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What Caused the Financial Crisis

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Expert points to government policy, not greedy bankers

Was the great financial crisis caused by greedy and reckless bankers and Wall Street players or by a broad range of individuals, financial institutions and governments who became less risk-averse and prudent or by government housing policies that brought on the housing bubble and mismanaged the risks? The lame-duck Congress now in session is about to make some major decisions on spending and taxes - when all too many members still are operating on the idea that greedy bankers and Wall Street players, rather than government housing policies, are the problem.

Without waiting for the evidence, many in the political class, and particularly those on the left, immediately bought into the argument that the financial crisis was caused by greed. This view of the cause provided much of the political energy behind the passage this year of the Dodd-Frank Act, also known as the financial reform act. Somewhat more sophisticated observers have claimed that all of the actors in the financial system are implicated. Peter J. Wallison, a former general counsel of the U.S. Treasury and now a fellow at the American Enterprise Institute (AEI), debunks these arguments and conclusively shows in a study that those were primarily government housing policies that caused the crisis. Mr. Wallison summarized the arguments of the collective responsibility/guilt crowd as follows:

- "Wall Street did not put into place sound risk-management processes.
- Government regulators did not properly or effectively oversee these processes or the banks, investment banks, and Fannie Mae and Freddie Mac.
- The rating agencies' models were flawed and the agencies themselves had conflicts of interest, allowing complex and ultimately toxic instruments to be released into the financial market.
- Borrowers obtained mortgages under false pretenses, and unregulated mortgage brokers took advantage of unsophisticated buyers.
- Homebuyers mistakenly believed housing prices would always go up."

All of the above-mentioned factors probably played some small part in the financial crisis, but greed and incompetence have always been with us, and so it is hard to believe that suddenly these factors combined to create the perfect financial storm. Brookings Institution scholars Martin Neil Baily and Douglas J. Elliott have argued that the quarter-century of record prosperity from 1982 to 2007 caused all of the financial players to become less risk-averse, and hence less prudent. Perhaps, but Mr. Wallison has set forth in the AEI October-November 2010 issue of Financial Services Outlook a much stronger and empirically based explanation for the financial meltdown.

Mr. Wallison argues that the housing bubble, driven by U.S. government policy to increase homeownership, is the primary cause of the financial crisis. He notes: "The most recent bubble involved increases in real (not nominal) home prices of 80 percent over 10 years, while the earlier ones involved increases of about 10 percent before they deflated." Starting in the late 1990s, the government, as a social policy to boost homeownership, required Fannie Mae and Freddie Mac to acquire increasing numbers of "affordable" housing loans. (An "affordable loan" is made to people who normally would not qualify.) By 2007, 55 percent of all loans made by Fannie and Freddie had to be "affordable." By June 2008, there were 27 million subprime housing loans outstanding (19.2 million of them directly owed by government or government-sponsored agencies), with an unpaid principal amount of $4.6 trillion. By the middle of this year, foreclosure starts jumped to a record 5 percent, four times higher than any previous housing bubble.

Mr. Wallison concludes his argument: "What we know is that almost 50 percent of all mortgages outstanding in the United States in 2008 were subprime or otherwise deficient and high-risk loans. The fact that two-thirds of these mortgages were on the balance sheets of government agencies, or firms required to buy them by government regulations, is irrefutable evidence that the government's housing policies were responsible for most of the weak mortgages that became delinquent and defaulted in unprecedented numbers when the housing bubble collapsed." The tragedy is that the financial crisis continues because Congress misdiagnosed the problem and came up with a 2,000-page "solution" that will only make matters worse.

Despite the well-known problems with Fannie and Freddie, they were ignored in the Dodd-Frank Act. Why? Because many members of Congress had conflicts of interest in that Fannie and Freddie were very large contributors to the political campaigns of numerous members. More direct conflicts of interest, by Senate Banking, Housing and Urban Affairs Committee Chairman Christopher J. Dodd and House Financial Services

Committee Chairman Barney Frank, were well publicized, forcing Mr. Dodd to retire and causing Mr. Frank to loan personal money to his own re-election campaign.

The numbers show that government policies (including actions by the Fed), not greedy bankers, caused the financial meltdown. As long as the government continues to force its agencies and private parties to give housing loans to those who cannot afford them, taxpayers will be on the hook for hundreds of billions of dollars in additional debt. But Washington is still in denial, from the president to the bureaucrats, including those at the Federal Reserve and, most of all, members of Congress - including, of course, the notorious Barney Frank, Charlie Rangel, Maxine Waters and Nancy Pelosi, all of whom won re-election rather than jail terms.

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