Chapter 1

Overleveraged, from Main Street to Wall Street

I have great, great confidence in our capital markets and in our financial institutions. Our financial institutions, banks and investment banks, are strong.

—Treasury Secretary Henry Paulson
March 16, 2008
CNN

but just six months later:

The financial security of all Americans . . . depends on our ability to restore our financial institutions to a sound footing.

—Treasury Secretary Henry Paulson
September 19, 2008
Press release

and after another two months:

We are going through a financial crisis more severe and unpredictable than any in our lifetimes.

—Treasury Secretary Henry Paulson
November 17, 2008
"Fighting the Financial Crisis, One Challenge at a Time"
The New York Times

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For generations, the home mortgage market has efficiently and successfully extended credit to more and more families, enabling millions of Americans to own their own homes. Indeed, the homeownership rate reached a record high of 69.2 percent in the second quarter of 2004. The growth of subprime mortgages that contributed to this record, moreover, meant that many families or individuals deemed to be less creditworthy were provided with greater opportunities to purchase homes.

But, unfortunately, a system borne of good intentions veered horribly off track, derailed by several factors, including poor risk-management practices, too many assets funded with too little homeowner-contributed equity capital, and lax regulatory oversight.

In the past, the vast majority of mortgages were more carefully vetted by well-capitalized neighborhood savings and loans, institutions that held and serviced these loans throughout their lifetimes. In recent years, however, the mortgage industry increasingly moved toward securitization (that is, packaging mortgages into securities and selling them in the secondary market).

This sweeping change in the marketplace was a positive innovation that provided the mortgage industry with greater liquidity, helping make new loans accessible to more Americans, at different levels of income, than ever before. This structure worked fairly well (with a few notable exceptions), producing a reasonable widening of consumers' access to credit. But by 2004, it was becoming ever more apparent credit was expanding too rapidly, and too many market participants at every level were taking on dangerous levels of leverage. What began as healthy growth in mortgage originations and housing starts swiftly became a home price bubble.

Ironically, it was the demise of *another* bubble that set the stage for the initial run-up in real estate. In the late 1990s, Internet stocks were sizzling; investors poured millions into start-ups that had never turned a dime of profit. When the dot-coms cratered in 2000 and 2001, they sent the broader stock markets tumbling. This crash, combined with the effects of the 9/11 terrorist attacks, sent the United States into a mild recession. To stimulate the economy and prevent deflation, the Federal Reserve slashed interest rates to historic lows—and suddenly, to borrowers and lenders alike, home mortgages looked too tempting to pass up. Having just been burned by one bubble, the nation wasted no time creating another in its wake.

Real estate was a real, tangible asset, and it seemed to be a safe haven in comparison to those high-flying, hard-crashing technology stocks. Unlike the dot-com boom, the housing expansion drew in millions of middle-class and lower-income families. There had been previous boom-and-bust cycles in real estate, of course, but caution was cast aside in the rush to get in on a "sure bet" with rapidly rising home prices—and nothing had ever before rivaled the recent housing market in terms of sheer scale and reach.

At the height of the boom, home prices were rising at a torrid pace in overheated markets like Southern California. Backyard barbecues were filled with talk of instant housing wealth, and anyone sitting out the party in a rental unit was regarded with bemused pity. Inland from Los Angeles, McMansions were sprouting in the desert, as developers raced to keep up with demand.

Today many of those same Southern California communities are dotted with abandoned properties and foreclosure signs. Countless families no doubt thought they had landed a piece of the American dream, only to see it slip through their fingers just a few years later.

California was by no means the only place where many dreams went sour. Variations on these stories played out from coast to coast. Unable to resist the many tempting deals being offered and lured in by the popular wisdom of the moment, home buyers rushed in, convinced that investing in real estate was the chance of a lifetime. Cable TV introduced average Americans to the concept of flipping houses for profit and encouraged them to tap their newfound equity for pricey renovations.

As home values escalated, many borrowers were unable to obtain loans on the basis of traditional standards. Mortgage brokers and lenders were able to keep churning out seemingly profitable mortgages in such an environment by casting their nets even wider, and borrowers were eager to accommodate them. Soon many loans were being written on such loose terms that they were clearly unsustainable unless home prices continued rising. Real estate agents and those originating mortgages who felt they had next to nothing to lose if things went bad allowed buyers with shaky credit histories and modest incomes to dive in. In the reach for yield, many financial institutions made loans to such home

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buyers, either holding on to them or packaging the loans for sale to investors. With the upside gain seeming limitless, it was hardly surprising that many were eager to participate, with the regulatory authorities taking no early and strong steps to slow things down to a more normal pace.

A host of new loan products offered buyers the chance to own a home with no money down or with temporarily low introductory payments. These products can have perfectly legitimate uses in the right circumstances but can prove dangerous in the wrong hands. All lenders and borrowers needed to know was that if prices kept rising, everyone would be happy. There would be plenty of time to refinance later, and in the process borrowers would be improving their credit records.

When home prices did come plunging back to earth, the outcome was much the same across the nation: too many homeowners found themselves in way over their heads, and too many home builders found themselves with an excess inventory of unsold homes. But this is not solely a tale of home buyers who overreached and home builders who overbuilt. The damage quickly grew and spread far beyond the scope of the actual mortgage defaults and foreclosures.

Not only did financial institutions suffer losses on mortgages they held, but so too did investors who bought mortgage-backed securities in the secondary market. These investments in essence themselves became a giant bubble, resting on the wobbly foundation of risky loans. Investors from around the world were clamoring for a piece of the action and got it with mortgage-backed securities—and even new securities *backed* by mortgage-backed securities. After all, ratings agencies essentially blessed by the regulatory authorities handed out AAA ratings on many of these investment vehicles. Some observers have tied this situation to the fact that these agencies were paid by the very parties who issued the securities.

In addition to the vast market for mortgage-backed securities, billions of dollars were soon at stake because insurance was available to cover losses on any defaults; coverage came in the form of newer derivatives known as credit default swaps that were issued on these securities. Some firms were even trading large amounts of these swaps on debt in which they had no ownership stake at all. Because these swaps were traded over the counter and not on a central exchange with member-contributed capital available to cover losses, concern grew regarding the ability of counterparties to fulfill their contractual agreements, heightening investors' sense of unease.

What initially appeared to be nothing more than a routine retrenchment in home prices soon morphed into a many-headed hydra. Throughout 2008, increasing losses and write-downs were announced by various financial firms (worldwide losses had reached $685 billion through October 31, 2008). Some venerable names were ultimately acquired or outright failed due to the enormity of their losses.

From Main Street to Wall Street, one common thread runs through all facets of this story: leverage. Homeowners and major financial firms alike had taken on too much risk and too much debt in their quest for gains. Whenever leverage is excessive, or too many assets are supported with too little owner-contributed equity capital, a decline in the value of the assets can leave the owner of those assets without the capital to cover losses. In short, an excessively leveraged nation is nothing more than a bubble nation.

As of this writing, the U.S. economy is engaged in a massive wave of deleveraging, a scramble to reduce debt and sell assets as well as an attempt to obtain new capital from any willing source, including the government. Unfortunately, this process has caused a major credit crunch and sent asset prices further downward. Even solid companies with no connection to the real estate and finance sectors have been affected as credit markets seized up. In the process, a rush to liquidity has created severe difficulties for individuals, small businesses, large corporations, and even state and local governments as they try to obtain short-term funding simply to meet payrolls and cover ongoing operating expenses.

In many cases, the government has now become the buyer of last, if not first, resort, intervening in the market in ways not seen since the New Deal. (See Appendix Figure A.1 and Table A.1 for a historical overview of the government's role in the banking sector.) To contain the damage, the government invoked some existing but seldom-used powers and created others out of whole cloth. As the financial sector continued to lurch from crisis to crisis in 2008, the government's response has been marked by an improvisational quality that has failed to restore confidence in the financial system.

The first truly startling intervention came about in March 2008, when the Federal Reserve provided a $29 billion loan to help JPMorgan Chase acquire Bear Stearns in the wake of that firm's sudden collapse. But months later, the Fed refused to bail Lehman Brothers out of similar straits, and the firm was forced to file for bankruptcy in September 2008. Just two days later came another flip-flop, when the Federal Reserve extended an $85 billion loan to the faltering insurance giant American International Group (AIG) in exchange for equity warrants that would give it a 79 percent ownership stake. A month later, the Fed agreed to extend AIG another lifeline of up to $37.8 billion in cash collateral in exchange for investment-grade, fixed-income securities. Then again in the following two months, it was announced that AIG was getting another $20.9 billion loan from the Fed and $40 billion in capital from Treasury.

The government has also attempted to shore up mortgages directly. In July 2008, the Housing and Economic Recovery Act authorized the Federal Housing Authority to guarantee up to $300 billion in new 30-year fixed-rate mortgages for subprime borrowers. But the guarantees were conditional on lenders voluntarily writing down principal loan balances to 90 percent of current appraisal value; there are indications that the program has not met with much initial success as of this writing. The Act also provided temporary authority to the Treasury Secretary to purchase any obligations and other securities in any amounts issued by Fannie Mae and Freddie Mac, the two big government-sponsored enterprises that hold and guarantee most of the nation's mortgages. But by September 7, 2008, both institutions had deteriorated sufficiently that they were placed into conservatorship, or effectively nationalized, to ensure that they would remain solvent. At the same time, the Treasury announced a temporary program to purchase Fannie Mae and Freddie Mac mortgage-backed securities to help make more mortgage financing available to home buyers.

When all of these government interventions failed to stem the growing crisis, even bolder action was undertaken in October 2008. At the request of the Bush administration, Congress passed the Emergency Economic Stabilization Act, granting the Treasury unprecedented powers to use up to $700 billion to stabilize the financial sector. The bailout plan also raised the limit on bank deposits secured by the Federal

Deposit Insurance Corporation (FDIC) from $100,000 to $250,000 per depositor, attempting to reassure depositors that their cash was safe in the banking system. Furthermore, the government announced it was insuring individual investors against losses in money market mutual funds, instruments that had for decades been regarded as safe havens before one such fund "broke the buck." The SEC also temporarily barred investors from taking any short positions in selected companies, in an effort to stop the bleeding in the stock market.

By late November 2008, Treasury had injected $179 billion in capital into 30 financial institutions. The FDIC had also extended unlimited insurance coverage to all noninterest-bearing transaction accounts. The Fed, in addition to several other new and historic programs, in the same month took steps to force down home mortgage rates by agreeing to buy up to $600 billion of housing-related securities issued and guaranteed by Fannie Mae, Freddie Mac, Ginnie Mae, and Federal Home Loan Banks as well as creating a $200 billion program to lend money against securities backed by car loans, student loans, credit card debt, and small-business loans.

The sheer size of the bailout, with $7.5 trillion or more committed as of late November 2008, provoked a storm of controversy. Many critics have cried foul about the government's lack of transparency; others fume that by rescuing firms and individuals that took on too much leverage, the government has created thorny new problems of moral hazard (the concept that shielding parties from the full consequences of their risk taking actually encourages them to take even greater risks in the future). Still others complained that insufficient effort and funds have thus far been devoted to halting the rising tide of home foreclosures. It is ironic to note that the United States has essentially been nationalizing its financial institutions while China has embarked on privatizing many of its own.

From its very outset, the Obama administration has been faced with the daunting task of quelling a crisis that has metastasized throughout the financial sector and into the real economy. Housing markets need to be stabilized, and the wave of foreclosures must be stemmed. But more than that, confidence in the nation's basic financial institutions and regulatory authorities must be restored, and reforms must be undertaken to better assure financial stability in the future.

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The government has taken on additional debt in an attempt to shore up the financial system, which only worsens the nation's already staggering deficit. Future administrations will be grappling with the ramifications of those decisions for years to come.

In a very real sense, the bill for this bubble has now been handed to taxpayers.