Domino Effect: The Housing Crisis

History

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The nation is currently experiencing a widespread economic crisis affecting many areas of our market economy, the center of which has its roots in the real estate market. Around the year 2000, the dot com bust had hurt many investors, and so people were looking for a secure way to reclaim their lost investments. The housing market was steadily increasing each year, and was thus seen as a very stable market to be investing in. Unfortunately, the mantra of many investors became “housing prices will always go up”. Through the following years, the real estate market experienced a boom until about 2006, when the situation reversed itself and developed the credit crisis we have today.

Many politicians are quick to blame deregulation for this catastrophe, however, this is false. A faulty government regulation which was put in place for a well-intentioned purpose is ultimately the cause of this economic crisis. This one small action affected many different areas of conventional housing policy, the American culture of homeownership, and essentially the entire economy until there was a domino effect that ended in disaster. Ultimately, the housing crisis was a result of greed, corruption, and misguided ideals that gave way to the widespread recession now gripping the country.

The last massive economic crisis the United States experienced was the Great Depression of the 1930s. Much of the New Deal legislation championed by Franklin Roosevelt still survives to today, including the Federal National Mortgage Association, better known as “Fannie Mae”, created in 1938. This organization was founded to help increase home ownership throughout the country. Around this time, in order to acquire a mortgage to put towards a house, a person would have to provide about 20% of the total cost up front just to be considered for a loan. The only place to go to get a loan was the local bank who had limited amounts of money. Fannie Mae’s purpose was to guarantee the loans from default and buy the mortgage slips from the banks, thus giving the banks back the cash they had lent through the mortgage. Fannie held on to the mortgages while the banks were free to invest or loan out the replaced money. According to Amity Schlaes, a Senior Fellow at the Council of Foreign Relations, “Roosevelt said...let there be a market in mortgages, and that’s what Fannie Mae does. It creates a market so you can buy and sell mortgages and there’s more cash available.” The ideal of every

1 Robert Goar, personal interview by Mary Alice Durchholz, Zionsville, Indiana, November 30, 2008.


3 Goar, personal interview, 2008.

American becoming a homeowner was an admirable one, but it would soon become apparent that the pursuit of making the American dream a reality for everyone would prove to be a mismanaged catastrophe.

During the Great Society implementations by the Johnson Administration, it was decided that Fannie Mae could flourish as a private company; its activities were officially taken off the government’s yearly budget and it became a government-sponsored enterprise, or GSE. Fannie’s business was booming, so in 1970 the government created another GSE, the Federal Home Loan Mortgage Corporation, or Freddie Mac, to give Fannie competition. While on paper Fannie Mae and Freddie Mac were private companies, the government was still in the shadows, ready to come to their aid in the event of a crisis. This bond with the federal government also gave the GSEs an advantage financially: they had access to unlimited funding. “When we have these organizations that are backed by the U.S. government, they will take risks that no other organization can take,” said Peter Wallison, former General Counsel of the Treasury Department. Fannie and Freddie’s access to a never-ending blank check from the federal government would soon prove to be problematic in the early years of this century with the rapid increase of demand for mortgages.

Even with the existence of Fannie Mae and Freddie Mac, some in the government felt that more needed to be done to increase home ownership. Jimmy Carter succeeded in signing the Community Reinvestment Act into law in 1977. The CRA assumed that banks had an obligation to help meet the credit needs of their local communities; in order to increase homeownership and eliminate redlining, or the discrimination against minorities by restricting their access to home loans, the CRA prodded institutions to enlarge their loans to the disadvantaged people in their communities. The passage of this act led to penalties against institutions that did not meet the law’s vague definition of “helping the local community”. The law was a well-intentioned measure, ensuring that the low-income and racially disadvantaged of society would have an equal chance at owning their homes. However, this law had a dark side to it that was not completely apparent at the time. The CRA’s downfall was the inclusion of retributions for banks and other financial institutions that did not give out loans to low-income or minorities. To comply with the CRA, banks began making loans with reduced credit standards. Without the correct interpretation and execution of the CRA, its implementation could, and did, have unintended consequences, driven by fear of federal penalties, and eventually greed. The intent behind the CRA of increasing home ownership was commendable, but people failed to see the risks involved in enforcing this policy; thus, financial institutions became predatory lenders to fulfill a directive from the government.

With the passage of the CRA, the process of taking out a mortgage changed. Faced with penalties if not in compliance with the CRA, banks began a new way of handling mortgages which precipitated a new form of investing. Robert Goar, a veteran Indianapolis, Indiana real estate agent for 33 years, explains that a new addition to the process significantly shaped the future of the mortgage market. The process of taking out a mortgage to put towards a home would involve the person going to their local bank or mortgage broker for the loan.

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5 Frame and White, “Fussing and Fuming over Fannie and Freddie,” 161.
6 Saving Our Economy, DVD, 2008.

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8 Saving Our Economy, DVD, 2008.
The bank or broker would then pull together a number of different mortgages together to create a financial instrument called a “mortgaged-backed security”, or MBS. Once the mortgages were packaged together, the bank or broker would then sell MBSes to either the GSEs, investment banks, pension funds or individual investors. These mortgage-backed securities became a very popular mode of investment in the late 1990’s and early years of this decade because it promised good prospects for profits.

As more MBSes came into being, demand for them skyrocketed. In 2000, the stock market had reeled from the dot com bust that sucked up many people’s savings. The next year, the terrorist attacks of September 11 closed the market for nearly a week and threw the country into recession. According to Alex Klein and Zachary Goldfarb, this sudden recession prompted other investment options to be considered: “The government’s efforts to counter the pain of that [dot com] bust soon pumped air in the next bubble: housing...Low [interest] rates kicked the housing market into high gear...and [housing] prices climbed”. At that point the real estate market was experiencing stable growth, and so investments in mortgages rose. Michael Flynn provides a reason for this trend: “Mortgages have historically been seen as among the safest investments. In an era of rising house values, ‘safe’ became ‘guaranteed returns.’” Investing in MBSes guaranteed at least a ten percent return, so many investors jumped at the chance to make their fortunes. “Housing prices will always go up” became the mantra for investors. The high demand for MBSes pushed financial institutions to give out even more mortgages, and they had to start relaxing credit standards increasingly to get as many mortgages as they could. This practice, along with other governmental factors would eventually result in a massive increase of mortgages.

This particular housing boom was driven by mortgages taken by borrowers of various financial backgrounds: those with little savings and spotty credit records. According to Klein and Goldfarb, in order to supply the demand on Wall Street, banks and mortgage brokers gave the “riskiest of these borrowers” subprime loans:

[These were] loans that required no documentation of a borrower’s income. No proof of employment. No money down...Most subprime loans gave borrowers a low ‘teaser’ [interest] rate for the first...three years, with the monthly payments ballooning after that. Because [they] were assumed to be higher credit risks, lenders charged them higher interest rates. That meant that investors who bought securities based on pools of subprime mortgages would enjoy higher returns.

The subprime loans, despite their risk, became the hottest commodities on Wall Street. Investors who got their hands on these loans would have most likely seen returns of nearly 10-12%, equal to the high interest rates given to these less-than reliable borrowers. But trusting their investments to these borrowers surprisingly did not worry many on Wall Street. Subprime loans were considered by lenders to be a safe bet. Since home prices began soaring, borrowers did not need to worry about adjustable rates drastically increasing their payments - they had the option of selling their homes at any time, often at a robust profit. Jeffrey Vratanina, a mortgage broker, summed up the situation concisely: “Quite candidly, it all boils down to one word: greed.”

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9 Goar, personal interview, 2008.
11 Ibid.
13 Goar, personal interview, 2008.
14 Klein and Goldfarb, “The Bubble.”
15 Ibid.
These circumstances encouraged many people to go into speculation, looking to get rich quickly by buying homes, renovating them, and reselling them.

As many housing markets experienced record growth, some could not resist jumping in to get their share of the wealth to be made. Popular media sources, always ready for the next big trend in culture, quickly caught on and blissfully embellished home speculation beyond reason. Reality television shows like “Flip That House” glorified speculation practices, and showcased happy couples making thousands of dollars flipping homes. And with subprime loans, people did not have to actually put any of their hard-earned savings into the house; in some ways, it was a “riskless” way to easily make a small fortune, because “housing prices always go up”. Many people looked to speculation as a way to help with their education loans, healthcare costs, and credit card debt. With this appeal coming from the media, the public was convinced that speculation with subprime loans was a good way to make money. This impact that speculation had on the culture of American homeownership was probably very underestimated in the eyes of politicians and economists; while noticed by bloggers and reality television shows, this ignorance of a cultural shift in homeownership highlights the degree to which the future crisis would affect the American public.

The popularity of subprime loans became prevalent on both Wall Street and Main Street. Traditional mortgage investments shifted to account for more subprime loans. The MBSes at first had a proportionally low amount of high-interest rate subprime mortgages compared to other stable prime mortgages featuring lower interest rates. In theory, this method of investment was a smart one, because if the subprime loans defaulted, the other mortgages would stabilize the MBS so the whole investment would not fail. For a few years this situation operated very well, and the housing boom kept chugging along. Flynn described the key ingredient for the success of this system: “Everything worked as long as housing prices continued to rise. The most pessimistic scenarios on Wall Street showed a leveling off of housing prices; no one foresaw an actual decline in prices.” Then, actions taken by Fannie Mae and Freddie Mac would cripple the mortgage market in a way that was not noticed for another two or three years, effectively destroying any chances that this setup on Wall Street would end well.

In 2003 and 2004, it was revealed that both Fannie Mae and Freddie Mac were mired in accounting scandals that involved them cooking the books to make their profits seem more than what they actually made. To keep the government from interfering with their operations, the GSEs made a deal to increase their commitment to expand the market for low-income homeowners. Despite President George W. Bush’s push for reforms for Fannie and Freddie, nearly all of the Democrats and a handful of Republicans in Congress accepted the deal, and a free pass was given to the GSEs. Thus, Fannie and Freddie would increase the amount of subprime mortgages in their portfolios in the name of “affordable housing”. However, even their staunchest defenders did not do their research on what Fannie’s and Freddie’s definition of “expansion of affordable housing” really was: an increase of very risky subprime loans.

To Fannie and Freddie, Congress’ hands-off

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17 Goar, personal interview, 2008.

18 Flynn, “The Roots of the Crisis.”

19 Ibid.
attitude encouraged them to embark on a colossal spending spree, as Flynn explains it, absorbing as many subprime loans as possible:

[Fannie and Freddie] made it clear that they wanted to buy all the subprime...mortgages that they could find, eventually acquiring around $1 trillion of the paper...In 2003, subprime mortgages made up less than 8 percent of all mortgages. By 2006, they were over 20 percent...Investment banks realized that if they laced ever increasing amounts of subprime mortgages into the MBSes, they could juice the returns and so earn bigger fees. The rating agencies, thinking they were simply dealing with traditional mortgages, didn’t look under the hood.\(^\text{20}\)

This subprime flooding of the market continued until the latter part of 2006, when the one thing that no one in Congress or on Wall Street could have predicted: housing prices dropped. And the decline was not confined to just one state or area: multiple housing markets across the country tanked all at once.\(^\text{21}\)

What happened to the housing prices? As Fannie and Freddie pushed for more subprime loans, a great number of them were taken out around the same time. This meant that those loans with an adjustable rate after three years would be increased simultaneously. For example, people that had taken a subprime mortgage in 2003 would see their interest rates rise in 2006. Those who did not resell their homes were now faced with more money out of pocket each month. Also around that time gas prices started rising, causing the price of any transported goods to increase as well. All of these elements blended together, squeezing paychecks across the country. Since most subprime loans were made with no money down, people were not completely anchored to their homes. Those who could not afford the higher monthly payments simply walked away from their properties without a backward glance, defaulting on their loans. Defaults resulted in foreclosures, which lowered home values in the neighborhoods around them. People were stuck paying for a $300,000 mortgage on a house that was now worth only $275,000. The drop in home values only increased defaults and foreclosures.\(^\text{22}\)

Soon the action on Main Street America would send reverberations throughout Wall Street.

Investors who had put their faith in these subprime borrowers were now the proud owners of worthless MBSes. Because of Fannie’s and Freddie’s subprime spending spree, the MBSes became overwhelmed with risky debt. Since the rating agencies failed to adjust for the influx of subprime loans, investors did not realize how toxic their MBSes were. No one had thought that multiple housing markets would fall at the same time, but since high gas prices and their effects had shown no discrimination, everyone had felt the crunch. In California, Florida, Michigan and New England, housing markets that had been experiencing phenomenal growth now suffered the worst losses. Higher standards of living in these states had put additional pressure on lower income households, resulting in more defaults. The system of checks and balances built into mortgage-backed securities, though brilliantly orchestrated at first, could not handle the swift downfalls over multiple markets.\(^\text{23}\)

According to Charles Calomiris and Peter Wallison, there was nothing amiss yet when the first of the defaulted loans occurred:

The overall numbers moving into foreclosure were small. Someone simply looking at housing stats could be forgiven for wondering what the fuss is about. Nationally, the number of mortgages moving into foreclosure [was] just around 1 to 2 percent, suggesting that 98 to 99 percent of mortgages [were] sound. But the foreclosed mortgages punched way above their weight class; they were laced throughout

\(^{20}\) Ibid.
\(^{21}\) Goar, personal interview, 2008.
\(^{22}\) Ibid.
\(^{23}\) Ibid.
Because so many investment banks, insurance companies and others had millions invested in these loans, most were now proud owners of mortgages that could not be valued. Without a monetary value attached to them, the MBSes ceased to be traded. Since investors would not trade MBSes, most had to be rated at a value close to zero. Losses were noted throughout Wall Street, bringing investment banks and other similar firms to the brink of bankruptcy—some did not survive. Banks became fearful of lending money, which resulted in a virtual freeze of the credit market. As many businesses depend on a credit line to conduct day to day operations, the consequences of the housing bust quickly spread to nearly every single business and person relying on the credit market. This could have potentially destroyed our entire economy if nothing was done.

Why did this happen? Before Fannie and Freddie went shopping, the mortgage market was far from perfect, but it probably could have continued without major incidences. In the early years of George W. Bush’s administration, one of his priorities was to introduce regulations for Fannie Mae and Freddie Mac, fearing the future effect their business practices would have on the economy. But with the recession after September 11, no one wanted to hear doomsday talk about what seemed to be the one bright spot in the economy: the boom in the housing market. Lawmakers were loath to interfere with the healthiest area in the economy, fearing that any new piece of legislation might dampen the economic growth that was sorely needed at the time. Also, Fannie Mae and Freddie Mac had powerful protection from members of Congress; despite dire warnings about the GSEs, providing affordable housing was a primary concern of many Congress members hoping to please their constituents. Many of these same Congressmen and women also enjoyed generous campaign contributions as backers of Fannie and Freddie, making them less likely to question the two companies’ business dealings. With this incentive, why would they have ever wanted to investigate the GSEs that were promoting the great cause of increasing homeownership? Calomiris and Wallison explain that Fannie and Freddie’s strategy enabled them to keep the authorities at bay for a little while longer:

The strategy of presenting themselves as the champions of affordable housing appears to have worked. Fannie and Freddie retained the support of many in Congress, particularly Democrats, and they were allowed to continue unrestrained....The hint to Fannie and Freddie was obvious: Concentrate on affordable housing and despite your problems, your congressional support is secure.

Because some Congress members chose to put aside accountability for their own political interests, Fannie and Freddie were given free rein to wreck havoc in the market. Wallison mused, “There was a real question in my mind whether Congress controlled Fannie Mae, or did Fannie Mae control Congress?”

The 2008 Presidential candidates had markedly different relationships with the two GSE’s. John McCain has been a reputed supporter of regulation increases for Fannie and Freddie for years. In 2005, he was one of several key Republicans cosponsors of

25 Flynn, “The Roots of the Crisis.”
26 Goar, personal interview, 2008.
27 Saving Our Economy, DVD, 2008.
28 Calomiris and Wallison, “Blame Fannie Mae and Congress For the Credit Mess.”
29 Saving Our Economy, DVD, 2008.
the Federal Housing Enterprise Regulatory Reform Act along with Senators Chuck Hagel, Elizabeth Dole and John Sununu. “The bill prohibited the GSEs from holding portfolios, and gave their regulator prudential authority...roughly equivalent to a bank regulator.”  

Essentially, the bill would have prevented Fannie and Freddie from gobbling up all the subprime loans that poisoned the mortgage market. Unfortunately the bill never went before the full Congress as it died before the Committee on Banking, Housing, and Urban Affairs. Since the bill never went to a full vote, its effect on preventing a major crisis cannot be fully known; however, this piece of legislation shows that there was legitimate concern for the GSEs business dealings and that several legislators were concerned enough to bring it to the attention of Congress. “In 2006, as the midterm elections loomed, the Republicans spent their resources defending decisions in Iraq. All the Democrats had to do was wait out the elections. They gained control of both houses of Congress that November, burying the bill for good.”  

Among the staunchest backers of Fannie and Freddie, Barack Obama made no move to support the regulation bill. Indeed, Obama had been the recipient of a great amount of campaign contributions from Fannie Mae. During his three years in the Senate, Obama received nearly $126,000 from Fannie Mae, the second-highest beneficiary of Fannie in Congress. For the record, John McCain received just over $21,000 from Fannie. It was only after the collapse of the mortgage market had revealed Fannie and Freddie’s role that Obama joined with McCain in criticizing the GSEs. “Sen. Obama’s conversion as a financial reformer marks a reversal from his actions in previous years, when he did nothing to disturb the status quo.” Obama, along with other indifferent Congress members, effectively killed any chance to avoid this financial crisis by not supporting the reform act. Those tied to Fannie and Freddie through campaign contributions obviously had no desire to increase transparency of the GSEs, as it would have been detrimental to both their own reputations and the “affordable housing” cause.  

The housing crisis had been developing ever since the creation of Fannie Mae and the passing of the Community Reinvestment Act in 1977. Did it have to happen? Absolutely not. All the aspects of this mess, from MBSes, speculation, subprime mortgages, Fannie Mae and Freddie Mac, were toxic when mixed together with the greed of investors and speculators, the corruption of politicians protecting dangerous business schemes, and the misguided ideals of the CRA. Many “what if” scenarios could be drawn to see what kind of path this crisis could have taken with a few deviations of events. But what stands out as the final nail in the coffin of the real estate market for Calomiris and Wallison was the failure of Congress to pass the Federal Housing Enterprise Regulatory Reform Act of 2005:

If the Democrats had let the 2005 legislation come to a vote, the huge growth in the subprime... portfolios of Fannie and Freddie could not have occurred, and the scale of the financial meltdown would have been substantially less. The same politicians who today decry the lack of intervention to stop excess risk taking in 2005-2006 were the ones who blocked the only legislative effort that could have stopped it.  

Indeed, once the crisis hit, many were quick to blame its cause on deregulation of the economy. Democratic Speaker of the House Nancy Pelosi said...
in a speech before the first vote on the $700 billion bailout plan that the Bush Administration’s failed economic policies were to blame for the credit mess; the partisan nature of her speech most likely caused the vote to be defeated.\textsuperscript{35} Her statement was blatantly deceiving, as many members of her party had resisted regulation for Fannie and Freddie in the first place on the grounds that the “affordable housing” cause would suffer; and Bush had pushed for reforms for the two GSEs since the beginning of his administration, yet it was not a popular action because there had been no immediate threat in the housing market at the time. The legacy of the Carter Administration, the Community Reinvestment Act, laid the foundations for the crisis. It was put into law for the good intention of helping people become homeowners, but it was this piece of misguided government regulation that created the environment that nurtured greed to overrule honesty and common sense.

For the recent actions of the past eight years, where does the blame lie? In Congress, the Democrats are far more culpable due to their close associations with Fannie Mae and Freddie Mac and their failure to support essential legislation that would have diverted economic disaster. While Republicans supported reform, it was mostly in the form of empty talk with no definite plan to actually do something about it. In the mortgage market, banks became predatory lenders to comply with the government mandate, causing subprime loans to be a common occurrence.\textsuperscript{36} As reported by Russ Wiles, mortgage brokers were immensely liable for a lot of misdeeds: “Brokers don’t lend their own money, but serve as middlemen, collecting commissions but sometimes without much regard to whether borrowers can make payments.”\textsuperscript{37} Brokers were worse than used car salesmen: they tried to make as many loans as they could because they could make a few thousand dollars in commission for each mortgage they made. Thus, they used any means to increase their salaries, and many people were swindled into taking subprime loans without fully comprehending the situation in which they found themselves.\textsuperscript{38} Investors had demanded for more MBSes to invest in to reclaim their losses during the recession in 2001. This caused banks and brokers to continually lower mortgage standards in order to get as many mortgages to possible.\textsuperscript{39} And finally, borrowers themselves played their own role in this crisis. While many were truly trying to just become homeowners for the first time, a lot of people took larger mortgages than what they could afford. Also, the housing boom combined with subprime loans encouraged speculation as an easy way to make money.\textsuperscript{40}

Admirable intentions of making housing affordable for everyone unfortunately produced the opposite situation. Even with the “affordable housing” mission of Fannie Mae and Freddie Mac, what was affordable about inflated housing prices and subprime variable rates? The illusion of affordability seduced many people into an unforgiving mortgage market, and now homelessness is on the rise; their ranks swelling with newly-evicted families who had sacrificed to own a home but are now left with nothing. Noble intentions became tainted with greed and corruption from those that we assume will look out for the common person in their time of need. If we learn anything from this

\textsuperscript{36} Saving Our Economy, DVD, 2008.
\textsuperscript{38} Goar, personal interview, 2008.
\textsuperscript{39} Ibid.
\textsuperscript{40} Ibid.
crisis, we must question and research every aspect of potentially volatile situations so we can strike down circumstances where assumptions such as “housing prices will always go up” would never take precedence over cold, hard facts.

REFERENCES


