

ORIGINS OF THE FINANCIAL MARKET CRISIS OF 2008

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I begin by describing the factors that contributed to the financial market crisis of 2008. I end by proposing policies that could have prevented the baleful effects that produced the crisis.

Factors Contributing to the Financial Crisis

At least three factors exercised significant influences on the emergence of the global financial crisis.

Factor One: Expansive Monetary Policy

The basic groundwork to the disruption of credit flows can be traced to the asset price bubble of the housing price boom. It has become a cliché to refer to an asset boom as a mania. The cliché, however, obscures why ordinary folk become avid buyers of whatever object has become the target of desire. An asset boom is propagated by an expansive monetary policy that lowers interest rates and induces borrowing beyond prudent bounds to acquire the asset.

The Fed was accommodative too long from 2001 on and was slow to tighten monetary policy, delaying tightening until June 2004 and then ending the monthly 25 basis point increase in August 2006. The rate cuts that began on August 10, 2007, and escalated in an unprecedented 75 basis point reduction on January 22, 2008, was announced at an unscheduled video conference meeting a week before a scheduled FOMC meeting. The rate increases in 2004 were too little

Cato Journal, Vol. 29, No. 1 (Winter 2009). Copyright © Cato Institute. All rights reserved.

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and ended too soon. This was the monetary policy setting for the housing price boom.

In the case of the housing price boom, the government played a role in stimulating demand for houses by proselytizing the benefits of home ownership for the well-being of individuals and families. Congress was also more than a bit player in this campaign. Fannie Mae and Freddie Mac were created as government-sponsored enterprises. Beginning in 1992 Congress pushed Fannie Mae and Freddie Mac to increase their purchases of mortgages going to low- and moderate-income borrowers. In 1996, HUD, the department of Housing and Urban Development, gave Fannie and Freddie an explicit target: 42 percent of their mortgage financing had to go to borrowers with incomes below the median income in their area. The target increased to 50 percent in 2000 and 52 percent in 2005. For 1996, HUD required that 12 percent of all mortgage purchases by Fannie and Freddie had to be “special affordable” loans, typically to borrowers with incomes less than 60 percent of their area’s median income. That number was increased to 20 percent in 2000 and 22 percent in 2005. The 2008 goal was to be 28 percent. Between 2000 and 2005 Freddie and Fannie met those goals every year, and funded hundreds of billions of dollars worth of loans, many of them subprime and adjustable-rate loans made to borrowers who bought houses with less than 10 percent down. Fannie and Freddie also purchased hundreds of billions of dollars worth of subprime securities for their own portfolios to make money and help satisfy HUD affordable housing goals. Fannie and Freddie were important contributors to the demand for subprime securities. Congress designed Fannie and Freddie to serve both their investors and the political class. Demanding that Fannie and Freddie do more to increase home ownership among poor people allowed Congress and the White House to subsidize low-income housing outside of the budget, at least in the short run. Unfortunately, that strategy remains at the heart of the political process, and of proposed solutions to this crisis (Roberts 2008). Fannie and Freddie were active politically, extending campaign contributions to legislators.

Factor Two: Flawed Financial Innovations

A second factor that influenced the emergence of the credit crisis was the adoption of innovations in investment instruments such as securitization, derivatives, and auction-rate securities before markets

became aware of the flaws in the design of these instruments. The basic flaw in each of them was the difficulty of determining their price. Securitization substituted the “originate to distribute securities” model of mortgage lending in lieu of the traditional “originate to hold mortgages” model. Additional banking innovations, notably the practices of the derivatives industry, made mortgage lending problems worse, shifting risk that is the basic property of derivatives in directions that became so complex that neither the designer nor the buyer of these instruments apparently understood the risks they imposed and implicated derivative owners in risky contingencies they did not realize they were assuming. Derivatives as well as mortgage-backed securities were difficult to price, an art that markets haven’t mastered. The securitization of mortgage loans spread from the mortgage industry to commercial paper issuance, student loans, credit card receivables, and other loan categories. The design of mortgage-backed securities collateralized by a pool of mortgages assumed that the pool would give the securities value. The pool, however, was an assortment of mortgages of varying quality. The designers gave no guidance on how to price the pool. They claimed that rating agencies would determine the price of the security. But the rating agencies had no formula for this task. They assigned ratings to complex securities as if they were ordinary corporate bonds and without examining the individual mortgages in the pool. Ratings tended to overstate the value of the securities and were fundamentally arbitrary. Absent securitization, all the various peripheral players in the credit market debacle including the bond insurers, who unwisely insured securities linked to subprime mortgages, would not have been drawn into the subsidiary roles they exploited.

Securities and banking supervisors knew that packaging of mortgage loans for resale as securities to investors was a threat to both investors and mortgage borrowers, but remained on the sidelines and made no attempt to halt the processes as they unfolded and transformed the mortgage market.

Factor Three: The Collapse of Trading

A third factor leading to the emergence of the credit crisis was the collapse of the market for some financial instruments. One particularly important instrument was the auction rate security, a long-term instrument for which the interest rate is reset periodically at auctions. The instrument was introduced in 1984 as an alternative to long-term

debt for borrowers who need long-term funding; but serves as a short-term security. In 2007 outstanding auction rate securities amounted to \$330 billion. Normally, the periodic auctions give the bonds the liquidity of a short-term asset that trades at about par. The main issuers of auction rate securities have been municipalities, hospitals, museums, student loan finance authorities, and closed-end mutual funds. When an auction fails, there are fewer bidders than the number of securities to be sold. When this happens, the securities are priced at a penalty rate—typically, the state usury maximum, or a spread over Libor. This means the investor is unable to redeem his money and the issuer has to pay a higher rate to borrow.

Failed auctions were rare before the credit market crisis. The banks that conducted the auctions would inject their own capital to prevent an auction failure. From the fall of 2007 on, these banks experienced credit losses and mortgage writedowns as a result of the subprime mortgage market collapse, and became less willing to commit their own money to keep auctions from failing. By February 2008 fears of such failures led investors to withdraw funds from the auction rate securities market. The rate on borrowing costs rose sharply after failed auctions. The market became chaotic with different rates resulting for basically identical auction rate securities. Different sectors have been distressed by the failure of the auction rate securities market (*Chicago Fed Letter* 2008).

The flaw in the design of this instrument has been revealed by its market collapse. A funding instrument that appears long-term to the borrower but short-term to the lender is an illusion. A funding instrument that is long-term for one party must be long-term for the counterparty. The auction rate securities market is another example of ingenuity, similar to the brainstorm that produced securitization. Each seemed to be a brilliant innovation. Securitization produced products that were difficult to price. Auction rate securities could not survive the inherent falsity of its conception. Both proved disastrous for credit market operations.

How to Avoid a Replay of the Three Factors That Produced the Credit Market Debacle

With respect to the first factor I've mentioned—the role of expansive monetary policy in propagating the housing price boom—let me first respond to Alan Greenspan's argument that no central bank

could have terminated the asset price boom because, had it done so, the economy would have been engulfed in a recession that the public in a democracy would not stand for (Greenspan 2008: 523). The argument is fallacious. Greenspan does not explain why the Fed could not have conducted a less expansive monetary policy that did not lower interest rates to levels that made mortgage lending and borrowing appear riskless and encouraged house price increases. If monetary policy had been more restrictive, the asset price boom in housing could have been avoided

The second factor I mentioned that led to the credit market debacle was the premature adoption of innovations in investment instruments that were flawed, principally because pricing the new instruments was difficult. Credit markets cannot operate normally if an accurate price cannot be assigned to the assets a would-be borrower includes in his portfolio. The lesson for investors' embrace of mortgage-backed securities and other new types of assets that were profitable to many purveyors of services in the distribution of these ingenious ways of making loans is to be wary of innovations that have not been thoroughly tested.

The final factor that credit markets have contended with is the collapse of trading in selected instruments that revealed their weaknesses. The losses investors experienced as a result will keep these markets from operating until tranquility returns to the credit market as a whole and the weaknesses have been corrected.

Conclusion

Much turmoil may still batter the credit markets. Capital impairment of banks and other financial firms remains to be dealt with. Insolvent firms must not be recapitalized with taxpayer funds. A systematic procedure for examining portfolios of these institutions needs to be followed to identify which are insolvent.

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