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Financial Bailout

Will U.S. and overseas action stem the global crisis?

Bowing to doomsday warnings that the U.S. and global financial systems could collapse, Congress passed a $700 billion rescue bill early this month. Part of a sweeping $1 trillion government plan to calm the stock market and unfreeze credit — the unprecedented rescue came amid mounting fears of a deep recession and the collapse of such major financial institutions as Lehman Brothers and Washington Mutual. The government's efforts included the federal takeover of mortgage giants Fannie Mae and Freddie Mac, which together hold or guarantee $5.4 trillion in mortgage loans — 45 percent of the national total. The quasi-governmental firms were dragged down by investments in subprime mortgages and other "toxic" financial instruments. Meanwhile, even as the Bush administration and congressional leaders were calling the bailout plan vital, fundamental questions were being raised, including: Is the bailout big enough? And did risky lending by Fannie and Freddie and poor regulatory oversight fuel the crisis?

U.S. Treasury Secretary Henry M. Paulson Jr. leaves the White House on Sept. 17, 2008, while working to shape the government's $700 billion financial rescue package for Wall Street.

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Financial Bailout

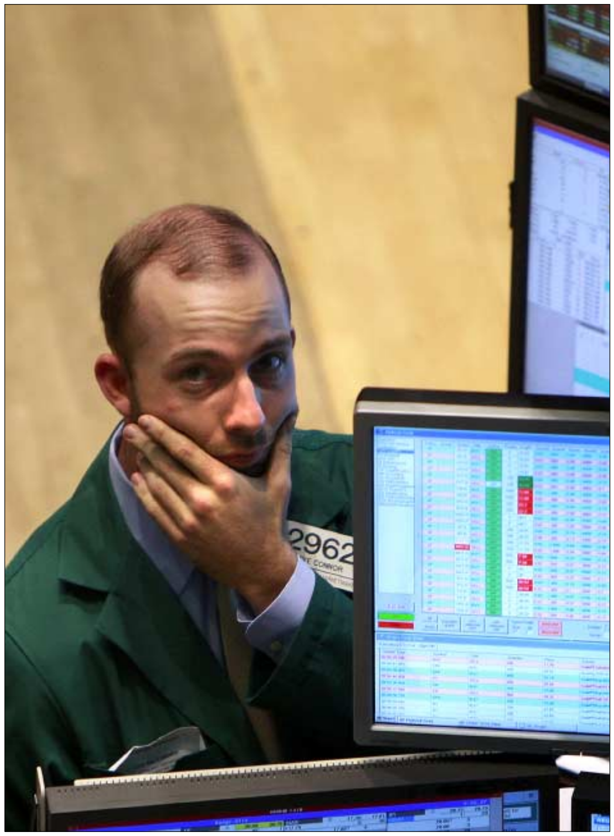
By Thomas J. Billitteri

The Issues

Anger was palpable this fall as Congress scrambled to quell a financial wildfire that began in the overheated home-mortgage market, raged through Wall Street, spread ominously to Main Street and then flared into a global financial catastrophe.

"We were told that markets knew best, and that we were entering a new world of global growth and prosperity," declared Sen. Charles E. Schumer, D-N.Y., chairman of the Joint Economic Committee. "We now have to pay for the greed and recklessness of those who should have known better." [1]

Such emotions have been widespread in the wake of the nation's — and perhaps the world's — worst financial crisis since the Great Depression. But agreement on the root causes and likely outcome of the crisis has been harder to find. [2]



Getty Images/Spencer Platt

A trader at the New York Stock Exchange on Sept. 16 follows one of the market's worst single-day declines. The continued volatility of the U.S. stock market signals that investors are not yet convinced the government's $700 billion financial bailout will work. In the past 15 months, several major U.S. banks have failed, and Americans have lost some $2 trillion in retirement savings that were invested in the market.

Early this month Congress overcame bitter ideological differences and passed a $700 billion bailout bill that permitted an immediate infusion of $250 billion into the banking system. Along with other loans, the government's potential tab for rescuing the American economy totaled at least $1 trillion in mid-October. [3] The federal government also announced on Oct. 23 it would guarantee up to $2.8 billion in debt and money market deposits.

Initially, the bailout's chief aim was to buy up "toxic" loans on lenders' books in the hopes of thawing the nation's frozen credit markets. As the crisis spread overseas, however, European central bankers — led by British Prime Minister Gordon Brown — began infusing their shaky banks with cash. Treasury Secretary Henry M. Paulson Jr. followed suit, committing the government to pumping $250 billion directly into U.S. banks to induce them to begin lending to each other again — vital to easing the nation's credit woes and bolstering confidence in the financial system.

As policy makers grasped for new options, experts remained divided over how much the plan will ultimately cost taxpayers, who should be held accountable for creating the economic debacle in the first place and whether the rescue plan would prevent a deep recession — an increasingly unlikely prospect.

The financial storm had been brewing for months, but it broke wide open in September with a shocking cascade of events over several tumultuous weeks. In the United States alone:

- Fannie Mae and Freddie Mac were seized by the federal government, which promised to inject up to $100 billion into each firm as concerns grew over the two mortgage titans' cash reserves;
- The investment bank Lehman Brothers collapsed in the biggest bankruptcy in U.S. history;
- Brokerage house Merrill Lynch narrowly averted Lehman's fate by selling to Bank of America;
- Global insurer American International Group (AIG) was propped up with an initial $85 billion federal bridge loan (since raised to as much as $123 billion);
- Washington Mutual failed, in the biggest bank collapse in U.S. history;
- Struggling Wachovia Bank planned to sell out to Wells Fargo, and
- Goldman Sachs and Morgan Stanley converted to commercial banks subject to stringent federal regulation, leaving Wall Street without major investment banks.

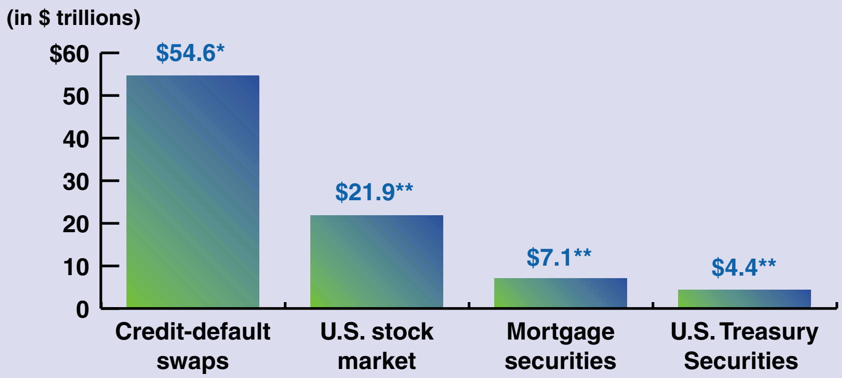
As the crisis intensified, Federal Reserve Chairman Ben S. Bernanke, Secretary Paulson and President George W. Bush urged quick congressional action. In a prime-time televised speech on Sept 24, Bush warned that without a rescue plan, "America could slip into a financial panic" and "a distressing scenario" of business failures, job losses and home foreclosures would follow.

But support for a bailout was far from universal, even within the president's own party. Sen. Jim Bunning,

Credit-Default Swaps Dominate Markets

The unregulated market for complex financial instruments known as credit-default swaps is estimated to be worth some $55 trillion, more than twice the value of the U.S. stock market and more than the combined values of the stock market, mortgage securities and U.S. Treasury instruments.

Value of Various Markets



* *As of June 2008*

** *As of 2007*

Sources: The New York Times*, February 2008, International Swaps and Derivatives Association*

a Kentucky Republican, said spending $700 billion in taxpayer money to "prop up and clean up the balance sheets of Wall Street" is "financial socialism" and "un-American." [4]

Still, many experts viewed the bailout as painful but necessary. "We have to do something," said Tony Plath, an associate professor of finance at the University of North Carolina at Charlotte. "We can't let the American system melt down."

The crisis has clearly spooked Main Street. A CNN/Opinion Research Corp. poll released on Oct. 6 found that nearly six in 10 Americans thought an economic depression was likely. [5]

How the financial system reached the brink of collapse is a complex story that economists and congressional leaders will be untangling for years. But as the crisis deepened, experts pointed to a variety of likely and alleged culprits, including:

A collapsing real estate market — Spurred by record-low interest rates earlier this decade, lenders fueled a massive housing bubble, betting that borrowers — even ones with bad credit or lacking the documented means to repay — could refinance based on ever-rising home values. That gamble proved catastrophically wrong. When home prices fell, millions of homeowners found themselves owing more than their homes were worth, sparking a flood of mortgage defaults and foreclosures. [6] That squeezed lenders who had made subprime, "Alt-A" and other shaky loans as well as investment banks that borrowed heavily to buy mortgage-backed securities based on such loans. (*See glossary, p. 873.*)

Fannie Mae and Freddie Mac — Some blame the Federal National Mortgage Association and Federal Home Loan Mortgage Corporation for fueling the market for reckless lending. The government-backed companies own or guarantee $5.4 trillion in mortgage loans — about 45 percent of the nation's total. Fannie alone bought or guaranteed at least $270 billion in risky loans between 2005 and 2008, *The New York Times* reported. [7]

Credit-default swaps — Ultimately, many experts say, the crisis was caused by little understood, unregulated, insurance-like contracts that are intended to guarantee against loan defaults. Subprime and other loans were backed by trillions of dollars in credit swaps. When home buyers began defaulting, financial institutions that sold the swaps lacked enough capital to make good on the guarantees, and investors who had purchased risky mortgage-backed securities were left hanging.

Plunging confidence in the financial system — Many major financial institutions, both in the United States and overseas, borrowed heavily to invest in mortgages, and their highly leveraged positions put them at risk of insolvency when defaults rose. As the financial crisis intensified, banks found it harder and harder to raise new capital to avert trouble. Meanwhile, investors and creditors began worrying that all kinds of assets on the books of financial institutions — not just residential real estate — might be grossly overvalued, further eroding confidence. When banks even became leery of lending to each other, consumer and business credit began freezing up.

The failure of government regulators — The 1999 repeal of the Glass-Steagall Act, a Depression-era law that split commercial banking from investment activities, helped set the stage for the current crisis, some experts say. Others cite what they argue was Congress' failure to rein in Fannie Mae and Freddie Mac. Critics also point to the 2000 Commodity Futures Modernization Act, which prohibited regulation of most swaps. Also under scrutiny is a 2004 Securities and Exchange Commission (SEC) decision to loosen capital rules for brokerage units of investment banks, which freed billions of dollars for investments in mortgage-backed securities, credit derivatives and other instruments. [8]

Whatever the policy roots of the crisis, its resolution has been maddeningly elusive. In the days following the rescue plan's passage, the Dow Jones Industrial Average suffered its worst single-week decline in its 112-year history. Stock markets around the world also plunged, a grim reminder that the crisis is global and threatens not only major European and Asian economies but emerging markets and poor nations as well.

In the United States, many economists remained skeptical that the infusions of capital and the purchase of toxic assets would lead banks to lend anew and get the economy moving again.

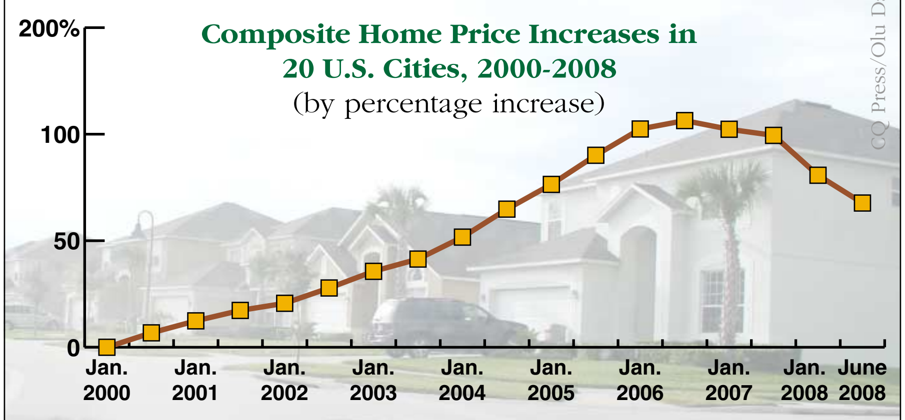
"Rather than jump into this morass again, a lot of commercial banks are going to opt for liquidity on their balance sheets," says a skeptical Robert Ekelund, professor emeritus of the economics of regulation at Auburn University.

Indeed, many see more pain ahead for the financial system and U.S. economy, including rising defaults on credit cards. [9] "We have to be prepared that it gets a lot worse," said Jamie Dimon, chief executive of JP Morgan Chase. [10]

As policy makers struggle to contain the damage from the economic crisis, these are some of the questions being asked:

Home Prices on the Decline

Home prices in 20 major U.S. cities doubled from 2000 to 2006. Prices, however, have steadily declined since 2006.



Source: S&P/Case-Shiller Home Price Indices

Will the bailout plan work?

On the first full day of stock trading after the bailout's passage on Oct. 3, the Dow plunged some 800 points before rebounding to "only" a 370-point loss. The sell-off rattled global markets, and President Bush sought to reassure a nervous world.

"It's going to take a while to restore confidence in the financial system," he said. "But one thing people can be certain of is that the bill I signed is a big step toward solving this problem." [11]

In fact, many see the $700 billion rescue bill as a necessary, albeit expensive, evil.

"The rescue plan is a smart thing," says Gregory Hess, a professor of public economics at Claremont McKenna College, in California. "You have to give credit markets every chance to create confidence and unwind the systemic uncertainty in the market. What monetary policy does and what finance does is that literally we're just trading pieces of paper. And until the Fed and the Treasury can create confidence and those pieces of paper are meaningful and trustworthy, we're not going to get out of this credit collapse."

But others are skeptical about the bailout plan. "What we really need to do is save the homeowners," says L. Randall Wray, an economics professor at the University of Missouri-Kansas City and a visiting senior scholar at the Jerome Levy Economics Institute at Bard College, in Annandale-on-Hudson, N.Y. "Several hundred billion into the hands of consumers will do a lot more than $700 billion in the hands of Wall Street."

The government's new plan to inject $250 billion into banks, announced Oct. 14, is probably an improvement over the original plan to just buy toxic assets, Wray says, but "it is still based on the unwarranted hope that severely troubled banks will now want to lend, and that overindebted firms and households want to borrow. That is why I favor putting income into the hands of consumers over relief for Wall Street."

Writing in *The Wall Street Journal*, Martin Feldstein, chairman of the Council of Economic Advisers in the Reagan administration and now a Harvard economics professor, said the bailout plan "does nothing to stop" what he called "the fundamental cause of the crisis: the downward spiral of house prices that devastates household wealth and destroys the capital of financial institutions that hold mortgages and mortgage-backed securities." [12]

Feldstein said a successful economic plan "must do more than buy back impaired debt from financial institutions." He urged a system of limited federal mortgage-replacement loans for struggling borrowers that would "break the downward spiral of house prices."

The global nature of the financial crisis has made it all the more difficult to control. Economists point out that while the United States has a centralized way to deal with systemic financial problems, a unified plan is much more difficult to execute in Europe, with its many separate national governments.

Still, the fate of the global financial system depends on how effectively nations can engineer a coordinated response to the crisis. (*See sidebar, p. 876.*)

"We're all in this together," says James J. Angel, an associate professor of finance at Georgetown University. "Our economic markets are interconnected, our financial markets are interconnected and weakness in one area quickly translates to weakness in other areas."

In the United States, Angel says, the bailout plan alone "is not a panacea that will fix all our problems." But the plan, in combination with other government action, "means we now have the tools to clean up the mess," he says.

Among those tools, Angel says, is Hope for Homeowners, a measure Congress passed last summer to help certain borrowers refinance their mortgages. He also points to a Federal Reserve decision, made in early October amid a rapidly weakening economy, to buy unsecured short-term commercial debt from eligible companies in an effort to revive moribund credit markets. [13]

Still, Angel says, "Having and using the tools are two different things. There's a lot of implementation work that needs to be done, and done well, to get things moving again."

Some experts have argued that buying toxic loans from banks could backfire by revealing the true value of assets that financial companies have on their books. [14]

"Ironically, the intervention could even trigger the additional failures of larger institutions, because some institutions may be carrying troubled assets on their books at inflated values," Peter R. Orszag, director of the Congressional Budget Office, told the House Budget Committee about a week before the bailout was signed into law. "Establishing clearer prices might reveal those institutions to be insolvent." [15]

In the long run, Ekelund, the emeritus Auburn professor, says he thinks credit eventually will thaw and banks will regain enough confidence in borrowers that they will start lending freely again. But he fears that when that happens banks will resort to old habits, figuring that "if they make mistakes, they'll be bailed out."

Did Fannie Mae and Freddie Mac cause the financial crisis?

As policy makers look ahead to the effects of the bailout plan, they also are looking back at the causes of the economic crisis, including the bitterly debated role of Fannie Mae and Freddie Mac.

The two quasi-federal entities don't lend money directly but rather buy mortgages from lenders, enabling lenders to replenish capital in order to make more home loans. Fannie and Freddie package some loans into mortgage-backed securities for sale to investors. In other cases, they buy and hold loans in their own portfolios.

As "government-sponsored enterprises," Fannie and Freddie serve both the profit motives of shareholders and an affordable-housing mission that is subsidized by the federal government. Their special status in the secondary mortgage market, long protected by millions of dollars in lobbying expenditures and campaign contributions, has allowed Fannie and Freddie to borrow at lower rates than their commercial competitors and maintain lower cash reserves to cushion risk.

Their special status also has led investors to think the government stood behind Fannie and Freddie's debts, giving the two entities a competitive edge over purely private companies. That "implicit guarantee" was never in writing until this summer, though, when Congress authorized the Treasury to bail out Fannie and Freddie as they appeared to be heading toward insolvency.

Fannie and Freddie's financial trouble stemmed from their investments in risky subprime and Alt A mortgage loans. James B. Lockhart, director of the companies' regulator, the Federal Housing Finance Agency, told a congressional panel in September that despite regulators' "repeated warnings about credit risk," Fannie and Freddie in 2006 and 2007 "bought or guaranteed many more low-documentation, low-verification and non-standard [adjustable rate] mortgages than they had in the past." In the first half of 2007, about a third of Fannie and Freddie's new business was in Alt-A and other risky loans, compared with 14 percent in 2005, Lockhart said. [16]

Investors that bought mortgage-backed securities from Fannie and Freddie — including banks in China and elsewhere — stood to lose billions of dollars, and their pressure on the U.S. government reportedly helped persuade Treasury to take over the mortgage giants in early September.

In the 12 months ending June 30, Washington-based Fannie and McLean, Va.-based Freddie had combined losses of $14 billion, according to *The Wall Street Journal*, which said the losses came "largely because they lowered their credit standards and purchased or guaranteed dubious home loans." [17]

The companies' downward cycle ended in the government bailout, which the Congressional Budget Office initially estimated last summer at $25 billion but whose eventual tab could run far more, depending on the outcome of the housing crisis and the value of the assets underlying loans that Fannie and Freddie bought or guaranteed.

Critics of Fannie and Freddie have long argued that their government strings should be cut. (*See "At Issue," p. 881.*) Accounting scandals earlier this decade, multimillion-dollar compensation packages paid to Fannie and Freddie executives and the emerging details of the companies' risky loan business have fed calls for them to be privatized. But advocates of Fannie and Freddie, including Democrat Barney Frank, chairman of the House Financial Services Committee, contend that the companies' congressionally mandated affordable-housing mission is too important to leave to purely commercial companies.

Now, with the nation's credit markets essentially frozen, that mission has become a lightning rod for Fannie and Freddie's detractors. Conservatives have accused congressional Democrats of protecting Fannie and Freddie from tougher regulation, but Frank called the charge "nonsense," arguing that when Republicans held a majority in Congress they didn't pass stiffer regulations of the companies. [18]

But the critics are relentless. The companies and their Washington supporters "are largely to blame for our current mess," charged Charles W. Calomiris, a professor of finance and economics at Columbia Business School and a scholar at the conservative American Enterprise Institute, and Peter J. Wallison, an institute senior fellow and former Treasury Department general counsel in the Reagan administration. [19]

"[T]o curry congressional support" after accounting scandals earlier this decade, Fannie and Freddie "committed to increased financing of 'affordable housing' [and] became the largest buyers of subprime and Alt-A mortgages between 2004 and 2007," they wrote. "In so doing, they stimulated the growth of the subpar mortgage market and substantially magnified the costs of its collapse." [20]

Calomiris and Wallison are not alone in that view. "You ended up with a larger market for these subprime loans than you would have otherwise had," argues Hans Bader, counsel for special projects at the free-market-oriented Competitive Enterprise Institute.

Jeffrey A. Miron, a senior lecturer in economics at Harvard University, also puts Fannie and Freddie "at the center of the crisis." Miron, who joined 166 academic economists in opposing the bailout plan, wrote that "[t]he government implicitly promised these institutions that it would make good on their debts, so Fannie and Freddie took on huge amounts of excessive risk. Worse . . ., Congress pushed mortgage lenders and Fannie/Freddie to expand subprime lending. The industry was happy to oblige, given the implicit promise of federal backing, and subprime lending soared. [21]

But others argue that Fannie and Freddie's purchases of risky mortgages, while imprudent, were more a reflection of their attempt to compete in what became a highly aggressive commercial mortgage market, not the main cause of it.

William K. Black, associate professor of economics and law at the University of Missouri-Kansas City School of Law, points out that Fannie and Freddie bought their risky loans almost exclusively from commercial companies. "Fannie and Freddie aren't making these mortgages," he says. "Somebody has to originate all this toxic waste."

Most of the bad loans in the market weren't bought by Fannie and Freddie but by investment and commercial banks and wealthy investors, Black says. Of the bad loans Fannie and Freddie did buy, if they hadn't done so, others would have, he says.

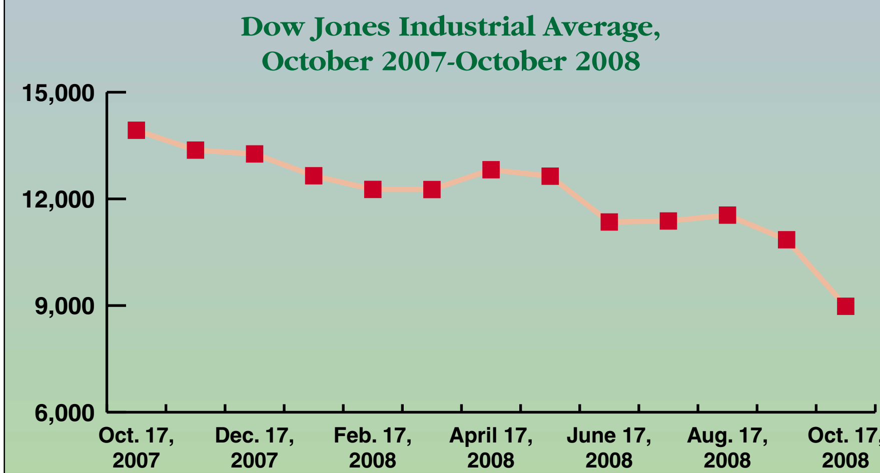
Most loans on Fannie and Freddie's books are high-quality, though they had enough "nonprime" mortgage-backed securities to render them insolvent, Black says. "Were those bad investments? You betcha. Does that prove Fannie and Freddie had some unique weakness? Well, no, they're about the fifth step in the food chain."

Mark Thoma, an associate professor of economics at the University of Oregon, argues that Fannie and Freddie "were followers, not leaders" of the subprime mortgage debacle.

Thoma contends that pressure from an unregulated "shadow industry" of hedge funds, investment banks and other institutions gave lenders a financial incentive to make risky loans. To remain competitive in a quickly evolving mortgage market, he says, Fannie and Freddie entered the subprime market in a big way, straying from their traditional

Dow Jones Average Has Plummeted

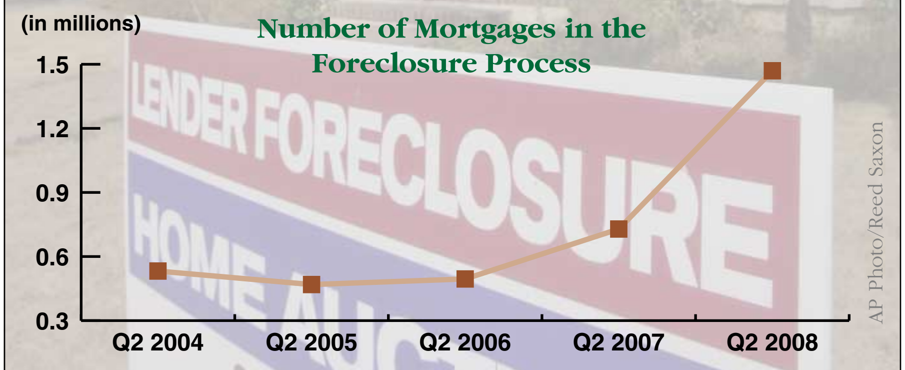
The Dow Jones Industrial Average — a performance index for 30 of the largest U.S. companies — is widely regarded as a bellwether for the health of the U.S. economy. The "Dow" has dropped precipitously — about 5,000 points, or 36 percent — from a year ago. The index recently dipped below 9,000 for the first time since 2003.



Source: Yahoo! Finance

Foreclosures Rising Steadily

Nearly 1.5 million residential mortgages were in foreclosure in the second quarter of 2008, nearly twice as many as in the same period a year earlier and nearly triple the total from four years earlier.



Source: Mortgage Bankers Association

practice of buying conventional loans made to people with good credit.

"I'm not going to defend them and say they didn't take on risk they shouldn't have," Thoma says. "It's just that they didn't start the problem."

Some conservative commentators have asserted that the 1977 Community Reinvestment Act (CRA), which encourages financial institutions to lend in low- and moderate-income neighborhoods, pushed Fannie and Freddie to support mortgages or people who couldn't repay. But others disagree.

"The notion that the Community Reinvestment Act is somehow responsible for poor lending decisions is absurd," wrote Daniel Gross, a columnist for *Newsweek* and *Slate*. While acknowledging that Fannie and Freddie were part of a culture of reckless lending, he said Wall Street investment banks created a demand for subprime loans and made those loans "for the same reason they made other loans: They could get paid for making the loans, for turning them into securities and for trading them — frequently using borrowed capital." [22]

Judith A. Kennedy, president of the National Association of Affordable Housing Lenders, also challenged the notion that the CRA led to the subprime mess. She blamed "the proliferation of unregulated mortgage originators during the housing boom, financed in part by . . . Fannie Mae and Freddie Mac." [23]

While CRA lending by banks "involves loans that help people with low or moderate incomes buy homes of high quality and lasting value," Fannie and Freddie "were determined to thwart the spirit, if not the letter, of a 1992 federal law that permitted them to take 'less than the return earned on other activities' to assist 'mortgages on housing for low- and moderate-income families," Kennedy asserted. "Instead of taking less of a return, Fannie Mae and Freddie Mac decided to take more of a return on affordable housing by issuing more than $400 billion in debt to finance higher-cost, higher-yield subprime mortgages, helping to fuel the subprime feeding frenzy."

Should Congress adopt tougher regulatory reforms?

Many argue that a failure of the regulatory system lies at the heart of the financial crisis.

"Wall Street is driven by two emotions, fear and greed," says John Bohn, a California Public Utilities Commission member and former head of both Moody's Investors Service, a major credit rating company, and the Export Import Bank of the United States. "When the fear of excessive risk goes away, greed does what it is expected to do. That is what happened. The whole mess is a monumental failure of regulation. One can blame all sorts of players, but it goes to the heart of the regulatory/political process. The fox was in the henhouse and dining in splendid fashion for a long time. If one looks for one major player who is at the heart of the problem, it is the SEC, which was supposed to police how all the new capital was to be used. It failed utterly."

Indeed, in late September the inspector general of the SEC issued a blistering report concluding that the commission had failed in its mission to oversee Bear Stearns, the Wall Street investment bank that collapsed in March. [24]

In 2006 the SEC "identified precisely the types of risks that evolved into the subprime crisis in the United States less than one year later" but "did not exert influence over Bear Stearns to use this experience to add a meltdown of the subprime market to its risk scenarios," the report said. [25]

Sen. Charles Grassley, R-Iowa , called the report, plus another on the SEC's regulation of brokerage companies, "another indictment of failed leadership.

"We had it at Fannie Mae and Freddie Mac, it was throughout Wall Street and these reports document the failure of regulators at the SEC to either make its oversight program work or seek authority from Congress so that it could work." [26]

Regulation of the financial markets has been a central theme in this year's presidential race, too, with Democratic candidate Sen. Barack Obama of Illinois and Republican Sen. John McCain of Arizona trading bitter accusations.

The crisis "is a final verdict on the failed economic policies of the last eight years, strongly promoted by

Glossary of Key Financial Terms

Alternative-A mortgage: "Alt-A" mortgages are considered riskier than prime mortgages — which only lend to individuals with high credit scores — but less risky than subprime mortgages, which go to those with low credit. Borrowers tend to have higher credit — sometimes "A-rated" — than subprime borrowers, but the application process often involves little or no documentation of income.

Collateralized debt obligation (CDO): An unregulated, investment-grade security backed by a pool of bonds, loans and other assets. Each CDO has various levels of risk, known as tranches. The higher the risk, the higher the reward so long as the underlying investments are free from default.

Credit-default swap: An unregulated type of "insurance" in which a buyer makes a series of payments in exchange for the right to receive a payoff if a credit instrument goes into default. Many sellers of swaps for mortgage-backed securities could not pay their buyers after subprime borrowers defaulted on their mortgages.

Leverage: Borrowing large amounts of capital to complete a broad range of transactions.

Mortgage-backed security: An asset-backed security whose cash flow is determined by the principal and interest payments of a set of mortgage loans. Payments are made over the lifetime of the underlying loan.

Prime mortgage: A high-quality mortgage eligible for purchase or securitization in the secondary mortgage market. Such loans have a low default risk and are only made to borrowers with good credit.

Stated income loan: A mortgage — sometimes called a "liar loan" — where the lender does not verify the borrower's income. Mainly intended for people who have difficulty documenting their income, they are particularly easy targets for fraud.

Subprime mortgage: Carries a higher interest rate and generally goes to borrowers with a history of loan delinquency or default, bankruptcy or those with limited debt experience.

— Darrell Dela Rosa

President Bush and supported by Sen. McCain, that essentially said that we should strip away regulation, consumer protections, let the market run wild and prosperity would rain down on all of us," Obama said at the second presidential debate on Oct. 7. [27]

McCain charged that "the match that lit the fire was Fannie Mae and Freddie Mac. . . . [T]hey're the ones that, with the encouragement of Sen. Obama and his cronies and his friends in Washington, went out and made all these risky loans, gave them to people that could never afford to pay back." [28]

One of the most contentious issues emerging from the financial collapse is whether a 1999 bill to dismantle the Depression-era Glass-Steagall Act touched off today's crisis. The 1933 law had erected a wall between commercial banking and the investment business. But the law was gradually weakened in the 1980s and '90s and finally repealed in 1999 with the Gramm-Leach-Bliley Act, passed by a Republican-controlled Congress and signed by Democratic President Bill Clinton.

Some lawmakers who fought repeal of Glass-Steagall insist they were right. "They could have put bamboo shoots under my fingernails, and I never would have voted for it," said Rep. John L. Mica, R-Fla., one of the few Republicans to vote against repeal efforts. "The financial industry put a full-court press on and said, 'Oh, we can't compete in other financial markets, and other countries are doing it, and it's going to be the end of banking and finance as we know it.' But it has come home to roost." [29]

But many others say it is misguided to implicate Glass-Steagall's repeal in today's crisis.

"I don't see that [the repeal] had anything to do with the current crisis," Clinton told *Business Week*. What's more, he said the ability to mix banks and brokerages actually helped to blunt the effects of this year's Wall Street collapse. "Indeed, one of the things that has helped stabilize the current situation as much as it has is the purchase of Merrill Lynch by Bank of America, which was much smoother than it would have been if I hadn't signed that bill." [30]

Bader of the Competitive Enterprise Institute says, too, that while the wreckage on Wall Street has many causes, deregulation of the financial-services industry through repeal of Glass-Steagall wasn't one of them. "Diversification is a good thing," he says. "The more isolated you are economically, the more [prone] you are to go bankrupt. You have more bank collapses when you have more artificial restrictions."

Others point out that the big institutions that collapsed this year, such as Bear and Lehman, were not commercial banks that ran into problems because of risky stock transactions — the problem that Glass-Steagall was designed to address.

David Leonhardt, an economics columnist for *The New York Times*, argued that it wasn't so much that Gramm-Leach-Bliley spawned the current crisis but rather that congressional Republicans and the Clinton administration failed to create effective new financial regulations in its wake. "[O]ne act of deregulation, even a big one, and the absence of other, good regulations aren't the same thing," he wrote. "The nursemaid of the current crisis isn't so much what Washington did . . . as what it didn't do." [31]

Leonhardt said Gramm-Leach-Bliley did encourage mergers that fueled banks with capital, some of which wound up in the subprime market. But he saved his most stinging rebuke for the Bush administration and former Chairman Alan Greenspan's Federal Reserve, whose "near-religious belief in the powers of the market led them to conclude that the mere fact that a company was willing to make an investment made that investment OK."

Looking past the immediate carnage on Wall Street, the University of Missouri's Wray says the system for overseeing financial institutions needs far more funding to hire enough examiners to police increasingly complex and opaque institutions.

What's more, Wray says the highly fractured regulatory framework, made up of agencies as diverse as the Office of Thrift Supervision, the Federal Reserve and various state regulators, needs complete revamping.

"We have to make sure the regulated institutions can't play one regulator against another," he says.

Roger Leeds, director of Johns Hopkins University's Center for International Business and Public Policy, says the financial crisis magnifies a longstanding "failure of the regulatory structure and framework to keep up with the enormous changes that have been taking place in the global financial system." Although the system has been "pretty vigilant" when it comes to commercial banks, he says, "banks are not the only important financial intermediaries anymore, and everybody knows that."

Leeds says the regulatory system was designed for an era when commercial banks were the mainstays of the financial sector. However, in recent years, he says, a highly diffuse network of investment banks, insurance companies, hedge funds and other financial intermediaries have become as important as commercial banks, but they have not been subjected to the same level of regulatory oversight and supervision.

For example, rules on leverage, capital adequacy and full disclosure of so-called off-balance-sheet transactions are lacking, Leeds says. Also, he says, although the Securities and Exchange Commission has oversight responsibility for investment banks, it has been "largely absent for at least the last eight years." And, he says, the institutional framework for financial regulation is "egregiously fragmented. There are too many regulatory institutions, and coordination among them is inadequate — they don't talk to each other very effectively."

Adds Hess of Claremont McKenna College, "We did not keep up with the pace of financial innovation. We need to regulate as new products are being developed, not after we've found out which ones don't work." ■

BACKGROUND

First Sparks

Henry Paulson said that when he became Treasury secretary in 2006 he could see that "some kind of market turbulence" was about due but that he "didn't expect quite this." Still, he told his colleagues, "[W]hen there's a lot of dry tinder out there, you never know what spark is gonna light the tinder." [32]

Some of the first sparks were struck early this decade. After the collapse of the technology-stock bubble in the late 1990s and the terrorist attacks of September 2001, the Federal Reserve started slashing interest rates to stimulate borrowing and spending. At the end of 2001 the discount rate — the rate the government charges commercial banks for short-term loans — was down to a paltry 1.25 percent.

Rates that low filter down to mortgages, says Ekelund, the Auburn professor emeritus. "You're going to have growth, but growth is going to be at the expense and stability of the financial system."

Meanwhile, banks, pension funds and other financial institutions in the United States and around the world were flush with trillions of dollars in assets. Indeed, according to International Monetary Fund economist Ceyla Pazarbasioglu, the global pool of capital amounts to an astonishing $70 trillion — nearly twice the amount available worldwide in 2000. [33]

Trillions of dollars were flooding into the United States from burgeoning markets in the Middle East, China (which joined the World Trade Organization in 2001) and elsewhere. With money sloshing through the U.S. and global economy and mortgage rates at lows not seen since the 1960s, home buyers stampeded into the market. As they did, institutional investors here and abroad — looking for profitable ways to invest — piled into mortgage-backed securities.

Home buyers included many well-qualified borrowers looking for owner-occupied homes, but also speculators and people with little means to sustain a monthly mortgage payment. Lenders were happy to accommodate them all — even borrowers with weak credit or other financial obstacles. In one example cited by *The Washington Post*, a mortgage broker told of securing a $500,000 loan for a $35,000-a-year McDonald's employee. [34]

Soaring Home Prices

Soaring home prices kept this fire burning. In many major cities, prices more than doubled between 2000 and 2006, according to the S&P/Case-Shiller Home Price Indices. In hot markets like Los Angeles and Miami they shot up even more.

As long as prices were climbing, borrowers, lenders and mortgage investors

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Chronology

1920s-1930s
Stock market collapse and Depression reshape federal financial policy.

1929
Stocks crash, heralding decade of economic decline.

1933
Glass-Steagall Act separates commercial and investment banking.

1938
Federal National Mortgage Association (Fannie Mae) established.

1960s-1970s
Inflation, war and other economic pressures spur policy changes.

1968
Congress shifts Fannie Mae ownership entirely to private investors.

1970
Congress creates Freddie Mac to compete with Fannie Mae.

1980s
Recession and high interest rates batter financial companies.

1982
"Collateralized mortgage obligations" are invented to bundle and sell mortgages to financial institutions. . . . Restrictions eased on savings and loan associations ("thrifts").

1984
Government rescues Continental Illinois National Bank and Trust.

1987
Alan Greenspan becomes Federal Reserve chairman. . . . Stock market crashes.

1989
Congress creates Resolution Trust Corp. to take over insolvent thrifts.

1990s
Financial institutions are deregulated.

1992
Office of Federal Housing Enterprise Oversight created to supervise Fannie and Freddie.

1998
Losses on derivatives trading sink Long-Term Capital Management, but Greenspan opposes new regulations.

1999
Gramm-Leach-Bliley Act repeals Glass-Steagall Act, enabling banks to own securities firms and insurance companies.

2000s
Reckless lending policies fuel housing bubble that explodes into global crisis.

2000
Commodity Futures Modernization Act deregulates derivatives.

2001
Federal Reserve slashes interest rates after tech-stock bubble and terrorist attacks hurt U.S. economy.

2003, 2004
Freddie Mac admits misstating earnings; accounting scandal hits Fannie Mae.

2001-2006
Housing prices in many cities double; home-equity loans boost consumer spending. . . . Subprime and other risky loans are growing share of residential mortgages.

2005
Congress rejects tighter regulation of Fannie, Freddie.

2007
Bear Stearns closes two big investment funds hit by subprime losses.

2008
March: Fed approves $29 billion loan to help JP Morgan Chase acquire Bear Stearns. . . . July 30: President Bush signs legislation authorizing Treasury to purchase Fannie, Freddie common stock and debt. . . . Sept. 7: U.S. seizes Fannie, Freddie. . . . Sept. 15: Lehman Brothers files for bankruptcy; Merrill Lynch agrees to sale to Bank of America. . . . Sept. 16: Fed bails out American International Group. . . . Sept. 18: Fed Chairman Henry Paulson Jr. announces $700 billion plan to buy banks' "toxic" debt. . . . Sept. 25: Washington Mutual collapse is biggest bank failure in history. . . . Sept. 29: House rejects bailout plan; negotiations resume. . . . Oct. 1: Senate passes revised bailout; House follows on Oct. 3, and Bush signs bill. . . . Oct. 10: Dow Jones Industrial Average ends worst week ever. . . . Oct. 13: Dow surges 936 points after European and U.S. leaders agree to support their financial systems. . . . Oct. 14: Treasury announces $250 billion plan to recapitalize U.S. banks. . . . Oct. 23: Government promises to provide $2.5 trillion to protect money market deposits and many loans. . . . Nov. 15: International meeting on economy called for in Washington by President Bush.

Global Financial Markets Face Meltdown

British Prime Minister Brown plays key rescue role.

The global banking and credit crisis bears a distinct "Made in America" tag, in the eyes of many foreign leaders and economists.

Denunciations by Russian Prime Minister Vladimir Putin were no surprise. As plunging prices in October forced Russia's two principal stock markets to shut down, he declared, "Trust in the United States as the leader of the free world and the free economy and confidence in Wall Street as the center of that trust has been damaged, I believe, forever. There will be no return to the previous situation." [1]

Friends of the United States were almost as critical. "The American banking system is going to have to reinvent itself," said Peter Mandelson of Britain, the European Union's trade commissioner. "It's going to be consolidated, it's going to operate in a different way, it's going to have to operate with more responsibility, less risk," as October's perilous month began. [2]

But as U.S. and European banks approached cardiac arrest on Oct. 10 after a devastating week of stock market losses, America-bashing took a back seat to collaboration.

Global financial markets were "on the brink of systemic meltdown," warned Dominique Strauss-Kahn, managing director of the International Monetary Fund (IMF). [3] "The days of finger-pointing and schadenfreude are over, former Federal Reserve Chairman Paul Volcker commented in *The Wall Street Journal.* [4]

French Finance Minister Christine Lagarde told the Council on Foreign Relations, "I'm not in the blame game, and it is pointless to do so. The first lesson to be learned is humility." [5]

Over the weekend, the Federal Reserve and European central banks engineered a joint reduction in interest rates and an agreement to pour more funds into endangered banks. Finance ministers from the six largest economies met in Washington with President George W. Bush and pledged cooperation.

The decisive move, however, was taken singly by British Prime Minister Gordon Brown's government. On Oct. 13 it bought majority control of the Royal Bank of Scotland and 40 percent stakes in HBOS, the holding company that owns the Scottish Bank and Lloyds/TSB for £50 billion ($81 billion). [6]

Britain's sudden move toward bank nationalization trumped the Bush administration's strategy, developed by Treasury Secretary Henry M. Paulson Jr., which focused on acquiring bad bank debt rather than infusing banks with much-needed cash, or liquidity — in effect, a partial federal takeover.

Britain was followed by France, Germany and Spain, all making similar investments in their nation's banks in return for shares of the financial institutions, and the United States was obliged to follow, analysts said. Otherwise, it risked a flight of investment capital from the United States toward European banks with seemingly greater government protection. Luxembourg, the Netherlands and Iceland have also intervened with governmental rescues of endangered banks. [7]

But Europe's share of the $4 trillion in new debt issued by major nations in the crisis will be harder to bear because their levels of taxation are relatively higher than in the United States, says David Smick, publisher of *The International Economy* quarterly. "The bottom line is that the Europeans have reason to be angry with the United States. The credit crisis has placed them in a fiscal stranglehold," Smick said in a statement.

On Oct. 13, Paulson moved the United States in line, announcing a $250 billion federal injection into the banking system by acquiring shares of Citigroup, Bank of America, Wells Fargo, Goldman Sachs, JP Morgan Chase and smaller banks and promising to make new loan guarantees, in order to unfreeze bank lending.

"The Europeans not only provided a blueprint but forced our hand," Harvard University Professor Kenneth S. Rogoff told *The New York Times.* [8]

"Today's actions are not what we ever wanted to do," Paulson acknowledged, "but today's actions are what we must do to restore confidence to our financial system." [9]

Stock markets around the world responded initially to the weekend's actions with a global exhale of relief. The Dow Jones Industrial Average in the United States soared a record 936 points on Oct. 13, and other stock markets in Europe and Asia registered double-digit gains. But the euphoria has not lasted.

Whatever the outcome of the October intervention, many world leaders and financial experts are declaring that the crisis has ended the 30-year domination of international economic

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felt safe. They figured homeowners could always refinance, based on homes' growing market value, or sell at a profit. The risks of default seemed low. Some lenders were making loans that exceeded a house's value, figuring home prices would rise at least enough to cover balloon payments that would come due in a few years.

But such assumptions were wrong. Builders had rapidly expanded the supply of available homes and condos, outstripping demand. Meanwhile, the economy was slowing, interest rates were edging higher and the hot real estate market had cooled. Soon, home prices were flattening, falling or in some places plummeting. In Boston and San Diego, the bubble began deflating in late 2005. By 2007 it was losing air everywhere, and fast.

The subprime crisis began gathering strength in early 2007 and then accelerated. The share of loans that entered the foreclosure process rose from 0.38 percent in the second quarter of 2005 to more than double that rate in the third quarter of 2007, according to the Mortgage Bankers Association policy by the laissez-faire, pro-market philosophies championed by the United States.

"The financial crisis continues to make victims," wrote Paul De Grauwe, an economics professor at Belgium's University of Leuven. [10] They include the U.S.-led belief in the supremacy of markets and its corollary hostility toward regulation, he said. "Helped by the missionary zeal of successive American administrations and pushed by international financial institutions, country after country freed their financial markets from pernicious government controls, hoping to share in these economic wonders. The credit crisis has destroyed the idea."

"People around the world once admired us for our economy, and we told them if you wanted to be like us, here's what you have to do — hand over power to the market," said Nobel Prize-winning U.S. economist Joseph Stiglitz. "The point now is that no one has respect for that kind of model anymore, given this crisis. And, of course, it raises questions about our credibility. Everyone feels they are suffering now because of us." [11]

French President Nicolas Sarkozy said on Sept. 25 that the crisis marked "the end of a world that was built on the fall of the Berlin Wall and the end of the Cold War — a big dream of liberty and prosperity." He called for "new balance" between the market and government regulation, adding, "The idea that markets are always right was a mad idea." [12]

Hindsight may not yield all the answers in a new global economy that faces several years or more of recession or stagnant growth, according to the IMF. "Many advanced economies are close to or are moving into recession; growth in emerging economies also is weakening," said IMF First Deputy Managing Director John Lipsky. [13]

Economist Dennis Snower, president of Germany's Kiel Institute, argues that the crisis signals a move away from the U.S. dollar as the world's dominant currency, a role it has held since the end of World War II. [14] The staggering initial costs of the U.S. rescue plan may drive America's 2009 federal deficit above $775 billion, estimates University of Wisconsin economist Menzie Chinn, or more than quadruple the amount in fiscal 2007. [15] That will make the U.S. even more dependent upon foreigners — and foreign central banks in particular — to purchase enough U.S. Treasury bonds and notes to balance the budget.

The critical issue is whether wealthy and developing nations have learned the necessity of working together, said the IMF's Strauss-Kahn. "All kinds of cooperation have to be commended. All lonely acts have to be avoided, if not condemned." [16]

— Peter Behr

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12 Peter Gumbel, "The Meltdown Goes Global," *Time*, Oct. 20, 2008, p. 32.

13 John Lipsky, "Navigating the Storm," *The Washington Post,* Oct. 10, 2008, p. A19.

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15 Menzie Chinn, "The Budget Deficit . . . and Macro Policies Going Forward," *Econbrowser*, Oct. 12, 2008, www.econbrowser.com/archives/2008/10/the_budget_defi.html.

16 Jim Puzzanghera and Maura Reynolds, "Financial Crisis: In Fear's Grip; Calls grow for global strategy; No country can solve the credit crisis alone, an IMF official says," *Los Angeles Times*, Oct. 10, 2008.

(MBA). It reached 1.08 percent in the second quarter of this year, according to the MBA's latest data. That means foreclosures began on more than one of every 100 loans in that quarter — a figure that represents billions of dollars in losses for lenders and investors.

With losses mounting, financial institutions such as UBS, Citigroup, Merrill Lynch and JP Morgan Chase took massive mortgage-related write-downs.

Then this past March came an event that would shake Wall Street to its foundation. The investment bank Bear Stearns, founded before the Great Depression, collapsed under the weight of subprime mortgage investments largely made with borrowed money. Bear sold for a mere $10 per share to JP Morgan Chase in a deal that included as much as $29 billion in federal support. A year earlier, Bear Stearns' shares had traded for $170 apiece. [35]

"This is like waking up in summer with snow on the ground," Ron Geffner, a former Securities and Exchange Commission enforcement lawyer, told *The New York Times*. [36]

Takeover of Fannie, Freddie

As stunning as Bear's collapse was, it was not as shocking as the wholesale reordering of the Wall Street terrain that would follow.

In September came the government's seizure of Fannie Mae and Freddie Mac after weeks of speculation that the mortgage behemoths could fail — with explosive consequences for the already teetering housing market.

Then, in rapid succession, came more bad news: On Sept. 15, real estate-related losses brought down Lehman Brothers, a Wall Street icon founded before the Civil War. The same day, the nation's biggest brokerage, Merrill Lynch, also crippled by mortgage investments, rushed into the embrace of Bank of America.

On Sept. 16 the Federal Reserve announced it was taking control of the global insurer American International Group. AIG's main insurance business was profitable; its troubles stemmed from credit-default swaps, which AIG sold to other institutions to guarantee their risky mortgage investments against default.

On Sept. 25 Washington Mutual collapsed and was sold by federal regulators to JP Morgan Chase. In a bankruptcy filing, a holding company for the 119-year-old firm listed more than $8 billion in debt, according to Bloomberg.com. [37]

Citing data from *Inside Mortgage Finance*, an industry newsletter, Bloomberg said WaMu was the second-biggest provider of so-called payment-option adjustable-rate mortgages, with $54 billion in WaMu's portfolio in the first quarter. Such instruments allow borrowers to miss part of their payment and add that amount to their loan's principal — meaning borrowers could owe more than their house is worth when home prices fall.

Soon after Washington Mutual's demise, Wachovia, one of the nation's largest commercial banks, went up for sale. Wachovia had recently purchased a major seller of subprime loans. In fact, Bloomberg said, Wachovia eclipsed WaMu in payment-option adjustable loans. [38]

Meanwhile, alarm was spreading through Washington that a massive credit crisis could topple the entire U.S. and global economies. On Sept. 16, the Reserve Primary Fund, a $65 billion money-market fund — a kind of savings vehicle long viewed as rock-solid — said it had "broken the buck" — its customers' accounts had fallen to 97 cents on the dollar because some investments had dropped in value. [39]

Startled government officials feared that customers would rush to cash in their money-market accounts, signaling a broad-scale financial panic. And if money funds — a key source of business credit — began shrinking, the chain reaction would shake the entire economy.

Rescue Plan

With chaos engulfing Wall Street and Washington, Fed Chairman Bernanke and Treasury Secretary Paulson hastily called a meeting on Capitol Hill on the evening of Sept. 18, where they put forth the outline of the $700 billion rescue plan. "If we don't do this," Bernanke reportedly said, "we may not have an economy on Monday." [40]

A week later, as congressional leaders sparred over details of a bailout, President Bush was even more blunt about the economy's prospects. "If money isn't loosened up," he warned, "this sucker could go down." [41]

Passage of the rescue plan on Oct. 3 did little — at least initially — to control what had become a global calamity. Over eight days in early October the Dow plunged 22 percent, posting the worst week in its 112-year history. [42] Overseas markets also sank. On the weekend of October 12, world leaders, meeting in Washington and elsewhere, scrambled to find a way to solve the crisis.

A plan to inject billions of dollars of capital into banks here and abroad seemed to restore some degree of confidence, and stocks began to recover some of their losses, but in mid-October the Dow Jones Industrial Average was roughly 40 percent below its high a year earlier.

Fears of a prolonged recession here and abroad rivaled concern over the subprime crisis.

As officials continued to seek solutions, they also were trying to untangle what led to the worst economic calamity since the Great Depression.

Lawrence White, an economics professor at New York University, says that investment banks and other financial firms ran into deep trouble when the real estate market declined because they had borrowed heavily to cash in on the mortgage boom. Some investment banks had borrowing levels — or leverage ratios — as much as 30 times their equity.

Institutions that had borrowed heavily and had a thin capital cushion for safety were vulnerable to even a small rise in defaults, White said.

When an institution is operating on a high leverage ratio, all it takes is a small decline in the value of an institution's assets to make creditors nervous about getting repaid, White says. And when those creditors panic, they pull back on lending, starting a chain reaction that ripples through the entire economy.

Leveraging — borrowing massive amounts of capital in order to complete a broad range of financial transactions — is commonplace on Wall Street. But it can turn deadly when the underlying assets that are used as collateral plummet in value, forcing borrowers to prematurely liquidate their investment or try to borrow more funds on far more onerous terms. Leverage "is how you make the most money in good times, and how you lose the most in bad times," says Johns Hopkins University's Leeds.

Leeds points, for example, to the spectacular failure in 1998 of the giant

New Rescue Plan Dwarfs Earlier Bailouts

Aid recipients ranged from railroads to cities.

The Bush administration's recent $1 trillion package to rescue the nation's banks, financial markets and largest insurer is worth more than the total of eight major bailouts undertaken by the federal government since 1970. The second-largest bailout occurred in 1989, when President George W. Bush's father, President George H. W. Bush, asked for about $160 billion to finance the breakup of the nation's troubled savings and loans.

During the Great Depression, the government also played a key role in trying to resuscitate the economy, launching programs ranging from the Works Progress Administration and Social Security to Fannie Mae.

Franklin D. Roosevelt's New Deal created the Emergency Banking Act, which helped reopen banks under the Treasury's supervision, making loans available when necessary. The sweeping New Deal also created the Farm Security Administration, Resettlement Administration, Rural Electrification Administration and Tennessee Valley Authority to help those living in severe poverty.

In addition to program assistance, the government also implemented numerous reforms designed to prevent future crises, such as the Federal Deposit Insurance Corporation (FDIC), the Economy Act, which cut the salaries of federal employees in order to balance the budget, and the National Industrial Recovery Act, which allowed blue-collar workers the right to collective bargaining.

The biggest government bailouts since 1970 were:

- **Penn Central Railroad ($676.3 million) —** Arguing that it provided crucial national defense and transportation services, the big railroad appealed to the Federal Reserve for aid in 1970 as it teetered on the verge of bankruptcy. President Richard M. Nixon and the Fed asked Congress for financial assistance, but lawmakers refused. The railroad declared bankruptcy in June, freeing it from its debts. To counteract the impact on the economy of the unpaid debts, the Fed agreed to provide commercial banks with $676.3 million to allow them to meet customers' credit needs.
- **Lockheed Corp. ($250 million) —** In August 1971 Congress passed the Emergency Loan Guarantee Act, which enabled the government to provide funds for any major business in crisis but was primarily used to bail out Lockheed, a struggling aircraft manufacturer. The company received $250 million based on concerns its failure would create significant job losses in California, contribute to a decline in GNP and harm national defense.
- **Franklin National Bank ($1.75 billion) —** After the Long Island bank posted an operating loss of $63.6 million in 1974, the Fed loaned it $1.75 billion.
- **New York City ($2.3 billion) —** With the city in crisis throughout the 1970s, President Gerald R. Ford signed the New York City Seasonal Financing Act, which authorized $2.3 billion in loans.
- **Chrysler Corp. ($1.5 billion) —** The nation's third-largest automaker asked the government for aid after losing $1.1 billion in 1979. The Chrysler Loan Guarantee Act provided $1.5 billion in loans to help rescue Chrysler from insolvency; U.S. and foreign banks matched that amount.
- **Continental Illinois National Bank and Trust Company ($4.5 billion) —** The bank suffered significant losses in 1984 after purchasing $1 billion in energy loans from the failing Penn Square Bank of Oklahoma. The Fed and FDIC devised a $4.5 billion plan to rescue the bank, which included replacing its top executives.
- **Savings and Loan Associations ($160.1 billion) —** Following the widespread failure of 747 savings and loan institutions, or "thrifts," Congress passed the Financial Institutions Reform Recovery and Enforcement Act to finance their dissolution.
- **Airline Industry ($15 billion) —** The Air Transportation Safety and Stabilization Act was signed into law by President George W. Bush to compensate airlines for the mandatory grounding of aircraft after the Sept. 11 terrorist attacks. The act released $5 billion in compensation along with more than $10 billion in loan guarantees or other credit instruments.
- **Current Financial Crisis ($1 trillion) —** In the fallout from a subprime mortgage meltdown and subsequent liquidity crisis, the federal government lent JP Morgan Chase up to $29 billion to help it acquire rival investment bank Bear Stearns; seized Fannie Mae and Freddie Mac after pumping $200 billion into the two mortgage giants; took over the nation's largest insurer, American International Group, after providing it with $123 billion to avoid a liquidity crisis; authorized the Treasury Department to spend up to $700 billion to purchase "toxic" mortgage-backed securities from Wall Street and invest in the nation's banks to unlock a credit freeze.

— Darrell Dela Rosa

hedge fund Long-Term Capital Management. It borrowed heavily to invest in sophisticated, seemingly sound financial instruments. When Russia suddenly defaulted on its short-term debt obligations — just a year after an Asian financial crisis — global investors fled to higher-quality investments that rendered Long-Term Capital's complex risk-management models useless. Within weeks the hedge fund lost more than $4 billion and collapsed, causing the Federal Reserve to intervene to avert a larger systemic crisis.

That collapse was a miniature version of today's crisis, many say. Yet Congress and federal regulators failed to grasp its lesson, Leeds says. "There was lots of talk about more tightening of disclosure, placing limits on leverage and so forth, and nothing happened," he says.

Besides excessive leverage, experts say another catalyst for today's crisis is "securitization," or the packaging by banks of illiquid debt obligations they are owed and creating tradable securities that are then sold to investors.

Bankers have been securitizing mortgages, student loans and credit card debt for decades, to great benefit. Lenders are able to move the loans off their balance sheets, freeing up capital so they can make more loans. And because investors are buying into a diversified pool of risk, the chances of getting stung by defaults are reduced.

But securitization also creates perverse incentives for lenders to take unwise risks. "Because the assets — mortgages for example — are no longer long-term commitments of the bank, there is less incentive to conduct rigorous due diligence on the borrower's creditworthiness," says Leeds. "Bankers are more willing to take these risks, knowing they are not going to be holding that asset for 20 or 30 years." In the current crisis, however, institutions haven't been able to sell many of those securitized assets because the market has been frozen.

The sale of mortgages packaged as collateralized debt obligations (CDOs) to Wall Street investment banks, pension and hedge funds, insurance companies and other investors mushroomed as the housing industry boomed. Lenders "were making these loans hand over fist without worrying very much about the long-term consequences because the risk wasn't going to be on their balance sheet — or at least that's what they thought," says Leeds. And "regulators were complicit by not imposing stricter disclosure requirements."

But some experts warned that CDOs suffered from a lack of transparency. "The danger in these products is that in changing hands so many times, no one knows their true makeup, and thus who is holding the risk," said Joshua Rosner, a managing director at Graham Fisher & Company, a New York research firm." [43]

Institutional investors borrowed heavily to buy CDOs, holding them in their own portfolios or reselling them to other investors. To hedge against losses, investors bought arcane, unregulated insurance contracts called credit-default swaps, in which buyers of swaps pay a premium to a "counterparty" that agrees to pay off a loan if the original borrower defaults. But sellers of swaps weren't required to hold cash reserves against the swaps, and when payments to buyers of the insurance-like instruments became necessary, they couldn't always pay off.

The market for credit-default swaps and other "credit derivatives" had a value of $55 trillion at mid-year, according to the International Swaps and Derivatives Association. [44] But credit swaps are unregulated, and critics have pointed to them as a prime culprit in the financial crisis.

Last month SEC Chairman Christopher Cox urged Congress to regulate the swaps, saying the market was "ripe for fraud and manipulation." [45] *The New York Times* noted that the government bailed out American International Group primarily because AIG was a counterparty to large amounts of swaps with global financial institutions. [46]

Helping to fuel the frenzy for collateralized debt obligations backed by subprime loans were big credit agencies that rate long-term debt. Even though CDOs were packed with potentially bad loans, the agencies often gave those securities high marks.

This summer, after a 10-month investigation, the SEC said in a scathing report that the major rating firms, Moody's Investor Services, Standard & Poor's Ratings Services and Fitch Ratings, had stumbled in their duty to protect investors.

"We've uncovered serious shortcomings at these firms, including a lack of disclosure to investors and the public, a lack of policies and procedures to manage the rating process and insufficient attention to conflicts of interest," said Cox. "When the firms didn't have enough staff to do the job right, they often cut corners." [47]

In one case, an analyst at a credit-ratings firm e-mailed a colleague that the firm's model didn't capture "half" of a certain deal's risk, but that "it could be structured by cows and we would rate it." In another case, a manager said the rating agencies were creating an "even bigger monster — the CDO market. Let's hope we are all wealthy and retired by the time this house of cards falters." [48]

Cox said the "good news" was that the credit-rating agencies' problems were "being fixed in real time." But not everyone agreed. "There was an utter failure and breakdown of control in these companies, and the SEC failed to catch any of it," said Rosner of Graham Fisher. "I'm certain there's a hell of a lot more incriminating e-mails. The SEC is glossing it over." [49] ■

CURRENT SITUATION

Red Ink

As extreme volatility continues to rock global markets, financial institutions are swimming in red ink.

This October Citigroup, a global financial company with interests ranging from investment banking to credit cards, reported a $2.8 billion third-quarter loss, the fourth period in a row it has had write-downs on investments and bigger consumer-loan losses. [50]

The New York Times noted that "every major region of the world where Citigroup operates, with the exception of the one anchored by the Middle East, reported a decline in revenue." [51]

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At Issue:

Should Fannie Mae and Freddie Mac be privatized?

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WRITTEN FOR *CQ RESEARCHER*, SEPTEMBER 2008

During the current market anxiety, the two mortgage giants, Fannie Mae and Freddie Mac, should remain as is: nationalized. But their proper place in the longer run is clear: They should be truly privatized.

Recall their previous status: They were nominally "normal" corporations, with shares traded on the New York Stock Exchange. But they had so many special features — each was a creature of federal legislation, which spelled out special privileges and obligations for the two companies — that they were "government-sponsored enterprises."

The financial markets treated their debt as special, so that they were able to borrow at rates about 0.40 percent lower than their stand-alone finances would have justified. In turn, the interest rates on the "conforming" mortgages that they could buy — to securitize and resell, or to hold — were about 0.25 percent lower than otherwise.

The political popularity of any arrangement that made mortgages cheaper but did not represent a federal budgetary outlay was understandable. Whether this represented good public policy is questionable.

In any event, the hybrid private/public nature of the two companies was unsustainable. They experienced conflicting pressures to earn good returns for their shareholders and also to support affordable housing. Low capital levels certainly allowed high returns but also meant that they couldn't weather the mortgage debacle that has engulfed the U.S. economy.

For the future, they should be fully privatized, with no special ties to government. Their existing organizations should remain intact, since they were relatively good — despite some lapses — at their secondary mortgage market operations.

All future debt incurred by Fannie and Freddie should be explicitly non-guaranteed. Cautious lenders will insist that they maintain higher capital levels and/or pay higher interest rates, and they will shrink relative to their recent sizes. That is all to the good.

Simultaneously, the valuable social function of encouraging low- and moderate-income families to become homeowners should be under the aegis of government, with substantial and transparent on-budget appropriations. That is good public policy, and good government.

Let the private sector do what it does best. Let the government perform the appropriate social function. Mixing the two was toxic. Let's not make that mistake again.

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WRITTEN FOR *CQ RESEARCHER*, SEPTEMBER 2008

Fannie Mae was set up by the Roosevelt administration 70 years ago to create a national mortgage market and thereby make home ownership more affordable. By all accounts, Fannie Mae and its twin, Freddie Mac, accomplished this goal. They have made mortgage loans cheaper and more widely available to tens of millions of homeowners.

These institutions failed to recognize the largest housing bubble in the history of the world. This failure left them exposed to the bubble's collapse and eventually threw them into the hands of the government. The question is whether it now makes sense to either privatize them outright or return them to their public/private status.

Privatization would end the role that these institutions played in promoting access to mortgage credit. Without Fannie and Freddie, we could expect to see a jump in mortgage interest rates nationwide. In the absence of the national market created by Fannie and Freddie there would be pockets with especially high interest rates. The private sector has no interest in assuring the general availability of mortgages.

Of course, we could allow private banks to issue mortgage-backed securities with a government guarantee, but unless we are anxious to see another financial collapse, this would not be a wise route to follow. It would be crazy to trust banks to act responsibly, and our current regulatory system is certainly not sufficient to rein in the wizards of Wall Street.

The serious question, then, is what the public could possibly gain by returning to the mixed public/private system. There seems little obvious gain from adding the private component to these institutions. Ordinarily, we look to the private sector because it is more innovative, and private entrepreneurs are more willing to take risk.

This is a case where innovation and risk-taking are not wanted. The basic task should be very mundane — buying up standard mortgages and packaging them into securities. Risk-taking is what got Fannie and Freddie into trouble. In fact, Fannie and Freddie's economists might have been more open to those of us warning about the housing bubble if their companies were not making so much money on loans to bubble-inflated markets.

In addition to risk, the private side adds costs: The dividends and high executive compensation in private financial companies are effectively a tax on homeowners.

In short, by accident, we ended up in a better place with Fannie and Freddie. Keep them public.

Continued from p. 880

Many eyes are on the United States and the prospects that its bailout plan will help reverse the steep economic decline that has spread worldwide. That may not be clear for a while, though. Earlier this month, federal officials, as well as investors and businesses, were still waiting to see how well the infusion of capital into banks would work.

Many banks remain leery of lending, and some banks are hanging on to their cash to shield themselves against future losses from credit-card defaults. Citing the latest Federal Reserve figures, *The Washington Post* said the rate of credit-card loans going bad rose 54 percent in the second quarter of this year from the same period in 2007. [52]

Meanwhile, it remains to be seen how deep a recession the U.S. economy is facing, but some government officials, including Fed Chairman Bernanke, are pushing for a new stimulus package to head off a steep decline.

"With the economy likely to be weak for several quarters, and with some risk of a protracted slowdown, consideration of a fiscal package by Congress at this juncture seems appropriate," Bernanke told the House Budget Committee on Oct. 20. [53]

It also remains to be seen how much the government might pay under the bailout plan for toxic mortgage debt on the books of lenders.

Valuing the bad debt is perhaps the trickiest part of the bailout effort. If the government pays too much, taxpayers will lose. If it doesn't pay enough, the bailout might not help banks enough or unthaw frozen credit markets. And because confidence in the credit markets and the economy has been at rock-bottom, some loans may be perceived as worthless even though borrowers are making scheduled payments and may continue to do so.

Moreover, many bad loans have been sliced up and packaged into complex securities along with solid loans, which makes it difficult to arrive at accurate valuations.

Financial experts continue to propose various ideas for putting the rescue plan into action. Many economists applauded Paulson's move to use $250 billion of the bailout money to buy equity in the banks, and some even recommended he spend the entire $700 billion on buying equity stakes in banks instead of toxic mortgage assets.

"I hope they won't buy any bad loans, and that they will keep this $700 billion to recapitalize the banking industry," said William Isaac, who chaired the FDIC during President Ronald Reagan's first term. For every dollar of equity the government buys, he said, banks can lend $10. "If all they do is buy bad loans, you don't get leverage out of that. If you buy $250 billion of capital, you increase bank lending capacity by $2.5 trillion." [54]

Earlier this month, for example, *The Wall Street Journal* reported that Treasury officials were mulling selling bundles of bad debt to partnerships owned jointly by investors and the government as opposed to selling debt directly to the private sector. *The Journal* noted that similar transactions were executed by the Resolution Trust Corp. during the savings and loan crisis of the late 1980s and early '90s, the last big real-estate bust. [55]

The S&L debacle cost taxpayers and the thrift industry more than $150 billion. [56]

Fate of Fannie, Freddie

In the longer term, policy makers must decide what to do about Fannie Mae and Freddie Mac, the quasi-government companies placed in federal conservatorship last month. The decision will turn on the views of Congress and, ultimately, the next president.

Critics, including Sen. McCain and other key congressional conservatives, argue that the government has no business putting taxpayers at risk to maintain Fannie and Freddie. But advocates of Fannie and Freddie, including Massachusetts Rep. Frank of the House Financial Services Committee, contend their affordable-housing mission is too important to jeopardize.

In coming months, policy makers will face three broad choices of what to do with Fannie and Freddie:

- Keep them as government-sponsored entities;
- Nationalize them, with the federal government assuming the risks of mortgage finance but also potentially reaping the profits; or
- "Privatize" them by breaking them up into smaller chunks, cutting off their government support and turning them loose to compete in the open market.

Claremont McKenna College's Hess favors privatization. But at a minimum, he says, the government should require Fannie and Freddie to maintain a larger capital cushion to cover mortgage defaults and to shun all but high-quality mortgages. In addition, he says policy makers should reduce Fannie and Freddie's dominance of the loan-purchase and loan-guarantee business by encouraging more competition from commercial companies.

"There's always a public responsibility for housing," but if the federal government wants to subsidize home ownership, it "should put that explicitly on its books and not create institutions with the potential for unlimited liability for the federal government," Hess says.

Sheila Crowley, president of the National Low-Income Housing Coalition, says she has worried about the potential for the government's seizure of Fannie and Freddie to curtail their contributions to low-income housing programs and ultimately force Fannie and Freddie into the private sector, ending their public affordable-housing mission. Still, Crowley is "optimistic that when the dust settles after the reworking of the housing finance system promised by the next Congress, none of those things will have come about."

Crowley also argues that Fannie and Freddie have helped temper the effects of the credit crisis by buying mortgages that private investors haven't wanted to touch.

"In this time of financial turmoil, the percentage of all mortgages bought by Fannie and Freddie has skyrocketed because the private sector backed out," she argues. "If you want stability, you need to have some way to temper the erratic nature of the market."

Placing Blame

As policy makers continue to plot a course for economic recovery, they will have to decide who to hold accountable for the turmoil. Earlier this month *The Washington Post* reported that Justice Department officials promised to untangle the credit-default swaps and other arcane transactions that helped spark the crisis but would "generally seek criminal charges against individual brokers and bankers, rather than companies themselves." [57]

"Mindful of the fallout from the last wave of business fraud cases six years ago, authorities are leaning against seeking indictments of major banks and insurers that may have inflated the value of their mortgage-related investments," said *The Post*. "Instead, prosecutors will look for such garden-variety crimes as false statements and insider trading by executives who tried to disguise financial problems or pad their wallets."

That may be of little solace to retirees who have seen their savings sharply eroded because of the crisis. [58]

Over the past 15 months, declines in the stock market have erased some $2 trillion in Americans' retirement savings, the Congressional Budget Office's Orszag told lawmakers early this month. [59]

"Americans were counting on much of this wealth for their retirement," said committee Chairman Rep. George Miller, D-Calif. "Now it is gone — as is their ability to adequately fund their retirement. . . . Retirement and financial experts now predict that retirees and older workers who rely on financial investments for retirement income may suffer more than any portion of the American population in the coming years." [60]

And those looking toward retirement aren't the only ones facing trouble.

The decline in home prices has left roughly 12 million households — nearly one in six — owing more on their mortgages than their homes are worth, increasing the chances of more defaults, *The Wall Street Journal* reported. [61]

Among those who bought their homes within the past five years, 29 percent owe more than the homes are worth, *The Journal* reported, citing an estimate by Zillow.com, a real-estate Web site.

Said Mark Zandi, Economy.com's chief economist: "It is very possible that there will ultimately be more homeowners under water in this period than any time in our history." [62] ■

OUTLOOK

Major Changes?

With financial markets deeply unsettled and debt-burdened lenders awaiting implementation of the bailout bill, the future course of the financial crisis is anything but clear. But experts say one thing is certain: The economic turmoil will alter the nation's financial, regulatory and political landscape in ways that would have been unimaginable only a few months ago.

Many observers expect a big push for greater disclosure of the risks inherent in exotic financial instruments, notably credit-default swaps.

Also under close inspection will be lavish executive compensation packages, which featured prominently in angry congressional hearings on Lehman Brothers and AIG this month. [63]

More broadly, the government's entire regulatory framework will be under review.

"It was a lack of regulation that allowed these firms to take on risk and got them into trouble," says University of Oregon economist Thoma. A way to achieve more efficient oversight is to consolidate the current hodge-podge of federal agencies that now oversee the financial sector — the Federal Deposit Insurance Corp., Federal Savings and Loan Insurance Corp., Comptroller of the Currency, and so on — into a new omnibus regulator whose purview would extend to "shadow industry" entities like hedge funds and investment banks, Thoma argues.

No matter how policy makers reform the financial system, said Norman Ornstein, a fellow at the American Enterprise Institute, the concept of "moral hazard" must be taken into account. Ornstein was referring to "situations where no adverse consequences flow from risky behavior or failure; and where wrongheaded, risky behavior that goes unpunished begets even more wrongheaded, risky behavior."

Moral hazard "must become a core concept of governance in the next regulatory regime," Ornstein argued in a recent blog. "The most important thing when restoring the long-term health of the financial system is to recreate the balance between risk and reward, and between benefits for exemplary performance and punishment for malfeasance or nonfeasance." [64]

As the financial crisis continues to unfold, it is likely that more and more observers — both in the United States and overseas — will be asking whether the failure of major financial institutions and the history-making involvement of government in private markets spell the "end of capitalism," a phrase that lately has turned up in blogs and news commentaries with increasing frequency.

What's more likely, many experts say, is the end of U.S. supremacy. "The history of capitalism is filled with credit crises, panics, financial meltdowns and recessions," *Newsweek* columnist Fareed Zakaria pointed out. The financial crisis "doesn't mean the end of capitalism. But it might well mean the end of a certain kind of global dominance for the United States."

Zakaria went on to say that "the real fallout" from the crisis "will be the delegitimization of American power. People around the world once saw the United States as the most modern, sophisticated and productive economy in the world. Now they wonder, was this all a house of cards? They listened to American policy makers with respect, even awe. Today, they wonder if these officials know what they are doing." [65] ■

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About the Author

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The Next Step:

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Amid the wreckage of the nation's financial system, a new era of finance is emerging in which there is greater regulation and less risk.

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