

THREE NARRATIVES ABOUT THE FINANCIAL CRISIS

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The most important lesson we can learn from the financial crisis is what caused it. Even though the Dodd-Frank Act (DFA) has been signed into law, this is still an important question. If we do not attribute the crisis to the right cause, we could well stumble into another crisis in the future; and if the DFA was directed at the wrong cause, we should consider its repeal. There are several competing narratives. One of them will eventually be accepted, and will determine how the great financial crisis of 2008 is interpreted, and thus how it affects public policy in the future.

A Brookings Institution study issued in late 2009 lays out three competing narratives, including the one favored by the authors, Douglas J. Elliott and Martin Neil Baily (Elliott and Baily 2009). The Elliott-Baily theory is interesting and explains much of what happened. Their view is that the “great moderation”—the quiet period of almost continuous growth and low inflation between 1982 and 2007—caused investors, managers, and regulators to believe that we had come to understand how the economy worked and how to tame the business cycle. This mistaken view in turn caused a decline in the normal aversion to risk, creating a housing bubble and the financial crisis. This is a compelling narrative and accounts for much of the risk-taking that was observed in the period leading up to the crisis, but in the end it is no more than an interesting theory. The reality is that, in pursuit of a social policy to increase homeownership, the U.S.

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government became a willing buyer of an unprecedented number of subprime and other high-risk mortgages. This social policy created a housing bubble of unprecedented size and duration, but only the taxpayers were taking the risks necessary to create this financial disaster.

The Elliott-Baily study, entitled “Telling the Narrative of the Financial Crisis: Not Just a Housing Bubble,” was published in November 2009. It is an important study for two reasons. First, it recognizes that a narrative—a story that explains an event—influences the legislation or other public policy actions that follow. Second, as implied by the title of their paper, Elliott and Baily developed their own narrative for what caused the financial crisis, and they use it to argue that the financial crisis was not caused by government housing policies (see Wallison 2009, 2010a, 2010b). This article considers whether the Elliott-Baily narrative is a better explanation of the financial crisis than the housing policies of the U.S. government.

The Elliott-Baily Narratives

Writing before the enactment of the DFA, Elliott and Baily (2009: 1) began their study by recognizing the importance of narratives:

Major crises such as the recent financial crisis, usually end up being understood by the public in terms of some simple narrative, which then heavily influences the choices politicians make. We believe there are three major story lines still vying for acceptance by the public and whichever one comes to dominate could strongly affect public policy. . . . One of the earliest theories of the Great Depression was that it sprang from the crash on Wall Street, which came to be associated with financial manipulation by bankers and rich speculators. This created much of the impetus for the separation of commercial and investment banking and the creation of the Securities and Exchange Commission and associated laws to protect investors.

These words are a reminder, not only of the importance of narratives in shaping policy responses, but also that certain impulses and ideas are carried forward over generations and resurface when those who have accepted them find the right opportunity.

Elliott and Baily identify three distinct narratives that have been used to explain the financial crisis. The first, which they call “narra-

tive 1,” is the view that government housing policies caused the crisis “by inflating a housing bubble and mismanaging the resulting risks and problems, especially in regard to Fannie Mae and Freddie Mac. This narrative is popular among conservatives, particularly since it argues for a scaling back of government interventions in the economy and suggests less regulation, not more” (Elliott and Baily 2009: 2).

The second narrative is that

Wall Street created the crisis by reckless behavior, greed, and arrogant belief in its own ability to understand and manage excessively complex investments. . . . This narrative is popular with the left, but is accepted much more widely than that, including by a broad populist sentiment that sees large banks and large corporations as at the root of many of the country’s economic problems. Many in the media have also adopted this position. . . . The housing part of the crisis is viewed as principally resulting from financiers pushing naïve consumers into taking on mortgages bigger than they could handle and which were structured to hide large fees and interest rates that would jump after a few years [Elliott and Baily 2009: 3].

This narrative, one might add, is easily recognizable as a lineal descendant of the ideas that motivated the New Deal.

The third narrative, and the one Elliott and Baily (2009: 4) endorse, is that

the crisis was a very broad-based event with a wide range of people and institutions bearing responsibility, including many outside the United States. . . . Wall Street financial institutions failed to put in place or enforce the sound risk management processes and restraints that were needed . . . [and] government regulators did not adequately oversee these institutions, including, importantly, Fannie Mae and Freddie Mac. . . . Some of the federal government’s actions to encourage home ownership also overshot and provided incentives for reckless behavior.

The DFA, adopted after the Elliott-Baily study appeared, demonstrates that they were correct about the importance of narratives. Congress enacted and the president signed legislation that rather faithfully reflected a combination of narratives 2 and 3. Anyone who followed the debate that preceded the enactment of

the DFA saw Congress directly responding to elements of both narratives. The Consumer Financial Protection Bureau was certainly written into the act because the Democrats who controlled the process believed—or said they did—that “naïve consumers” were duped into buying homes they could not afford in order to create fees for the mortgage originators and the “financiers” (this closely follows narrative 2). This is clearly the modern analogue of the New Deal-era view that the Great Depression was caused by financial manipulation and the abuse of investors. Similarly, the stringent regulation and supervision prescribed by the DFA for the largest bank holding companies and other systemically relevant firms was a reaction to the view that regulation had not been tough enough and had allowed too much risk-taking to occur. This response can be seen as the result of the general view that private decisionmaking and markets need some government supervision or they will veer into crisis (basically narrative 3).

This article argues that—despite the Elliott-Baily theory—narrative 1 is a better explanation of the financial crisis than narratives 2 and 3. In other words, government housing policy caused the financial crisis, not too little regulation, not predatory lending, and not excessive risk-taking. To be sure, all those things occurred—they always will—but none of them was significant enough to cause a worldwide financial crisis. If we come to believe that these were the causes of the crisis, we will simply be inviting another crisis to creep up on us while we are looking the wrong way. A strikingly clear example of this possibility is the introduction in Congress in late September 2010 of a bill to extend the Community Reinvestment Act (CRA)—which currently applies only to insured banks and savings and loans (S&Ls)—to the rest of the financial system.¹ The CRA requires insured banks and S&Ls to make loans (primarily mortgages) to borrowers in their service areas who are at or below 80 percent of the median income where they live. Banks must show that they are making such loans irrespective of whether the loans meet the bank’s usual credit standards. That requirement contributed to the large number of subprime and other risky loans that failed in the financial crisis. If the narrative we adopt for what caused the

¹“To Amend the Community Reinvestment Act of 1977 to Improve the Assessments of Regulated Financial Institutions, and for Other Purposes,” 111th Cong., 2d sess. (29 September 2010).

financial crisis does not regard these loans as contributing factors—and narratives 2 and 3 certainly do not—then the conditions that gave rise to the crisis will eventually be repeated.

There is much more to narrative 1 than Elliott and Baily describe, but before introducing those points I will first outline in detail the case that Elliott and Baily make for narrative 3, which I believe is the most sophisticated and important alternative to the idea that government housing policies created the financial crisis.

The Elliott-Baily Narrative: Decline in Risk Aversion

The principal characteristic of narrative 3 is its comprehensiveness. All the main actors in the financial system are implicated (Elliott and Baily 2009: 4):

- Wall Street did not put in 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.

This approach—that virtually everyone was responsible for the financial crisis—is susceptible to the objection that it is blaming the crisis on a lot of random errors that all happened to occur at the same time. The central conceptual problem with all narratives that cite multiple factors as causes of the crisis is that as “perfect storm” descriptions they do not explain why all the various errors occurred together, except by chance, and what would have happened if they had not. Other perfect storm explanations are unsatisfactory for this reason.

In January 2011, the Financial Crisis Inquiry Commission issued a report signed by a majority of its members. The commission,

consisting of six Democrats and four Republicans, had been appointed by Congress in 2009 to find and report on the causes of the financial crisis. The six members who signed the majority report were all Democrats. The Republicans issued two dissents, of which mine was one (Wallison 2011). The other three Republicans signed a second dissent. The majority report was very close to Elliott and Bailey's narrative 2. Their view was that the financial crisis was caused by greed on Wall Street, predatory lending, excessive risk-taking, breaches of ethics and responsibility, and similar private sector misdemeanors, all of which could have been prevented if government regulation had not been so lax.

The other Republican dissent was much closer to narrative 3, but based its analysis on the implausible idea that 10 specific deficiencies—which it called the “essential causes”—caused the financial crisis. This is a perfect storm analysis writ large, and is subject to the logical question whether the financial crisis would not have happened if one of those “essential” causes had not been present.

However, in their analysis, Elliott and Baily (2009: 5) introduce a new idea that addresses the perfect storm problem rather neatly and distinguishes narrative 3 from many others:

The principal underlying cause of the behaviors listed above was a major reduction in the risk premium [the additional interest rate required because of additional risk] resulting from 25 years of strong performance by the financial markets, encouraged by and associated with the “great moderation” in the macro-economy, whereby business cycles seemed almost to vanish.

Thus, Elliott and Baily are identifying a deeper cause of the financial crisis than has generally been outlined in conventional perfect storm explanations, an element that in effect underlies the more superficial actions that have been cited as causes. That cause, explained in narrative 3, was a general relaxation in the usual fear of risk, induced by the “great moderation”—a period of general prosperity and growth that prevailed with few interruptions for the quarter century from 1982 to 2007.

During that period, they argue,

many people, both experts and non-experts, believed that central banks and governments around the world had learned

the secrets necessary to tame the business cycle. . . . People learned to take risks. Not only would one expect on average to be rewarded, as the textbooks tell us, but actual experience showed it almost always paid off much more handsomely and with less pain than the theories said. Individuals learned a similar thing with housing. . . . Since homeowners were usually highly levered through mortgage debt [that is, they made low down payments when they bought their homes], a fairly steady and decent return [on a home investment] became a very attractive levered return. . . . This increased willingness to take risks worked in dangerous combinations with the “easy money” conditions of the mid-2000s.

So the heart of the argument for narrative 3 is that the long period of growth in the economy, without any serious financial crises, taught investors, corporate managers, and consumers that the risks of excessive leverage were limited. They could acquire assets and make investments with very little money of their own and profit a lot when the assets appreciated in value. That unhealthy process was exacerbated by Federal Reserve policies that made large amounts of credit available to support risk-taking. These elements account for most if not all of the errors made by banks, rating agencies, investors, and consumers in narrative 3.

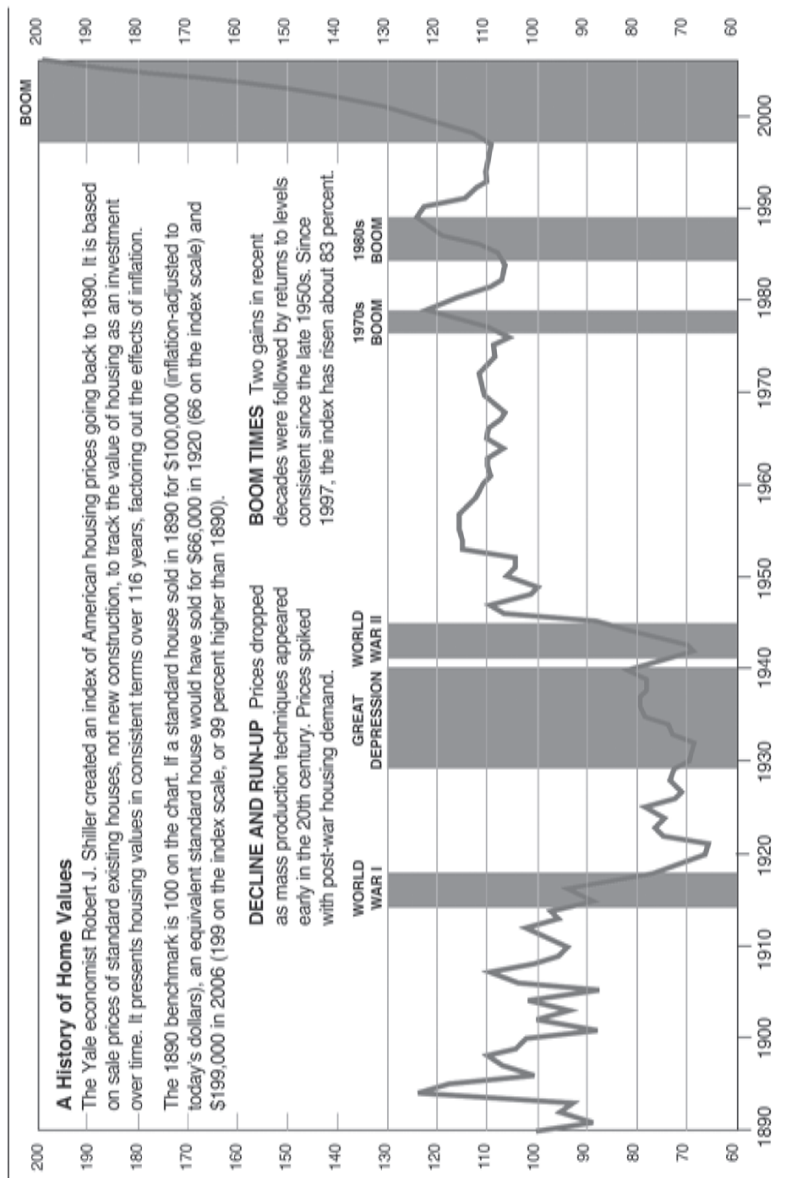
In the next section, I will outline why the housing bubble was not just any bubble, why it was a *sine qua non*—a “but for” cause—of the financial crisis, and why it was sufficient to cause the financial crisis without any excessive risk-taking by market participants.

The Role of Government Housing Policy

Since much of the Elliott-Baily study is about bubbles, and whether the recent housing bubble was any more significant than other bubbles that might have been created by a market that had lost its fear of risk, any response should begin by examining the dimension of the housing bubble that began to deflate in 2007. Figure 1 is a chart prepared by the *New York Times* and based on the work of Robert J. Shiller. It shows the extraordinary growth of the 1997–2007 bubble, especially when compared to previous bubbles.

Two things stand out about the most recent bubble: it was much larger in real terms than any of the previous housing bubbles, and it lasted more than twice as long as any previous bubble, especially the

FIGURE 1
A HISTORY OF U.S. HOME VALUES



SOURCE: Shiller (2005).

two that occurred before 1980 and 1990. 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. Asset bubbles in other sectors might be comparable, but none is likely to involve an asset that is one-sixth of the U.S. economy, and none—as I will show—was composed to such a large degree of weak and high-risk assets.

Why did this bubble last so long? This is an important question; bubbles get more destructive the longer they last because people who believe that prices will continue to rise stretch further and take more risks (use more leverage) to acquire assets that they believe will increase in value. This is exactly what happened in housing, as more and more people took out adjustable-rate mortgages with low “teaser” rates, or mortgages with low or no down payments, so they could afford the monthly payment on homes that they thought were going to rise in value. A bubble, as Elliott and Baily point out, feeds on itself because as long as it lasts it disguises the risks that are being taken by those buying the inflating asset. In the housing bubble, for example, there were few losses from this risk-taking until the bubble burst, because those who could not afford to pay for their homes could always refinance by using the higher appraised value of the home in a rising market. When the music stopped, these people were left without a method of refinancing, and the delinquencies and defaults began. As Warren Buffett said, “When the tide goes out, you can see who’s swimming naked.”

In the case of the 1997–2007 bubble, however, one of the major contributors was not motivated by profit or concerned about risk. It was the U.S. government, following a social policy—using government’s financial and regulatory power to boost homeownership by increasing the credit available to low-income borrowers. This was done, first, by requiring Fannie Mae and Freddie Mac to acquire increasing numbers of “affordable” housing loans. An affordable-housing loan was one made to a borrower at or below the median income in the area where the borrower lived. This was required in legislation that Congress adopted in the early 1990s, the Housing and Community Development Act of 1992. Initially, the act required that 30 percent of all loans Fannie and Freddie acquired had to be affordable, but the Department of Housing and Urban Development (HUD) was given authority under the act to increase these requirements. It did so repeatedly from 1995 until 2007, so

that by 2007, 55 percent of all loans Fannie and Freddie acquired had to be affordable, with a subgoal of 25 percent for low-income borrowers who were at or below 60 percent of the area median income (see Table 1).

In effect, Fannie and Freddie were put into competition with the Federal Housing Administration (FHA), which also was required to insure mortgages for borrowers at or below the median income, and with insured banks, which were required under the Community Reinvestment Act (CRA) to make loans to borrowers who were at or below 80 percent of the median income in the banks' service areas. It should be obvious that when Fannie and Freddie, FHA, and all insured banks are trying to find the same borrowers—those who are at or below the median income (or 80 percent of the median income in the case of CRA) where they live—borrowers who could meet the standards for prime loans (a substantial down payment, unblemished credit, a steady job, and an income that would support a mortgage) might be difficult to find. But all these lenders were required by law or regulation to make the loans, so they had to settle for lower-quality loans than they would prefer or had customarily required.

Moreover, in competing with one another, they paid more for these loans than they were worth on a risk-adjusted basis and thus underpriced the risks. The result by 2008, according to research by my AEI colleague Edward Pinto (2010a), was that two-thirds of the subprime and other high-risk loans were held or guaranteed by government entities or entities required by the government to acquire, guarantee, or insure the loans (Table 2). This makes it very clear that the great bubble of 1997–2007 did not develop naturally as an ordinary bubble; it was driven by a government social policy intended to increase homeownership in the United States. For this reason, that bubble cannot be classified as just another bubble among many that the Elliott-Baily study describes. Not only was it larger than any other known bubble in its dollar amount, but because of its provenance as an artifact of government policy it lasted well beyond the time that other bubbles would naturally have collapsed. For this reason alone, it was more destructive than any other bubble in history when it finally burst. Moreover, because of the low quality of the mortgages it contained, that collapse resulted in an unprecedented number of delinquencies and defaults.

Table 3 shows the delinquency rates on the 27 million subprime and Alt-A mortgages that were in the bubble before the financial

TABLE 1
HOUSING GOALS FOR FANNIE MAE AND FREDDIE MAC, 1996–2008
(PERCENT)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
<i>Low & Mod Housing Goals</i>	40	42	42	42	42	50	50	50	50	52	53	55	56
Fannie Actual	45	45	44	46	50	51	52	52	53	55	57	56	54
Freddie Actual	41	43	43	46	50	53	50	51	52	54	56	56	51
<i>Special Affordable Goal</i>	12	14	14	14	14	20	20	20	20	22	23	25	27
Fannie Actual	15	17	15	18	19	22	21	21	24	24	28	27	26
Freddie Actual	14	15	16	18	21	23	20	21	23	26	26	26	23
<i>Underserved Goal</i>	21	24	24	24	24	31	31	31	31	37	38	38	39
Fannie Actual	25	29	27	27	31	33	33	32	32	41	43	43	39
Freddie Actual	28	26	26	27	29	32	31	33	34	43	44	43	38

SOURCE: Federal Housing Finance Agency (2010).

TABLE 2
SUBPRIME AND ALT-A LOANS BY ISSUER OR HOLDER OF
CREDIT RISK, JUNE 30, 2008

Entity	Number of Subprime and Alt-A Loans* (millions)	Unpaid Principal Amount (trillions of dollars)
Fannie Mae and Freddie Mac	12.0	1.8
FHA and Other Federal	5.0	0.6
CRA and HUD Programs	2.2	0.3
<i>Total Federal Government</i>	19.2	2.7
Other (including subprime and Alt-A private label MBS issued by Countrywide, Wall Street and others)	7.8	1.9
<i>Total</i>	27.0	4.6

*Subprime loans are usually defined as loans to borrowers with blemished credit, signified by Fair Isaac Corporation scores lower than 660. Alt-A loans are also not classified as prime because there are deficiencies in the loan itself, such as low or no documentation, an adjustable rate with a teaser, negative amortization, or low or no down payment.

SOURCE: Pinto (2010a).

crisis. These delinquency rates should be compared to the delinquency rates on Fannie and Freddie *prime* mortgages, which in 2008 constituted about 60 percent of their portfolios. That rate was 2.9 percent, less than a quarter of the rate on the best-quality subprime and Alt-A loans that government agencies or government regulated financial institutions held or had guaranteed or insured.

The bubble was more destructive than others for yet another reason. Earlier bubbles deflated in only a few years. This is natural, because the bad loans made during the bubble's growth usually begin to default reasonably quickly and this brings the bubble's growth to a halt. However, in the 1997–2007 bubble, the money pumped in by government policy kept the bubble growing. To afford the higher prices and get the home they wanted borrowers tried to

TABLE 3
 DELINQUENCY RATES ON SUBPRIME AND ALT-A
 MORTGAGES BEFORE THE 2008 FINANCIAL CRISIS

Loan Type	Estimated Loans (millions)	Total Delinquency Rate (%) (30+ Days and in Foreclosure)
1. High-Rate Subprime (including Fannie/ Freddie private MBS holdings)	6.7	45.0
2. Option ARM	1.1	30.5
3. Alt-A (including Fannie/ Freddie/FHLBs private MBS holdings)	2.4	23.0
4. Fannie Subprime/ Alt-A/Nonprime	6.6	17.3
5. Freddie Subprime/ Alt-A/Nonprime	4.1	13.8
6. Government (FHA, VA FHLBs)	4.8	13.5
7. Non-Agency Subprime and CRA Type Loans (not high-rate)	1.0	NA
Total Number of Loans	26.7	

SOURCE: Pinto (2010b).

keep monthly payments low. This led to teaser rates on adjustable rate mortgages, interest only loans, and even to mortgages with negative amortization. It was certain, when the bubble began to deflate and these mortgages could no longer be refinanced, that they would fail in unprecedented numbers.

What we know now is that by 2008 almost 50 percent of all mortgages outstanding in the United States 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. Under these circumstances, one does not have to reach for reduced fear of risk as the explanation for the financial crisis. It's right there in the housing data.

Conclusion

Elliott and Baily make a strong case for explaining the financial crisis as the result of a general decline in risk aversion because of the effect of the great moderation—the period from 1982 to 2007 when it seemed that we understood the causes of financial crises and had found a way to avoid or mitigate them. The evidence for a general weakening in risk aversion coming out of this period is plausible. But the Elliott-Baily narrative assumes that the enormous size of the 1997–2007 housing bubble was also caused by this factor, and that seems implausible. The extraordinary lengths to which the government went to force private sector lending that would not otherwise have occurred—through affordable-housing requirements for Fannie and Freddie as well as demands on FHA and on the banks under CRA—show that the housing bubble that ended in 2007 was not a natural occurrence or the result of mere risk aversion. If it had been, there would have been no need for these government programs.

The housing bubble that finally burst in 2007 was driven by a U.S. government social policy that was intended to increase home ownership in the United States and was thus not subject to the usual limits on the length and size of asset bubbles. As such, it was far larger and lasted far longer than any other bubble in modern times, and, when it deflated, the vast number of poor-quality mortgages it contained defaulted at unprecedented rates. This drove down U.S. housing values and caused the weakening of financial institutions around the world that we know as the financial crisis.

Market participants were certainly taking risks as the bubble grew, and it may well be, as Elliott and Baily posit, that this private risk taking was greater than in the past. But the facts show that that the bubble was inflated by a government social policy that created a vast number of subprime and Alt-A mortgages that would not otherwise have existed. And the risks associated with this policy, which could

produce losses of more than \$400 billion at Fannie and Freddie alone, were being taken by only one unwitting group—the taxpayers.

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