The Unintended Consequences of Regulatory, Federal Reserve, and Fiscal Policies: Part 1
PART 1

HAVE COMMERCIAL BANKS BEEN HANDED THE SHORT STRAW IN THE AFTERMATH OF THE FINANCIAL CRISIS?

By Rick Buczynski and Robert Kennedy

“Unintended consequences” has recently become a catch-phrase for critics of American economic policy. In this paper, the authors uncover several instances where policies may have had unforeseen and undesirable effects on commercial banks and the general public. They argue that all too often inappropriate data is analyzed, which together with a lack of distinction between causality and correlation, results in both serious policy errors and mixed signals communicated by policymakers and politicians. Misidentifying the true causes of the financial crisis has been a distraction preventing us from dealing with the real challenges. We believe that an outside-the-box bipartisan debate is required.

Elements of this paper, particularly how the housing bust precipitated the recent financial crisis, were presented at a session sponsored by IBISWorld at RMA’s Annual Risk Management Conference in October 2014 in Washington, D.C. There, IBISWorld’s chief economist Rick Buczynski was joined by Richard J. Parsons, author of the 2013 RMA-published book *Broke: America's Banking System, Common Sense Ideas to Fix Banking in America.*
WE HAVE MISINTERPRETED THE TRUE CAUSES OF THE FINANCIAL CRISIS, AND HAVE A LONG WAY TO GO

Let’s think back to 2008 and 2009: Suddenly, 8 million Americans found themselves unemployed or underemployed, and in due course millions of households were faced with underwater mortgages. The Fed, using its monetary policy and supervisory tools, acted quickly and with determination to prevent a meltdown of the financial system and permanent damage to the economy. Initially, the common wisdom in the media, the government, and even in the banking industry was that we were dealing with a mess created by large commercial banks and investment firms. Politicians saw the opportunity to punish banks, bankers, and even key government agencies, as evidenced by Henry Waxman’s attack on Federal Reserve Chairman Alan Greenspan in a Congressional hearing on October 23, 2008.¹

More than half a decade later, it is clear there were other causes. For instance, the government’s pro-housing policies—together with the Federal Reserve’s easy money stance—helped fuel the housing boom that went bust and prompted the Great Recession. Meanwhile, Wall Street’s bundling and securitization of subprime loans, which were indirectly sanctioned by inside-the-Beltway politicians, were the conduit of the contagion. The veritable missing link in this discussion, though, is the stagnant wages of the poorest 40% of American households. After being force-fed homeownership through misguided policies and actions, it turned out these households were frankly unable to afford "affordable housing." For all that went wrong in the run-up to the crisis, if income growth had been stronger, the bubble’s demise would have been limited to a serious but cyclical “pop”—and not the most horrific economic meltdown since the Great Depression.

By promoting homeownership through dubious policies, government officials got it wrong leading up to the crisis. Now, in the aftermath, they are getting it wrong again by addressing symptoms and not causes of the predicament. The unintended consequences of the vast new regulatory regime created by Congress and official rhetoric, combined with

¹. Rick Parsons emphasized this point at the October 2014 RMA Annual Risk Management Conference in Washington, D.C.
the economy’s persistent structural issues, are multifaceted:

- The mess could happen again because of the undying desire of the government to increase homeownership despite the income problem.
- Overregulation² is driving up compliance costs for all banks, not just institutions with over $50 billion in assets.
- Although, as of this writing, the U.S. economy is apparently gaining momentum, the recovery has been historically lackluster (perhaps because stimulus efforts have been overly driven by political motivations, rather than serious dialog, debate, and action with long-term, structural improvements in mind).
- There are serious conflicts between the Dodd-Frank legislation, which calls for a return to tighter underwriting standards, and official pleas for banks to open up their lending wallets. Mixed signals pervade.
- Younger people are unable to secure credit either because of low incomes and/or little credit history.

In addition to all this, have we forgotten that we are due for another cyclical downturn, and that global conditions at present pose serious risks? With this in mind, this paper is intended to inform and promote a meeting of the minds among government officials, regulators out in the field, academics, and banks big and small. We are all indeed in the same boat. Let’s keep it from capsizing again. Or even worse: sinking.

PRE-CRISIS POLICIES: BOOM TO BUST

There are numerous well-researched accounts of the financial crisis, its origins, and how the calamity morphed from a serious but short-lived downturn into the “Great Recession.”

Several government reports, particularly the Financial Crisis Inquiry Committee’s (FCIC) 663-page issuance, provide a comprehensive analysis. The FCIC concluded, “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…”

While we agree with that basic assertion, we find the analysis of the committee (and others) seriously flawed in many ways, specifically in the failure to distinguish between the symptoms and causes of the disease. This unfortunately renders the committee’s policy prescriptions ineffective at best and destructive at worst. Constructed before the publication of the report, Dodd-Frank’s premises were similarly faulty. The authors of this paper are more in line with the two dissenting statements that appear at the end of the FCIC report, particularly those of Peter J. Wallison of the American Enterprise Institute. It seems abundantly clear that this crisis was rooted in the government’s aggressive affordable housing goals under both Presidents Clinton and Bush—and Congress. To increase home ownership during the 1990s and 2000s, Fannie Mae and Freddie Mac stimulated mortgage lending through dramatically reduced underwriting criteria.

The unintended consequences of such policies reached critical mass in 2008. In the run-up, economic policymakers had underestimated growing imbalances and so failed to introduce preventative measures.

We are not absolving banks, Wall Street’s financial engineers, credit agencies, or subprime lenders from their roles in fomenting the crisis. Nor are we absolving most of the 400+ community banks that failed because of flawed business models and substantial concentrations in residential real estate lending. Still, it is obvious to us that the primary culprits lay inside the Beltway, which the FCIC report tactfully avoids.

**AMERICAN DREAM OR NIGHTMARE?**

In addition to Fannie and Freddie’s role in creating the bubble, in the 1990s banking regulators sought to increase mortgage lending by commercial banks. The idea was to replace the lending of the largely defunct S&L industry. This came in the form of a considerable ramping up of the Community Reinvestment Act (CRA) in 1995, which required banks to quantify their lending to lower-income communities. As noted by Wallison and Edward Pinto in “A Government-Mandated Housing Bubble” (Forbes, February 16, 2009), “As the enforcers of CRA, the regulators themselves were co-opted into this process, approving lending practices that they would otherwise have scorned. The erosion of traditional mortgage standards had begun.”

The jury is still out as to the role the CRA played in the crisis and it continues to be a matter of dispute even within the FCIC report. However, as Richard Parsons observes in his 2013 book *Broke: America’s Banking System, Common Sense Ideas to Fix Banking in America*, in the 30 years following CRA’s 1977 passage, “astute lawmakers came to realize the personal power they gained by leveraging banks for social engineering.

**Figure 1: Home Prices Soar While Household Incomes Limp Along**

Sources/notes: Bureau of Economic Analysis, Federal Reserve Board, S&P Case-Shiller. Home prices and disposable income were re-based 1981=100.

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5. As Parsons points out in *Broke*, the Garn-St. Germain Depository Act of 1982 had the unintended consequence of encouraging deadly concentrations in commercial real estate for S&Ls by allowing them to enter commercial lending.

And as banks became instruments of social policy, lawmakers also came to see banks as an extension of law enforcement.” We conclude that the political mindset was in place for the federal government’s increased tinkering in the housing market and, in effect, the allocation of credit. The tinkering, by the way, came from both sides of the political aisle.

Added to the equation was a financial system awash in cash and cheap financing, owing to Fed Chair Alan Greenspan’s low interest policies and capital inflows from abroad (the latter was pointed out in Hennessey, Holtz-Eakin, and Thomas’s dissents in the FCIC inquiry).

In the 10 years leading to the Great Recession, housing prices more than doubled, while Americans’ disposable incomes limped along, barely keeping ahead of inflation (see Figure 1).

All the while Fannie and Freddie continued to feed the frenzy. As Wallison and Pinto point out, from 1994 to 2003 “Fannie and Freddie’s purchases of mortgages, as a percentage of all mortgage originations, increased from 37% to an all-time high of 57%, effectively cornering the conventional conforming market… Fannie and Freddie were competing with Wall Street and one another for low-quality loans.”

*While Fannie and Freddie did not make all of the subprime and alt-A loans, the fact that they accepted reduced underwriting standards and loan documentation lowered the bar for the rest of the marketplace.*

In this context, we find it beneficial to include a table from page 456 of the FCIC report.

### Table 1: Non-Traditional Mortgages Held or Guaranteed Prior to the Financial Crisis

<table>
<thead>
<tr>
<th>Entity</th>
<th># of Subprime &amp; Alt-A Loans</th>
<th>Unpaid Principal Amt</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fannie Mae and Freddie Mac</td>
<td>12 million</td>
<td>$1.8 trillion</td>
</tr>
<tr>
<td>FHA and other Federal</td>
<td>5 million</td>
<td>$0.6 trillion</td>
</tr>
<tr>
<td>CRA and HUD Programs</td>
<td>2.2 million</td>
<td>$0.3 trillion</td>
</tr>
<tr>
<td>Total Federal Government</td>
<td>19.2 million</td>
<td>$2.7 trillion</td>
</tr>
<tr>
<td>Other (including subprime and</td>
<td>7.8 million</td>
<td>$1.9 trillion</td>
</tr>
<tr>
<td>Alt-A PMBS issued by Countrywide,</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Wall Street and others)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>27 million</td>
<td>$4.6 trillion</td>
</tr>
</tbody>
</table>

Table 1 clearly illustrates that government agencies, or private institutions acting on their behalf, either held or guaranteed the bulk of risky non-traditional mortgages (NTMs) that were outstanding at this point; it wasn’t just the private nonbank subprime lenders that were culpable. Plus, keep in
mind that subprime and Alt-A mortgages accounted for half of all mortgages by early 2008—a staggering statistic that was obviously trivialized.

Fannie and Freddie were extremely active in the purchases of NTMs, private mortgage-backed securities (PMBS), and high loan-to-value (LTV) mortgages. This accelerated, coincidentally, during the Fed’s low interest foray.

**Figure 2: Government-Sponsored Enterprise (GSE) Purchases of Subprime and Alt-A loans**

(Cumulative since 1997 $Bn)

Source: FCIC Report, data on page 504.

*No data available for Alt-A until 2002. Includes high LTV loans.

After averaging around 64% in the period from 1980 to 1994, the home ownership rate passed 69% in early 2005. This translated into about 16 million more homeowners in the 10-year period commencing around 1994. The government had achieved its goal. Was this desirable? The housing boom sure did provide jobs in the construction industry. But that industry’s strong economic multipliers are short-lived, while the economy was left with millions of long-term loans that turned out to be far from “affordable.”
As home ownership surged in the early to mid-2000s, inflation-adjusted family income largely stagnated for the lowest-earning 40% of households, as shown in Figure 3. After 2005, incomes among the poorest 40% of households actually declined. From 1989 to 2013, annual income of the lowest two quintiles each rose only $2,000, while the middle quintile’s income rose by less than $1,000.

Figure 3: Mean Value of Before-Tax Family Income* (Thousands 2013 Dollars)

Source: Survey of Consumer Finances, Federal Reserve Board, September 2014

* Mean and medium are statistically equivalent for these categories.

Figure 4 provides a slightly different perspective of the issues we raise, depicting a timeline of housing-start and homeownership data. (Incidentally, in 1992 Congress authorized Freddie and Fannie to establish affordable housing goals.)

**Figure 4: Timeline of Boom to Bust**

![Timeline of Boom to Bust](image)

Source: Census Bureau

Coinciding with the housing boom was a serious erosion in household finances, as debt servicing rose and savings rates plummeted. This was indeed a house of cards as policymakers clearly missed these worrisome signs.

**Figure 5: Household Debt Service and Savings Ratios (% Disposable Income)**

![Household Debt Service and Savings Ratios](image)

Source: Bureau of Economic Analysis
Figure 6 provides a simplified view of the chain of causality.

**Figure 6: Financial Crisis Chain of Events: Did We All Miss the Point?**

The noxious combination of the government’s aggressive pro-homeownership mandate and the Fed’s low interest rate policy juxtaposed with weak wages, particularly for lower income households, fueled the unintended consequence of the Great Recession. (The writing was on the wall well before the collapse. In fact, RMA/IBISWorld’s forward looking Industry Risk Ratings red-flagged single family housing in early 2005. RMA Statement Studies data showed profits as a percentage of sales for single family home builders dropping to zero in 2008 from 5.8% in 2006.)

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