NATIONAL CENTER FOR POLICY ANALYSIS

The Financial Crisis: Causes, Recollections and the Aftermath

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The Financial Crisis of 2007-2009, and the aftermath, is the defining moment of my career in banking. Having served in government for 17 years, 10 of those in the bank regulatory arena, I managed to be present at some interesting places leading up to the events of 2007-2009, and served on the front lines of the recovery effort thereafter. Those experiences gave me insight into how federal policy affects financial markets, the private sector's recovery capabilities and the consequences of government responses.

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The Role of Government. The federal government set the stage for the crisis — not through a "lack of regulation," as Hollywood and political lore would have you believe — but through affirmative policies that created an extraordinary housing bubble based on an unprecedented political and economic consensus.

Before 2007, two facts were widely accepted both in the financial arena and in virtually every household in America: every single American should be able to own a home. The idea had credence since home mortgages were less risky than other financial assets. On these two bedrock assumptions were built political consensus, public goodwill, financial consensus, companies, empires, fortunes and economic growth.

The widespread political consensus manifested itself in the significant growth of the government sponsored enterprises (GSEs). These companies — Fannie Mae and Freddie Mac — had the best of both worlds: private benefits of success and public placement of risk. Of course, their connection with, and reliance on, the government was as vigorously denied in the run up to the crisis as it was vigorously accepted when the government took on their balance sheet liabilities via conservatorship in 2008.

The mortgage-loan liquidity provided by these enterprises was not a major driver of the crisis. Rather, their starring role in the events of 2008-2009 came from the affordable housing mission instituted in the early 1990s that required the GSEs to establish quotas for lending to low- and moderate-income borrowers.

Contrary to the stereotype of the greedy banker devising ways to imprison poor people in debt, the subprime mortgage lending business began with the sponsorship and permission of the United States government. These quotas grew over time to 56 percent of originations by 2008. Research by Edward Pinto argues that GSEs purchased approximately $4.1 trillion of these subprime and Alt-A mortgages since the early 1990s. Immediately prior to the financial crisis in 2008, the GSEs held or guaranteed 12 million subprime and Alt-A loans.

A bipartisan political consensus welcomed this significant entry of government into subprime mortgage lending. Former Secretary of Housing and Urban Development Andrew Cuomo said in 1997 that the "GSE presence

in the subprime market could be of significant benefit to lower income families, minorities, and families living in underserved areas." The political harmony included significant pushback against the notion that the GSEs should be subjected to safety and soundness regulations and strong governmental oversight. As Congressman Barney Frank worried in a hearing in 1991, the focus on safety and soundness recommended at the time would "sacrifice our ability to do housing."

For a long time thereafter, the assumptions went unchallenged that housing was "different" and thus less vulnerable to the types of deflationary events that affected other assets or sectors — such as commodities or technology companies. Indeed, because there were millions of home mortgages, risk managers believed the risk of any one mortgage holder failing didn't imperil the whole. These mortgages were also backed by an underlying hard asset that had shown remarkable stability and resilience over the course of time. This political, economic and market consensus about the stability inherent in mortgage paper and homeowners of all economic classes set the table for the excesses that followed.

The Regulatory Consensus. A regulatory consensus surrounding the subprime housing also emerged. While the legislative reforms enacted following the banking crisis of the 1980s and 1990s reduced bank leverage and provided a more solid capital foundation for the industry, risk-based capital regulations served to undermine some of this focus.

Under these regulations, banks were required to hold 8 percent capital against corporate loans, 4 percent capital against mortgage loans for one-to-four-family residential properties (including duplexes and fourplexes) and 1.6 percent capital against securities secured by mortgage loans. As we saw in the crisis, this was in no way indicative of the risk of these instruments and introduced a significant incentive to skew banks toward not only originating these loans, but also holding them on their books. This happened not because we lacked regulation, but rather because the regulation required it. This, and the political consensus, were significant enablers that were lost in much of the reporting on the crisis — both in the media and in popular culture.

Other Critical Enablers. First, technology advances dating back to the 1970s enhanced companies' ability to manipulate and manage data, and significantly expanded a given manager's span of control. The business now had the technological capability to handle ever-more-complex chores with the same number of people, or fewer. This, combined with the political and regulatory consensus, allowed the "supercharging" necessary to create a bubble like we experienced in housing during the mid-2000s.

The ability to manage and manipulate data gave rise to a new era in risk management. Risk managers, equipped with more advanced systems and computing power, significantly expanded the securitization of mortgage cash flows into more and more complex instruments — tailored, in many cases, to meet market demand for both types and quantities of risk. Thus, the traditional mortgage-backed security pioneered in the 1980s gave way to more complex instruments like collateralized debt obligations, or CDOs, or synthetic instruments designed to mimic the market's pricing without being tied contractually to any underlying instrument.

This technological complexity transformed a simple mortgage in small town America into a very complex risk management instrument designed to appeal to end users as diverse as a sophisticated Swiss bank or a town treasurer in Norway. Further advances in financial engineering — nearby, but not directly related to the mortgage products — resulted in utilizing derivative products as a form of alternative insurance. Again, protected from prudent regulation by Congress, derivatives allowed the hedging of large exposures at major banks in a manner acceptable to both the internal risk managers and the many regulators tasked with monitoring the companies' exposure to this sector or that.

Nonetheless, the utilization of these products introduced counterparty risk: a new and underappreciated system variable. The lack of attention to the solvency of counterparties resulted in laying off risk on entities without sufficient crisis liquidity to handle all the counterparty issues.

The Role of the Federal Deposit Insurance Corporation. I learned early in my tenure with the FDIC that the intent of the international business standard on cash reserves, known as the Basel 2 process, was to retain the current requirements for a majority of the banks in the system. However, the proposal relied much more heavily on the large, internationally active companies' own internal risk models and the judgment of the rating agencies.

The FDIC took a keen interest in this issue due to the fact that our deposit insurance fund, which held reserves in excess of $40 billion at the time, was in a first-loss position in the event of bank failures. In fact, we knew that under typical loss scenarios, a single large bank failure would swamp our ability to handle the failure in-house and would require our tapping into the U.S. Treasury to make good on our commitment to insure depositors. It didn't initially seem reasonable to lower capital requirements on the most complex banking organizations simply because their own internal modeling indicated it would all work out.

It also became clear that there was significant disagreement among the regulators about the U.S. negotiating position at Basel, and that this disagreement

impaired our ability to safeguard capital policy reforms, like the leverage ratio, on which the FDIC placed great emphasis. An FDIC paper later alerted the system to the imbalances inherent in the Basel 2 approach; but the FDIC, nonetheless, acquiesced to the lowering of the risk weights for any asset-based security with a credit rating of AAA or AA. The move to reduce risk weightings had the effect of lowering the capital banks held against these securities from 4 percent to 1.6 percent, and encouraged the rush to pack banks' balance sheets with mortgage-related assets. There was remarkably little controversy at the time; however, I dealt with it later when I had to close banks in 2008 because of extraordinary losses in otherwise highly rated investment portfolio securities.

The Office of Thrift Supervision. The first order of business when I joined OTS was establishing information-sharing agreements with key international regulators, getting a handle on the organizational charts of the international companies we were charged with supervising and understanding how their nonbanking financial business intersected with the banks we had chartered.

We stood up and organized an examination effort at a trillion-dollar conglomerate with operations in nearly every country in the world, consisting of three to seven individuals onsite at any given time. Beginning with our first risk assessment in 2006, we identified American International Group (AIG) Financial Products as an area of supervisory concern — until the ill-fated credit default swaps led to the company's demise.

From 2006 to 2008, we increased our supervisory criticism of AIG FP and the parent company's risk management practices related to that subsidiary. In 2007, we recommended that AIG revise its modeling assumptions in light of deteriorating market conditions. Our findings indicated that shortcomings in the modeling of credit default swap products camouflaged the true extent of the company's exposure. We (and I, personally) raised these concerns to the AIG board of directors at a meeting in December 2007, with little effect.

The lack of response to our increasing concerns resulted in the OTS downgrading the company's supervisory rating in March 2008 and placing the company under an enforcement action. Our March 2008 order cited, among other things, deficiencies in AIG's risk management program that led to AIG FP effectively limiting the parent company's access to bad news emanating from the troubled subsidiary. We cited the company's failure to discern risk in the housing industry — a failure that resulted in one part of AIG pulling back from housing exposure while other subsidiaries increased their exposure to the sector. We noted the calls on the parent's liquidity resulting from large losses in the securities lending program — a product related to the housing market offered by the insurance company subsidiaries, which were regulated by the states and were off-limits to OTS examiners. In addition to the rating downgrade, OTS directed AIG to correct all control weaknesses and improve oversight of corporate subsidiaries like FP.

We also made mistakes in the process. Our supervisory efforts, while rigorous and defensible, were late. The OTS took on responsibility for these holding companies when the underlying banks were chartered in 1999. It took until 2006 and two changes of OTS directors to get the examination program underway. Even then, despite providing the effort with a mandate and a skeleton staff, OTS leadership displayed a disappointing lack of confidence in the effort.

Despite making considerable progress in our analysis of AIG's risk management challenges, it took several tries to get on the director's agenda to brief him on our findings. And, despite succeeding in the challenge of identifying the issues that ultimately led to AIG's demise, our director still seemed anxious to deride our efforts to congressional investigators — saying at one point that our efforts were like the proverbial "gnat on an elephant," and that our intention to build a credible supervisory program for a company like AIG was "pie in the sky dreaming." Those of us who put in the hours and did the work beg to differ.

We found the root causes of a financial crisis months before the downturn — and nobody listened. Not the company and certainly not the OTS leadership. After signing the enforcement order, I was offered the opportunity to move my family to Dallas and take charge of the Dallas regional office. After I left, the program was disbanded, and no one followed up on the orders we stipulated. Nobody thought anything further on the matter until September, when AIG became a household name. At that time, a new acting director was quick to point out that OTS "fell short" in its supervision of AIG. That may be true of the leadership, not the happy few examiners who put in the long hours in the trenches.

A Missed Opportunity. The immediate after-effect of the failures of AIG, Lehman Brothers and the housing GSEs came by way of the Troubled Asset Relief Program, or TARP. This was originally intended to take toxic assets off banks books and push them quickly back into the broader economy. Many of us in the trenches welcomed this approach because it seemed, for a moment, like the policymakers had learned the lessons of the last financial crisis (the collapse of the savings and loan industry in the 1980s). In that crisis, the Resolution Trust Corporation absorbed the bad assets from bank failures, rapidly marking them to market and selling them back to investors at the "reset" price. That policy led to a sharp economic rebound and set the foundation for the economic boom that persisted throughout the 1990s.

But, immediately after passage, the Treasury redefined TARP's mission and made the strategic error of using the $700 billion to make strategic investments in banks nationwide. By using the money for capital injections rather than asset acquisition, the toxic assets remained on banks' books, impairing the recovery, taking up management's time and attention, along with preventing a resurgence of lending at hundreds if not thousands of the country's banks.

As a regional director of OTS, it was my job to make the first round of recommendations as to which banks were "TARP worthy," and which ones weren't. In effect, the regulators picked winners and losers in the marketplace because to be denied TARP was truly a kiss of death. While the program ultimately made money for the Treasury, the economic impact was profoundly negative and is still being felt.

The Aftermath. Several encouraging developments since the crisis will serve us in good stead going forward. First, the marginal products, typified by loose underwriting standards and alarmingly imprudent loan structures, have been all but eradicated from the system. We don't see "option ARM" mortgages any more, for good reason. And the precrisis consensus around the supposedly "risk free" nature of housing loans seems to have been definitively smashed. Regulators are sensitive to prudent underwriting and the industry's rebound from the credit problems of 2008 and 2009 has been impressive.

Further, the industry is much better capitalized now than it was before the crisis — particularly in the big banks. Community banks have always carried near double-digit capital ratios out of prudence and economic necessity, but the capital levels at the large banks during the crisis were abysmally low. A concerted campaign of ever-more-stringent requirements has bolstered the industry's capital and put it on a much stronger financial footing.

But problems also exist. First of all, the Dodd-Frank reform bill is so Byzantine and complex that it will be years before it is fully understood and decades before we can unwind its ill-effects. For instance, the bill essentially eliminated one regulator (OTS), with good reason, and immediately created three more (the CFPB, the Systemic Risk Council, and the Office of Insurance Regulation) — leading to a regulatory structure more complex and full of contradiction than the one America had precrisis.

The bill also injected the Federal Reserve into a Byzantine dispute between big box retailers and big banks over industrial banking, as if that had anything to do with the crisis. It introduced a "Volcker Rule" so complex in its regulation of bank trading activity that it will be years before it is understood and fully implemented. It has the potential to impede bank hedging activities leading to the perverse result of more risky large enterprises rather than fewer. And the large banks' exit from bond trading has created a significant lack of liquidity in these markets that will not truly be felt until we have the next crisis and the seller of a security cannot get a bid.

While bringing derivatives into the regulated arena, the Dodd-Frank Act mandates a central clearinghouse for derivatives settlement, creating yet another systemically important enterprise whose failure could harm the economy. While the act mandates the FDIC prepare for and manage the resolution of systemic firms, many worry that this and the Systemic Risk Council simply codifies the "too big to fail" ethic and further enhances moral hazard in the system. The unintended consequences of many provisions of Dodd-Frank are still being measured and won't likely be felt until they come into view at the next crisis.

Finally, beyond Dodd-Frank, the investigations of zealous federal and state attorneys — as well as regulatory agencies full of hindsight wisdom — have yielded billions and billions of dollars' worth of punitive settlements by market participants. This will surely have a chilling effect on the industry's willingness to step up and help in the aftermath of the next crisis. Much of the risk assumed by the industry this time around will be absorbed by the taxpayer next time.

Conclusion. We got here because we used public money and influence to underwrite and backstop private risk. Every instrument of national policy was directed at enhancing the value of one asset: housing. AIG and the big banks were not alone in attempting to capitalize on what was, by consensus, an important national goal. The failure to anticipate the unintended consequences of this policy have been profound, prolonged and ongoing.

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