowingly by betting on rising housing prices, while others paid insufficient attention to the potential risk of carrying large amounts of housing risk on their balance sheets. This enabled large but seemingly manageable mortgage losses to precipitate the collapse of large financial institutions.

VI. **Leverage and liquidity risk.** Managers of these financial firms amplified this concentrated housing risk by holding too little capital relative to the risks they were carrying on their balance sheets. Many placed their firms on a hair trigger by relying heavily on short-term financing in repo and commercial paper markets for their day-to-day liquidity. They placed solvency bets (sometimes unknowingly) that their housing investments were solid, and liquidity bets that overnight money would always be available. Both turned out to be bad bets. In several cases, failed solvency bets triggered liquidity crises, causing some of the largest financial firms to fail or nearly fail. Firms were insufficiently transparent about their housing risk, creating uncertainty in mar-

kets that made it difficult for some to access additional capital and liquidity when needed.

VII. **Risk of contagion.** The risk of contagion was an essential cause of the crisis. In some cases, the financial system was vulnerable because policymakers were afraid of a large firm's sudden and disorderly failure triggering balance-sheet losses in its counterparties. These institutions were deemed too big and interconnected to other firms through counterparty credit risk for policymakers to be willing to allow them to fail suddenly.

VIII. **Common shock.** In other cases, unrelated financial institutions failed because of a common shock: they made similar failed bets on housing. Unconnected financial firms failed for the same reason and at roughly the same time because they had the same problem: large housing losses. This common shock meant that the problem was broader than a single failed bank–key large financial institutions were undercapitalized because of this common shock.

IX. **Financial shock and panic.** In quick succession in September 2008, the failures, near-failures, and restructurings of ten firms triggered a global financial panic. Confidence and trust in the financial system began to evaporate as the health of almost every large and midsize financial institution in the United States and Europe was questioned.

X. **Financial crisis causes economic crisis.** The financial shock and panic caused a severe contraction in the real economy. The shock and panic ended in early 2009. Harm to the real economy continues through today.

We now describe these ten essential causes of the crisis in more detail.

THE CREDIT BUBBLE: GLOBAL CAPITAL FLOWS, UNDERPRICED RISK, AND FEDERAL RESERVE POLICY

The financial and economic crisis began with a credit bubble in the United States and Europe. Credit spreads narrowed significantly, meaning that the cost of borrowing to finance risky investments declined relative to safe assets such as U.S. Treasury securities. The most notable of these risky investments were high-risk mortgages.

The U.S. housing bubble was the most visible effect of the credit bubble but not the only one. Commercial real estate, high-yield debt, and leveraged loans were all boosted by the surplus of inexpensive credit.

There are three major possible explanations for the credit bubble: global capital flows, the repricing of risk, and monetary policy.

Global capital flows

Starting in the late 1990s, China, other large developing countries, and the big oil-producing nations consumed and invested domestically less than they earned. As

China and other Asian economies grew, their savings grew as well. In addition, boosted by high global oil prices, the largest oil-producing nations built up large capital surpluses and looked to invest in the United States and Europe. Massive amounts of inexpensive capital flowed into the United States, making borrowing inexpensive. Americans used the cheap credit to make riskier investments than in the past. The same dynamic was at work in Europe. Germany saved, and its capital flowed to Ireland, Italy, Spain and Portugal.

Fed Chairman Ben Bernanke describes the strong relationship between financial account surplus growth (the mirror of current account deficit growth) and house price appreciation: "Countries in which current accounts worsened and capital inflows rose . . . had greater house price appreciation [from 2001 to 2006] . . . The relationship is highly significant, both statistically and economically, and about 31 percent of the variability in house price appreciation across countries is explained."[2]

Global imbalances are an essential cause of the crisis and the most important macroeconomic explanation. Steady and large increases in capital inflows into the U.S. and European economies encouraged significant increases in domestic lending, especially in high-risk mortgages.

The repricing of risk

Low-cost capital can but does not necessarily have to lead to an increase in risky investments. Increased capital flows to the United States and Europe cannot alone explain the credit bubble.

We still don't know whether the credit bubble was the result of rational or irrational behavior. Investors may have been rational—their preferences may have changed, making them willing to accept lower returns for high-risk investments. They may have collectively been irrational—they may have adopted a bubble mentality and assumed that, while they were paying a higher price for risky assets, they could resell them later for even more. Or they may have mistakenly assumed that the world had gotten safer and that the risk of bad outcomes (especially in U.S. housing markets) had declined.

For some combination of these reasons, over a period of many years leading up to the crisis, investors grew willing to pay more for risky assets. When the housing bubble burst and the financial shock hit, investors everywhere reassessed what return they would demand for a risky investment, and therefore what price they were willing to pay for a risky asset. Credit spreads for all types of risk around the world increased suddenly and sharply, and the prices of risky assets plummeted. This was most evident in but not limited to the U.S. market for financial assets backed by high-risk, nontraditional mortgages. The credit bubble burst and caused tremendous damage.

Monetary policy

The Federal Reserve significantly affects the availability and price of capital. This leads some to argue that the Fed contributed to the increased demand for risky in-

vestments by keeping interest rates too low for too long. Critics of Fed policy argue that, beginning under Chairman Greenspan and continuing under Chairman Bernanke, the Fed kept rates too low for too long and created a bubble in housing.

Dr. John B. Taylor is a proponent of this argument. He argues that the Fed set interest rates too low in 2002–2006 and that these low rates fueled the housing bubble as measured by housing starts. He suggests that this Fed-created housing bubble was the essential cause of the financial crisis. He further argues that, had federal funds rates instead followed the path recommended by the Taylor Rule (a monetary policy formula for setting the funds rate), the housing boom and subsequent bust would have been much smaller. He also applies this analysis to European economies and concludes that similar forces were at play.

Current Fed Chairman Bernanke and former Fed Chairman Greenspan disagree with Taylor's analysis. Chairman Bernanke argues that the Taylor Rule is a descriptive rule of thumb, but that "simple policy rules" are insufficient for making monetary policy decisions.[3] He further argues that, depending on the construction of the particular Taylor Rule, the monetary policy stance of the Fed may not have diverged significantly from its historical path. Former Chairman Greenspan adds that the connection between short-term interest rates and house prices is weak—that even if the Fed's target for overnight lending between banks was too low, this has little power to explain why rates on thirty-year mortgages were also too low.

This debate intertwines several monetary policy questions:

- How heavily should the Fed weigh a policy rule in its decisions to set interest rates? Should monetary policy be mostly rule-based or mostly discretionary?
- If the Fed thinks an asset bubble is developing, should it use monetary policy to try to pop or prevent it?
- Were interest rates too low in 2002–2006?
- Did too-low federal funds rates cause or contribute to the housing bubble?

This debate is complex and thus far unresolved. Loose monetary policy does not necessarily lead to smaller credit spreads. There are open questions about the link between short-term interest rates and house price appreciation, whether housing starts are the best measure of the housing bubble, the timing of housing price increases relative to the interest rates in 2002–2006, the European comparison, and whether the magnitude of the bubble can be explained by the gap between the Taylor Rule prescription and historic rates. At the same time, many observers argue that Taylor is right that short-term interest rates were too low during this period, and therefore that his argument is at least plausible if not provable.

We conclude that global capital flows and risk repricing caused the credit bubble, and we consider them essential to explaining the crisis. U.S. monetary policy may have been an amplifying factor, but it did not by itself cause the credit bubble, nor was it essential to causing the crisis.

The Commission should have focused more time and energy on exploring these questions about global capital flows, risk repricing, and monetary policy. Instead, the

Commission focused thousands of staff hours on investigation, and not nearly enough on analyzing these critical economic questions. The investigations were in many cases productive and informative, but there should have been more balance between investigation and analysis.

Conclusions:

- The credit bubble was an essential cause of the financial crisis.
- Global capital flows lowered the price of capital in the United States and much of Europe.
- Over time, investors lowered the return they required for risky investments. Their preferences may have changed, they may have adopted an irrational bubble mentality, or they may have mistakenly assumed that the world had become safer. This inflated prices for risky assets.
- U.S. monetary policy may have contributed to the credit bubble but did not cause it.

THE HOUSING BUBBLE

The housing bubble had two components: the actual homes and the mortgages that financed them. We look briefly at each component and its possible causes.

There was a *housing* bubble in the United States—the price of U.S. housing increased by more than could be explained by market developments. This included both a national housing bubble and more concentrated regional bubbles in four "Sand States": California, Nevada, Arizona, and Florida.

Conventional wisdom is that a bubble is hard to spot while you're in one, and painfully obvious after it has burst. Even after the U.S. housing bubble burst, there is no consensus on what caused it.

While we still don't know the relative importance of the possible causes of the housing bubble, we can at least identify some of the most important hypotheses:

- **Population growth.** Arizona, Florida, Nevada, and parts of California all experienced population growth that far exceeded the national average. More people fueled more demand for houses.
- **Land use restrictions.** In some areas, local zoning rules and other land use restrictions, as well as natural barriers to building, made it hard to build new houses to meet increased demand resulting from population growth. When supply is constrained and demand increases, prices go up.
- **Over-optimism.** Even absent market fundamentals driving up prices, shared expectations of future price increases can generate booms. This is the classic explanation of a bubble.
- **Easy financing.** Nontraditional (and higher risk) mortgages made it easier for potential homebuyers to borrow enough to buy more expensive homes. This doesn't mean they could afford those homes or future mortgage payments in

the long run, but only that someone was willing to provide the initial loan. Mortgage originators often had insufficient incentive to encourage borrowers to get sustainable mortgages.

Some combination of the first two factors may apply in parts of the Sand States, but these don't explain the nationwide increase in prices.

The closely related and nationwide *mortgage* bubble was the largest and most significant manifestation of a more generalized credit bubble in the United States and Europe. Mortgage rates were low relative to the risk of losses, and risky borrowers, who in the past would have been turned down, found it possible to obtain a mortgage.[4]

In addition to the credit bubble, the proliferation of nontraditional mortgage products was a key cause of this surge in mortgage lending. Use of these products increased rapidly from the early part of the decade through 2006. There was a steady deterioration in mortgage underwriting standards (enabled by securitizers that lowered the credit quality of the mortgages they would accept, and credit rating agencies that overrated the subsequent securities and derivatives). There was a contemporaneous increase in mortgages that required little to no documentation.

As house prices rose, declining affordability would normally have constrained demand, but lenders and borrowers increasingly relied on nontraditional mortgage products to paper over this affordability issue. These mortgage products included interest-only adjustable rate mortgages (ARMs), pay-option ARMs that gave borrowers flexibility on the size of early monthly payments, and negative amortization products in which the initial payment did not even cover interest costs. These exotic mortgage products would often result in significant reductions in the initial monthly payment compared with even a standard ARM. Not surprisingly, they were the mortgages of choice for many lenders and borrowers focused on minimizing initial monthly payments.

Fed Chairman Bernanke sums up the situation this way: "At some point, both lenders and borrowers became convinced that house prices would only go up. Borrowers chose, and were extended, mortgages that they could not be expected to service in the longer term. They were provided these loans on the expectation that accumulating home equity would soon allow refinancing into more sustainable mortgages. For a time, rising house prices became a self-fulfilling prophecy, but ultimately, further appreciation could not be sustained and house prices collapsed."[5]

This explanation posits a relationship between the surge in housing prices and the surge in mortgage lending. There is not yet a consensus on which was the cause and which the effect. They appear to have been mutually reinforcing.

In understanding the growth of nontraditional mortgages, it is also difficult to determine the relative importance of causal factors, but again we can at least list those that are important:

- Nonbank mortgage lenders like New Century and Ameriquest flourished under ineffective regulatory regimes, especially at the state level. Weak disclosure standards and underwriting rules made it easy for irresponsible lenders to issue

mortgages that would probably never be repaid. Federally regulated bank and thrift lenders, such as Countrywide, Wachovia, and Washington Mutual, had lenient regulatory oversight on mortgage origination as well.

- Mortgage brokers were paid for new originations but did not ultimately bear the losses on poorly performing mortgages. Mortgage brokers therefore had an incentive to ignore negative information about borrowers.
- Many borrowers neither understood the terms of their mortgage nor appreciated the risk that home values could fall significantly, while others borrowed too much and bought bigger houses than they could ever reasonably expect to afford.
- All these factors were supplemented by government policies, many of which had been in effect for decades, that subsidized homeownership but created hidden costs to taxpayers and the economy. Elected officials of both parties pushed housing subsidies too far.

The Commission heard convincing testimony of serious mortgage fraud problems. Excruciating anecdotes showed that mortgage fraud increased substantially during the housing bubble. There is no question that this fraud did tremendous harm. But while that fraud is infuriating and may have been significant in certain areas (like Florida), the Commission was unable to measure the impact of fraud relative to the overall housing bubble.

The explosion of legal but questionable lending is an easier explanation for the creation of so many bad mortgages. Lending standards were lax enough that lenders could remain within the law but still generate huge volumes of bad mortgages. It is likely that the housing bubble and the crisis would have occurred even if there had been no mortgage fraud. We therefore classify mortgage fraud not as an essential cause of the crisis but as a contributing factor and a deplorable effect of the bubble. Even if the number of fraudulent loans was not substantial enough to have a large impact on the bubble, the increase in fraudulent activity should have been a leading indicator of deeper structural problems in the market.

Conclusions:

- Beginning in the late 1990s and accelerating in the 2000s, there was a large and sustained housing bubble in the United States. The bubble was characterized both by national increases in house prices well above the historical trend and by more rapid regional boom-and-bust cycles in California, Nevada, Arizona, and Florida.
- There was also a contemporaneous mortgage bubble, caused primarily by the broader credit bubble.
- The causes of the housing bubble are still poorly understood. Explanations include population growth, land use restrictions, bubble psychology, and easy financing.
- The causes of the mortgage bubble and its relationship to the housing bubble

are also still poorly understood. Important factors include weak disclosure standards and underwriting rules for bank and nonbank mortgage lenders alike, the way in which mortgage brokers were compensated, borrowers who bought too much house and didn't understand or ignored the terms of their mortgages, and elected officials who over years piled on layer upon layer of government housing subsidies.

- Mortgage fraud increased substantially, but the evidence gathered by the Commission does not show that it was quantitatively significant enough to conclude that it was an essential cause.

TURNING BAD MORTGAGES INTO TOXIC FINANCIAL ASSETS

The mortgage securitization process turned mortgages into mortgage-backed securities through the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac, as well as Countrywide and other "private label" competitors. The securitization process allows capital to flow from investors to homebuyers. Without it, mortgage lending would be limited to banks and other portfolio lenders, supported by traditional funding sources such as deposits. Securitization allows homeowners access to enormous amounts of additional funding and thereby makes homeownership more affordable. It also can diversify housing risk among different types of lenders. If everything else is working properly, these are good things. Everything else was not working properly.

Some focus their criticism on the *form* of these financial instruments. For example, financial instruments called collateralized debt obligations (CDOs) were engineered from different bundled payment streams from mortgage-backed securities. Some argue that the conversion of a bundle of simple mortgages to a mortgage-backed security, and then to a collateralized debt obligation, was a problem. They argue that complex financial derivatives caused the crisis. We conclude that the details of this engineering are incidental to understanding the essential causes of the crisis. If the system works properly, reconfiguring streams of mortgage payments has little effect. The total amount of risk in a mortgage is unchanged if the pieces are put together in a different way.

Unfortunately, the system did not work as it should have. There were several flaws in the securitization and collateralization process that made things worse.

- Fannie Mae and Freddie Mac, as well as Countrywide and other private label competitors, all lowered the credit quality standards of the mortgages they securitized.[6] A mortgage-backed security was therefore "worse" during the crisis than in preceding years because the underlying mortgages were generally of poorer quality. This turned a bad mortgage into a worse security.
- Mortgage originators took advantage of these lower credit quality securitization standards and the easy flow of credit to relax the underwriting discipline in the loans they issued. As long as they could resell a mortgage to the secondary market, they didn't care about its quality.

- The increasing complexity of housing-related assets and the many steps between the borrower and final investor increased the importance of credit rating agencies and made independent risk assessment by investors more difficult. In this respect, complexity did contribute to the problem, but the other problems listed here are more important.
- Credit rating agencies assigned overly optimistic ratings to the CDOs built from mortgage-backed securities.[7] By erroneously rating these bundles of mortgage-backed security payments too highly, the credit rating agencies substantially contributed to the creation of toxic financial assets.
- Borrowers, originators, securitizers, rating agencies, and the ultimate buyers of the securities into which the risky mortgages were packaged all failed to exercise prudence and perform due diligence in their respective transactions. In particular, CDO buyers who were, in theory, sophisticated investors relied too heavily on credit ratings.
- Many financial institutions chose to make highly concentrated bets on housing prices. While in some cases they did that with whole loans, they were able to more easily and efficiently do so with CDOs and derivative securities.
- Regulatory capital standards, both domestically and internationally, gave preferential treatment to highly rated debt, further empowering the rating agencies and increasing the desirability of mortgage-backed structured products.
- There is a way that housing bets can be magnified using a form of derivative. A *synthetic CDO* is a security whose payments mimic that of a CDO that contains real mortgages. This is a "side bet" that allows you to assume the same risk as if you held pieces of actual mortgages. To the extent that investors and financial institutions wanted to increase their bets on housing, they were able to use synthetic CDOs. The risks in these synthetic CDOs, however, are zero-sum, since for every investor making a bet that housing performance will fall there must be other investors with equal-sized bets in the opposite direction.

These are related but different problems. While many involve the word "derivative," it is a mistake to bundle them together and say, "Derivatives or CDOs caused the crisis." In each case, we assign responsibility for the failures to the people and institutions rather than to the financial instruments they used.

Conclusions:

Rather than "derivatives and CDOs caused the financial crisis," it is more accurate to say:

- Securitizers lowered credit quality standards;
- Mortgage originators took advantage of this to create junk mortgages;
- Credit rating agencies assigned overly optimistic ratings;
- Securities investors and others failed to perform sufficient due diligence;

- International and domestic regulators encouraged arbitrage toward lower capital standards;
- Some investors used these securities to concentrate rather than diversify risk; and
- Others used synthetic CDOs to amplify their housing bets.

The dangerous imprecision of the term "shadow banking"

Part II of the majority's report begins with an extensive discussion of the failures of the "shadow banking system," which it defines as a "financial institutions and activities that in some respects parallel banking activities but are subject to less regulation than commercial banks." The majority's report suggests that the shadow banking system was a cause of the financial crisis.

"Shadow banking" is a term used to represent a collection of different financial institutions, instruments, and issues within the financial system. Indeed, "shadow banking" can refer to any financial activity that transforms short-term borrowing into long-term lending without a government backstop. This term can therefore include financial instruments and institutions as diverse as:

- The tri-party repo market;
- Structured Investment Vehicles and other off-balance-sheet entities used to increase leverage;
- Fannie Mae and Freddie Mac;
- Credit default swaps; and
- Hedge funds, monoline insurers, commercial paper, money market mutual funds, and investment banks.

As discussed in other parts of this paper, some of these items were important causes of the crisis. No matter what their individual roles in causing or contributing to the crisis, however, they are undoubtedly different. It is a mistake to group these issues and problems together. Each should be considered on its merits, rather than painting a poorly defined swath of the financial sector with a common brush of "too little regulation."

BIG BANK BETS AND WHY BANKS FAILED

The story so far involves significant lost housing wealth and diminished values of securities financing those homes. Yet even larger past wealth losses did not bring the global financial system to its knees. The key differences in this case were leverage and risk concentration. Highly correlated housing risk was concentrated in large and highly leveraged financial institutions in the United States and much of Europe. This leverage magnified the effect of a housing loss on a financial institution's capital reserve, and the concentration meant these losses occurred in parallel.

In effect, many of the largest financial institutions in the world, along with hundreds of smaller ones, bet the survival of their institutions on housing prices. Some did this knowingly; others not.

Many investors made three bad assumptions about U.S. housing prices. They assumed:

- A low probability that housing prices would decline significantly;
- Prices were largely uncorrelated across different regions, so that a local housing bubble bursting in Nevada would not happen at the same time as one bursting in Florida; and
- A relatively low level of *strategic defaults*, in which an underwater homeowner voluntarily defaults on a non-recourse mortgage.

When housing prices declined nationally and quite severely in certain areas, these flawed assumptions, magnified by other problems described in previous steps, created enormous financial losses for firms exposed to housing investments.

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. Each failed firm that the Commission examined failed in part because its leaders poorly managed risk.

Based on testimony from the executives of several of the largest failed firms and the Commission staff's investigative work, we can group common risk management failures into several classes:

- **Concentration of highly correlated (housing) risk.** Firm managers bet massively on one type of asset, counting on high rates of return while comforting themselves that their competitors were doing the same.
- **Insufficient capital.** Some of the failed institutions were levered 35:1 or higher. This meant that every $35 of assets was financed with $1 of equity capital and $34 of debt. This made these firms enormously profitable when things were going well, but incredibly sensitive to even a small loss, as a 3 percent decline in the market value of these assets would leave them technically insolvent. In some cases, this increased leverage was direct and transparent. In other cases, firms used Structured Investment Vehicles, asset-backed commercial paper conduits, and other off-balance-sheet entities to try to have it both ways: further increasing their leverage while appearing not to do so. Highly concentrated, highly correlated risk combined with high leverage makes a fragile financial sector and creates a financial accident waiting to happen. These firms should have had much larger capital cushions and/or mechanisms for contingent capital upon which to draw in a crisis.
- **Overdependence on short-term liquidity from repo and commercial paper markets.** Just as each lacked sufficient capital cushions, in each case the failing firm's liquidity cushion ran out within days. The failed firms appear to have based their liquidity strategies on the flawed assumption that both the firm and

these funding markets would always be healthy and functioning smoothly. By failing to provide sufficiently for disruptions in their short-term financing, management put their firm's survival on a hair trigger.

- **Poor risk management systems.** A number of firms were unable to easily aggregate their housing risks across various business lines. Once the market began to decline, those firms that understood their total exposure were able to effectively sell or hedge their risk before the market turned down too far. Those that didn't were stuck with toxic assets in a disintegrating market.

Solvency failure versus liquidity failure

The Commission heard testimony from the former heads of Bear Stearns, Lehman, Citigroup, and AIG, among others. A common theme pervaded the testimony of these witnesses:

- We were solvent before the liquidity run started.
- Someone (unnamed) spread bad information and started an unjustified liquidity run.
- Had that unjustified liquidity run not happened, given enough time we would have recovered and returned to a position of strength.
- Therefore, the firm failed because we ran out of time, and it's not my fault.

In each case, experts and regulators contested the former CEO's "we were solvent" claim. Technical issues make it difficult to prove otherwise, especially because the answer depends on when solvency is measured. After a few days of selling assets at fire-sale prices during a liquidity run, a highly leveraged firm's balance sheet will look measurably worse. In each case, whether or not the firm was technically solvent, the evidence strongly supports the claim that those pulling back from doing business with the firm were not irrational. In each of the cases we examined, there were huge financial losses that at a minimum placed the firm's solvency in serious doubt.

Interestingly, in each case, the CEO was willing to admit that he had poorly managed his firm's liquidity risk, but unwilling to admit that his firm was insolvent or nearly so. In each case the CEO's claims were highly unpersuasive. These firm managers knew or should have known that they were risking the solvency and therefore the survival of their firms.

Conclusions:

- Managers of many large and midsize financial institutions in the United States and Europe amassed enormous concentrations of highly correlated housing risk on their balance sheets. In doing so they turned a building housing crisis into a subsequent crisis of failing financial institutions. Some did this knowingly; others, unknowingly.
- Managers of the largest financial firms further amplified these big bad bets by

holding too little capital and having insufficiently robust access to liquidity. Many placed their firms on a hair trigger by becoming dependent upon short-term financing from commercial paper and repo markets for their day-to-day funding. They placed failed solvency bets that their housing investments were solid, and failed liquidity bets that overnight money would always be there no matter what. In several cases, failed solvency bets triggered liquidity crises, causing some of the largest financial firms to fail or nearly fail.

"Investment banks caused the crisis"

A persistent debate among members of the Commission was the relative importance of a firm's legal form and regulatory regime in the failures of large financial institutions. For example, Commissioners agreed that investment bank holding companies were too lightly (barely) regulated by the SEC leading up to the crisis and that the Consolidated Supervised Entities program of voluntary regulation of these firms failed. As a result, no regulator could force these firms to strengthen their capital or liquidity buffers. There was agreement among Commissioners that this was a contributing factor to the failure of these firms. The Commission split, however, on whether the *relatively* weaker regulation of investment banks was an essential cause of the crisis.

Institutional structure and differential regulation of various types of financial institutions were less important in causing the crisis than common factors that spanned different firm structures and regulatory regimes. Investment banks failed in the United States, and so did many commercial banks, large and small, despite a stronger regulatory and supervisory regime. Wachovia, for example, was a large insured depository institution supervised by the Fed, OCC, and FDIC. Yet it experienced a liquidity run that led to its near failure and prompted the first-ever invocation of the FDIC's systemic risk exception. Insurance companies failed as well, notably AIG and the monoline bond insurers.

Banks with different structures and operating in vastly differing regulatory regimes failed or had to be rescued in the United Kingdom, Germany, Iceland, Belgium, the Netherlands, France, Spain, Switzerland, Ireland, and Denmark. Some of these nations had far stricter regulatory and supervisory regimes than the United States. The bad loans in the United Kingdom, Ireland, and Spain were financed by federally-regulated lenders–not by "shadow banks."

Rather than attributing the crisis principally to differences in the stringency of regulation of these large financial institutions, it makes more sense to look for common factors:

- Different types of financial firms in the United States and Europe made highly concentrated, highly correlated bets on housing.
- Managers of different types of financial firms in the United States and Europe poorly managed their solvency and liquidity risk.

TWO TYPES OF SYSTEMIC FAILURE

Government policymakers were afraid of large firms' sudden and disorderly failure and chose to intervene as a result. At times, intervention itself contributed to fear and uncertainty about the stability of the financial system. These interventions responded to two types of systemic failure.

Systemic failure type one: contagion

We begin by defining **contagion** and **too big to fail**.

If financial firm X is a large counterparty to other firms, X's sudden and disorderly bankruptcy might weaken the finances of those other firms and cause them to fail. We call this the risk of **contagion**, when, because of a direct financial link between firms, the failure of one causes the failure of another. Financial firm X is **too big to fail** if policymakers fear contagion so much that they are unwilling to allow it to go bankrupt in a sudden and disorderly fashion. Policymakers make this judgment in large part based on how much counterparty risk other firms have to the failing firm, along with a judgment about the likelihood and possible damage of contagion.

Policymakers may also act if they worry about the effects of a failed firm on a particular financial market in which that firm is a large participant.

The determination of too big to fail rests in the minds of the policymakers who must decide whether to "bail out" a failing firm. They may be more likely to act if they are uncertain about the size of counterparty credit risk or about the health of an important financial market, or if broader market or economic conditions make them more risk averse.

This logic can explain the actions of policymakers[8] in several cases in 2008:

- In March, the Fed facilitated JPMorgan's purchase of Bear Stearns by providing a bridge loan and loss protection on a pool of Bear's assets. While policymakers were concerned about the failure of Bear Stearns itself and its direct effects on other firms, their decision to act was heightened by their uncertainty about potential broader market instability and the potential impact of Bear Stearns' sudden failure on the tri-party repo market.
- In September, the Federal Housing Finance Agency (FHFA) put Fannie Mae and Freddie Mac into conservatorship. Policymakers in effect promised that "the line would be drawn between debt and equity," such that equity holders were wiped out but GSE debt would be worth 100 cents on the dollar. They made this decision because banking regulators (and others) treated Fannie and Freddie debt as equivalent to Treasuries. A bank cannot hold all of its assets in debt issued by General Electric or AT&T, but can hold it all in Fannie or Freddie debt. The same is true for many other investors in the United States and around the world–they assumed that GSE debt was perfectly safe and so they weighted it too heavily in their portfolios. Policymakers were convinced that

this counterparty risk faced by many financial institutions meant that any write-down of GSE debt would trigger a chain of failures throughout the financial system. In addition, GSE debt was used as collateral in short-term lending markets, and by extension, their failure would have led to a sudden massive contraction of credit beyond what did occur. Finally, mortgage markets depended so heavily on the GSEs for securitization that policymakers concluded that their sudden failure would effectively halt the creation of new mortgages. All three reasons led policymakers to conclude that Fannie Mae and Freddie Mac were too big to fail.

- In September, the Federal Reserve, with support from Treasury, "bailed out" AIG, preventing it from sudden disorderly failure. They took this action because AIG was a huge seller of credit default swaps to a number of large financial firms, and they were concerned that an AIG default would trigger mandatory write-downs on those firms' balance sheets, forcing counterparties to scramble to replace hedges in a distressed market and potentially triggering a cascade of failures. AIG also had important lines of business in insuring consumer and business activities that would have been threatened by a failure of AIG's financial products division and potentially led to severe shocks to business and consumer confidence. The decision to aid AIG was also influenced by the extremely stressed market conditions resulting from other institutional failures in prior days and weeks.
- In November, the Federal Reserve, FDIC, and Treasury provided assistance to Citigroup. Regulators feared that the failure of Citigroup, one of the nation's largest banks, would both undermine confidence the financial system gained after TARP and potentially lead to the failures of Citi's major counterparties.

Conclusion:

The risk of contagion was an essential cause of the crisis. In some cases the financial system was vulnerable because policymakers were afraid of a large firm's sudden and disorderly failure triggering balance-sheet losses in its counterparties. These institutions were too big and interconnected to other firms, through counterparty credit risk, for policymakers to be willing to allow them to fail suddenly.

Systemic failure type two: a common shock

If contagion is like the flu, then a common shock is like food poisoning. A common factor affects a number of firms in the same way, and they all get sick at the same time. In a common shock, the failure of one firm may inform us about the breadth or depth of the problem, but the failure of one firm does not cause the failure of another.

The common factor in this case was concentrated losses on housing-related assets in large and midsize financial firms in the United States and some in Europe.

These losses wiped out capital throughout the financial sector. Policymakers were not just dealing with a single insolvent firm that might transmit its failure to others. They were dealing with a scenario in which many large, midsize, and small financial institutions took large losses at roughly the same time.

Conclusion:

Some financial institutions failed because of a common shock: they made similar failed bets on housing. Unconnected financial firms were failing for the same reason and at roughly the same time because they had the same problem of large housing losses. This common shock meant the problem was broader than a single failed bank–key large financial institutions were undercapitalized because of this common shock.

We examine two frequently debated topics about the events of September 2008.

"The government should not have bailed out _____"

Some argue that no firm is too big to fail, and that policymakers erred when they "bailed out" Bear Stearns, Fannie and Freddie, AIG, and later Citigroup. In our view, this misses the basic arithmetic of policymaking. Policymakers were presented, for example, with the news that "AIG is about to fail" and counseled that its sudden and disorderly failure *might* trigger a chain reaction. Given the preceding failures of Fannie Mae and Freddie Mac, the Merrill Lynch merger, Lehman's bankruptcy, and the Reserve Primary Fund breaking the buck, market confidence was on a knife's edge. A chain reaction could cause a run on the global financial system. They feared not just a run on a bank, but a generalized panic that might crash the entire system–that is, the risk of an event comparable to the Great Depression.

For a policymaker, the calculus is simple: if you bail out AIG and you're wrong, you will have wasted taxpayer money and provoked public outrage. If you don't bail out AIG and you're wrong, the global financial system collapses. It should be easy to see why policymakers favored action–there was a chance of being wrong either way, and the costs of being wrong without action were far greater than the costs of being wrong with action.

"Bernanke, Geithner, and Paulson should not have chosen to let Lehman fail"

This is probably the most frequently discussed element of the financial crisis. To make this case one must argue:

- Bernanke, Geithner, and Paulson had a legal and viable option available to them other than Lehman filing bankruptcy.
- They knew they had this option, considered it, and rejected it.

- They were wrong to do so.
- They had a reason for choosing to allow Lehman to fail.

We have yet to find someone who can make a plausible case on all four counts. We think that these three policymakers would have saved Lehman if they thought they had a legal and viable option to do so. In hindsight, we also think they were right at the time–they did not have a legal and viable option to save Lehman.

Many prominent public officials and market observers have accused these three of making a mistake. These critics usually argue that these three *should have* saved Lehman. When asked what else they could have done, the critic's usual response is, "I don't know, but surely they could have done *something*. They chose not to and caused the crisis."

Those who want to label Lehman's failure a policy mistake are obliged to suggest an alternate course of action.

The Fed's assistance for Bear Stearns, and FDIC and Treasury's assistance for Wachovia, followed a pattern. In each case, the failing firm or the government found a buyer, and the government subsidized the purchase. In the case of Bear Stearns, the government subsidized the purchase, and in the case of Wachovia, the government made clear that assistance would be available if it were needed. The specific mechanics of the subsidy differed between the two cases, but in each bailout the key condition was the presence of a willing buyer.

Lehman had no willing buyer. Bank of America bought Merrill Lynch instead, and no other American financial institution was willing or able to step up. For months, government officials had tried and failed to facilitate transactions with possible domestic and foreign purchasers. At the end of "Lehman weekend," the most viable candidate was the British bank Barclays. To make the purchase, Barclays needed either a shareholder vote, which would take several weeks to execute, or the permission of their regulator. They could get neither in the time available.

Lehman was therefore facing an imminent liquidity run without a path to success. There was no buyer. There was the possibility that Barclays might be a buyer, some weeks in the future. Bernanke, Geithner, and Paulson were then confronted with the question of whether to provide an effectively uncapped loan to Lehman to supplant its disappearing liquidity while Lehman searched for a buyer.

This loan would have to come from the Fed, since before the enactment of the TARP legislation, Treasury had no authority to provide such financing. The law limits the Fed in these cases. The Fed can only provide *secured* loans. They were able to make this work for Bear Stearns and AIG because there were sufficient unencumbered assets to serve as collateral. Fed officials argue that Lehman had insufficient unpledged assets to secure the loan it would have needed to survive. Former Lehman executives and Fed critics argue otherwise, even though private market participants were unwilling to provide credit.

Was there another option? The Fed leaders would have had to direct the staff to re-evaluate in a more optimistic way the analysis of Lehman's balance sheet to justify a secured loan. They then would have had to decide to provide liquidity support to

Lehman for an indefinite time period while Lehman searched for a buyer. That asset revaluation would later have come under intense legal scrutiny, especially given the likely large and potentially uncapped cost to the taxpayer. In the meantime, other creditors to Lehman could have cashed out at 100 cents on the dollar, leaving taxpayers holding the bag for losses.

Fed Chairman Bernanke, his general counsel Scott Alvarez, and New York Fed general counsel Thomas C. Baxter Jr. all argued in sworn testimony that this option would not have been legal. Bernanke suggested that it also would have been unwise because, in effect, the Fed would have been providing an open-ended commitment to allow Lehman to shop for a buyer. Bernanke testified that such a loan would merely waste taxpayer money for an outcome that was quite unlikely to change.

Based on their actions to deal with other failing financial institutions in 2008, we think these policymakers would have taken any available option they thought was legal and viable. This was an active team that was in all cases erring on the side of intervention to reduce the risk of catastrophic outcomes. Fed Chairman Bernanke said that he "was very, very confident that Lehman's demise was going to be a catastrophe."[9] We find it implausible to conclude that they would have broken pattern on this one case at such an obviously risky moment if they had thought they had another option.

Some find it inconceivable that policymakers could be confronted with a situation in which there was no legal and viable course of action to avoid financial catastrophe. In this case, that is what happened.

THE SHOCK AND THE PANIC

Conventional wisdom is that the failure of Lehman Brothers triggered the financial panic. This is because Lehman's failure was unexpected and because the debate about whether government officials could have saved Lehman is so intense.

The focus on Lehman's failure is too narrow. The events of September 2008 were a chain of one firm failure after another:

- Sunday, September 7, FHFA put Fannie Mae and Freddie Mac into conservatorship.
- This was followed by "Lehman weekend at the New York Fed," which was in fact broader than just Lehman. At the end of that weekend, Bank of America had agreed to buy Merrill Lynch, Lehman was filing for bankruptcy, and AIG was on the verge of failure.
- Monday, September 15, Lehman filed for Chapter 11 bankruptcy protection.
- Tuesday, September 16, the Reserve Primary Fund, a money market mutual fund, "broke the buck" after facing an investor run. Its net asset value declined below $1, meaning that an investment in the fund had actually lost money. This is a critical psychological threshold for a money market fund. On the same day, the Fed approved an $85 billion emergency loan to AIG to prevent it from sudden failure.

- Thursday, September 18, the Bush Administration, supported by Fed Chairman Bernanke, proposed to Congressional leaders that they appropriate funds for a new Troubled Asset Relief Program (TARP) to recapitalize banks.
- Friday, September 19, the $700 billion TARP was publically announced.
- Sunday, September 21, the Fed agreed to accept Goldman Sachs and Morgan Stanley as bank holding companies, putting them under the Fed's regulatory purview. After this, there were no large standalone investment banks remaining in the United States.
- Thursday, September 25, the FDIC was appointed receiver of Washington Mutual and later sold it to JPMorgan.
- Monday, September 29, the TARP bill failed to pass the House of Representatives, and the FDIC agreed to provide assistance to facilitate a sale of Wachovia to Citigroup.
- Wednesday, October 1, the Senate passed a revised TARP bill. Two days later, the House passed it, and the President signed it into law. Wells Fargo, rather than Citigroup, bought Wachovia.
- As the month progressed, interbank lending rates soared, indicating the heightened fear and threatening a complete freeze of lending.

The financial panic was triggered and then amplified by the close succession of these events, and not just by Lehman's failure. Lehman was the most unexpected bad news in that succession, but it's a mistake to attribute the panic entirely to Lehman's failure. There was growing realization by investors that mortgage losses were concentrated in the financial system, but nobody knew precisely where they lay.

Conclusion:

In quick succession in September 2008, the failure, near-failure, or restructuring of ten firms triggered a global financial panic. Confidence and trust in the financial system began to evaporate as the health of almost every large and midsize financial institution in the United States and Europe was questioned.

We briefly discuss two of these failures.

The Reserve Primary Fund

The role of the Reserve Primary Fund's failure in triggering the panic is underappreciated. This money market mutual fund faced escalating redemption requests and had to take losses from its holdings of Lehman debt. On Tuesday, September 16, it broke the buck in a disorganized manner. Investors who withdrew early recouped 100 cents on the dollar, with the remaining investors bearing the losses. This spread fear among investors that other similarly situated funds might follow. By the middle of the following week, prime money market mutual fund investors had withdrawn $349 billion.

When the SEC was unable to reassure market participants that the problem was isolated, money market mutual fund managers, in anticipation of future runs, refused to

renew the commercial paper they were funding and began to convert their holdings to Treasuries and cash. Corporations that had relied on commercial paper markets for short-term financing suddenly had to draw down their backstop lines of credit. No one had expected these corporate lines of credit to be triggered simultaneously, and this "involuntary lending" meant that banks would have to pull back on other activities.

The role of Fannie Mae and Freddie Mac in causing the crisis

The government-sponsored enterprises Fannie Mae and Freddie Mac were elements of the crisis in several ways:

- They were part of the securitization process that lowered mortgage credit quality standards.
- As large financial institutions whose failures risked contagion, they were massive and multidimensional cases of the too big to fail problem. Policymakers were unwilling to let them fail because:
  - Financial institutions around the world bore significant counterparty risk to them through holdings of GSE debt;
  - Certain funding markets depended on the value of their debt; and
  - Ongoing mortgage market operation depended on their continued existence.
- They were by far the most expensive institutional failures to the taxpayer and are an ongoing cost.

There is vigorous debate about how big a role these two firms played in securitization relative to "private label" securitizers. There is also vigorous debate about why these two firms got involved in this problem. We think both questions are less important than the multiple points of contact Fannie Mae and Freddie Mac had with the financial system.

These two firms were guarantors and securitizers, financial institutions holding enormous portfolios of housing-related assets, and the issuers of debt that was treated like government debt by the financial system. Fannie Mae and Freddie Mac did not by themselves cause the crisis, but they contributed significantly in a number of ways.

THE SYSTEM FREEZING

Following the shock and panic, financial intermediation operated with escalating frictions. Some funding markets collapsed entirely. Others experienced a rapid blowout in spreads following the shock and stabilized slowly as the panic subsided and the government stepped in to backstop markets and firms. We highlight three funding markets here:

- **Interbank lending.** Lending dynamics changed quickly in the federal funds market where banks loan excess reserves to one another overnight. Even large

banks were unable to get overnight loans, compounding an increasingly restricted ability to raise short-term funds elsewhere.

- **Repo.** By September 2008, repo rates increased substantially, and haircuts ballooned. Nontraditional mortgages were no longer acceptable collateral.
- **Commercial paper.** The failure of Lehman and the Reserve Primary Fund breaking the buck sparked a run on prime money market mutual funds. Money market mutual funds withdrew from investing in the commercial paper market, leading to a rapid increase in funding costs for financial and nonfinancial firms that relied on commercial paper.

The inability to find funding, financial firm deleveraging, and macroeconomic weakness translated into tighter credit for consumers and businesses. Securitization markets for other kinds of debt collapsed rapidly in 2008 and still have not recovered fully, cutting off a substantial source of financing for credit cards, car loans, student loans, and small business loans.

Decreased credit availability, the collapse of the housing bubble, and additional wealth losses from a declining stock market led to a sharp contraction in consumption and output and an increase in unemployment.

Real GDP contracted at an annual rate of 4.0 percent in the third quarter of 2008, 6.8 percent in the fourth quarter, and 4.9 percent in the first quarter of 2009. The economic contraction in the fourth quarter of 2008 was the worst in nearly three decades. Firms and households that had not previously been directly affected by the financial crisis suddenly pulled back–businesses stopped hiring and halted new investments, while families put spending plans on hold. After the panic began, the rate at which the economy shed jobs jumped, going from an average of 185,000 jobs lost per month in the first three quarters of 2008, to an average of over 700,000 jobs lost per month in the fourth quarter of 2008 and the first quarter of 2009. The economy continued to lose jobs through most of 2009, with the unemployment rate peaking at 10.1 percent in October 2009 and remaining above 9.5 percent for the rest of 2009 and the first eleven months of 2010.

While the shock and panic therefore appear to have ended in early 2009, the harm to the real economy continues through today. Firms and families are still deleveraging and are uncertain about both future economic growth and the direction of future policy. The final tragedy of the financial and economic crisis is that the needed recovery is slow and looks to be so for a while longer.

NOTES

1. A vote of the Commission on December 6, 2010, limited dissenters to nine pages each in the approximately 550-page commercially published book. No limits apply to the official version submitted to the President and the Congress.

2. Ben S. Bernanke, "Monetary Policy and the Housing Bubble," Speech at the Annual Meeting of the American Economic Association, Atlanta, Georgia, January 3, 2010 (www.federalreserve.gov/newsevents/speech/bernanke20100103a.htm).

3. Ibid.

4. "Risky borrowers" does not mean poor. While many risky borrowers were low-income, a borrower with unproven income applying for a no-documentation mortgage for a vacation home was also risky.

5. Bernanke, "Monetary Policy and the Housing Bubble."

6. The Commission vigorously debated the relative importance and the motivations of the different types of securitizers in lowering credit quality. We think that both types of securitizers were in part responsible and that these debates are less important than the existence of lower standards and how this problem fits into the broader context.

7. While bad information created by credit rating agencies was an essential cause of the crisis, it is less clear why they did this. Important hypotheses include: (1) bad analytic models that failed to account for correlated housing price declines across wide geographies, (2) an industry model that encouraged the rating agencies to skew their ratings upward to generate business, and (3) a lack of market competition due to their government-induced oligopoly.

8. In most cases during the crisis, the three key policymakers were Treasury Secretary Henry Paulson, Federal Reserve Chairman Ben Bernanke, and Federal Reserve Bank of New York President Timothy Geithner. Other officials were key in particular cases, such as FHFA Director Jim Lockhart's GSE actions and FDIC Chairman Sheila Bair's extension of temporary loan guarantees to bank borrowing in the fall of 2008. During the financial recovery and rebuilding stage that began in early 2009, the three key policymakers were Treasury Secretary Timothy Geithner, Fed Chairman Ben Bernanke, and White House National Economic Council Director Larry Summers.

9. Ben S. Bernanke, testimony before the FCIC, Hearing on Too Big to Fail: Expectations and Impact of Extraordinary Government Intervention and the Role of Systemic Risk in the Financial Crisis, session 1: The Federal Reserve, September 2, transcript, p. 78.

Appendix C:

"Rethinking the Great Recession"

By Robert J. Samuelson

The Wilson Quarterly
Winter 2011

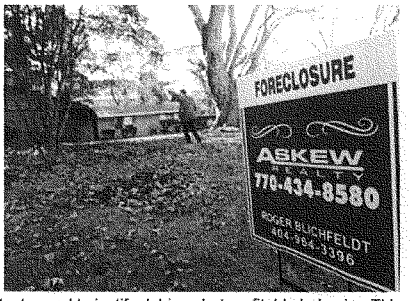
The WILSON QUARTERLY
SURVEYING THE WORLD OF IDEAS
Published by the Woodrow Wilson International Center for Scholars

WINTER 2011

Rethinking the Great Recession

by Robert J. Samuelson

In embracing a victims-and-villains explanation of the recession, Americans are missing important lessons
about the future of the U.S. economy.



We Americans turn every major crisis into a morality tale in which the good guys and the bad guys are identified and praised or vilified accordingly. There's a political, journalistic, and intellectual imperative to find out who caused the crisis, who can be blamed, and who can be indicted (either in legal courts or the court of public opinion) and, if found guilty, be jailed or publicly humbled. The great economic and financial crisis that began in 2007 has been no exception. It has stimulated an outpouring of books, articles, and studies that describe what happened: the making of the housing bubble, the explosion of complex mortgage-backed securities, the ethical and legal shortcuts used to justify dubious but profitable behavior. This extended inquest has produced a long list of possible villains: greedy mortgage brokers and investment bankers, inept government regulators, naive economists, self-serving politicians. What it hasn't done is explain why all this happened.

The story has been all about crime and punishment when it should have been about boom and bust. The boom did not begin with the rise of home prices, as is usually asserted. It began instead with the suppression of double-digit inflation in the early 1980s, an event that unleashed a quarter-century of what seemed to be steady and dependable prosperity. There were only two recessions, both of them short and mild. Unemployment peaked at 7.8 percent. As inflation fell, interest rates followed. The stock market soared. From 1979 to 1999, stock values rose 14-fold. Housing prices climbed, though less spectacularly. Enriched, Americans borrowed and spent more. But what started as a justifiable response to good economic news—lower inflation—slowly evolved into corrupting overconfidence, the catalyst for the reckless borrowing, overspending, financial speculation, and regulatory lapses that caused the bust.

In some ways, the boom-bust story is both more innocent and more disturbing than the standard explanations of blundering and wrongdoing. It does not excuse the financial excesses, policy mistakes, economic miscalculations, deceits, and crimes that contributed to the collapse. But it does provide a broader explanation

and a context. People were conditioned by a quarter-century of good economic times to believe that we had moved into a new era of reliable economic growth. Homeowners, investors, bankers, and economists all suspended disbelief. Their heady assumptions fostered a get-rich-quick climate in which wishful thinking, exploitation, and illegality flourished. People took shortcuts and thought they would get away with them. In this sense, the story is more understandable and innocent than the standard tale of calculated greed and dishonesty.

But the story is also more disturbing in that it batters our faith that modern economics—whether of the Left or Right—can protect us against great instability and insecurity. The financial panic and subsequent Great Recession have demonstrated that the advances in economic management and financial understanding that supposedly protected us from violent business cycles—ruling out another Great Depression—were oversold, exposing us to larger economic reversals than we thought possible. It's true that we've so far avoided another depression, but it was a close call, and the fact that all the standard weapons (low interest rates, huge government budget deficits) have already been deployed leaves open the disquieting question of what would happen if the economic system again lurched violently into reverse. The economic theorems and tools that we thought could forewarn and protect us are more primitive than we imagined. We have not traveled so far from the panic-prone economies of 1857, 1893, and 1907 as we supposed.

Our experience since 2007 has also revealed a huge contradiction at the center of our politics. Prosperity is almost everyone's goal, but too much prosperity enjoyed for too long tends to destroy itself. It seems that periodic recessions and burst bubbles—at least those of modest proportions—serve a social purpose by reminding people of economic and financial hazards and by rewarding prudence. Milder setbacks may avert less frequent but larger and more damaging convulsions—such as the one we're now experiencing—that shake the country's very political and social foundations. But hardly anyone wants to admit this publicly. What politician is going to campaign on the slogan, "More Recessions, Please"?

In a more honest telling of the story, avaricious Wall Street types, fumbling government regulators, and clueless economists become supporting players in a larger tragedy that is not mainly of their making. If you ask who did make it, the most honest answer is: We all did. Put differently, the widely shared quest for ever-improving prosperity contributed to the conditions that led to the financial and economic collapse. Our economic technocrats as well as our politicians and the general public constantly strive for expansions that last longer, unemployment that falls lower, economic growth that increases faster. Americans crave booms, which bring on busts. That is the unspoken contradiction.

Naturally, it's unwelcome and unacknowledged. What we want to hear is that we were victimized and that, once the bad actors and practices are purged, we can resume the pursuit of uninterrupted and greater prosperity. So that's what most crisis postmortems aim to do. They tell us who's to blame and what we must accomplish to resume the quest for ever greater prosperity. Good policies will replace bad. To simplify only slightly, the theories of the crisis break into two camps—one from the Left, one from the Right.

From the Left, the explanation is greed, deregulation, misaligned pay incentives, and a mindless devotion to "free markets" and "efficient markets" theory. The result, it's said, was an orgy of risk taking, unrestrained either by self-imposed prudence or sensible government oversight. Mortgage brokers and others relaxed lending standards for home mortgages because they were not holding them but passing them on to investment bankers, who packaged them in increasingly arcane securities, which were then bought by other investment entities (pension funds, hedge funds, foreign banks). These investors were in turn reassured because the securities had received high ratings from agencies such as Moody's, Standard & Poor's, and Fitch. All along the financial supply chain, people had incentives to minimize or ignore risks because the volume of loans,

securitizations, or ratings determined their compensation. The more they ignored risk, the more they earned. The result was a mountain of bad debt that had to collapse, to the great peril of the entire financial system and the economy.

The Right's critique blames the crisis mainly on government, which, it is alleged, encouraged risk taking in two ways. First, through a series of interventions in financial markets, it seemed to protect large investors against losses. Portfolio managers and lenders were conditioned to expect bailouts. Profits were privatized, it said, and losses socialized. In 1984, government bailed out Continental Illinois National Bank and Trust Company, then the nation's seventh-largest bank. In the early 1990s, the Treasury rescued Mexico, thus protecting private creditors who had invested in short-term Mexican government securities. The protection continued with the bailout of the hedge fund Long-Term Capital Management in 1998. After the tech bubble burst in 2000, the Federal Reserve again rescued investors by lowering interest rates.

The second part of the Right's argument is that government directly inflated the bubble by keeping interest rates too low (the Federal Reserve's key rate fell to one percent in 2003) and subsidizing housing. In particular, Fannie Mae and Freddie Mac—government-created and -subsidized institutions—underwrote large parts of the mortgage market, including subprime mortgages.

We can test these theories of the crisis against the evidence. Note: Each aims to answer the same questions. Why did the system spin out of control? What caused the surge in borrowing by households and financial institutions? What led to the decline in lending standards and, as important, the misreading of risk, even by supposedly sophisticated players and observers?

Let's start with the critique from the Left. The presumption is that with adequate regulation, problems would have been identified and corrected before they reached crisis proportions. Although this analysis seems plausible—and has been embraced by many journalists, economists, and politicians, and by much of the public—it rests on a wobbly factual foundation. For starters, many major players *were* regulated: Multiple agencies, including the Federal Reserve, supervised all the large bank-holding companies, including Citigroup, Bank of America, and Wachovia. Washington Mutual, a large mortgage lender that had to be rescued and was merged into JPMorgan Chase, was regulated by the Office of Thrift Supervision. Fannie and Freddie were regulated. To be sure, gaps existed; many mortgage brokers were on loose leashes. But there was enough oversight that alert regulators should have spotted problems and intervened to stop dubious lending.

The problem was not absent regulation; it was that the regulators were no smarter than the regulated. By and large, they didn't anticipate the troubles that would afflict subprime mortgages or the devastating financial and economic ripple effects. The idea that regulators possess superior wisdom rests mainly on the myth that tough regulation in the 1970s and '80s prevented major financial problems. History says otherwise. In the 1980s, more than 1,800 banks failed, including savings and loan associations. Their problems were not anticipated.

More important, many of the largest U.S. banks almost failed. They had lent billions of dollars to Mexico, Brazil, and other developing countries—loans that could not be repaid. If banks had been forced to recognize these losses immediately, much of the banking system would have been "nationalized," writes William Isaac, who headed the Federal Deposit Insurance Corporation between 1981 and 1985, in his recent book *Senseless Panic.* Losses would have depleted banks' reserves and capital. Instead, regulators temporized. They allowed bad loans to be refinanced until banks' capital increased sufficiently to bear the losses. Still, regulators weren't smart enough to prevent the loans from being made in the first place.

As for greed and dishonesty, their role in the crisis is exaggerated. Of course, greed was widespread on Wall Street and elsewhere. It always is. There was also much mistaken analysis about the worth of mortgages and the complex securities derived from them. But being wrong is not the same as being dishonest, and being greedy is not the same as being criminal. In general, banks and investment banks weren't universally offloading mortgage securities known to be overvalued. Some of this happened; testimony before the Financial Crisis Inquiry Commission shows that some banks knew (or should have known) about the poor quality of mortgages. But many big financial institutions kept huge volumes of these securities. They, too, were duped—or duped themselves. That's why there was a crisis. Merrill Lynch, Bear Stearns, and Wachovia, among others, belonged to this group.

If anything, the Right's critique—Wall Street became incautious because government conditioned it to be incautious—is weaker. It's the textbook "moral hazard" argument: If you protect people against the consequences of their bad behavior, you will incite bad behavior. But this explanation simply doesn't fit the facts. Investors usually weren't shielded from their mistakes, and even when they were, it was not possible to know in advance who would and wouldn't be helped. In 1984, the shareholders of Continental Illinois weren't protected; when the FDIC rescued the bank, it also acquired 80 percent of the company's stock. When the Federal Reserve orchestrated a bailout of Long-Term Capital Management in 1998, most of the original shareholders lost the majority of their stake. After the bursting of the stock market bubble in 2000, most investors weren't spared massive paper losses, even with Alan Greenspan's easy money. From the market's peak in early 2000 to its trough in October 2002, stock values dropped 50 percent, a wealth loss of about $8.5 trillion, according to the investment advisory firm Wilshire Associates.

Likewise, many investors weren't protected in the current crisis. The share prices of most major financial institutions—even those that survived—declined dramatically. The stockholders of Bear Stearns and Lehman Brothers suffered massive losses, and their executives and employees were among the biggest losers. Fannie and Freddie's shareholders met a similar fate. Institutions that were "too big to fail" did fail in a practical sense. It is true that, both before and after the present crisis, some creditors were shielded. Foreign lenders in the Mexican debt crisis of the early 1990s were protected, and most (though not all) lenders to major financial institutions were protected in the present crisis. But to repeat: The protections were not pervasive or predictable enough to inspire the sort of reckless risk taking that actually occurred.

As for interest rates, it is probably true that the very low rates adopted by Greenspan (the one percent rate on overnight loans lasted from June 2003 to June 2004, and even after that, rates remained low for several years) contributed to the speculative climate. Some investors did shift to riskier long-term bonds in an attempt to capture higher interest rates, and the additional demand likely reduced the return on these bonds somewhat. But a bigger effect on long-term rates, including mortgages, seems to have come from massive inflows of foreign money over which the Federal Reserve had no control. Moreover, the fact that housing booms also occurred in England, Spain, and Ireland, among other countries, seems to exonerate the Fed's interest rates policies as the main cause of the housing bubble.

The central question about the crisis that must be answered is, Why was almost everyone fooled? "Almost everyone" includes most economists (starting with Fed chairmen Alan Greenspan and Ben Bernanke), most investors, most traders, most bankers, the rating agencies, most government regulators, most corporate executives, and most ordinary Americans. There were, of course, exceptions or partial exceptions. Warren Buffett warned against the dangers of financial derivatives—but did not anticipate the problem of mortgages. In *The Big Short* (2010), journalist Michael Lewis chronicled the tale of professional investors who were dismissed as oddballs and deviants when they correctly questioned the worth of subprime mortgages. Economist Nouriel

Roubini foresaw the connections between fragile financial markets and the real economy, but his early pessimism was a minority view.

People are conditioned by their experiences. The most obvious explanation of why so many people did not see what was coming is that they'd lived through several decades of good economic times that made them optimistic. Prolonged prosperity seemed to signal that the economic world had become less risky. Of course, there were interruptions to prosperity. Indeed, for much of this period, Americans groused about the economy's shortcomings. Incomes weren't rising fast enough; there was too much inequality; unemployment was a shade too high. These were common complaints. Prosperity didn't seem exceptional. It seemed flawed and imperfect.

That's the point. Beneath the grumbling, people of all walks were coming to take a basic stability and state of well-being for granted. Though business cycles endured, the expectation was that recessions would be infrequent and mild. When large crises loomed, governments—mainly through their central banks, such as the Federal Reserve—seemed capable of preventing calamities. Economists generally concurred that the economy had entered a new era of relative calm. A whole generation of portfolio managers, investors, and financial strategists had profited from decades of exceptional returns on stocks and bonds. But what people didn't realize then—and still don't—is that almost all these favorable trends flowed in one way or another from the suppression of high inflation.

It's hard to recall now, but three decades ago, inflation was the nation's main economic problem. It had risen from negligible levels of about one percent in 1960 to about six percent at the end of the 1960s and to 12 to 14 percent in 1979 and 1980. Hardly anyone believed it could be controlled, although it was a source of deepening havoc, spurring four recessions since 1969, a stagnant stock market, and rising interest rates. And yet, the pessimists were proven wrong. A wrenching recession—deliberately engineered by then–Federal Reserve chairman Paul Volcker and supported by the newly elected Ronald Reagan—smothered inflationary psychology. It did so in a conventionally destructive way. Volcker tightened credit. Banks' prime interest rates, the rates they charged on loans to their best customers, averaged 19 percent in 1981. There were gluts of jobless workers (unemployment reached 10.8 percent in late 1982), underutilized factories, and vacant stores and office buildings. But by 1984, inflation was down to four percent, and by 2000 it had gradually declined to the unthreatening levels of the early 1960s.

When Americans think of this inflation—if they think of it at all—they focus on inflation's rise and ignore the consequences of its fall, disinflation. But these consequences were huge and mostly beneficial. The two recessions that occurred between 1982 and 2007—those of 1990–91 and 2001—each lasted only eight months. Over an entire quarter-century, the economy was in recession for a total of only 16 months, slightly more than a year. By contrast, the four recessions that struck between 1969 to 1982 lasted a total of 49 months, or about four years out of 13. Peak unemployment, 10.8 percent as noted, was much higher than in the following quarter-century, when it topped out at 7.8 percent. Economists called this subdued business cycle "the Great Moderation," and wrote papers and organized conferences to explore it. But the basic explanation seemed evident: High and rising inflation was immensely destabilizing; low and falling inflation was not.

Declining inflation also stoked stock market and housing booms. By the end of 1979, the Standard & Poor's 500 index had barely budged from its 1968 level; by year-end 1999, it had risen by a factor of 14. The rise in housing prices was less steep, though still impressive. In 1980, the median-priced existing home sold for $62,000; by 1999, the median price had climbed to $141,000. Declining interest rates propelled these increases. As inflation subsided—and as Americans realized that its decline was permanent—interest rates followed. From 1981 to 1999, interest rates on 10-year Treasury bonds fell from almost 14 percent to less than six percent. Lower rates boosted stocks, which became more attractive compared with bonds or money market

funds. Greater economic stability helped by making future profits more certain. Lower interest rates increased housing prices by enabling buyers to pay more for homes.

Millions of Americans grew richer. From 1980 to 2000, households' mutual funds and stocks rose in value from $1.1 trillion to $10.9 trillion. The 10-fold increase outpaced that of median income, which roughly doubled during the same period, reaching $42,000. Over the same years, households' real estate wealth jumped from $2.9 trillion to $12.2 trillion. Feeling richer and less vulnerable to recessions, Americans borrowed more (often against their higher home values). This borrowing helped fuel a consumption boom that sustained economic expansion. Disinflation had, it seemed, triggered a virtuous circle of steady economic and wealth growth.

It was not just the real economy of production and jobs that seemed to have become more stable. Financial markets—stocks, bonds, foreign exchange, and securities of all sorts—also seemed calmer. Volatility, a measure of how much prices typically fluctuate, declined in the early 2000s. Sophisticated investors and traders understood this. Studies confirmed it.

Finally, government economic management seemed more skillful. The gravest threats to stability never materialized. In October 1987, the stock market dropped a frightening 20 percent in a single day, but that did not trigger a deep recession. Neither did the 1997–98 Asian financial crisis (when some countries defaulted on loans) or the bursting of the tech bubble in 2000. In each case, the Federal Reserve seemed to check the worst consequences. Faith in the Fed grew; Greenspan was dubbed the "maestro."

Well, if the real economy and financial markets were more stable and the government more adept, then once risky private behaviors would be perceived as less hazardous. People could assume larger debts, because their job and repayment prospects were better and their personal wealth was steadily increasing. Lenders could liberalize credit standards, because borrowers were more reliable. Investors could adopt riskier strategies, because markets were less frenetic. In particular, they could add "leverage"—i.e., borrow more—which, on any given trade, might enhance profits.

So, paradoxically, the reduction of risk prompted Americans to take on more risk. From 1995 to 2007, household debt grew from 92 percent to 138 percent of disposable income. Bear Stearns, Lehman Brothers, and other financial institutions became heavily dependent on short-term loans that underpinned leverage ratios of 30 to 1 or more. (In effect, firms had $30 of loans for every $1 of shareholder capital.) Economists and government regulators became complacent and permissive. Optimism became self-fulfilling and self-reinforcing. Americans didn't think they were behaving foolishly because so many people were doing the same thing. This—not deregulation or investor "moral hazard"—was the foundry in which the crisis was forged.

What now seems unwise could be rationalized then. Although households borrowed more, their wealth expanded so rapidly that their net worth—the difference between what they owned and what they owed—increased. Their financial positions looked stronger. From 1982 to 2004, households' net worth jumped from $11 trillion to $53 trillion. Ascending home prices justified easier credit standards, because if (heaven forbid) borrowers defaulted, loans could be recouped from higher home values. Because the rating agencies adopted similarly favorable price assumptions, their models concluded that the risks of mortgage-backed securities were low. No less a figure than Greenspan himself dismissed the possibility of a nationwide housing collapse. People who sold a house usually had to buy another. They had to live somewhere. That process would sustain demand. "While local economies may experience significant speculative price imbalances," he said in 2004, "a national severe price distortion seems most unlikely."

As time passed, the whole system became more fragile and vulnerable. If the complex mortgage securities held by banks and others began to default—as they did—then the short-term loans that were used to finance the purchase of these securities would be curtailed or withdrawn, threatening the banks' survival. Because no one knew precisely which banks held which securities (and, therefore, which banks were weakest), this process—once started—could cause a panic within the financial system. Banks, hedge funds, pensions, and corporations would retreat from trading and lending for fear that they might not be repaid. As banks and companies hoarded cash, production and jobs would decrease. Basically, that's what happened. The initial reaction to disinflation, reflecting its real benefits, had disintegrated into overborrowing, speculation, and self-deception.

It's worth noting that this explanation of the present crisis is neither widely held nor original. It vindicates Charles Kindleberger, the late economic historian who argued in his 1978 book *Manias, Panics, and Crashes* that financial crises occur in three stages. First comes "displacement": a favorable development such as new technology, the end of a war, or a change in government that improves the economic outlook. Next is "euphoria": the process by which a proportionate response to the original development becomes an artificial "bubble." The last stage is "revulsion": the recognition of excesses, which leads to panic and a collapse of speculative prices.

Beginning in the 1980s, the U.S. economy followed exactly this pattern. The decline of double-digit inflation was the original "displacement." The ensuing prolonged prosperity spawned "euphoria," which culminated in the "revulsion" and panic of 2008. But Kindleberger's views—which built on those of the economist Hyman Minsky—have never commanded center stage among academic economists. Though widely read and respected, Kindleberger was always something of a renegade. He expressed skepticism and even contempt for the mathematical models and theoretical constructs that have defined mainstream macroeconomics for decades, while paying great attention to historical conditions and events.

If this explanation of the crisis is correct, it raises momentous questions. Since World War II, American democracy has been largely premised on its ability to create ever greater economic benefits—higher living standards, more social protections, greater job and income security—for most of its citizens. The promise has largely succeeded and, in turn, rests heavily on the belief, shared unconsciously by leaders in both parties, that we retain basic control over the economy. Until recently, the consensus among economists was that another Great Depression was unthinkable. We could prevent it. As for recessions, we might not be able to eliminate them entirely, but we could regulate them and minimize the damage. Economic knowledge and management had progressed. These comforting assumptions now hang in doubt.

The great delusion of the boom was that we mistook the one-time benefits of disinflation for a permanent advance in the art of economic stabilization. We did so because it fulfilled our political wish. Ironically, the impulse to improve economic performance degraded economic performance. This happened once before, in the 1960s and '70s, when academic economists—among them Walter Heller of the University of Minnesota, James Tobin of Yale, and Robert Solow of MIT—sold political leaders on an ambitious agenda. Despite widespread post–World War II prosperity, there had been recessions every three or four years. Invoking John Maynard Keynes, the economists said they could—by manipulating budget deficits and interest rates—smooth business cycles and maintain "full employment" (then defined as four percent unemployment) most of the time. They couldn't, and the effort to do so created the inflation that crippled the economy for 15 years.

We still haven't forsaken the hope for perfected prosperity. After the recent crisis, both liberals and conservatives offered therapeutic visions. Liberals promoted expanded regulation to curb Wall Street's excesses. Conservatives wanted a less activist government that would let markets perform their disciplining

functions. Both may achieve some goals. Liberals have already engineered greater regulation. Banks will be required to hold more capital as a cushion against losses. The new financial reform legislation would allow government to shut large failing financial institutions, such as Lehman Brothers, without resorting to disruptive bankruptcy. Conservatives may take solace from fewer bailouts. They are so unpopular that investors must know that the chances of getting one have diminished. Together, these changes may make the financial system safer.

The trouble is that, like generals fighting the last war, we may be fighting the last economic crisis. Future threats to stability may originate elsewhere. One danger spot is globalization. Economies are intertwined in ways that are only crudely understood. Supply chains are global. Vast sums of money routinely cross borders and shift among currencies. Countries are mutually dependent and mutually vulnerable through many channels: Supplies of oil and other essential raw materials may be curtailed; cyberattacks could cripple vital computer networks; manipulated exchange rates might disrupt trade and investment flows. Economic activity has grown more international, while decision making remains largely with nation-states. Although the global economy has remained basically stable since World War II, there is really no good theory as to why it should stay so—and there are some signs (currency tensions, for instance) that it may not.

Overcommitted welfare states pose another threat. Most affluent nations face similar problems: High budget deficits and government debts may portend a loss of investor confidence, but the deficits and debts have been driven higher by massive social spending—on pensions, health care, unemployment insurance, education—that people have come to expect. Economics and politics are colliding. If the debt and deficits aren't controlled, will investors someday desert bond markets, jolting interest rates upward and triggering a new financial crisis? But if many countries try to control deficits simultaneously, might a tidal wave of spending cuts and tax increases cause a global depression? (The United States, Europe, and Japan still constitute about half the world's economy.) These are all good questions without good answers. The underlying problem is that economic change seems to have outrun economic understanding and control.

It's widely believed that the financial panic and Great Recession constitute a watershed for global capitalism, which has been (it's said) permanently discredited. Around the world, the political pendulum is swinging from unfettered competition toward more government oversight. Markets have been deemed incorrigibly erratic. Greed must be contained, and the greedy must be taxed. These ideas reflect a real shift in thinking, but in time that may not be seen as the main consequence of the economic collapse. These ideas imply that capitalism was unsupervised and untaxed before. Of course, this is not true. Businesses everywhere, big and small, were and are regulated and taxed. Future changes are likely to be those of degree, in part because countervailing forces, mobile capital being the most obvious, will impose limits. Countries that oppressively regulate or tax are likely to see businesses go elsewhere.

What looms as the most significant legacy of the crisis is a loss of economic control. Keynes famously remarked that "practical men" are "usually the slaves of some defunct economist." By this he meant that politics and public opinion are often governed by what economists (living and dead, actually) define as desirable and doable. In the years after World War II, the prevailing assumption among economists, embraced by much of the public, was that we had conquered the classic problem of booms and busts. Grave economic crises afflicted only developing countries or developed countries that had grossly mismanaged their affairs. This common view is no longer tenable. It has been refuted by events.

Our economic knowledge and tools came up short. Either they were overwhelmed by change or their power was always exaggerated. This does not mean that economic growth will cease. Chances are that the United States and the other prosperous nations of the developed world will, over time, get wealthier as a result of

technological changes that are now barely glimpsed. But the widespread faith—and the sense of security it imparted—that economic management would forever spare us devastating disruptions has been shattered. Just as there has never been a war to end all wars, there has yet to be an economic theory that can end all serious instability.

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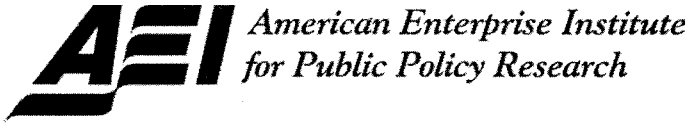

Statement before the Housing Financial Services Committee
On The Financial Crisis Inquiry Commission

The Financial Crisis Inquiry Commission

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February 16, 2011

The views expressed in this testimony are those of the author alone and do not necessarily represent those of the American Enterprise Institute.

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

[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)

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[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.

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Representative Emanuel Cleaver
Financial Services Committee Hearing
February 16, 2011
Financial Crisis Inquiry Commission Report

TO: Phil Angelides

1. Nine of ten commissioners concluded that the Community Reinvestment Act was not a cause of the financial crisis, is that correct? On what basis did you reach that conclusion?

2. The body of the report (in chapter 9) clearly show that the affordable housing goals prescribed for Fannie and Freddie were not the primary driver of their problems whereas the desire for market share and profit were. Is that your conclusion?

3. Having knocked down two possible causes (CRA and the GSE affordable housing goals), is it your conclusion that predatory lending caused the housing bubble? What were the major factors that caused the housing bubble?

4. Are bubbles inevitable in a free enterprise system?

5. Who should have been doing better due diligence on the mortgages and mortgage backed securities? [the securitizers, the rating agencies, the risk management departments of the loan originators?] If they all fell down on the job, then who should be held legally responsible?

Responses to Questions from Representative Emanuel Cleaver
House Committee on Financial Services Hearing of February 16, 2011
Re: Financial Crisis Inquiry Report

1) The conclusions of the report, which were approved by six members of the Commission, state, "The Commission concludes the CRA was not a significant factor in subprime lending or the crisis." In addition, the dissenting statement submitted by Mr. Thomas, Mr. Holtz-Eakin, and Mr. Hennessey states that " Neither the Community Reinvestment Act nor removal of the Glass Steagall firewall was a significant cause."

The report's conclusions were based on the research and investigation undertaken by the Commission during the course of our inquiry. For example, many subprime lenders were not subject to the CRA. As another example, research indicates that only 6% of high cost loans – a proxy for subprime loans – had any connection to the law. Loans made by CRA regulated lenders in the neighborhoods in which they were required to lend were half as likely to default as similar loans made in the same neighborhoods by independent mortgage originators not subject to the law.

2) The report concluded that Fannie Mae and Freddie Mac relaxed their underwriting standards to purchase and guarantee riskier mortgage loans and related securities in order to meet stock market analysts' and investors' expectations for growth, to regain market share, and to ensure generous compensation for their executives and employees. Based on the evidence collected in our investigation, including interviews with dozens of individuals involved in or familiar with the Department of Housing and Urban Development's affordable housing goals for the GSEs, the report concluded that these goals only contributed marginally to the GSEs' participation in risky mortgages.

3) The Commission concluded that a number of factors contributed to the housing bubble. Among the conclusions were the following:

- Unsustainable, toxic loans polluted the financial system and fueled the housing bubble;
- The Federal Reserve's policies and pronouncements encouraged rather than inhibited the growth of mortgage debt and the housing bubble; and
- Certain financial instruments - including collateralized debt obligations (CDOs), CDOs squared, credit default swaps, synthetic CDOs, and asset backed commercial paper programs that invested in mortgage backed securities – fueled demand for nonprime mortgage securitization and contributed to the housing bubble.

The Commission concluded that the monetary policy of the Federal Reserve, along with capital flows from abroad, created conditions in which a housing bubble could develop. Those conditions created increased risks, which should have been recognized by market participants, policy makers, and regulators. However, these conditions need not have led to a crisis. The Federal Reserve and other regulators did not take the actions necessary to constrain the bubble. As irresponsible lending, including predatory and fraudulent practices, became more prevalent, the Federal Reserve neglected its mission "to ensure the safety and soundness of the nation's banking and financial system and to protect the credit rights of consumers." It failed to stem the flow of toxic mortgages, which it could have done by setting prudent mortgage lending standards. And the Office of the Comptroller of the Currency and the Office of Thrift Supervision, caught up in turf wars, preempted state regulators from reining in abuses.

4) As we noted at the very front of our conclusions, the profound events of 2007 were neither bumps in the road nor an accentuated dip in the financial and business cycles we have come to expect in a free market economic system. This crisis was a fundamental disruption – a financial upheaval if you will – in which millions of Americans lost their jobs, their homes, and their life savings. This was an avoidable, not an inevitable, crisis. While the business cycle cannot be repealed, a crisis of this magnitude need not have occurred.

5) Our report describes in detail the significant failures of loan originators, credit rating agencies, and securitizers to undertake adequate due diligence on mortgage loans that were made to borrowers and were packaged and sold to investors. The record of our examination includes evidence of serious mortgage fraud and financial institutions that made, bought, and sold mortgage securities they never examined, did not care to examine, or knew to be defective. Our report also concludes that the financial crisis could not have happened without the actions of the rating agencies.

It is the responsibility of the appropriate authorities to examine the facts of our report and other available information to determine legal responsibility and to vigorously pursue legal action if laws have been violated.

Douglas Holtz-Eakin
March 17, 2011

Question:

Can you tell me what were the areas of agreement and disagreement between the majority and the dissent?

Answer:

One way to characterize the majority report is that it mentions essentially everything as a contributing cause of the financial crisis. In this sense, there is a lot of agreement between the two reports. However, there are significant disagreements in two ways. First, our dissent undertook to specifically list 10 factors that we believe were essential to the crisis; i.e., had any one of those not been present the crisis would not have unfolded as it did. The majority report did not provide such disciplined answer.

Second, we specifically could not agree with the majority report in the areas of:

- Its U.S.-centric view of the crisis; our reading of the evidence placed an important weight on global factors and evidence;
- The role of supervision of financial institutions, as the majority elevated this above where we believe it merits placement;
- The role of derivatives, as the majority vastly overstates their scope and importance;
- The role of the repeal of Glass-Steagall, which had nothing to do with the crisis; and
- The degree to which the crisis could be foreseen and thus avoided.

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