What Caused the Financial Crisis of 2008?

What caused the financial crisis of 2008? This is just a guess, but I bet at least 90% of us have strong opinions on this. But, and this is not a guess, most of those opinions are not based on our own critical examination of the issues. One reason for this is because we believe we just don't understand the arguments. We feel they are too technical and beyond us. Honestly, at first blush they do seem that way because of the jargon of finance. Every discipline has its unique language and the key to understanding is to learn the language. In the discipline of finance this is important because it is a language we deal with daily in our money transactions. So it is to our benefit to at least have a rudimentary understanding. Another reason for our unsupported strong opinions is that we are, and have been, lazy about reasoning for ourselves issues important to us. We have a predisposition already developed and we fit what we hear into that bias. It's easy, simple, requires no real thought, just our reaction, so we go with it without investigation into its legitimacy.

At one time or another I have been guilty of all this. There are two basic biases we tend to gravitate to in this crisis:

1. Greedy bankers; and
2. Government intervention through social engineering.

I have an anti-government bias so I begin from number 2. Some of you have an anti-large-business bias and that's where you begin. Okay, there is truth in both positions so we have a partial leg to stand on. Where it becomes wrong is we begin and end there assuming that is the only answer and reason for the crisis of 2008. We hear what we already believe, that reinforces our belief, and we speak out for either number 1 or number 2 as the truth. You understand, don't you, this is a logical fallacy called circular reasoning. You have a belief; you hear something that in your mind supports your belief so you believe it. It is self-validating without ever having to prove the truth.

My whole reason for beginning Shaping How We Think is to expose us to expanding our thinking, to look at issues from several different perspectives, to not read just pro, but con articles to a subject, to ask questions before we come to our conclusions, and then not to plant our conclusions into cement but keep them floating, subject to new information.

Most Americans have been sold the theory that the crash came about because of the greediness of bankers and financial institutions. It was the dominant rhetoric surrounding bailouts, both in the Bush and Obama administrations. Conservatives tried to get their theory out that it was government interference into the economy and the government's concept of social justice that led to the crash, or downturn, but not many listened because by then an anti-big business mentality had already rooted. So both sides of this coin were there, it's just that we tended to only look at one side and not both.

Envy is a driving emotion that has always been around. It's an unnatural/natural feeling to be envious of someone that has more than we do, especially if they have a lot more than we. Of course, to justify our envy and make it something it is not—righteous indignation—we charge those that have more than we to have taken it from us. Kind of like there is only x-amount of dollars available to everyone and so if someone has more than us it prevents us from getting more than we have because there is only x-amount. The rich are hogging the money and need to share it evenly. Well, "even" isn't really at the heart here. We want to punish the rich and take all they have. Even is us having more than the corrupt rich. It's really our greed, but we would never admit it.

Don't mistake what I'm doing here. I know that there are greedy people (and don't think that greed is a driving force of just the rich) and some of the problem leading to the crash came because of greedy people. I'm not denying this and when I'm finished you will understand that they will have to be dealt with. But be careful of the size of greed-brush you paint everyone with because it is a color that doesn't fit every player and justice isn't served by painting everyone the same color.

The Straw and the Camel's Back

Housing was the straw that broke the camel's back. Way back in the 1970s I bought a home that cost me $21,000. Five years later I sold it for $61,000. What made the value of my home go up that much? Nothing. Nothing, real, that is. Today I live in a home that was built for $63,000 and it is valued at over $450,000. What made the value of this home go up so much? Nothing. Nothing real, that is. It's just a plain three-bedroom community home, not very big, not fancy at all, nothing about it screams rich, yet it takes a rich person to purchase it. That's why I rent, I'm not rich.

I had my beliefs for this outrageously inflated price of homes and I wasn't wrong, except there was more to it than I imagined. This outrageous inflation of home prices came about by the confluence of three factors, two of which are related. In the late 1970s and early 80s it began with the rise in the price of a barrel of oil out of OPEC driving up the price at the pump. Price of oil? Price of gas at the pump? How cold this be related to home prices? They drove up the price of oil simply by raising the price, and by shorting the supply that always in itself drives up the price. (You need to understand that there wasn't a real reason for driving up the price, like it became harder to get the oil out of the ground, etc., it was a political decision by OPEC. The hedge against this kind of inflation is competition, but by now we were—the United States—already shorting our own oil shifting our purchasing of oil to OPEC.) Since oil is not only the basic cost of transportation, but in many, many products as well that are manufactured by petroleum, that meant a rise in price of just about everything shrinking our disposable dollars. This inflation of all things brought about a drop in the value of our dollar, so home sellers began raising the price of their home to make up the shortage in loss of disposable income. Short of getting a second or third job, it was the only thing a homeowner had in their wheelhouse of options. (For those of us who rent we had nor have any options.) Speculators jumped onto this raising the price of homes even more. These are the two related factors in this abnormal inflation of home prices: the need to get more—not necessarily to have more but to keep even; and greed pushing the price of homes as far as possible to make more.

A third factor that brought about this steep increase in home prices was the influx of foreign money. Foreigners had more on-hand cash than most Americans and were investing that money in the United States, particularly in real estate. They had so much cash that they didn't balk at the high prices of homes and just plopped the money down for whatever the price was. It began a spiraling circle upwards where things began to cost more and more, wages were raised to keep up with inflation, the price of goods went up to pay for the increase in wages and on and on and on it went until this plain box house I live in costs nearly a half million dollars.

For Americans our home was never about a financial investment that would bring large returns, it was our refuge, a bit of property that we could call our own, where we raised our family, where we did expect a gradual increase so we could move up into a larger home. If we wanted to get rich quick we invested in stocks or we worked harder and longer. Sure, those who already had money and bought second, third, and more houses did so for quick get-rich sales, but that was the exception not the norm. But when our homes became the best way to "catch up" with what we were losing otherwise, or to get rich quick, Americans began inflating their selling price and soon began thinking of their home as that get-rich quick investment forgoing the traditional reasons for owning a home.

If you are going to understand properly what happened in 2008 then you must understand that it was the events listed above that put us on the path to this crisis. This road we got on in the 1980s had its destination in 2008, but it was never inevitable that we take it to the end, there were exits along the way we could have pulled into, we just didn't.

Following One Review of the Crisis

In reviewing this subject there is no shortage of material taking up every position imaginable. I did run across one study from San Jose State College that is perhaps the best common sense approach to the subject I've read. If you are a coffee drinker pour yourself a cup. If you prefer tea, boil a pot of your favorite. If you like beer, forget it, you need a clear head. Even as simple as this study was, I would read a paragraph, stop and contemplate it until it jelled into sense for me, then move on to the next paragraph. And, of course, have a sip of coffee while contemplating. I will attempt to distill this distilled study even further so all of us can understand what happened.

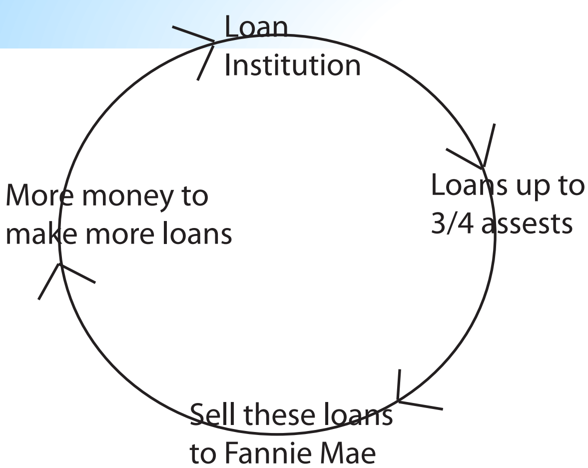
The Nature and the Origin of the Subprime Mortgage Crisis, by Thayer Watkins, San Jose State University Department of Economics. For the full text you can go HERE.

My favorite saying has become, If you don't know history you can't possibly know who and where you are now. Everything comes from something and like it or not, understanding that something helps define our now. For you old timers, when I say I'm going to pull a bit of James Michener on you, you understand that he began most of his sagas deep into prehistory so we understood better the story he was telling of the now. But I'm not going to go as far as he, not this time, anyway, and I'll make it short, but if we don't understand why financial institutions came into being, how are we going to understand what needs fixing, or dumping?

Prior to banks, everyone hid their money under their mattress or kept it in a jar hidden in the kitchen. Enterprising people saw a need, a place where citizens could keep their money safe, except for the occasional bank robbery. People needed to borrow money to buy this or that and with the money investors put into the bank, and the deposits of citizens, money was loaned out. Of course, it's a little more complicated than this but this is a good simple picture. From the San Jose study is this:

> Various financial institutions were set up over time to make the securing of a mortgage quick and convenient. There once were Savings and Loan Associations that were savings institutions which could only invest in home mortgages. Fannie Mae (the Federal Nation Mortgage Association FNMA) was set up in 1938 to provide a secondary market for home mortgages. This meant that if a bank granted a mortgage to someone and later the bank needed funds the bank could readily sell the mortgage to Fannie Mae. However, in order for lending institutions to have access to the secondary mortgage market of Fannie Mae they had to abide by Fannie Mae's rules.

Financial institutions were created in the marketplace, by the marketplace to help families purchase a home, or start a business. In 1938 the Federal government got into the marketplace by setting up Fannie Mae. If mortgage institutions ran short of money to make home loans because they had already loaned out most of their resources, they could borrow from the Federal government through Fannie Mae by selling them their mortgages so the institutions could continue making home loans. It seems simple, enough, and if it were just about money it would be simple, excluding the fact that government money is money taken from people and not invested by them. The catch was that they had to play by Fannie Mae's rules (replace Fannie Mae with government).



As the government does every time, if you borrow money from them, or they give it to you, strings are attached. The government would engineer the marketplace through these secondary regulations placed on loan companies that had to then pass on to the borrower. You know the saying, the man with the money makes the rules. This isn't necessarily bad if those rules are an attempt to protect the investment. The government had other plans with their rules, though; social engineering.

RED LINING

The first issue the government tackled was "red lining". Lending institutions stayed out of certain areas—poor areas—because when they loaned money to people living there more often than not the loan wouldn't be paid back. And even if the borrower could pay back their loan, the market price of their home would go down because the community continued to degrade. So they created this artificial red line that on one side they would make loans and on the other they would not. Was it fair? Weren't the people living in these red-lined areas entitled to own property? The answer to both questions is yes. But wait, how can it be fair and unfair at the same time? It was fair only in the pragmatic sense of protecting the institution's ability to make loans by having money to do so. Their investment would be paid back so other loans could be made. Money loaned into those areas rarely came back, though, and a lending institution had the right to take this into account. It was unfair to those who didn't make enough to live in a better area but did make enough to live in the poorer area, and pay their debts, but weren't given the opportunity to own their own home because of issues outside them or their control. And no, it wasn't about fat-cat bankers wanting just to make profits, it was for many an honest attempt to protect the money they had so those who could and would pay back their loans got the money. Harsh reality, but reality. Those who could make their loan payments were understandably angry when denied simply based upon the area they wanted to move into.

Politicians began to look at red lining not in terms of economics 101 but in terms of racial discrimination because typically these poorer neighborhoods were comprised mostly of minority (black and Hispanic) citizens. Not exclusively minority, but mostly, at least in the government's eyes. Lending institutions were being accused not of following good fiscal policy but deliberately discriminating against minorities and the poor.

I'm not here going to say, nor am I saying that red lining was proper and good. It wasn't, even if understandable. What happened by the government stepping in can be laid at our feet—we the people—because we didn't step out of our comfort zone and find ways to change the situation. Redevelopment isn't necessarily a government thing, it can be a community thing if enough of us are concerned. Of course, it isn't quite this simple because there are other factors leading to poverty. There is a correlation between government dependence and personal responsibility: the more dependent you become on government doing everything for you the less you feel personally responsible to help yourself. But this correlation is for another time.

When the government (a progressive government) stepped in it couched the issues in terms of class and racial warfare, leaving economics entirely out. One issue out of the many became the defining issue and everything else would get lost. The Community Reinvestment Act of 1977 was the progressive answer passed to stop the practice of red lining. About the CRA from the San Jose study is this:

> In the 1970's there was fertile field for community organizers to exploit. One of these community organizers in Chicago was Gale Cincotta. She was convinced that red lining was preventing her neighborhood in west Chicago from developing. She and other members of a community organization talked to bank officials. When that did not produce the results she wanted she organized an action in which her followers interrupted bank business by flooding the bank with demands for time consuming services. Following that action she organized a march of 600 to a meeting of the Chicago city council. When that action failed to produce results she organized 1200 to make a protest at the Department of Housing and Urban Development, a Federal Government Agency. That action produced significant results, an investigation of the situation in west Chicago by the Nixon Administration.
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> Community Organizers
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> Gale Cincotta then sought to prevent a bank from closing its local branch. She organized a protest at the bank and the bank capitulated. It kept its branch open and promised to invest several million dollars in west Chicago. This victory led her to found in 1972 two organizations, the National People's Action (NPA) and the National Training and Information Center (NTIC).
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> By 1975 she had now acquired a significant amount of political power. In that year she organized a conference in Chicago on the matter of red lining. That brought the issue to the attention of the general public and Congress. In 1976 Congress passed the Home and Mortgage Disclosure Act and Gerald Ford signed it into law. This act required banks to disclose where they were granting mortgages. That information allowed Gale Cincotta and other community organizers to make accusations of red lining and racial discrimination against banks. The media picked up and publicized the issue.
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> The Community Reinvestment Act of 1977
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> In 1976 Gale Cincotta announced the formulation of new policy that ultimately became the Community Reinvestment Act (CRA). She propounded the notion that it was immoral for banks to take the deposits of people in one community and lend them for investment in another community. Behind this idea was the belief, held by many not in business, that businesses can easily operate at a profit and constraining their actions for social purposes imposes no cost on their operations. According to Gale Cincotta's belief, banks have a duty to lend to people in the neighborhoods where they operate.
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> Cincotta's ideas caught the attention of William Proxmire, a U.S. Senator for Wisconsin. Proxmire's background was in journalism and he saw no problem in forcing banks to lend to people in the neighborhoods where they operate even if

such loans cannot be justified on the basis of profitability. Proxmire believed that something like Cincotta's proposal would be required to end racial discrimination of banks.

Proxmire had his staff cooperate with Cincotta and her associates. Basically the Community Reinvestment Act of 1977, a piece of legislation of enormous financial and economic consequence, was written by Gale Cincotta and her community organizer associates.

The bill as written by Gale Cincotta and Shel Trapp, another community organizer, required that banks maintain records of where they made loans and that information would be made available to community organizations.

As written the CRA provided that when a bank appeared before regulatory agencies the community organizers had a right to testify about the bank's fulfillment of its duty to serve the needs of the community in which it operates. This enabled the community organizers to extort large donations from banks. If a bank wanted to undertake any new action it knew that it would have to payoff the community organizers to get the request approved by the bank regulators.

Does the term "community organizer" ring a bell?

Were the poor communities behind the red line justified in their complaints? Yes. Were the banks justified in creating a red line? Yes and no. Could compromises be made between poor communities and lending institutions? Yes, and they should have been made, but . . .

I've made this statement in the past and it is fitting here; they began the discussion in the wrong place. The CRA is understandable but the premise behind it is that all lending institutions are evil and out to only make huge profits off the poor and need to be punished. Economics are not even in the discussion. This is the language of Progressivism, of Marxism, of Socialism. Each movement wants to establish its legitimacy as an ideology by vilifying the actions of others and create an "us" versus "them"; the evil bourgeoisie versus the good proletariat. The CRA was an attempt at social justice but the presuppositions of social justice are not the same as those for justice that works out in the social setting. The CRA would in the end create more problems than it solved, and it didn't really solve much.

Read again this last paragraph from the study on CRA: "As written the CRA provided that when a bank appeared before regulatory agencies the community organizers had a right to testify about the bank's fulfillment of its duty to serve the needs of the community in which it operates. This enabled the community organizers to extort large donations from banks. If a bank wanted to undertake any new action it knew that it would have to payoff the community organizers to get the request approved by the bank regulators." As clearly seen here, the motives were not really about solving problems but about power and control: the power and control of the few. People like Gale accused the bankers of being the powerful and the few, and in typical Marxism it wasn't an exchange of the few to the many (the rhetoric used) but an exchange of one "few" to another "few". The many never win in this scenario. Study history and you will see this.

When Marxists wrest a country away from dictators it's nothing more than one evil being exchanged for a different evil, both are evil and the citizens never win. The CRA was less an exchange of evil for good, it was really an exchange of one power group for a different power group. Again, don't mistake me as saying what was happening in red lining was right and good, it wasn't, it was wrong and bad. But correcting one bad with another bad doesn't come out with good. As the old saw goes: two wrongs don't make a right. The CRA was a shot in the class warfare between the evil rich and the good poor, and class warfare is a staple of progressivism. It places the battlefield in emotions (and there is nothing wrong with emotions having a part) while totally excluding the rational.

Returning to the San Jose study:

> In the 1990's under the administration of Franklin Raines, a Clinton Administration appointee, Fannie Mae began to demand that the lending institutions that it dealt with prove that they were not redlining. This meant that the lending institutions would have to fulfill a quota of minority mortgage lending. This in turn meant that the lending agencies would have to lower their standards in terms of such things as down payments and the required incomes. These subprime borrowers would be charged a higher interest rate. Having put the lending agencies into the position of granting subprime mortgages Fannie Mae then had to accept lower standards in the mortgages it purchased. That set the ball rolling. If a bank granted a mortgage to a borrower that was not likely to successfully pay off the mortgage then all the bank had to do was to sell such mortgages to Fannie Mae. The banks typically earned a loan origination fee when the mortgage was granted. The lending agencies could then make substantial profits dealing in subprime mortgages.

The CRA said that lending institutions had to stop red lining. This didn't mean that those who could qualify for a home loan with the ability to repay the loan now got loans. Lending institutions would have to fulfill a quota of minority mortgage lending, not taking into account the reasonability of repayment. This in turn meant that the lending agencies would have to lower their standards in terms of such things as down payments and the required incomes. Remember, the cause for red lining was not the rich against the poor but fiscal prudency that looked at a communities' ability to repay loans given. It was seen that some communities, because the lack of upkeep of the property in those communities, kept losing in value and this meant a couple of things: the value of a home that had a loan would, as we today say, go upside down. That is, it's value would fall below the amount loaned so even if the owner sold the property what they received would not be enough to repay the loan. Secondly, such communities had a high unemployment rate, and those who worked had little income and chances were far greater than not money would only be lost in these communities.

I don't like "bean counters". A bean counter is one who can only look at the beans and count their gain or loss without understanding why there is a gain or loss. They want to protect their beans and do nothing that would take them away and do only that which would increase the number of beans. All they see are beans. Red lining was bean counting. On the other side are those (the government, community organizers) who don't want to look at the beans, don't want to consider them at all. These people had the power, had the control, and because for them the bottom line issue was that lending intuitions were evil fat cats, they were going to force the evil fat cats to make up for their sin by blinding them to beans and loaning to anyone who wanted a loan. This was their solution to red lining.

On a non-emotional level with pragmatic eyes just look at this answer and reason out if it is really workable. You want to help the poor, okay, but in the end will this really be of help? Step away from continuing to read this essay and let this last question percolate in your brain. Follow all your thoughts to their logical conclusions. Then come back and continue reading.

A new term came into our lexicon: subprime. "The term subprime refers to the credit quality of particular borrowers, who have weakened credit histories and a greater risk of loan default than prime borrowers." (Wikipedia). Don't ever mistake this fact: lending institutions were required to make subprime loans, it was not a practice they began on their own since default was greater than repayment and they would in the end lose.

(Now, this is tangential, but something that has always been curious: This subprime borrower—meaning someone who really didn't have the means to repay for the loan they received but were given it anyway—were charged a higher interest rate than those prime borrowers. Okay, the borrower will have a hard time repaying the loan so let's charge them a higher rate that will make it even harder for them to repay the loan. Make sense? I understand that risks come with a higher interest rate because the risk justifies a higher return. That is what helps someone take that higher risk, they will get a high return for their risk because they have an equal chance of losing what they risked. But a risk in a potentially high return investment is different than the risk in a loan. The higher interest rate on a shaky loan will only increase the likely failure of that loan. Maybe it's just me, but I have always found this curious.)

You will recall that all this is going through the governmental institution called Fannie Mae, and later they would add into the mix Freddie Mac. Lending institutions use what is called a "market line" to assess risks, that is, the expected rate of return versus risk. Subprime loans fall below this line meaning the rate of expected return is low and the risk is very high. Given this, why would any lender in their right mind give such a loan? If I come to you and ask you to loan me $1,000 but at the moment I don't have a job and no income to pay you back, but I promise to get a job and pay you, what is the chance you are going to loan me that money? Not very great. So to assume that lenders didn't care about the market line on subprime loans, only greed, what greed is there here? Then let's ask why they would in the face of loss make the loans. There has to be a reason beyond selfish greed from the get-go. Remember, this isn't an institutional decision to give out subprime loans, they are being forced to do so by the government, the community organizers. And now everything begins to change. Forced to do something unprofitable that would drive lenders out of business, lenders now have to find ways to make obvious loss into some kind of gain and the only rule becomes survive at all costs. Now, those of you with an anti-business bias get out of it for a moment and think that if a business only loses money, not makes it, it won't stay in business. You can't have it both ways, not make money and stay in business. Honest lenders are forced to play games to survive. Not-so-honest lenders find ways in this game to not just survive but to make even more money, but in the end we all lose. Add to this "get rich quick" investors who are willing to push everything to its extreme to make more profit. Players are being forced into immoral acts to survive, or their immorality is being fed, but don't forget this game was forged outside the players in such a way to guarantee destruction. Everyone ends up guilty.

The Attraction of Subprime Lending

The first attempt to make subprime lending more attractive was to increase the interest rate so that the return on investment would be great enough to encourage the risk taken. The junk bond market should have been a teacher in this regard. The junk bond market collapsed for the same reason, the high rate of interest was not "sufficient to compensate for their higher risk" of loss. Investors bought junk bonds with the hope of a miracle that what otherwise was a hopeless return might just make it. Get rich quick greed fueled the junk bond market and greedy sellers and greedy buyers lost everything and took a lot of innocent people down with them. You all remember Michael Milken who fueled the junk bond market, then lost everything. What he did was to pool a number of these junk bond mortgages placing them into a bag and sell off the bag to investors with the promise that while some would collapse others would survive and more money would be made than lost. Didn't work, but that was the promise. Yes, one can blame Milken for making such illogical promises, but then you must also blame those who bought the snake oil because they are ultimately responsible for the decisions they make. Being too lazy to research is not an excuse.

Well, good 'ol Freddie Mac and Fannie Mae were created to solve the subprime market and they took this idea of Milken's and packaged the subprime loans, then created a securities market that covered the packages in case of default. It was insurance on bad investments. What an idea! Kind of like selling $100,000 insurance policies to 95-year olds thinking some would live to be 120 paying off their policies and money would be made. And when they didn't there was an insurance paying off the debt.

From the study we read these thoughts:

> "A similar sort of thing occurred with the subprime mortgages. Fannie Mae and Freddie Mac pooled the subprime mortgages and then created securities which were sold around the world. When the subprime borrowers defaulted on their mortgage payments that led to the real estate market being flooded with houses for sale. The subsequent decline in housing prices then led even prime borrowers to walk away from mortgages where the mortgage debt exceeded the market value of the property. Fannie Mae and Freddie Mac were inundated by default claims from the mortgage default insurance they had provided. When Fannie Mae and Freddie Mac were declared bankrupt by their managers there was an instantaneous loss in value for not only the subprime mortgages but also the prime mortgages."

Read the second and third sentence again because it's important. Subprime mortgages sold to people with questionable abilities to repay were a promise of failure waiting to happen, and it did. And it did in a big way because there were so many of those subprime mortgages sold. Now lending institutions, including banks, not only were holding "bad paper", they were also holding a ton of homes that sent the market price of homes spiraling downward. Okay, this is understandable. The third sentence, however, is a shocker: "When the subprime borrowers defaulted on their mortgage payments that led to the real estate market being flooded with houses for sale". The natural shame of losing your home because you could not make the payments was lessened because so many of your neighbors, including so many around the nation, were losing their homes for the same reason; a failure guaranteed because the loan should never have been made in the first place. It became okay to just walk out of your home. This mentality filtered upward to people who could afford their home, could make the payments, but were finding it hard to do so because of circumstances in their lives. Also, many of them were buying homes of greater value than they could personally afford but under the practice of subprime were being ushered into new homes. Many of these homeowners were now making the same choice, It's okay to walk out of the home and let the bank take it back. If you've ever built a snowball you know the snowball effect: it begins small and keeps growing larger and larger as you roll it in the snow. And now the housing market crashes.

A Listing of Straws

This was the straw that broke the camel's back, but it wasn't the only straw on his back. I'll come back to the housing market but let's take a peek at those other straws that were being added to the camel's back.

<u>Greed</u>: "a selfish and excessive desire for more of something (as money) than is needed." No, Charles, it didn't begin with Ronald Reagan. We saw it first in the Garden of Eden when the Serpent tried to convince (and basically won the argument) that Adam and Eve could have more power than God had given them. And no, Charles, greed is not a byproduct of democracy. It is a distinct and individual human sin. No political system in itself prevents greed. Communism, now in America known as progressivism, touts a language that sounds like a greed killer.

<u>Communism</u>: "a : a theory advocating elimination of private property b : a system in which goods are owned in common and are available to all as needed."

<u>Utopia</u>: "1: an imaginary and indefinitely remote place 2 often capitalized : a place of ideal perfection especially in laws, government, and social conditions 3: an impractical scheme for social improvement."

We typically ignore definition 1 & 3 in respect to utopia, so let's concentrate on definition 2, though 1 & 3 is the telling definition.

I once wrote an article titled "We live between the Garden of Eden and the New Jerusalem: Our heritage: the Garden of Eden: Our hope: the New Jerusalem". We look backward to the one and forward to the other. Both are idealistic, utopian societies where everything is perfect. To use a modern phrase, their reality is hardwired into our very soul and every fiber of our being knows we belong there and wants to get back. There is only one way back and that is through God. Rejecting God does not deny that image within us, or the desire, but it does lead us into futile ways of getting there. The Tower of Babel being a visible image of both the attempt and the failure.

Many of us have been persuaded that primitive natives lived in harmony with nature and with each other in a utopian society (one of the premises in the movie Dances With Wolves). They were closer to nature, and therefore closer to God, and greed was never a thought. Well, history shows that this is a myth because greed is not the byproduct of any political system, it is an individual sin that can become a collective sin where the few lord it over the many. This is the historical truth, but it sounds good to believe that primitives with nothing enjoyed life better than we moderns with so much. As we are investigating greed, let's not forget that greed isn't limited to things in themselves but can be seen as greed for power. Lust for power is an expression of greed in its most evil form.

That industrialization brought with it greed is one of those myths driving us today. It is a myth. Some individuals with the newfound tools of industrialization found their inner greed excited. Take those tools away and the greed won't go away, it will still be there to find another outlet. You see, we want to blame the system so we can excuse the individual, us. We want to blame someone else instead of ourselves. We want others to be responsible but not us. We want to blame lending institutions, banks, even government, but never us. No, they are not blameless, but neither are we.

You see, definition of utopia 1 and 3 says it all: imaginary and impractical. We want to believe if we just put the right policies in place we can make utopia both real and practical. So community organizers and government come in and say we have the answer, but their answer never solves the real problem, it only creates new problems.

In 1968 Fannie Mae was turned into a private company in large part because Congress wanted to separate Fannie Mae from its own budget accounting. Fannie Mae up until that time had had a virtual monopoly in the secondary mortgage market. Having privatized Fannie Mae it was appropriate for the Federal Government to create competition in the secondary mortgage market. It did this in 1970 when it created the Federal Home Loan Mortgage Corporation (FHLMC). Since the FNMA had the euphonic nickname of Fannie Mae the FHLMC was given the catchy but illogical name of Freddie Mac. Freddie Mac was intended for expanding the secondary mortgage market.

Fannie Mae and Freddie Mac both not only purchased mortgages they also provided payment insurance, for a fee, for other mortgages. They also created pools of mortgages and issued securities based upon the revenue received. This procedure was called securitization and the securities created were called collateralized debt obligations, CDO's. Such securities allowed investors to invest in the mortgage market by diversifying the risk. If such investors purchased a single mortgage there would have been too much risk concentrated in that single mortgage but if they, in effect, purchase one percent of a hundred such mortgage their risk would be diversified.

Not only did Fannie Mae, Freddie Mac and other institutions create diversification through securitization but they created securities that partitioned the risk. One security would have first claim to the mortgage payments, another second claim; i.e., that security would receive payments only after the first claim security's obligations had been met. And so on down the line. The security last in line was the most risky and came to be known as toxic waste. Thus this partitioned securitization created some securities that were riskier than the original mortgages. It was difficult to ascertain what values the various securities should have.

First the government created the problem when requiring subprime loans, then tried to help the lending institutions with possible and real loss by giving them a place to sell off those bad loans when they created Fannie Mae and Freddie Mac. To have the pretense that it wasn't all government, they privatized Fannie and Freddie, although they continued total control over these institutions and funded them pouring in millions and millions to cover their losses.

The second and third paragraph detail how they worked: they bought those subprime mortgages from lending institutions creating those grab bags of pooled mortgages so that lending institutions wouldn't lose and could continue to make loans. Read the game played in the third paragraph several times because it was a game, a game that put us all at risk. The goal of the game for those purchasing the grab bags was that the price of the bags was appropriate, made attractive with the promise of profit, and for a time profits were being made. Here, again, is a tragic circle: the government forces subprime loans they know are risky, so purchase those loans selling off grab bags to investors so more loans can be made that are risky, requiring more grab bags.

Thus a demand was created for mortgages, even subprime mortgages. Not only did it seem that a profit could be made in securitization of even subprime mortgages, profits were being made. Securitizers like Fannie Mae and Freddie Mac were being drawn into the process from the apparent profitability of the process, thus justifying their creation of a market for subprime mortgages. It was as though the U.S. Treasury started buying pyrite (fool's gold) as well as real gold. The fact that the Treasury was buying pyrite resulted in private companies also buying pyrite and thus the price of pyrite would increase. The Treasury then seeing the value of its stocks of pyrite increasing would then believe that the original decision to buy pyrite was justified and thus buy more.

If I have in my hand a dozen gold nuggets and eight are real, only two are false, I'm going to make money. But if more of those nuggets are pyrite and not real, even if I believe that the few that are real will make up for the many that are not, at some point the marketplace will recognize that most of my gold is really pyrite and I'm going to lose everything, the few real gold nuggets cannot make up for the pyrite. The government pretended that they could require risky loans and cover any minimal loss. Investors pretended they could make money on the deal.

In the case of the subprime borrowers they were charged higher interest rates and were required to pay for default insurance. This higher burden increased the risk of default. The subprime mortgages became bad investments and no amount of securitization would alter this aspect. But the process of producing graduated risk securities backed by the subprime mortgages disguised the fact that they were bad investments. The perceived status of Fannie Mae and Freddie Mac as quasi-governmental institutions enabled them to sell their toxic product world-wide.

Although some people erroneously attribute the financial crisis to this mortgage default insurance and/or to securitization, these practices are perfectly legitimate and appropriate for financial markets. The problem arose because Fannie Mae and Freddie Mac were the key institutions in providing mortgage default insurance and in buying subprime mortgages. There were abuses of the derivative instruments that should have been punished by the market but were not because the perpetrators were ultimately bailed out.

Let's try to get a full picture, here. Lending institutions were created to make loans so people can begin businesses or move into homes. The flow of money allows these institutions to keep lending so even in good times they will package loans and sell them so they have the cash for more loans. They don't do it because there might be bad loans in that bundle, they do it because they need cash now. It's like selling your jewelry because you need the cash. That's normal business. What changed is that lending institutions were required for various reasons to make loans that were risky, then promised through Fannie Mae and Freddie Mac that potential losses would be covered and that created a mindset that it's okay to keep making risky loans and selling off the grab bags, not just to Mac and Mae but to others, as well. The last sentence in the quote above, however, tells the truth. Without Mae and Mac the market would have recognized the toxic nature of these loans and stopped buying the grab bags and lending institutions would have been forced to stop risky loans for their own survival. Because of government intervention the marketplace was not allowed to work.

Let me now turn to the study's conclusions:

The subprime mortgage crisis had its origin in the program the directors of Fannie Mae initiated in the late 1990's to pursue social welfare goals rather than maintain financial viability. Lenders were strongly encouraged to reduce the requirements for mortgage below what had been found to be the minimum adequate levels. Having pushed the lenders into the subprime mortgage market Fannie Mae made the financially infeasible feasible by being willing to buy such subprime mortgage and to grant default insurance on such mortgages. When Fannie Mae effectively went bankrupt the lenders who had written such subprime mortgages found that there was no longer a market for them and thus they were stuck with them. Also those lenders who had obtained default insurance now find that insurance is useless if Fannie Mae cannot pay off on the defaulted mortgages. The lenders should have been aware that there is a risk with any insurance company that it might not be willing and able to pay off on claims. The supposed guarantee of Fannie Mae obligations by the Federal Government removed any concern of businesses with the risk of counter-party default. It is unwise to encourage such behavior.

On May 6, 2009 the Center for Public Integrity published a study entitled Who's Behind the Financial Meltdown. The six member team of journalists preparing the study surveyed government data on millions of subprime mortgages issued between 2005 and 2007. Some of their major findings were

- Nine of the top 10 lenders were based in California, including all of the top five: Countrywide Financial Corp., Ameriquest Mortgage Co., New Century Financial
- Corp., First Franklin Corp., and Long Beach Mortgage Co.
- Altogether 56 percent of the $1.38 trillion of subprime
- Mortgages in the study period were written by California firms.
- Some lenders allowed borrowers to state their incomes without providing documentation.

There are plenty of parties to blame for the subprime mortgage crisis, but a large share of that blame rests with Franklin Raines, Timothy Howard and the other members of the inner circle of Fannie Mae. The lenders would not have written the flawed mortgages with their booby-trapped conditions if they could not have counted on selling them to Fannie Mae or getting default insurance from such sources. And finally scuttling Fannie Mae in September of 2008 before it was technically bankrupt produced a shocked surprise for the stock market that produced the panic selling and the collapse of stock price

Still, today, Congress is blaming banks for the crisis and are still trying to punish them and regulate them as though this will solve the problem. And too many of us believe this lie. If your car won't start because it has bad sparkplug wires, a bad starter, and a dead battery, fixing the sparkplug wires will not get the car going again. But this is what we are doing. We are acting like it's all the sparkplug wire's fault.

Yes, the wires need changing, but that's only one of three things that need changing for the car to run, again. The car did break down because someone tampered with the starter (the government being the starter), but then the wires went bad (the lending institutions) and the battery went dead (us).

Greed is individual, first, then corporate later. You may want to fall back on the tactic of blaming the other guy, i.e., the government, the bank promised me it would work; but we are ultimately responsibility for our beliefs and our actions. When we start being responsible for ourselves then we will reason through a promise to see if it is real or a pie-in-the-sky promise. No one owes us a home. It's not a right to own a home, it's a privilege, one earned. We do have a right to expect fair play, but fair play doesn't mean given to us. We have a right (personal) to earn a profit but we don't have a right to gouge out a profit from others. We must honestly earn it. When we, individually, decide to be moral, then we will have a right to say to others, stop being immoral. But not until then.