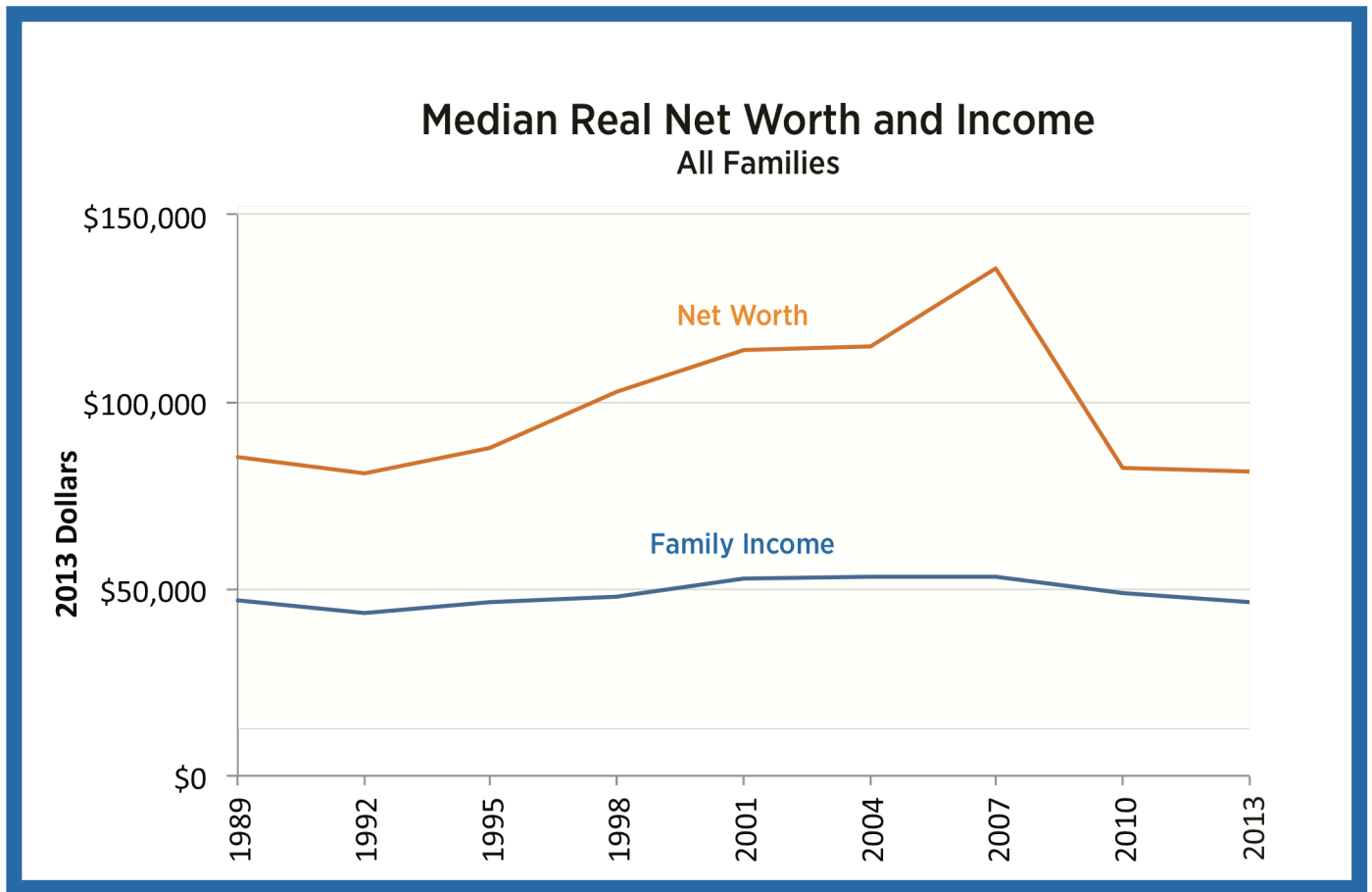




12th Grade Great Recession Inquiry

Who's to Blame for the Great Recession?



Federal Reserve Bank of St. Louis, chart depicting the change in family income and worth, "Median Real Net Worth and Income: All Families," 2013. Courtesy of Federal Reserve Bank of St. Louis. <https://www.stlouisfed.org/on-the-economy/2014/september/the-great-recession-casts-a-long-shadow-on-family-finances>

Supporting Questions

1. What role did the government play in causing the Great Recession?
2. What role did consumers play in causing the Great Recession?
3. What role did financial institutions play in causing the Great Recession?



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<p>New York State Social Studies Framework Key Ideas & Practices</p>	<p>12.E1 INDIVIDUAL RESPONSIBILITY AND THE ECONOMY: Individuals should set personal financial goals, recognize their income needs and debt obligations, and know how to utilize effective budgeting, borrowing, and investment strategies to maximize financial health.</p> <p>12.E3 THE IMPACTS OF AMERICAN CAPITALISM IN A GLOBAL ECONOMY: There are various economic systems in the world. The United States operates within a mixed free-market economy characterized by competition and a limited role of government in economic affairs. Economic policy makers face considerable challenges within a capitalist system, including unemployment, inflation, poverty, and environmental impact. Globalization significantly increases the complexity of these challenges and has exerted strong and transformative effects on workers and entrepreneurs in the US economy.</p> <p>✔ Gathering, Using, and Interpreting Evidence ✔ Economics and Economic Systems ✔ Chronological Reasoning and Causation</p>
<p>Staging the Compelling Question</p>	<p>Examine the long-term impact of the Great Recession and investigate who is experiencing the consequences of the financial crisis of 2008.</p>

<p>Supporting Question 1</p> <p>What role did the government play in causing the Great Recession?</p>	<p>Supporting Question 2</p> <p>What role did consumers play in causing the Great Recession?</p>	<p>Supporting Question 3</p> <p>What role did financial institutions play in causing the Great Recession?</p>
<p>Formative Performance Task</p> <p>List government actions that caused or led to the Great Recession and state the impact those actions had on the economy. Support each statement with evidence.</p>	<p>Formative Performance Task</p> <p>List consumers' actions that caused or led to the Great Recession and state the impact those actions had on the economy. Support each statement with evidence.</p>	<p>Formative Performance Task</p> <p>List financial institutions' actions that caused or led to the Great Recession and state the impact those actions had on the economy. Support each statement with evidence.</p>

Featured Sources

Source A: *Conclusions of the Financial Crisis Inquiry Commission*

Source B: *Conclusions of the Financial Crisis Inquiry Commission, Dissenting Statement*

Source C: "25 People to Blame for the Financial Crisis"

Source D: "The Origins of the Financial Crisis"

Source E: Prologue from *Too Big to Fail: The Inside Story of How Wall Street and Washington Fought to Save the Financial System—And Themselves*

Source F: *State of Lending: Mortgages*

Source G: Remarks by the President at the signing of Dodd-Frank Wall Street Reform and Consumer Protection Act

Source H: "The Debt Indulgence"

Source I: Excerpt from "So We Thought. But Then Again . . ."

Source J: Excerpt from "The Financial Crisis at the Kitchen Table: Trends in Household Debt and Credit"

<p>Summative Performance Task</p>	<p>ARGUMENT Who's to blame for the Great Recession? Construct an argument (e.g., detailed outline, poster, essay) that addresses the compelling question using specific claims and relevant evidence from historical sources while acknowledging competing views.</p> <p>EXTENSION Put the sectors of the economy (i.e., government, consumers, financial institutions) on trial and determine who should be held responsible for the Great Recession. If any sector is found guilty, decide a just punishment.</p>
<p>Taking Informed Action</p>	<p>UNDERSTAND Research the Dodd-Frank Wall Street Reform and Consumer Protection Act (July 21, 2010).</p> <p>ASSESS Determine the extent of the bill's effectiveness at avoiding another recession.</p> <p>ACT Write a letter to a legislator regarding the Dodd-Frank bill, discussing whether the legislation should be revised, repealed, or left as it is.</p>

Overview

Inquiry Description

This inquiry leads students through an investigation of the 2007–2008 subprime-mortgage crisis that ultimately led to the Great Recession, the worst economic downturn in the United States since the Great Depression of the 1920s. The US Financial Crisis Inquiry Commission concluded that the “crisis was avoidable” and that entire sectors of the economy (e.g., financial institutions, banking regulators, policy makers, consumers) all contributed to “putting the financial system on a collision course with crisis.” By investigating the compelling question of who is to blame for the Great Recession, students untangle key aspects of the financial crisis including, but not limited to, the role of government in financial oversight and the degree to which the Federal Reserve and others were prepared for and responded ably to the crisis; the role of consumers and the extent to which they escalated the debt crisis and contributed to the housing bubble; and the role of financial institutions in creating, bundling, and insuring new investment products and the extent to which these put the economy in jeopardy. In investigating a range of contemporary sources, students should develop a complex interpretation of the financial crisis and begin to evaluate the extent to which downturns in the business cycle can be pinned on any one economic sector.

In addition to the Key Ideas listed earlier, this inquiry highlights the following Conceptual Understandings:

- (12.E1c) Managing personal finance effectively requires an understanding of the forms and purposes of financial credit, the impact of personal debt, the role and impact of interest, and the distinction between nominal and real returns. Predatory lending practices target and impact those who are least informed and can least afford such practices. Interest rates reflect perceived risk, so maintaining a healthy credit rating lowers the cost of borrowing.
- (12.E3c) The freedom of the United States economy encourages entrepreneurialism. This is an important factor behind economic growth that can lead to intended consequences (e.g., growth, competition, innovation, improved standard of living, productivity, specialization, trade, outsourcing, class mobility, positive externalities) and unintended consequences (e.g., recession, depression, trade, unemployment, outsourcing, generational poverty, income inequality, the challenges of class mobility, negative externalities.).

NOTE: This inquiry is expected to take four to six 40-minute class periods. The inquiry time frame could expand if teachers think their students need additional instructional experiences (i.e., supporting questions, formative performance tasks, and featured sources). Teachers are encouraged to adapt the inquiries in order to meet the needs and interests of their particular students. Resources can also be modified as necessary to meet individualized education programs (IEPs) or Section 504 Plans for students with disabilities.

Structure of the Inquiry

In addressing the compelling question “Who’s to blame for the Great Recession?” students work through a series of supporting questions, formative performance tasks, and featured sources in order to construct an argument with evidence and counterevidence from a variety of sources.



Staging the Compelling Question

Teachers could stage the compelling question by having students examine the impact of the Great Recession on the typical American family. According to the Federal Reserve, median real net worth of the American family declined 40.1 percent between 2007 and 2013. Economists Ray Boshara, William Emmons, and Bryan Noeth write that “the financial impact of the Great Recession was so severe that all the gains achieved during the 1990s and 2000s were wiped out” (See Staging the Compelling Question, Featured Source A). Students could then investigate who was held accountable and what changed as a result of the financial crisis (e.g., Dodd-Frank Wall Street Reform and Consumer Protection Act). Teachers could use this as an opportunity to launch the compelling question “Who’s to blame for the Great Recession?” and to preview the inquiry extension of bringing the sectors of the economy to justice.

Supporting Questions 1, 2, and 3

The supporting questions ask what roles government, consumers, and financial institutions played in causing the Great Recession. Teachers could easily add additional categories (e.g., other countries) or further break down these existing categories (e.g., proxies for “government” could be the Federal Reserve, Freddie Mac and Fannie Mae, rating agencies, and/or policy makers).

Formative Performance Tasks 1, 2, and 3

Each of the three formative performance tasks calls on students to make parallel lists for each of the three primary stakeholders in the Great Recession. The first task asks students to make a list of governmental actions that caused or led to the Great Recession and the impact those actions had on the economy. In the second formative performance task, students make a similar list of consumers’ actions that caused or led to the Great Recession and the impact those actions had on the economy. Finally, in the third formative performance task, students create a list of financial institutions’ actions that caused or led to the Great Recession and the impact those actions had on the economy. Each item on each list should be supported with evidence from the shared featured sources. Teachers might adapt the three lists in the Formative Performance Tasks by creating a chart or table for students to complete that would list Government, Consumers, and Financial Institutions in the far left column with Causes, Effects (optional), and Evidence from Sources along the top row.



Featured Sources

This inquiry bundles the featured sources into one bank for students to sift through as they address the formative performance tasks. In this way, students are encouraged to examine the sources closely and to see how diverse authors assign blame for the financial crisis. For example, in the Featured Source A, *Conclusions of the Financial Crisis Inquiry Commission*, students should note that the authors assign blame to all three sectors, including government regulators, investment bankers, and consumers. As students begin to read other sources, their job is to see both the systematic failure and the individual actions within each sector that contributed to the crisis. As part of their work with these sources, students could investigate issues and people raised in a source like featured Source C, “25 People to Blame for the Financial Crisis,” to understand the issues more completely.

Summative Performance Task

At this point in the inquiry, students have examined the unique and interrelated roles that the government, consumers, and financial institutions played in causing the Great Recession. Students should be able to demonstrate the breadth of their understandings and their abilities to use evidence from multiple sources to support their claims. In this task, students construct an evidence-based argument responding to the compelling question “Who’s to blame for the Great Recession?” It is important to note that students’ arguments could take a variety of forms, including a detailed outline, poster, or essay.

Students’ arguments likely will vary, but could include any of the following:

- Everybody involved with the 2007–2008 financial crisis is partly to blame for the Great Recession: the government, for a lack of oversight; consumers, for reckless borrowing; and financial institutions, for predatory lending and unscrupulous bundling and selling of mortgage-backed securities.
- Consumers are ultimately to blame for the Great Recession, since they recklessly took on debt and defaulted at historically high rates.
- The Federal Reserve was to blame for the Great Recession, because it created the conditions for a housing bubble that led to the economic downturn and because it was instrumental in perpetuating the crisis by not doing enough to stop it.
- Financial institutions were to blame for the Great Recession, because they created trillions of dollars in risky mortgages and they packaged, repackaged, and sold those loans to investors around the world.

Students could extend the arguments by putting the sectors of the economy (i.e., government, consumers, and financial institutions) on trial and answering the compelling question “Who’s to blame for the Great Recession?” If any sector is found guilty, students could determine a just punishment.

Students have the opportunity to Take Informed Action by drawing on their knowledge of the causes of the Great Recession. They demonstrate that they *understand* by researching the Dodd-Frank Wall Street Reform and Consumer Protection Act signed into law on July 21, 2010. They show their ability to *assess* by determining the extent of the bill’s effectiveness at avoiding another recession. And they can *act* by writing a letter to a legislator regarding the Dodd-Frank bill in which they discuss whether the legislation ought to be repealed, revised, or left as it is.

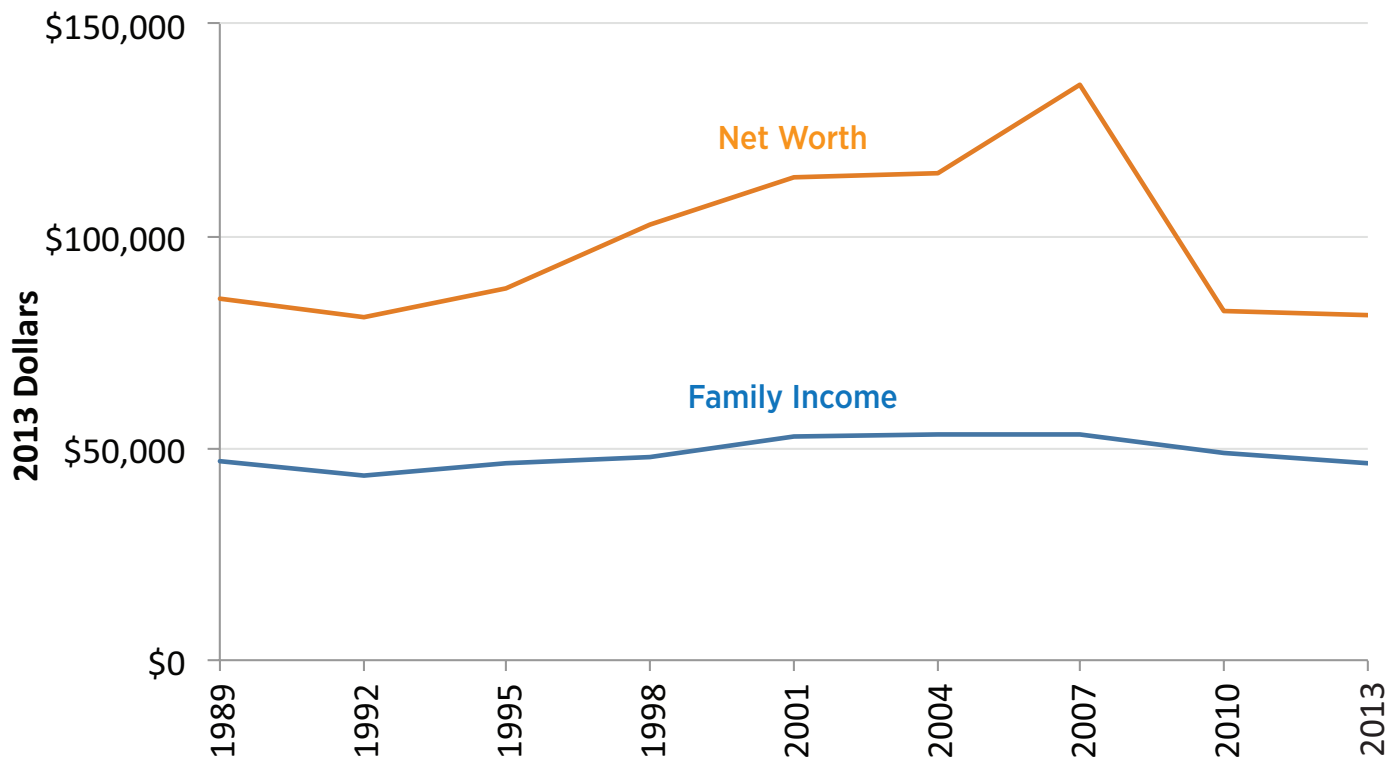
Staging the Compelling Question

Featured Source

Source A: Ray Boshara, William Emmons, and Bryan Noeth, article describing the effect of the recession on the American family, "The Great Recession Casts a Long Shadow on Family Finances" (excerpts), September 9, 2014

The income and wealth of the typical American family declined between 2010 and 2013, according to the Federal Reserve’s latest Survey of Consumer Finances. (See the figure below.) These declines reduced the median real (inflation-adjusted) family income and net worth in the United States in 2013 to \$46,668 (from \$49,022 in 2010) and to \$81,400 (from \$82,521 in 2010), respectively.

Median Real Net Worth and Income All Families



SOURCE: Federal Reserve Board’s Survey of Consumer Finances.

FEDERAL RESERVE BANK of ST. LOUIS

Combined with significant declines between 2007 and 2010 on both measures, the cumulative decline in median real family income between 2007 and 2013 was 12.1 percent, while median real net worth declined 40.1 percent. The financial impact of the Great Recession was so severe that all the gains achieved during the 1990s and 2000s were wiped out. Median real family income was 1.0 percent lower in 2013 than in 1989, while median real net worth in 2013 was 4.3 percent below its 1989 level.

As discouraging as these declines are, several economically vulnerable groups have fared even worse....The median real income among families headed by someone under 40 has fallen from 96 percent of the overall median income

in 1989 to only 87 percent in 2013. The median income of families headed by an African-American or someone of Hispanic origin (of any race) reached only 67 percent of the overall median in 2013, down from 70 percent in 2007. Among families headed by someone without a high-school degree, the median real income in 2013 was only 48 percent of the overall median, down from 51 percent three years earlier.

Even in the sixth year of economic recovery, the Great Recession's impact on American families' income and wealth continues to be felt widely. The most economically vulnerable groups of families generally have suffered even larger setbacks than the typical family in the overall population.

The data now affirm what most Americans have been feeling since the recession ended—that their own recovery is not yet complete. And as many families continue to accumulate new debt at a slower pace or actually “delever” their balance sheets, shedding the debts accumulated in the run-up to the financial crisis, we believe less than robust economic growth will continue.

Courtesy of Federal Reserve Bank of St. Louis. <https://www.stlouisfed.org/on-the-economy/2014/september/the-great-recession-casts-a-long-shadow-on-family-finances>



Supporting Questions 1, 2, 3

Featured Source

Source A: Financial Crisis Inquiry Commission, report on causes and scope of the financial crisis of 2007-2008, “Conclusions of the Financial Crisis Inquiry Commission,” January 2011

In this report, we detail the events of the crisis. But a simple summary, as we see it, is useful at the outset. While the vulnerabilities that created the potential for crisis were years in the making, it was the collapse of the housing bubble—fueled by low interest rates, easy and available credit, scant regulation, and toxic mortgages—that was the spark that ignited a string of events, which led to a full-blown crisis in the fall of 2008. Trillions of dollars in risky mortgages had become embedded throughout the financial system, as mortgage-related securities were packaged, repackaged, and sold to investors around the world. When the bubble burst, hundreds of billions of dollars in losses in mortgages and mortgage-related securities shook markets as well as financial institutions that had significant exposures to those mortgages and had borrowed heavily against them. This happened not just in the United States but around the world. The losses were magnified by derivatives such as synthetic securities.

The crisis reached seismic proportions in September 2008 with the failure of Lehman Brothers and the impending collapse of the insurance giant American International Group (AIG). Panic fanned by a lack of transparency of the balance sheets of major financial institutions, coupled with a tangle of interconnections among institutions perceived to be “too big to fail,” caused the credit markets to seize up. Trading ground to a halt. The stock market plummeted. The economy plunged into a deep recession.

The financial system we examined bears little resemblance to that of our parents’ generation. The changes in the past three decades alone have been remarkable. The financial markets have become increasingly globalized. Technology has transformed the efficiency, speed, and complexity of financial instruments and transactions. There is broader access to and lower costs of financing than ever before. And the financial sector itself has become a much more dominant force in our economy.

From 1978 to 2007 the amount of debt held by the financial sector soared from \$3 trillion to \$36 trillion, more than doubling as a share of gross domestic product. The very nature of many Wall Street firms changed—from relatively staid private partnerships to publicly traded corporations taking greater and more diverse kinds of risks. By 2005, the 10 largest U.S. commercial banks held 55% of the industry’s assets, more than double the level held in 1990. On the eve of the crisis in 2006, financial sector profits constituted 27% of all corporate profits in the United States, up from 15% in 1980. Understanding this transformation has been critical to the Commission’s analysis.

Now to our major findings and conclusions, which are based on the facts contained in this report: they are offered with the hope that lessons may be learned to help avoid future catastrophe.

- **We conclude this financial crisis was avoidable.** The crisis was the result of human action and inaction, not of Mother Nature or computer models gone haywire. The captains of finance and the public stewards of our financial system ignored warnings and failed to question, understand, and manage evolving risks within a system essential to the well-being of the American public. Theirs was a big miss, not a stumble. While the business cycle cannot be repealed, a crisis of this magnitude need not have occurred. To paraphrase Shakespeare, the fault lies not in the stars, but in us.
- Despite the expressed view of many on Wall Street and in Washington that the crisis could not have been foreseen or avoided, there were warning signs. The tragedy was that they were ignored or discounted. There was an explosion in risky subprime lending and securitization, an unsustainable rise in housing prices, widespread reports of egregious and predatory lending practices, dramatic increases in household

mortgage debt, and exponential growth in financial firms' trading activities, unregulated derivatives, and short-term "repo" lending markets, among many other red flags. Yet there was pervasive permissiveness; little meaningful action was taken to quell the threats in a timely manner.

The prime example is the Federal Reserve's pivotal failure to stem the flow of toxic mortgages, which it could have done by setting prudent mortgage-lending standards. The Federal Reserve was the one entity empowered to do so and it did not. The record of our examination is replete with evidence of other failures: financial institutions made, bought, and sold mortgage securities they never examined, did not care to examine, or knew to be defective; firms depended on tens of billions of dollars of borrowing that had to be renewed each and every night, secured by subprime mortgage securities; and major firms and investors blindly relied on credit rating agencies as their arbiters of risk. What else could one expect on a highway where there were neither speed limits nor neatly painted lines?

- **We conclude widespread failures in financial regulation and supervision proved devastating to the stability of the nation's financial markets.** The sentries were not at their posts, in no small part due to the widely accepted faith in the self-correcting nature of the markets and the ability of financial institutions to effectively police themselves. More than 30 years of deregulation and reliance on self-regulation by financial institutions, championed by former Federal Reserve chairman Alan Greenspan and others, supported by successive administrations and Congresses, and actively pushed by the powerful financial industry at every turn, had stripped away key safeguards, which could have helped avoid catastrophe. This approach had opened up gaps in oversight of critical areas with trillions of dollars at risk, such as the shadow banking system and over-the-counter derivatives markets. In addition, the government permitted financial firms to pick their preferred regulators in what became a race to the weakest supervisor.

Yet we do not accept the view that regulators lacked the power to protect the financial system. They had ample power in many arenas and they chose not to use it. To give just three examples: the Securities and Exchange Commission could have required more capital and halted risky practices at the big investment banks. It did not. The Federal Reserve Bank of New York and other regulators could have clamped down on Citigroup's excesses in the run-up to the crisis. They did not. Policy makers and regulators could have stopped the runaway mortgage securitization train. They did not. In case after case after case, regulators continued to rate the institutions they oversaw as safe and sound even in the face of mounting troubles, often downgrading them just before their collapse. And where regulators lacked authority, they could have sought it. Too often, they lacked the political will—in a political and ideological environment that constrained it—as well as the fortitude to critically challenge the institutions and the entire system they were entrusted to oversee.

Changes in the regulatory system occurred in many instances as financial markets evolved. But as the report will show, the financial industry itself played a key role in weakening regulatory constraints on institutions, markets, and products. It did not surprise the Commission that an industry of such wealth and power would exert pressure on policy makers and regulators. From 1999 to 2008, the financial sector expended \$2.7 billion in reported federal lobbying expenses; individuals and political action committees in the sector made more than \$1 billion in campaign contributions. What troubled us was the extent to which the nation was deprived of the necessary strength and independence of the oversight necessary to safeguard financial stability.

- **We conclude dramatic failures of corporate governance and risk management at many systemically important financial institutions were a key cause of this crisis.** There was a view that instincts for self-preservation inside major financial firms would shield them from fatal risk-taking without the need for a steady regulatory hand, which, the firms argued, would stifle innovation. Too many of these institutions

acted recklessly, taking on too much risk, with too little capital, and with too much dependence on short-term funding. In many respects, this reflected a fundamental change in these institutions, particularly the large investment banks and bank holding companies, which focused their activities increasingly on risky trading activities that produced hefty profits. They took on enormous exposures in acquiring and supporting subprime lenders and creating, packaging, repackaging, and selling trillions of dollars in mortgage-related securities, including synthetic financial products. Like Icarus, they never feared flying ever closer to the sun.

Many of these institutions grew aggressively through poorly executed acquisition and integration strategies that made effective management more challenging. The CEO of Citigroup told the Commission that a \$40 billion position in highly rated mortgage securities would “not in any way have excited my attention,” and the co-head of Citigroup’s investment bank said he spent “a small fraction of 1%” of his time on those securities. In this instance, too big to fail meant too big to manage.

Financial institutions and credit rating agencies embraced mathematical models as reliable predictors of risks, replacing judgment in too many instances. Too often, risk management became risk justification.

Compensation systems—designed in an environment of cheap money, intense competition, and light regulation—too often rewarded the quick deal, the short-term gain—without proper consideration of long-term consequences. Often, those systems encouraged the big bet—where the payoff on the upside could be huge and the down-side limited. This was the case up and down the line—from the corporate boardroom to the mortgage broker on the street.

Our examination revealed stunning instances of governance breakdowns and irresponsibility. You will read, among other things, about AIG senior management’s ignorance of the terms and risks of the company’s \$79 billion derivatives exposure to mortgage-related securities; Fannie Mae’s quest for bigger market share, profits, and bonuses, which led it to ramp up its exposure to risky loans and securities as the housing market was peaking; and the costly surprise when Merrill Lynch’s top management realized that the company held \$55 billion in “super-senior” and supposedly “super-safe” mortgage-related securities that resulted in billions of dollars in losses.

- **We conclude a combination of excessive borrowing, risky investments, and lack of transparency put the financial system on a collision course with crisis.** Clearly, this vulnerability was related to failures of corporate governance and regulation, but it is significant enough by itself to warrant our attention here.

In the years leading up to the crisis, too many financial institutions, as well as too many households, borrowed to the hilt, leaving them vulnerable to financial distress or ruin if the value of their investments declined even modestly. For example, as of 2007, the five major investment banks—Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley—were operating with extraordinarily thin capital. By one measure, their leverage ratios were as high as 40 to 1 meaning for every \$40 in assets, there was only \$1 in capital to cover losses. Less than a 3% drop in asset values could wipe out a firm. To make matters worse, much of their borrowing was short-term, in the overnight market—meaning the borrowing had to be renewed each and every day. For example, at the end of 2007, Bear Stearns had \$11.8 billion in equity and \$383.6 billion in liabilities and was borrowing as much as \$70 billion in the overnight market. It was the equivalent of a small business with \$50,000 in equity borrowing \$1.6 million, with \$296,750 of that due each and every day. One can’t really ask “What were they thinking?” when it seems that too many of them were thinking alike.

And the leverage was often hidden—in derivatives positions, in off-balance-sheet entities, and through “window dressing” of financial reports available to the investing public.

The kings of leverage were Fannie Mae and Freddie Mac, the two behemoth government-sponsored enterprises (GSEs). For example, by the end of 2007, Fannie’s and Freddie’s combined leverage ratio, including loans they owned and guaranteed, stood at 75 to 1.

But financial firms were not alone in the borrowing spree: from 2001 to 2007, national mortgage debt almost doubled, and the amount of mortgage debt per household rose more than 63% from \$91,500 to \$149,500, even while wages were essentially stagnant. When the housing downturn hit, heavily indebted financial firms and families alike were walloped.

The heavy debt taken on by some financial institutions was exacerbated by the risky assets they were acquiring with that debt. As the mortgage and real estate markets churned out riskier and riskier loans and securities, many financial institutions loaded up on them. By the end of 2007, Lehman had amassed \$111 billion in commercial and residential real estate holdings and securities, which was almost twice what it held just two years before, and more than four times its total equity. And again, the risk wasn’t being taken on just by the big financial firms, but by families, too. Nearly one in 10 mortgage borrowers in 2005 and 2006 took out “option ARM” loans, which meant they could choose to make payments so low that their mortgage balances rose every month.

Within the financial system, the dangers of this debt were magnified because transparency was not required or desired. Massive, short-term borrowing, combined with obligations unseen by others in the market, heightened the chances the system could rapidly unravel. In the early part of the 20th century, we erected a series of protections—the Federal Reserve as a lender of last resort, federal deposit insurance, ample regulations—to provide a bulwark against the panics that had regularly plagued America’s banking system in the 19th century. Yet, over the past 30-plus years, we permitted the growth of a shadow banking system—opaque and laden with short-term debt—that rivaled the size of the traditional banking system. Key components of the market—for example, the multitrillion-dollar repo lending market, off-balance-sheet entities, and the use of over-the-counter derivatives—were hidden from view, without the protections we had constructed to prevent financial meltdowns. We had a 21st-century financial system with 19th-century safeguards.

When the housing and mortgage markets cratered, the lack of transparency, the extraordinary debt loads, the short-term loans, and the risky assets all came home to roost. What resulted was panic. We had reaped what we had sown.

- **We conclude the government was ill prepared for the crisis, and its inconsistent response added to the uncertainty and panic in the financial markets.** As part of our charge, it was appropriate to review government actions taken in response to the developing crisis, not just those policies or actions that preceded it, to determine if any of those responses contributed to or exacerbated the crisis.

As our report shows, key policy makers—the Treasury Department, the Federal Reserve Board, and the Federal Reserve Bank of New York—who were best positioned to watch over our markets were ill prepared for the events of 2007 and 2008. Other agencies were also behind the curve. They were hampered because they did not have a clear grasp of the financial system they were charged with overseeing, particularly as it had evolved in the years leading up to the crisis. This was in no small measure due to the lack of transparency in key markets. They thought risk had been diversified when, in fact, it had

been concentrated. Time and again, from the spring of 2007 on, policy makers and regulators were caught off guard as the contagion spread, responding on an ad hoc basis with specific programs to put fingers in the dike. There was no comprehensive and strategic plan for containment, because they lacked a full understanding of the risks and interconnections in the financial markets. Some regulators have conceded this error. We had allowed the system to race ahead of our ability to protect it.

While there was some awareness of, or at least a debate about, the housing bubble, the record reflects that senior public officials did not recognize that a bursting of the bubble could threaten the entire financial system. Throughout the summer of 2007, both Federal Reserve Chairman Ben Bernanke and Treasury Secretary Henry Paulson offered public assurances that the turmoil in the subprime mortgage markets would be contained. When Bear Stearns's hedge funds, which were heavily invested in mortgage-related securities, imploded in June 2007, the Federal Reserve discussed the implications of the collapse. Despite the fact that so many other funds were exposed to the same risks as those hedge funds, the Bear Stearns funds were thought to be "relatively unique." Days before the collapse of Bear Stearns in March 2008, SEC Chairman Christopher Cox expressed "comfort about the capital cushions" at the big investment banks. It was not until August 2008, just weeks before the government takeover of Fannie Mae and Freddie Mac, that the Treasury Department understood the full measure of the dire financial conditions of those two institutions. And just a month before Lehman's collapse, the Federal Reserve Bank of New York was still seeking information on the exposures created by Lehman's more than 900,000 derivatives contracts.

In addition, the government's inconsistent handling of major financial institutions during the crisis—the decision to rescue Bear Stearns and then to place Fannie Mae and Freddie Mac into conservatorship, followed by its decision not to save Lehman Brothers and then to save AIG—increased uncertainty and panic in the market.

In making these observations, we deeply respect and appreciate the efforts made by Secretary Paulson, Chairman Bernanke, and Timothy Geithner, formerly president of the Federal Reserve Bank of New York and now treasury secretary, and so many others who labored to stabilize our financial system and our economy in the most chaotic and challenging of circumstances.

- **We conclude there was a systemic breakdown in accountability and ethics.** The integrity of our financial markets and the public's trust in those markets are essential to the economic well-being of our nation. The soundness and the sustained prosperity of the financial system and our economy rely on the notions of fair dealing, responsibility, and transparency. In our economy, we expect businesses and individuals to pursue profits, at the same time that they produce products and services of quality and conduct themselves well. Unfortunately—as has been the case in past speculative booms and busts—we witnessed an erosion of standards of responsibility and ethics that exacerbated the financial crisis. This was not universal, but these breaches stretched from the ground level to the corporate suites. They resulted not only in significant financial consequences but also in damage to the trust of investors, businesses, and the public in the financial system.

For example, our examination found, according to one measure, that the percentage of borrowers who defaulted on their mortgages within just a matter of months after taking a loan nearly doubled from the summer of 2006 to late 2007. This data indicates they likely took out mortgages that they never had the capacity or intention to pay. You will read about mortgage brokers who were paid "yield spread premiums" by lenders to put borrowers into higher-cost loans so they would get bigger fees, often never disclosed to borrowers. The report catalogues the rising incidence of mortgage fraud, which flourished in an environment of collapsing lending standards and lax regulation. The number of suspicious activity

reports—reports of possible financial crimes filed by depository banks and their affiliates—related to mortgage fraud grew 20-fold between 1996 and 2005 and then more than doubled again between 2005 and 2009. One study places the losses resulting from fraud on mortgage loans made between 2005 and 2007 at \$112 billion.

Lenders made loans that they knew borrowers could not afford and that could cause massive losses to investors in mortgage securities. As early as September 2004, Countrywide executives recognized that many of the loans they were originating could result in “catastrophic consequences.” Less than a year later, they noted that certain high-risk loans they were making could result not only in foreclosures but also in “financial and reputational catastrophe” for the firm. But they did not stop.

And the report documents that major financial institutions ineffectively sampled loans they were purchasing to package and sell to investors. They knew a significant percentage of the sampled loans did not meet their own underwriting standards or those of the originators. Nonetheless, they sold those securities to investors. The Commission’s review of many prospectuses provided to investors found that this critical information was not disclosed.

THESE CONCLUSIONS must be viewed in the context of human nature and individual and societal responsibility. First, to pin this crisis on mortal flaws like greed and hubris would be simplistic. It was the failure to account for human weakness that is relevant to this crisis.

Second, we clearly believe the crisis was a result of human mistakes, misjudgments, and misdeeds that resulted in systemic failures for which our nation has paid dearly. As you read this report, you will see that specific firms and individuals acted irresponsibly. Yet a crisis of this magnitude cannot be the work of a few bad actors, and such was not the case here. At the same time, the breadth of this crisis does not mean that “everyone is at fault”; many firms and individuals did not participate in the excesses that spawned disaster.

We do place special responsibility with the public leaders charged with protecting our financial system, those entrusted to run our regulatory agencies, and the chief executives of companies whose failures drove us to crisis. These individuals sought and accepted positions of significant responsibility and obligation. Tone at the top does matter and, in this instance, we were let down. No one said “no.”

But as a nation, we must also accept responsibility for what we permitted to occur. Collectively, but certainly not unanimously, we acquiesced to or embraced a system, a set of policies and actions, that gave rise to our present predicament.

Courtesy of Peter J. Wallison, Arthur F. Burns Fellow in Financial Policy Studies, American Enterprise Institute. Used with Permission. <http://cybercemetery.unt.edu/archive/fcic/20110310173538/http://www.fcic.gov/report>



Supporting Questions 1, 2, 3

Featured Source

Source B: Peter Wallison and Arthur Burns, opinion that the financial crisis was caused by deregulation and predatory lending practices, “Conclusions of the Financial Crisis Inquiry Commission, Dissenting Statement,” January 2011

What Caused the Financial Crisis?

George Santayana is often quoted for the aphorism that “Those who cannot remember the past are condemned to repeat it.” Looking back on the financial crisis, we can see why the study of history is often so contentious and why revisionist histories are so easy to construct. There are always many factors that could have caused an historical event; the difficult task is to discern which, among a welter of possible causes, were the significant ones—the ones without which history would have been different. Using this standard, I believe that the sine qua non of the financial crisis was U.S. government housing policy, which led to the creation of 27 million subprime and other risky loans—half of all mortgages in the United States—which were ready to default as soon as the massive 1997-2007 housing bubble began to deflate. If the U.S. government had not chosen this policy path—fostering the growth of a bubble of unprecedented size and an equally unprecedented number of weak and high-risk residential mortgages—the great financial crisis of 2008 would never have occurred.

Initiated by Congress in 1992 and pressed by HUD in both the Clinton and George W. Bush Administrations, the U.S. government’s housing policy sought to increase home ownership in the United States through an intensive effort to reduce mortgage underwriting standards. In pursuit of this policy, HUD used (i) the affordable housing requirements imposed by Congress in 1992 on the government- sponsored enterprises (GSEs) Fannie Mae and Freddie Mac, (ii) its control over the policies of the Federal Housing Administration (FHA), and (iii) a “Best Practices Initiative” for subprime lenders and mortgage banks, to encourage greater subprime and other high risk lending. HUD’s key role in the growth of subprime and other high risk mortgage lending is covered in detail in Part III.

Ultimately, all these entities, as well as insured banks covered by the CRA, were compelled to compete for mortgage borrowers who were at or below the median income in the areas in which they lived. This competition caused underwriting standards to decline, increased the numbers of weak and high risk loans far beyond what the market would produce without government influence, and contributed importantly to the growth of the 1997-2007 housing bubble.

When the bubble began to deflate in mid-2007, the low quality and high risk loans engendered by government policies failed in unprecedented numbers. The effect of these defaults was exacerbated by the fact that few if any investors—including housing market analysts—understood at the time that Fannie Mae and Freddie Mac had been acquiring large numbers of subprime and other high risk loans in order to meet HUD’s affordable housing goals.

Alarmed by the unexpected delinquencies and defaults that began to appear in mid-2007, investors fled the multi-trillion dollar market for mortgage-backed securities (MBS), dropping MBS values—and especially those MBS backed by subprime and other risky loans—to fractions of their former prices. Mark-to-market accounting then required financial institutions to write down the value of their assets—reducing their capital positions and causing great investor and creditor unease. The mechanism by which the defaults and delinquencies on subprime and other high risk mortgages were transmitted to the financial system as a whole is covered in detail in Part II.

In this environment, the government’s rescue of Bear Stearns in March of 2008 temporarily calmed investor fears but created a significant moral hazard; investors and other market participants reasonably believed after the rescue of Bear that all large financial institutions would also be rescued if they encountered financial difficulties. However, when Lehman Brothers—an investment bank even larger than Bear—was allowed to fail, market participants were shocked; suddenly, they were forced to consider the financial health of their counterparties, many of which appeared weakened by losses and the capital writedowns required by mark-to-market accounting. This caused a halt to lending and a hoarding of cash—a virtually unprecedented period of market paralysis and panic that we know as the financial crisis of 2008.

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http://cybercemetery.unt.edu/archive/fcic/20110310173535/http://c0182732.cdn1.cloudfiles.rackspacecloud.com/fcic_final_report_wallison_dissent.pdf



Supporting Questions 1, 2, 3

Featured Source

Source C: Staff writers, list of people claimed to be responsible for the financial crisis of 2007-2008, "25 People to Blame for the Financial Crisis: The Good Intentions, Bad Managers, and Greed behind the Meltdown," *Time*, 2009

TIME's picks for the top 25 people to blame for the financial crisis includes everyone from former Federal Reserve chairman Alan Greenspan and former President George W. Bush to the former CEO of Merrill Lynch and you—the American consumer. As you read our choices, we'd like to know who you think deserves the most blame, and the least. After voting on the relative guilt (or innocence) of each person, view the full results here.

Angelo Mozilo

Phil Gramm

Alan Greenspan

Chris Cox

American Consumers

Hank Paulson

Joe Cassano

Ian McCarthy

Frank Raines

Kathleen Corbet

Dick Fuld

Marion and Herb Sandler

Bill Clinton

George W. Bush

Stan O'Neal

Wen Jiabao

David Lereah

John Devaney

Bernie Madoff

Lew Ranieri

Burton Jablin

Fred Goodwin

Sandy Weill

David Oddsson

Jimmy Cayne

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Supporting Questions 1, 2, 3

Featured Source

Source D: Staff writers, article describing the causes and effects of the financial crisis, “The Origins of the Financial Crisis,” *The Economist*, September 7, 2011

The collapse of Lehman Brothers, a sprawling global bank, in September 2008 almost brought down the world’s financial system. It took huge taxpayer-financed bail-outs to shore up the industry. Even so, the ensuing credit crunch turned what was already a nasty downturn into the worst recession in 80 years. Massive monetary and fiscal stimulus prevented a buddy-can-you-spare-a-dime depression, but the recovery remains feeble compared with previous post-war upturns. GDP is still below its pre-crisis peak in many rich countries, especially in Europe, where the financial crisis has evolved into the euro crisis. The effects of the crash are still rippling through the world economy: witness the wobbles in financial markets as America’s Federal Reserve prepares to scale back its effort to pep up growth by buying bonds.

With half a decade’s hindsight, it is clear the crisis had multiple causes. The most obvious is the financiers themselves—especially the irrationally exuberant Anglo-Saxon sort, who claimed to have found a way to banish risk when in fact they had simply lost track of it. Central bankers and other regulators also bear blame, for it was they who tolerated this folly. The macroeconomic backdrop was important, too. The “Great Moderation”—years of low inflation and stable growth—fostered complacency and risk-taking. A “savings glut” in Asia pushed down global interest rates. Some research also implicates European banks, which borrowed greedily in American money markets before the crisis and used the funds to buy dodgy securities. All these factors came together to foster a surge of debt in what seemed to have become a less risky world.

Start with the folly of the financiers. The years before the crisis saw a flood of irresponsible mortgage lending in America. Loans were doled out to “subprime” borrowers with poor credit histories who struggled to repay them. These risky mortgages were passed on to financial engineers at the big banks, who turned them into supposedly low-risk securities by putting large numbers of them together in pools. Pooling works when the risks of each loan are uncorrelated. The big banks argued that the property markets in different American cities would rise and fall independently of one another. But this proved wrong. Starting in 2006, America suffered a nationwide house-price slump.

The pooled mortgages were used to back securities known as collateralised debt obligations (CDOs), which were sliced into tranches by degree of exposure to default. Investors bought the safer tranches because they trusted the triple-A credit ratings assigned by agencies such as Moody’s and Standard & Poor’s. This was another mistake. The agencies were paid by, and so beholden to, the banks that created the CDOs. They were far too generous in their assessments of them.

Investors sought out these securitised products because they appeared to be relatively safe while providing higher returns in a world of low interest rates. Economists still disagree over whether these low rates were the result of central bankers’ mistakes or broader shifts in the world economy. Some accuse the Fed of keeping short-term rates too low, pulling longer-term mortgage rates down with them. The Fed’s defenders shift the blame to the savings glut—the surfeit of saving over investment in emerging economies, especially China. That capital flooded into safe American-government bonds, driving down interest rates.

Low interest rates created an incentive for banks, hedge funds and other investors to hunt for riskier assets that offered higher returns. They also made it profitable for such outfits to borrow and use the extra cash to amplify their investments, on the assumption that the returns would exceed the cost of borrowing. The low volatility of the Great Moderation increased the temptation to “leverage” in this way. If short-term interest rates are low but unstable, investors will hesitate before leveraging their bets. But if rates appear stable, investors will take the risk

of borrowing in the money markets to buy longer-dated, higher-yielding securities. That is indeed what happened.

From houses to money markets

When America's housing market turned, a chain reaction exposed fragilities in the financial system. Pooling and other clever financial engineering did not provide investors with the promised protection. Mortgage-backed securities slumped in value, if they could be valued at all. Supposedly safe CDOs turned out to be worthless, despite the ratings agencies' seal of approval. It became difficult to sell suspect assets at almost any price, or to use them as collateral for the short-term funding that so many banks relied on. Fire-sale prices, in turn, instantly dented banks' capital thanks to "mark-to-market" accounting rules, which required them to revalue their assets at current prices and thus acknowledge losses on paper that might never actually be incurred.

Trust, the ultimate glue of all financial systems, began to dissolve in 2007—a year before Lehman's bankruptcy—as banks started questioning the viability of their counterparties. They and other sources of wholesale funding began to withhold short-term credit, causing those most reliant on it to founder. Northern Rock, a British mortgage lender, was an early casualty in the autumn of 2007.

Complex chains of debt between counterparties were vulnerable to just one link breaking. Financial instruments such as credit-default swaps (in which the seller agrees to compensate the buyer if a third party defaults on a loan) that were meant to spread risk turned out to concentrate it. AIG, an American insurance giant buckled within days of the Lehman bankruptcy under the weight of the expansive credit-risk protection it had sold. The whole system was revealed to have been built on flimsy foundations: banks had allowed their balance-sheets to bloat, but set aside too little capital to absorb losses. In effect they had bet on themselves with borrowed money, a gamble that had paid off in good times but proved catastrophic in bad.

Regulators asleep at the wheel

Failures in finance were at the heart of the crash. But bankers were not the only people to blame. Central bankers and other regulators bear responsibility too, for mishandling the crisis, for failing to keep economic imbalances in check and for failing to exercise proper oversight of financial institutions.

The regulators' most dramatic error was to let Lehman Brothers go bankrupt. This multiplied the panic in markets. Suddenly, nobody trusted anybody, so nobody would lend. Non-financial companies, unable to rely on being able to borrow to pay suppliers or workers, froze spending in order to hoard cash, causing a seizure in the real economy. Ironically, the decision to stand back and allow Lehman to go bankrupt resulted in more government intervention, not less. To stem the consequent panic, regulators had to rescue scores of other companies.

But the regulators made mistakes long before the Lehman bankruptcy, most notably by tolerating global current-account imbalances and the housing bubbles that they helped to inflate. Central bankers had long expressed concerns about America's big deficit and the offsetting capital inflows from Asia's excess savings. Ben Bernanke highlighted the savings glut in early 2005, a year before he took over as chairman of the Fed from Alan Greenspan. But the focus on net capital flows from Asia left a blind spot for the much bigger gross capital flows from European banks. They bought lots of dodgy American securities, financing their purchases in large part by borrowing from American money-market funds.

In other words, although Europeans claimed to be innocent victims of Anglo-Saxon excess, their banks were actually in the thick of things. The creation of the euro prompted an extraordinary expansion of the financial sector both within the euro area and in nearby banking hubs such as London and Switzerland. Recent research by Hyun Song Shin, an economist at Princeton University, has focused on the European role in fomenting the crisis. The glut that caused America's loose credit conditions before the crisis, he argues, was in global banking rather than in world savings.

Moreover, Europe had its own internal imbalances that proved just as significant as those between America and China. Southern European economies racked up huge current-account deficits in the first decade of the euro while countries in northern Europe ran offsetting surpluses. The imbalances were financed by credit flows from the euro-zone core to the overheated housing markets of countries like Spain and Ireland. The euro crisis has in this respect been a continuation of the financial crisis by other means, as markets have agonised over the weaknesses of European banks loaded with bad debts following property busts.

Central banks could have done more to address all this. The Fed made no attempt to stem the housing bubble. The European Central Bank did nothing to restrain the credit surge on the periphery, believing (wrongly) that current-account imbalances did not matter in a monetary union. The Bank of England, having lost control over banking supervision when it was made independent in 1997, took a mistakenly narrow view of its responsibility to maintain financial stability.

Central bankers insist that it would have been difficult to temper the housing and credit boom through higher interest rates. Perhaps so, but they had other regulatory tools at their disposal, such as lowering maximum loan-to-value ratios for mortgages, or demanding that banks should set aside more capital.

Lax capital ratios proved the biggest shortcoming. Since 1988 a committee of central bankers and supervisors meeting in Basel has negotiated international rules for the minimum amount of capital banks must hold relative to their assets. But these rules did not define capital strictly enough, which let banks smuggle in forms of debt that did not have the same loss-absorbing capacity as equity.

Under pressure from shareholders to increase returns, banks operated with minimal equity, leaving them vulnerable if things went wrong. And from the mid-1990s they were allowed more and more to use their own internal models to assess risk—in effect setting their own capital requirements. Predictably, they judged their assets to be ever safer, allowing balance-sheets to balloon without a commensurate rise in capital.

The Basel committee also did not make any rules regarding the share of a bank's assets that should be liquid. And it failed to set up a mechanism to allow a big international bank to go bust without causing the rest of the system to seize up.

All in it together

The regulatory reforms that have since been pushed through at Basel read as an extended *mea culpa* by central bankers for getting things so grievously wrong before the financial crisis. But regulators and bankers were not alone in making misjudgments. When economies are doing well there are powerful political pressures not to rock the boat. With inflation at bay central bankers could not appeal to their usual rationale for spoiling the party. The long period of economic and price stability over which they presided encouraged risk-taking. And as so often in the history of financial crashes, humble consumers also joined in the collective delusion that lasting prosperity could be built on ever-bigger piles of debt.

“The origins of the financial crisis: Crash course”, *The Economist*, 7 Sept 2013 <http://www.economist.com/node/21584534> © The Economist newspaper Limited, London (7 Sept 2013). <http://www.economist.com/node/21584534/print>.

Supporting Questions 1, 2, 3

Featured Source

Source E: Andrew Sorkin, prologue about the financial crisis from the viewpoint of the JP Morgan CEO, *Too Big to Fail: The Inside Story of How Wall Street and Washington Fought to Save the Financial System—And Themselves*, 2009

PROLOGUE

Standing in the kitchen of his Park Avenue apartment, Jamie Dimon poured himself a cup of coffee, hoping it might ease his headache. He was recovering from a slight hangover, but his head really hurt for a different reason: *He knew too much.*

It was just past 7:00 a.m. on the morning of Saturday, September 13, 2008. Dimon, the chief executive of JP Morgan Chase, the nation's third largest bank, had spent part of the prior evening at an emergency, all-hands-on-deck meeting at the Federal Reserve Bank of New York with a dozen of his rival Wall Street CEOs. Their assignment was to come up with a plan to save Lehman Brothers, the nation's fourth-largest investment bank—or risk the collateral damage that might ensue in the markets.

To Dimon it was a terrifying predicament that caused his mind to spin as he rushed home afterward. He was already more than two hours late for a dinner party that his wife, Judy, was hosting. He was embarrassed by his delay because the dinner was for the parents of their daughter's boyfriend, whom he was meeting for the first time.

"Honestly, I'm never this late," he offered, hoping to elicit some sympathy.

Trying to avoid saying more than he should, still he dropped some hints about what had happened at the meeting. "You know, I am not lying about how serious this situation is," Dimon told his slightly alarmed guests as he mixed himself a martini. "You're going to read about it tomorrow in the papers."

As he promised, Saturday's papers prominently featured the dramatic news to which he had alluded. Leaning against the kitchen counter, Dimon opened the *Wall Street Journal* and read the headline of its lead story: "Lehman Races Clock; Crisis Spreads."

Dimon knew that Lehman Brothers might not make it through the weekend. JP Morgan had examined its books earlier that week as a potential lender and had been unimpressed. He also had decided to request some extra collateral from the firm out of fear it might fall. In the next twenty four hours, Dimon knew, Lehman would either be rescued or ruined.

Knowing what he did, however, Dimon was concerned about more than just Lehman Brothers. He was aware that Merrill Lynch, another icon of Wall Street, was in trouble, too, and he had just asked his staff to make sure JP Morgan had enough collateral from that firm as well. And he was also acutely aware of new dangers developing at the global insurance giant American International Group (AIG) that so far had gone relatively unnoticed by the public—it was his firm's client, and they were scrambling to raise additional capital to save it. By his estimation AIG had only about a week to find a solution, or it, too, could falter.

Of the handful of principals involved in the dialogue about the enveloping crisis—the government included—Dimon was in an especially unusual position. He had the closest thing to perfect, real-time information. That "deal flow" enabled him to identify the fraying threads in the fabric of the financial system, even in the safety nets that others assumed would save the day.

Dimon began contemplating a worst-case scenario, and at 7:30 a.m. he went into his home library and dialed into a conference call with two dozen members of his management team.

"You are about to experience the most unbelievable week in America ever, and we have to prepare for the absolutely worst case," Dimon told his staff. "We have to protect the firm. This is about our survival."

His staff listened intently, but no one was quite certain what Dimon was trying to say.

Like most people on Wall Street—including Richard S. Fuld Jr., Lehman's CEO, who enjoyed one of the longest reigns of any of its leaders—many of those listening to the call assumed that the government would intervene and prevent its failure. Dimon hastened to disabuse them of the notion.

"That's wishful thinking. There is no way, in my opinion, that Washington is going to bail out an investment bank. Nor should they," he said decisively. "I want you all to know that this is a matter of life and death. I'm serious."

Then he dropped his bombshell, one that he had been contemplating for the entire morning. It was his ultimate doomsday scenario.

"Here's the drill," he continued. "We need to prepare right now for Lehman Brothers filing." Then he paused. "And for Merrill Lynch filing." He paused again. "And for AIG filing." Another pause. "And for Morgan Stanley filing." And after a final, even longer pause he added: "And potentially for Goldman Sachs filing."

There was a collective gasp on the phone.

As Dimon had presciently warned in his conference call, the following days would bring a near collapse of the financial system, forcing a government rescue effort with no precedent in modern history. In a period of less than eighteen months, Wall Street had gone from celebrating its most profitable age to finding itself on the brink of an epochal devastation.

Trillions of dollars in wealth had vanished, and the financial landscape was entirely reconfigured. The calamity would definitively shatter some of the most cherished principles of capitalism. The idea that financial wizards had conjured up a new era of low-risk profits, and that American-style financial engineering was the global gold standard, was officially dead.

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Supporting Questions 1, 2, 3

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Source F: Center for Responsible Lending, video overview of and article about the root causes of the financial crisis of 2007-2008, *State of Lending: Mortgages*, December 12, 2012

NOTE: The screen shot below is the initial image of the video on mortgage lending. Teachers and students can view the video by clicking on this link: <http://www.responsiblelending.org/state-of-lending/mortgages/>.



NOTE: At the same site, is a lengthy article on mortgages. The following excerpt, “Lending Abuses and Predatory Practices,” is on page 10 of the article.

The increased complexity in the mortgage market created a chasm between those who originated loans and those who bore the risk of defaults. Under a “traditional” lending model—where lenders both originated and held their mortgages—lenders had a vested interest in ensuring that borrowers could afford to repay their loans. In the more

recent “originate-to-securitize” system, the compensation of brokers, lenders, and securitizers was based on transaction volume, not loan performance. Consequently, many lenders and brokers aggressively marketed and originated loans without evaluating the borrowers’ ability to repay them.

This evolution led to a new breed of dangerous mortgages—such as loans with introductory “teaser” rates that reset after a few years to much higher rates; loans that did not require income verification; and loans with prepayment penalties that locked borrowers into high rates or risky terms. These loans were often made with scant underwriting and marketed without regard for whether they were suitable for the borrowers. Accompanying this expansion of risky loan terms was a deterioration of lending standards. These developments are discussed in more detail in the following *Abuses in Subprime and Alt-A Lending* section.

The severe decline in loan quality was facilitated by two factors. First, the growth in private-label securitization by Wall Street meant that mortgage originators did not need to conform to the lending standards of the GSEs in order to sell their loans. In fact, Wall Street rewarded loan originators for riskier loan products by paying a higher premium for non-conforming loans. At the same time, subprime lenders targeted many of the same borrowers who had been traditionally served by the FHA and VA programs, saddling these borrowers with much riskier debt than they would have received had they gone through the government programs. Worse, evidence suggests that many subprime borrowers could have qualified for conforming or lower-priced loans.¹⁴ Meanwhile, the credit agencies charged with rating the quality of mortgage-backed investments were assigning high ratings to securities backed by these dangerous and unsustainable loans. This gave false assurance to investors that these products were safe.

Credit line: Courtesy of Center for Responsible Lending. Used with Permission.



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Source G: President Barak Obama, remarks at the signing of Dodd-Frank Wall Street Reform and Consumer Protection Act, July 21, 2010

Ronald Reagan Building
11:34 A.M. EDT

THE PRESIDENT: Well, good morning, everyone.

AUDIENCE: Good morning.

THE PRESIDENT: We are gathered in the heart of our nation’s capital, surrounded by memorials to leaders and citizens who served our nation in its earliest days and in its days of greatest trial. Today is such a time for America.

Over the past two years, we have faced the worst recession since the Great Depression. Eight million people lost their jobs. Tens of millions saw the value of their homes and retirement savings plummet. Countless businesses have been unable to get the loans they need and many have been forced to shut their doors. And although the economy is growing again, too many people are still feeling the pain of the downturn.

Now, while a number of factors led to such a severe recession, the primary cause was a breakdown in our financial system. It was a crisis born of a failure of responsibility from certain corners of Wall Street to the halls of power in Washington. For years, our financial sector was governed by antiquated and poorly enforced rules that allowed some to game the system and take risks that endangered the entire economy.

Unscrupulous lenders locked consumers into complex loans with hidden costs. Firms like AIG placed massive, risky bets with borrowed money. And while the rules left abuse and excess unchecked, they also left taxpayers on the hook if a big bank or financial institution ever failed.

Now, even before the crisis hit, I went to Wall Street and I called for common-sense reforms to protect consumers and our economy as a whole. And soon after taking office, I proposed a set of reforms to empower consumers and investors, to bring the shadowy deals that caused this crisis into the light of day, and to put a stop to taxpayer bailouts once and for all. (Applause.) Today, thanks to a lot of people in this room, those reforms will become the law of the land.

For the last year, Chairmen Barney Frank and Chris Dodd have worked day and night—(applause)—Barney and Chris have worked day and night to bring about this reform. And I am profoundly grateful to them. I would be remiss if I didn’t also express my appreciation to Senator Harry Reid and Speaker Nancy Pelosi for their leadership. It wouldn’t have happened without them. (Applause.)

Passing this bill was no easy task. To get there, we had to overcome the furious lobbying of an array of powerful interest groups and a partisan minority determined to block change. So the members who are here today, both on the stage and in the audience, they have done a great service in devoting so much time and expertise to this effort, to looking out for the public interests and not the special interests. (Applause.) And I also want to thank the three Republican senators who put partisanship aside—(applause)—judged this bill on the merits, and voted for reform. We’re grateful to them. (Applause.) And the Republican House members. (Applause.) Good to see you, Joe. (Applause.)

Now, let’s put this in perspective. The fact is, the financial industry is central to our nation’s ability to grow, to

prosper, to compete and to innovate. There are a lot of banks that understand and fulfill this vital role, and there are a whole lot of bankers who want to do right—and do right—by their customers. This reform will help foster innovation, not hamper it. It is designed to make sure that everybody follows the same set of rules, so that firms compete on price and quality, not on tricks and not on traps.

It demands accountability and responsibility from everyone. It provides certainty to everybody, from bankers to farmers to business owners to consumers. And unless your business model depends on cutting corners or bilking your customers, you've got nothing to fear from reform. (Applause.)

Now, for all those Americans who are wondering what Wall Street reform means for you, here's what you can expect. If you've ever applied for a credit card, a student loan, or a mortgage, you know the feeling of signing your name to pages of barely understandable fine print. What often happens as a result is that many Americans are caught by hidden fees and penalties, or saddled with loans they can't afford.

That's what happened to Robin Fox, hit with a massive rate increase on her credit card balance even though she paid her bills on time. That's what happened to Andrew Giordano, who discovered hundreds of dollars in overdraft fees on his bank statement—fees he had no idea he might face. Both are here today. Well, with this law, unfair rate hikes, like the one that hit Robin, will end for good. (Applause.) And we'll ensure that people like Andrew aren't unwittingly caught by overdraft fees when they sign up for a checking account. (Applause.)

With this law, we'll crack down on abusive practices in the mortgage industry. We'll make sure that contracts are simpler—putting an end to many hidden penalties and fees in complex mortgages—so folks know what they're signing.

With this law, students who take out college loans will be provided clear and concise information about their obligations.

And with this law, ordinary investors—like seniors and folks saving for retirement—will be able to receive more information about the costs and risks of mutual funds and other investment products, so that they can make better financial decisions as to what will work for them.

So, all told, these reforms represent the strongest consumer financial protections in history. (Applause.) In history. And these protections will be enforced by a new consumer watchdog with just one job: looking out for people—not big banks, not lenders, not investment houses—looking out for people as they interact with the financial system.

And that's not just good for consumers; that's good for the economy. Because reform will put a stop to a lot of the bad loans that fueled a debt-based bubble. And it will mean all companies will have to seek customers by offering better products, instead of more deceptive ones.

Now, beyond the consumer protections I've outlined, reform will also rein in the abuse and excess that nearly brought down our financial system. It will finally bring transparency to the kinds of complex and risky transactions that helped trigger the financial crisis. Shareholders will also have a greater say on the pay of CEOs and other executives, so they can reward success instead of failure.

And finally, because of this law, the American people will never again be asked to foot the bill for Wall Street's mistakes. (Applause.) There will be no more tax-funded bailouts—period. (Applause.) If a large financial institution should ever fail, this reform gives us the ability to wind it down without endangering the broader economy. And there will be new rules to make clear that no firm is somehow protected because it is “too big to fail,” so we don't have another AIG.

That's what this reform will mean. Now, it doesn't mean our work is over. For these new rules to be effective,

regulators will have to be vigilant. We may need to make adjustments along the way as our financial system adapts to these new changes and changes around the globe. No law can force anybody to be responsible; it's still incumbent on those on Wall Street to heed the lessons of this crisis in terms of how they conduct their businesses.

The fact is every American—from Main Street to Wall Street—has a stake in our financial system. Wall Street banks and firms invest the capital that makes it possible for start-ups to sell new products. They provide loans to businesses to expand and to hire. They back mortgages for families purchasing a new home. That's why we'll all stand to gain from these reforms. We all win when investors around the world have confidence in our markets. We all win when shareholders have more power and more information. We all win when consumers are protected against abuse. And we all win when folks are rewarded based on how well they perform, not how well they evade accountability.

In the end, our financial system only works—our market is only free—when there are clear rules and basic safeguards that prevent abuse, that check excess, that ensure that it is more profitable to play by the rules than to game the system. And that's what these reforms are designed to achieve—no more, no less. Because that's how we will ensure that our economy works for consumers, that it works for investors, that it works for financial institutions—that it works for all of us.

This is the central lesson not only of this crisis but of our history. Ultimately, there's no dividing line between Main Street and Wall Street. We rise or fall together as one nation. So these reforms will help lift our economy and lead all of us to a stronger, more prosperous future.

And that's why I'm so honored to sign these reforms into law, and I'm so grateful to everybody who worked so hard to make this day possible. Thank you very much, everybody. (Applause.)
(The bill is signed.) (Applause.)

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Supporting Questions 1, 2, 3

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Source H: David Brooks, editorial that examines the growing tolerance of debt, “The Debt Indulgence,” *New York Times*, June 4, 2012

Every generation has an incentive to borrow money from the future to spend on itself. But, until ours, no generation of Americans has done it to the same extent. Why?

A huge reason is that earlier generations were insecure. They lived without modern medicine, without modern technology and without modern welfare states. They lived one illness, one drought and one recession away from catastrophe. They developed a moral abhorrence about things like excessive debt, which would further magnify their vulnerability.

Recently, life has become better and more secure. But the aversion to debt has diminished amid the progress. Credit card companies seduced people into borrowing more. Politicians found that they could buy votes with borrowed money. People became more comfortable with red ink.

Today we are living in an era of indebtedness. Over the past several years, society has oscillated ever more wildly through three debt-fueled bubbles. First, there was the dot-com bubble. Then, in 2008, the mortgage-finance bubble. Now, we are living in the fiscal bubble.

In this country, the federal government has borrowed more than \$6 trillion in the last four years alone, trying to counteract the effects of the last two bubbles. States struggle with pension promises that should never have been made. Europe is on the verge of collapse because governments there can’t figure out how to deal with their debts. Nations around the globe have debt-to-G.D.P. ratios at or approaching 90 percent—the point at which growth slows and prosperity stalls.

It all goes back to the increase in the tolerance for debt.

Democrats and Republicans argue about how quickly deficits should be brought down. But everybody knows debt has to be restrained at some point. The problem is that nobody has been able to find a political way to do it.

The common view among politicians is that pundits may rail against debt, but voters don’t actually care. Voters don’t want to face the consequences of their spending demands. They’ll throw you out of office if you make the tough decisions required to cut deficits. That’s why debt mounts and mounts. Voters want it to.

Until maybe today.

Today voters in Wisconsin go to the polls to decide whether to recall Gov. Scott Walker. I’m not a complete fan of the way Walker went about reducing debt. In an age of tough choices, one bedrock principle should be: We’re all in this together. If you are going to cut from the opposing party’s interest groups, you should also cut from some of your own. That’s how you build trust and sustain progress, one administration to the next.

Walker didn’t do that. He just sliced Democrats. But, in the real world, we don’t get to choose perfect test cases. And Walker did at least take on entrenched interest groups. He did turn a \$3.6 billion deficit into a \$150 million surplus, albeit with the help of a tax collection surge. He did make it possible for willing school districts to save money on health insurance so they could spend it on students.

Walker's method was obnoxious, but if he is recalled that will send a broader message, with effects far beyond Wisconsin. It will be a signal that voters are, indeed, unwilling to tolerate tough decisions to reduce debt. In Washington and in state capitals, it will confirm the view that voters don't really care about red ink. It will remove any hope this country might have of avoiding a fiscal catastrophe.

On the other hand, if Walker wins today, it will be a sign, as the pollster Scott Rasmussen has been arguing, that the voters are ahead of the politicians. It will be a sign that voters do value deficit reduction and will vote for people who accomplish it, even in a state that has voted Democratic in every presidential election since 1984.

A vote to keep Walker won't be an antiunion vote. It will be a vote against any special interest that seeks to preserve exorbitant middle-class benefits at the expense of the public good. It will tell the presidential candidates that it is safe to get specific about what they will do this December, when hard deficit choices will have to be made.

President Obama has hung back from the Wisconsin race. I'm hoping that's not crass political opportunism but an acknowledgment that governments do have to confront their unaffordable commitments. Mitt Romney has been more straightforward, but even he hasn't campaigned on the choices he would make. If Walker wins, the presidential candidates would have to be as clear before their election as Walker has been after his.

The era of indebtedness began with a cultural shift. It will require a gradual popular shift to reverse. Today's Wisconsin vote might mark the moment when the nation's long debt indulgence finally began to turn around.

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Supporting Questions 1, 2, 3

Featured Source

Source I: Tyler Cowen, article examining fraudulent borrowing practices on the part of consumers leading up to the financial crisis of 2007-2008, “So We Thought. But Then Again . . .” (excerpt), *New York Times*, January 13, 2008 ”

...IT’S NOT JUST THE LENDERS There has been plenty of talk about “predatory lending,” but “predatory borrowing” may have been the bigger problem. As much as 70 percent of recent early payment defaults had fraudulent misrepresentations on their original loan applications, according to one recent study. The research was done by BasePoint Analytics, which helps banks and lenders identify fraudulent transactions; the study looked at more than three million loans from 1997 to 2006, with a majority from 2005 to 2006. Applications with misrepresentations were also five times as likely to go into default.

Many of the frauds were simple rather than ingenious. In some cases, borrowers who were asked to state their incomes just lied, sometimes reporting five times actual income; other borrowers falsified income documents by using computers. Too often, mortgage originators and middlemen looked the other way rather than slowing down the process or insisting on adequate documentation of income and assets. As long as housing prices kept rising, it didn’t seem to matter.

In other words, many of the people now losing their homes committed fraud. And when a mortgage goes into default in its first year, the chance is high that there was fraud in the initial application, especially because unemployment in general has been low during the last two years.

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http://www.nytimes.com/2008/01/13/business/13view.html?_r=0.



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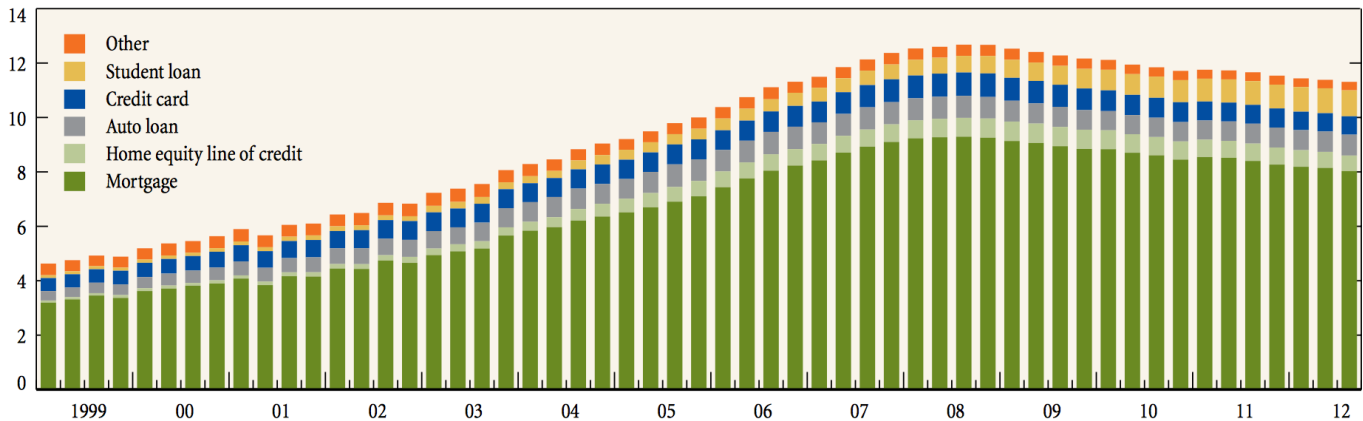
Featured Source

Source J: Meta Brown, Andrew Haughwout, Donghoon Lee, and Wilbert van der Klaauw, study examining total consumer debt over time, “The Financial Crisis at the Kitchen Table: Trends in Household Debt and Credit” (excerpt), 2013

Chart 1

Total Debt Balance and Its Composition

Trillions of dollars



Source: Federal Reserve Bank of New York Consumer Credit Panel/Equifax.

Note: Student loan data prior to 2003 reflect some delays in the reporting of student loans by servicers to credit bureaus. This could lead to some undercounting of student loan totals in specific periods and impact other student loan-specific measurements. However, variability in student loan balances prior to 2003 does not materially affect the aggregate debt time series because the variability is small relative to the total balances. Other components of household debt are unaffected.

Consumer Debt during the Pre-crisis Period

From first-quarter 1999 (when our data begin) through third-quarter 2008, we observe substantial increases in consumer indebtedness. On March 31, 1999, consumers owed about \$4.6 trillion to creditors. During the subsequent nine years, consumer indebtedness rose more than 170 percent, reaching \$12.7 trillion at the end of third-quarter 2008. The driving force behind these changes was debt secured by residential real estate, which accounts for the great majority—more than 70 percent in all periods—of household liabilities. Amounts owed on installment mortgages and home equity lines of credit (HELOCs) tripled over this period—from \$3.3 trillion to \$10 trillion—accounting for \$6.7 trillion of the total \$8 trillion increase in consumer liabilities. Nonetheless, other forms of consumer debt also rose sharply, nearly doubling from \$1.4 trillion to \$2.7 trillion. Many factors were responsible for these increases, including rising populations, incomes, stock and house prices, falling interest rates, and the democratization of credit. Indeed, while consumer indebtedness—the liabilities side of the household balance sheet—was rising sharply, the Flow of Funds Accounts indicate that assets owned by the household sector were growing as well, leaving consumers’ net wealth (the difference between the value of assets owned and liabilities owed) to grow steadily over the period.

Like the Consumer Credit Panel, the Flow of Funds Accounts show an increase in consumer debt from 1999 through mid-2008. Housing’s share of overall debt is roughly 70 to 80 percent during the period in both series, and the relative contributions of housing and nonhousing debt to the consumer debt climb are similar in the Panel and Flow of Funds.

Delinquency rates remained stable from 1999 through 2006 in the Consumer Credit Panel, with roughly 4 percent of total outstanding debt thirty or more days past due (delinquent) and 2 percent of total debt ninety or more days past due (severely delinquent). However, delinquency rose quickly during 2007, reaching 6.7 percent by the end of the year and 8.5 percent by the peak of consumer debt in third-quarter 2008. Severe delinquency climbed to 3.6 percent by the end of 2007 and 5.1 percent by third-quarter 2008. Hence, the data reveal both a pre-crisis period of credit expansion associated with very steady consumer debt performance and emerging evidence of repayment difficulties as early as 2007.

Consumer Debt since the Financial Crisis

Since the end of third-quarter 2008, U.S. consumers have reduced their indebtedness by \$1.4 trillion, resulting in a decrease in the aggregate consumer debt balance from \$12.7 trillion at its peak in third-quarter 2008 to \$11.3 trillion at the end of third-quarter 2012. Chart 1 shows the total debt observed on credit reports for the entire life of the Panel, in the aggregate and broken down by loan type. Total household debt has decreased roughly 11 percent since its peak. Mortgage-related debt now accounts for 76 percent of total debt, with the remainder comprising credit cards, auto loans, student loans, and other consumer debt...

Meta Brown, Andrew Haughwout, Donghoon Lee, and Wilbert van der Klaauw. "The Financial Crisis at the Kitchen Table: Trends in Household Debt and Credit" Federal Reserve Bank of New York Current Issues in Economics and Finance, vol. 19, no. 2 (2013). http://www.newyorkfed.org/research/current_issues/ci19-2.pdf.