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Chapter 1: Before Our Very Eyes

United States: Financial Crisis Inquiry Commission (FCIC)

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PART I

Crisis on the Horizon

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BEFORE OUR VERY EYES

In examining the worst financial meltdown since the Great Depression, the Financial Crisis Inquiry Commission reviewed millions of pages of documents and questioned hundreds of individuals—financial executives, business leaders, policy makers, regulators, community leaders, people from all walks of life—to find out how and why it happened.

In public hearings and interviews, many financial industry executives and top public officials testified that they had been blindsided by the crisis, describing it as a dramatic and mystifying turn of events. Even among those who worried that the housing bubble might burst, few—if any—foresaw the magnitude of the crisis that would ensue.

Charles Prince, the former chairman and chief executive officer of Citigroup Inc., called the collapse in housing prices “wholly unanticipated.”¹ Warren Buffett, the chairman and chief executive officer of Berkshire Hathaway Inc., which until 2009 was the largest single shareholder of Moody’s Corporation, told the Commission that “very, very few people could appreciate the bubble,” which he called a “mass delusion” shared by “300 million Americans.”² Lloyd Blankfein, the chairman and chief executive officer of Goldman Sachs Group, Inc., likened the financial crisis to a hurricane.³

Regulators echoed a similar refrain. Ben Bernanke, the chairman of the Federal Reserve Board since 2006, told the Commission a “perfect storm” had occurred that regulators could not have anticipated; but when asked about whether the Fed’s lack of aggressiveness in regulating the mortgage market during the housing boom was a failure, Bernanke responded, “It was, indeed. I think it was the most severe failure of the Fed in this particular episode.”⁴ Alan Greenspan, the Fed chairman during the two decades leading up to the crash, told the Commission that it was beyond the ability of regulators to ever foresee such a sharp decline. “History tells us [regulators] cannot identify the timing of a crisis, or anticipate exactly where it will be located or how large the losses and spillovers will be.”⁵

In fact, there were warning signs. In the decade preceding the collapse, there were many signs that house prices were inflated, that lending practices had spun out of control, that too many homeowners were taking on mortgages and debt they could ill afford, and that risks to the financial system were growing unchecked. Alarm bells

were clanging inside financial institutions, regulatory offices, consumer service organizations, state law enforcement agencies, and corporations throughout America, as well as in neighborhoods across the country. Many knowledgeable executives saw trouble and managed to avoid the train wreck. While countless Americans joined in the financial euphoria that seized the nation, many others were shouting to government officials in Washington and within state legislatures, pointing to what would become a human disaster, not just an economic debacle.

“Everybody in the whole world knew that the mortgage bubble was there,” said Richard Breeden, the former chairman of the Securities and Exchange Commission appointed by President George H. W. Bush. “I mean, it wasn’t hidden. . . . You cannot look at any of this and say that the regulators did their job. This was not some hidden problem. It wasn’t out on Mars or Pluto or somewhere. It was right here. . . . You can’t make trillions of dollars’ worth of mortgages and not have people notice.”⁶

Paul McCulley, a managing director at PIMCO, one of the nation’s largest money management firms, told the Commission that he and his colleagues began to get worried about “serious signs of bubbles” in 2005; they therefore sent out credit analysts to 20 cities to do what he called “old-fashioned shoe-leather research,” talking to real estate brokers, mortgage brokers, and local investors about the housing and mortgage markets. They witnessed what he called “the outright degradation of underwriting standards,” McCulley asserted, and they shared what they had learned when they got back home to the company’s Newport Beach, California, headquarters. “And when our group came back, they reported what they saw, and we adjusted our risk accordingly,” McCulley told the Commission. The company “severely limited” its participation in risky mortgage securities.⁷

Veteran bankers, particularly those who remembered the savings and loan crisis, knew that age-old rules of prudent lending had been cast aside. Arnold Cattani, the chairman of Bakersfield, California–based Mission Bank, told the Commission that he grew uncomfortable with the “pure lunacy” he saw in the local home-building market, fueled by “voracious” Wall Street investment banks; he thus opted out of certain kinds of investments by 2005.⁸

William Martin, the vice chairman and chief executive officer of Service 1st Bank of Nevada, told the FCIC that the desire for a “high and quick return” blinded people to fiscal realities. “You may recall Tommy Lee Jones in *Men in Black*, where he holds a device in the air, and with a bright flash wipes clean the memories of everyone who has witnessed an alien event,” he said.⁹

Unlike so many other bubbles—tulip bulbs in Holland in the 1600s, South Sea stocks in the 1700s, Internet stocks in the late 1990s—this one involved not just another commodity but a building block of community and social life and a cornerstone of the economy: the family home. Homes are the foundation upon which many of our social, personal, governmental, and economic structures rest. Children usually go to schools linked to their home addresses; local governments decide how much money they can spend on roads, firehouses, and public safety based on how much property tax revenue they have; house prices are tied to consumer spending. Downturns in the housing industry can cause ripple effects almost everywhere.

When the Federal Reserve cut interest rates early in the new century and mortgage rates fell, home refinancing surged, climbing from \$460 billion in 2000 to \$2.8 trillion in 2003,¹⁰ allowing people to withdraw equity built up over previous decades and to consume more, despite stagnant wages. Home sales volume started to increase, and average home prices nationwide climbed, rising 67% in eight years by one measure and hitting a national high of \$227,100 in early 2006.¹¹ Home prices in many areas skyrocketed: prices increased nearly two and one-half times in Sacramento, for example, in just five years,¹² and shot up by about the same percentage in Bakersfield, Miami, and Key West. Prices about doubled in more than 110 metropolitan areas, including Phoenix, Atlantic City, Baltimore, Ft. Lauderdale, Los Angeles, Poughkeepsie, San Diego, and West Palm Beach.¹³ Housing starts nationwide climbed 53%, from 1.4 million in 1995 to more than 2 million in 2005. Encouraged by government policies, homeownership reached a record 69.2% in the spring of 2004, although it wouldn't rise an inch further even as the mortgage machine kept churning for another three years. By refinancing their homes, Americans extracted \$2.0 trillion in home equity between 2000 and 2007, including \$334 billion in 2006 alone, more than seven times the amount they took out in 1996.¹⁴ Real estate speculators and potential homeowners stood in line outside new subdivisions for a chance to buy houses before the ground had even been broken. By the first half of 2005, more than one out of every ten home sales was to an investor, speculator, or someone buying a second home.¹⁵ Bigger was better, and even the structures themselves ballooned in size; the floor area of an average new home grew by 15%, to 2,277 square feet, in the decade from 1997 to 2007.

Money washed through the economy like water rushing through a broken dam. Low interest rates and then foreign capital helped fuel the boom. Construction workers, landscape architects, real estate agents, loan brokers, and appraisers profited on Main Street, while investment bankers and traders on Wall Street moved even higher on the American earnings pyramid and the share prices of the most aggressive financial service firms reached all-time highs.¹⁶ Homeowners pulled cash out of their homes to send their kids to college, pay medical bills, install designer kitchens with granite counters, take vacations, or launch new businesses. They also paid off credit cards, even as personal debt rose nationally. Survey evidence shows that about 5% of homeowners pulled out cash to buy a vehicle and over 40% spent the cash on a catch-all category including tax payments, clothing, gifts, and living expenses.¹⁷ Renters used new forms of loans to buy homes and to move to suburban subdivisions, erecting swing sets in their backyards and enrolling their children in local schools.

In an interview with the Commission, Angelo Mozilo, the longtime CEO of Countrywide Financial—a lender brought down by its risky mortgages—said that a “gold rush” mentality overtook the country during these years, and that he was swept up in it as well: “Housing prices were rising so rapidly—at a rate that I'd never seen in my 55 years in the business—that people, regular people, average people got caught up in the mania of buying a house, and flipping it, making money. It was happening. They buy a house, make \$50,000 . . . and talk at a cocktail party about it. . . . Housing suddenly went from being part of the American dream to house my family to settle

down—it became a commodity. That was a change in the culture. . . . It was sudden, unexpected.”¹⁸

On the surface, it looked like prosperity. After all, the basic mechanisms making the real estate machine hum—the mortgage-lending instruments and the financing techniques that turned mortgages into investments called securities, which kept cash flowing from Wall Street into the U.S. housing market—were tools that had worked well for many years.

But underneath, something was going wrong. Like a science fiction movie in which ordinary household objects turn hostile, familiar market mechanisms were being transformed. The time-tested 30-year fixed-rate mortgage, with a 20% down payment, went out of style. There was a burgeoning global demand for residential mortgage-backed securities that offered seemingly solid and secure returns. Investors around the world clamored to purchase securities built on American real estate, seemingly one of the safest bets in the world.

Wall Street labored mightily to meet that demand. Bond salesmen earned multi-million-dollar bonuses packaging and selling new kinds of loans, offered by new kinds of lenders, into new kinds of investment products that were deemed safe but possessed complex and hidden risks. Federal officials praised the changes—these financial innovations, they said, had lowered borrowing costs for consumers and moved risks away from the biggest and most systemically important financial institutions. But the nation’s financial system had become vulnerable and interconnected in ways that were not understood by either the captains of finance or the system’s public stewards. In fact, some of the largest institutions had taken on what would prove to be debilitating risks. Trillions of dollars had been wagered on the belief that housing prices would always rise and that borrowers would seldom default on mortgages, even as their debt grew. Shaky loans had been bundled into investment products in ways that seemed to give investors the best of both worlds—high-yield, risk-free—but instead, in many cases, would prove to be high-risk and yield-free.

All this financial creativity was a lot “like cheap sangria,” said Michael Mayo, a managing director and financial services analyst at Calyon Securities (USA) Inc. “A lot of cheap ingredients repackaged to sell at a premium,” he told the Commission. “It might taste good for a while, but then you get headaches later and you have no idea what’s really inside.”¹⁹

The securitization machine began to guzzle these once-rare mortgage products with their strange-sounding names: Alt-A, subprime, I-O (interest-only), low-doc, no-doc, or ninja (no income, no job, no assets) loans; 2-28s and 3-27s; liar loans; piggyback second mortgages; payment-option or pick-a-pay adjustable rate mortgages. New variants on adjustable-rate mortgages, called “exploding” ARMs, featured low monthly costs at first, but payments could suddenly double or triple, if borrowers were unable to refinance. Loans with negative amortization would eat away the borrower’s equity. Soon there were a multitude of different kinds of mortgages available on the market, confounding consumers who didn’t examine the fine print, baffling

conscientious borrowers who tried to puzzle out their implications, and opening the door for those who wanted in on the action.

Many people chose poorly. Some people wanted to live beyond their means, and by mid-2005, nearly one-quarter of all borrowers nationwide were taking out interest-only loans that allowed them to defer the payment of principal.²⁰ Some borrowers opted for nontraditional mortgages because that was the only way they could get a foothold in areas such as the sky-high California housing market.²¹ Some speculators saw the chance to snatch up investment properties and flip them for profit—and Florida and Georgia became a particular target for investors who used these loans to acquire real estate.²² Some were misled by salespeople who came to their homes and persuaded them to sign loan documents on their kitchen tables. Some borrowers naively trusted mortgage brokers who earned more money placing them in risky loans than in safe ones.²³ With these loans, buyers were able to bid up the prices of houses even if they didn't have enough income to qualify for traditional loans.

Some of these exotic loans had existed in the past, used by high-income, financially secure people as a cash-management tool. Some had been targeted to borrowers with impaired credit, offering them the opportunity to build a stronger payment history before they refinanced. But the instruments began to deluge the larger market in 2004 and 2005. The change occurred “almost overnight,” Faith Schwartz, then an executive at the subprime lender Option One and later the executive director of Hope Now, a lending-industry foreclosure relief group, told the Federal Reserve's Consumer Advisory Council. “I would suggest most every lender in the country is in it, one way or another.”²⁴

At first not a lot of people really understood the potential hazards of these new loans. They were new, they were different, and the consequences were uncertain. But it soon became apparent that what had looked like newfound wealth was a mirage based on borrowed money. Overall mortgage indebtedness in the United States climbed from \$5.3 trillion in 2001 to \$10.5 trillion in 2007. The mortgage debt of American households rose almost as much in the six years from 2001 to 2007 as it had over the course of the country's more than 200-year history. The amount of mortgage debt per household rose from \$91,500 in 2001 to \$149,500 in 2007.²⁵ With a simple flourish of a pen on paper, millions of Americans traded away decades of equity tucked away in their homes.

Under the radar, the lending and the financial services industry had mutated. In the past, lenders had avoided making unsound loans because they would be stuck with them in their loan portfolios. But because of the growth of securitization, it wasn't even clear anymore who the lender was. The mortgages would be packaged, sliced, repackaged, insured, and sold as incomprehensibly complicated debt securities to an assortment of hungry investors. Now even the worst loans could find a buyer.

More loan sales meant higher profits for everyone in the chain. Business boomed for Christopher Cruise, a Maryland-based corporate educator who trained loan officers for companies that were expanding mortgage originations. He crisscrossed the nation, coaching about 10,000 loan originators a year in auditoriums and classrooms.

His clients included many of the largest lenders—Countrywide, Ameriquest, and Ditech among them. Most of their new hires were young, with no mortgage experience, fresh out of school and with previous jobs “flipping burgers,” he told the FCIC. Given the right training, however, the best of them could “easily” earn millions.²⁶

“I was a sales and marketing trainer in terms of helping people to know how to sell these products to, in some cases, frankly unsophisticated and unsuspecting borrowers,” he said. He taught them the new playbook: “You had no incentive whatsoever to be concerned about the quality of the loan, whether it was suitable for the borrower or whether the loan performed. In fact, you were in a way encouraged not to worry about those macro issues.” He added, “I knew that the risk was being shunted off. I knew that we could be writing crap. But in the end it was like a game of musical chairs. Volume might go down but we were not going to be hurt.”²⁷

On Wall Street, where many of these loans were packaged into securities and sold to investors around the globe, a new term was coined: IBGYBG, “I’ll be gone, you’ll be gone.”²⁸ It referred to deals that brought in big fees up front while risking much larger losses in the future. And, for a long time, IBGYBG worked at every level.

Most home loans entered the pipeline soon after borrowers signed the documents and picked up their keys. Loans were put into packages and sold off in bulk to securitization firms—including investment banks such as Merrill Lynch, Bear Stearns, and Lehman Brothers, and commercial banks and thrifts such as Citibank, Wells Fargo, and Washington Mutual. The firms would package the loans into residential mortgage-backed securities that would mostly be stamped with triple-A ratings by the credit rating agencies, and sold to investors. In many cases, the securities were repackaged again into collateralized debt obligations (CDOs)—often composed of the riskier portions of these securities—which would then be sold to other investors. Most of these securities would also receive the coveted triple-A ratings that investors believed attested to their quality and safety. Some investors would buy an invention from the 1990s called a credit default swap (CDS) to protect against the securities’ defaulting. For every buyer of a credit default swap, there was a seller: as these investors made opposing bets, the layers of entanglement in the securities market increased.

The instruments grew more and more complex; CDOs were constructed out of CDOs, creating CDOs squared. When firms ran out of real product, they started generating cheaper-to-produce synthetic CDOs—composed not of real mortgage securities but just of bets on other mortgage products. Each new permutation created an opportunity to extract more fees and trading profits. And each new layer brought in more investors wagering on the mortgage market—even well after the market had started to turn. So by the time the process was complete, a mortgage on a home in south Florida might become part of dozens of securities owned by hundreds of investors—or parts of bets being made by hundreds more. Treasury Secretary Timothy Geithner, the president of the New York Federal Reserve Bank during the crisis, described the resulting product as “cooked spaghetti” that became hard to “untangle.”²⁹

Ralph Cioffi spent several years creating CDOs for Bear Stearns and a couple of more years on the repurchase or “repo” desk, which was responsible for borrowing

money every night to finance Bear Stearns's broader securities portfolio. In September 2003, Cioffi created a hedge fund within Bear Stearns with a minimum investment of \$1 million. As was common, he used borrowed money—up to \$9 borrowed for every \$1 from investors—to buy CDOs. Cioffi's first fund was extremely successful; it earned 17% for investors in 2004 and 10% in 2005—after the annual management fee and the 20% slice of the profit for Cioffi and his Bear Stearns team—and grew to almost \$9 billion by the end of 2005. In the fall of 2006, he created another, more aggressive fund. This one would shoot for leverage of up to 12 to 1. By the end of 2006, the two hedge funds had \$18 billion invested, half in securities issued by CDOs centered on housing. As a CDO manager, Cioffi also managed another \$18 billion of mortgage-related CDOs for other investors.

Cioffi's investors and others like them wanted high-yielding mortgage securities. That, in turn, required high-yielding mortgages. An advertising barrage bombarded potential borrowers, urging them to buy or refinance homes. Direct-mail solicitations flooded people's mailboxes.³⁰ Dancing figures, depicting happy homeowners, boogied on computer monitors. Telephones began ringing off the hook with calls from loan officers offering the latest loan products: One percent loan! (But only for the first year.) No money down! (Leaving no equity if home prices fell.) No income documentation needed! (Mortgages soon dubbed "liar loans" by the industry itself.) Borrowers answered the call, many believing that with ever-rising prices, housing was the investment that couldn't lose.

In Washington, four intermingled issues came into play that made it difficult to acknowledge the looming threats. First, efforts to boost homeownership had broad political support—from Presidents Bill Clinton and George W. Bush and successive Congresses—even though in reality the homeownership rate had peaked in the spring of 2004. Second, the real estate boom was generating a lot of cash on Wall Street and creating a lot of jobs in the housing industry at a time when performance in other sectors of the economy was dreary. Third, many top officials and regulators were reluctant to challenge the profitable and powerful financial industry. And finally, policy makers believed that even if the housing market tanked, the broader financial system and economy would hold up.

As the mortgage market began its transformation in the late 1990s, consumer advocates and front-line local government officials were among the first to spot the changes: homeowners began streaming into their offices to seek help in dealing with mortgages they could not afford to pay. They began raising the issue with the Federal Reserve and other banking regulators.³¹ Bob Gnaizda, the general counsel and policy director of the Greenlining Institute, a California-based nonprofit housing group, told the Commission that he began meeting with Greenspan at least once a year starting in 1999, each time highlighting to him the growth of predatory lending practices and discussing with him the social and economic problems they were creating.³²

One of the first places to see the bad lending practices envelop an entire market was Cleveland, Ohio. From 1989 to 1999, home prices in Cleveland rose 66%, climbing from a median of \$75,200 to \$125,100, while home prices nationally rose about 49% in those same years; at the same time, the city's unemployment rate, ranging

from 5.8% in 1990 to 4.2% in 1999, more or less tracked the broader U.S. pattern. James Rokakis, the longtime county treasurer of Cuyahoga County, where Cleveland is located, told the Commission that the region's housing market was juiced by "flipping on mega-steroids," with rings of real estate agents, appraisers, and loan originators earning fees on each transaction and feeding the securitized loans to Wall Street. City officials began to hear reports that these activities were being propelled by new kinds of nontraditional loans that enabled investors to buy properties with little or no money down and gave homeowners the ability to refinance their houses, regardless of whether they could afford to repay the loans. Foreclosures shot up in Cuyahoga County from 3,500 a year in 1995 to 7,000 a year in 2000.³³ Rokakis and other public officials watched as families who had lived for years in modest residences lost their homes. After they were gone, many homes were ultimately abandoned, vandalized, and then stripped bare, as scavengers ripped away their copper pipes and aluminum siding to sell for scrap.

"Securitization was one of the most brilliant financial innovations of the 20th century," Rokakis told the Commission. "It freed up a lot of capital. If it had been done responsibly, it would have been a wondrous thing because nothing is more stable, there's nothing safer, than the American mortgage market. . . . It worked for years. But then people realized they could scam it."³⁴

Officials in Cleveland and other Ohio cities reached out to the federal government for help. They asked the Federal Reserve, the one entity with the authority to regulate risky lending practices by all mortgage lenders, to use the power it had been granted in 1994 under the Home Ownership and Equity Protection Act (HOEPA) to issue new mortgage lending rules. In March 2001, Fed Governor Edward Gramlich, an advocate for expanding access to credit but only with safeguards in place, attended a conference on the topic in Cleveland. He spoke about the Fed's power under HOEPA, declared some of the lending practices to be "clearly illegal," and said they could be "combated with legal enforcement measures."³⁵

Looking back, Rokakis remarked to the Commission, "I naively believed they'd go back and tell Mr. Greenspan and presto, we'd have some new rules. . . . I thought it would result in action being taken. It was kind of quaint."³⁶

In 2000, when Cleveland was looking for help from the federal government, other cities around the country were doing the same. John Taylor, the president of the National Community Reinvestment Coalition, with the support of community leaders from Nevada, Michigan, Maryland, Delaware, Chicago, Vermont, North Carolina, New Jersey, and Ohio, went to the Office of Thrift Supervision (OTS), which regulated savings and loan institutions, asking the agency to crack down on what they called "exploitative" practices they believed were putting both borrowers and lenders at risk.³⁷

The California Reinvestment Coalition, a nonprofit housing group based in Northern California, also begged regulators to act, CRC officials told the Commission. The nonprofit group had reviewed the loans of 125 borrowers and discovered that many individuals were being placed into high-cost loans when they qualified for better mortgages and that many had been misled about the terms of their loans.³⁸

There were government reports, too. The Department of Housing and Urban Development and the Treasury Department issued a joint report on predatory lending in June 2000 that made a number of recommendations for reducing the risks to borrowers.³⁹ In December 2001, the Federal Reserve Board used the HOEPA law to amend some regulations; among the changes were new rules aimed at limiting high-interest lending and preventing multiple refinancings over a short period of time, if they were not in the borrower's best interest.⁴⁰ As it would turn out, those rules covered only 1% of subprime loans. FDIC Chairman Sheila C. Bair, then an assistant treasury secretary in the administration of President George W. Bush, characterized the action to the FCIC as addressing only a "narrow range of predatory lending issues."⁴¹ In 2002, Gramlich noted again the "increasing reports of abusive, unethical and in some cases, illegal, lending practices."⁴²

Bair told the Commission that this was when "really poorly underwritten loans, the payment shock loans" were beginning to proliferate, placing "pressure" on traditional banks to follow suit.⁴³ She said that she and Gramlich considered seeking rules to rein in the growth of these kinds of loans, but Gramlich told her that he thought the Fed, despite its broad powers in this area, would not support the effort. Instead, they sought voluntary rules for lenders, but that effort fell by the wayside as well.⁴⁴

In an environment of minimal government restrictions, the number of nontraditional loans surged and lending standards declined. The companies issuing these loans made profits that attracted envious eyes. New lenders entered the field. Investors clamored for mortgage-related securities and borrowers wanted mortgages. The volume of subprime and nontraditional lending rose sharply. In 2000, the top 25 nonprime lenders originated \$105 billion in loans. Their volume rose to \$188 billion in 2002, and then \$310 billion in 2003.⁴⁵

California, with its high housing costs, was a particular hotbed for this kind of lending. In 2001, nearly \$52 billion, or 25% of all nontraditional loans nationwide, were made in that state; California's share rose to 35% by 2003, with these kinds of loans growing to \$95 billion or by 84% in California in just two years.⁴⁶ In those years, "subprime and option ARM loans saturated California communities," Kevin Stein, the associate director of the California Reinvestment Coalition, testified to the Commission. "We estimated at that time that the average subprime borrower in California was paying over \$600 more per month on their mortgage payment as a result of having received the subprime loan."⁴⁷

Gail Burks, president and CEO of Nevada Fair Housing, Inc., a Las Vegas-based housing clinic, told the Commission she and other groups took their concerns directly to Greenspan at this time, describing to him in person what she called the "metamorphosis" in the lending industry. She told him that besides predatory lending practices such as flipping loans or misinforming seniors about reverse mortgages, she also witnessed examples of growing sloppiness in paperwork: not crediting payments appropriately or miscalculating accounts.⁴⁸

Lisa Madigan, the attorney general in Illinois, also spotted the emergence of a troubling trend. She joined state attorneys general from Minnesota, California, Washington, Arizona, Florida, New York, and Massachusetts in pursuing allegations

about First Alliance Mortgage Company, a California-based mortgage lender. Consumers complained that they had been deceived into taking out loans with hefty fees. The company was then packaging the loans and selling them as securities to Lehman Brothers, Madigan said. The case was settled in 2002, and borrowers received \$50 million. First Alliance went out of business. But other firms stepped into the void.⁴⁹

State officials from around the country joined together again in 2003 to investigate another fast-growing lender, California-based Ameriquest. It became the nation's largest subprime lender, originating \$39 billion in subprime loans in 2003—mostly refinances that let borrowers take cash out of their homes, but with hefty fees that ate away at their equity.⁵⁰ Madigan testified to the FCIC, “Our multi-state investigation of Ameriquest revealed that the company engaged in the kinds of fraudulent practices that other predatory lenders subsequently emulated on a wide scale: inflating home appraisals; increasing the interest rates on borrowers’ loans or switching their loans from fixed to adjustable interest rates at closing; and promising borrowers that they could refinance their costly loans into loans with better terms in just a few months or a year, even when borrowers had no equity to absorb another refinance.”⁵¹

Ed Parker, the former head of Ameriquest’s Mortgage Fraud Investigations Department, told the Commission that he detected fraud at the company within one month of starting his job there in January 2003, but senior management did nothing with the reports he sent. He heard that other departments were complaining he “looked too much” into the loans. In November 2005, he was downgraded from “manager” to “supervisor,” and was laid off in May 2006.⁵²

In late 2003, Prentiss Cox, then a Minnesota assistant attorney general, asked Ameriquest to produce information about its loans. He received about 10 boxes of documents. He pulled one file at random, and stared at it. He pulled out another and another. He noted file after file where the borrowers were described as “antiques dealers”—in his view, a blatant misrepresentation of employment. In another loan file, he recalled in an interview with the FCIC, a disabled borrower in his 80s who used a walker was described in the loan application as being employed in “light construction.”⁵³

“It didn’t take Sherlock Holmes to figure out this was bogus,” Cox told the Commission. As he tried to figure out why Ameriquest would make such obviously fraudulent loans, a friend suggested that he “look upstream.” Cox suddenly realized that the lenders were simply generating product to ship to Wall Street to sell to investors. “I got that it had shifted,” Cox recalled. “The lending pattern had shifted.”⁵⁴

Ultimately, 49 states and the District of Columbia joined in the lawsuit against Ameriquest, on behalf of “more than 240,000 borrowers.” The result was a \$325 million settlement. But during the years when the investigation was under way, between 2002 and 2005, Ameriquest originated another \$217.9 billion in loans,⁵⁵ which then flowed to Wall Street for securitization.

Although the federal government played no role in the Ameriquest investigation, some federal officials said they had followed the case. At the Department of Housing and Urban Development, “we began to get rumors” that other firms were “running

wild, taking applications over the Internet, not verifying peoples' income or their ability to have a job," recalled Alphonso Jackson, the HUD secretary from 2004 to 2008, in an interview with the Commission. "Everybody was making a great deal of money . . . and there wasn't a great deal of oversight going on." Although he was the nation's top housing official at the time, he placed much of the blame on Congress.⁵⁶

Cox, the former Minnesota prosecutor, and Madigan, the Illinois attorney general, told the Commission that one of the single biggest obstacles to effective state regulation of unfair lending came from the federal government, particularly the Office of the Comptroller of the Currency (OCC), which regulated nationally chartered banks—including Bank of America, Citibank, and Wachovia—and the OTS, which regulated nationally chartered thrifts. The OCC and OTS issued rules preempting states from enforcing rules against national banks and thrifts.⁵⁷ Cox recalled that in 2001, Julie Williams, the chief counsel of the OCC, had delivered what he called a "lecture" to the states' attorneys general, in a meeting in Washington, warning them that the OCC would "quash" them if they persisted in attempting to control the consumer practices of nationally regulated institutions.⁵⁸

Two former OCC comptrollers, John Hawke and John Dugan, told the Commission that they were defending the agency's constitutional obligation to block state efforts to impinge on federally created entities. Because state-chartered lenders had more lending problems, they said, the states should have been focusing there rather than looking to involve themselves in federally chartered institutions, an arena where they had no jurisdiction.⁵⁹ However, Madigan told the Commission that national banks funded 21 of the 25 largest subprime loan issuers operating with state charters, and that those banks were the end market for abusive loans originated by the state-chartered firms. She noted that the OCC was "particularly zealous in its efforts to thwart state authority over national lenders, and lax in its efforts to protect consumers from the coming crisis."⁶⁰

Many states nevertheless pushed ahead in enforcing their own lending regulations, as did some cities. In 2003, Charlotte, North Carolina-based Wachovia Bank told state regulators that it would not abide by state laws, because it was a national bank and fell under the supervision of the OCC. Michigan protested Wachovia's announcement, and Wachovia sued Michigan. The OCC, the American Bankers Association, and the Mortgage Bankers Association entered the fray on Wachovia's side; the other 49 states, Puerto Rico, and the District of Columbia aligned themselves with Michigan. The legal battle lasted four years. The Supreme Court ruled 5–3 in Wachovia's favor on April 17, 2007, leaving the OCC its sole regulator for mortgage lending. Cox criticized the federal government: "Not only were they negligent, they were aggressive players attempting to stop any enforcement action[s]. . . . Those guys should have been on our side."⁶¹

Nonprime lending surged to \$730 billion in 2004 and then \$1.0 trillion in 2005, and its impact began to be felt in more and more places.⁶² Many of those loans were funneled into the pipeline by mortgage brokers—the link between borrowers and the lenders who financed the mortgages—who prepared the paperwork for loans and earned fees from lenders for doing it. More than 200,000 new mortgage brokers

began their jobs during the boom, and some were less than honorable in their dealings with borrowers.⁶³ According to an investigative news report published in 2008, between 2000 and 2007, at least 10,500 people with criminal records entered the field in Florida, for example, including 4,065 who had previously been convicted of such crimes as fraud, bank robbery, racketeering, and extortion.⁶⁴ J. Thomas Cardwell, the commissioner of the Florida Office of Financial Regulation, told the Commission that “lax lending standards” and a “lack of accountability . . . created a condition in which fraud flourished.”⁶⁵ Marc S. Savitt, a past president of the National Association of Mortgage Brokers, told the Commission that while most mortgage brokers looked out for borrowers’ best interests and steered them away from risky loans, about 50,000 of the newcomers to the field nationwide were willing to do whatever it took to maximize the number of loans they made. He added that some loan origination firms, such as Ameriquest, were “absolutely” corrupt.⁶⁶

In Bakersfield, California, where home starts doubled and home values grew even faster between 2001 and 2006, the real estate appraiser Gary Crabtree initially felt pride that his birthplace, 110 miles north of Los Angeles, “had finally been discovered” by other Californians. The city, a farming and oil industry center in the San Joaquin Valley, was drawing national attention for the pace of its development. Wide-open farm fields were plowed under and divided into thousands of building lots. Home prices jumped 11% in Bakersfield in 2002, 17% in 2003, 32% in 2004, and 29% more in 2005.

Crabtree, an appraiser for 48 years, started in 2003 and 2004 to think that things were not making sense. People were paying inflated prices for their homes, and they didn’t seem to have enough income to pay for what they had bought. Within a few years, when he passed some of these same houses, he saw that they were vacant. “For sale” signs appeared on the front lawns. And when he passed again, the yards were untended and the grass was turning brown. Next, the houses went into foreclosure, and that’s when he noticed that the empty houses were being vandalized, which pulled down values for the new suburban subdivisions.

The Cleveland phenomenon had come to Bakersfield, a place far from the Rust Belt. Crabtree watched as foreclosures spread like an infectious disease through the community. Houses fell into disrepair and neighborhoods disintegrated.

Crabtree began studying the market. In 2006, he ended up identifying what he believed were 214 fraudulent transactions in Bakersfield; some, for instance, were allowing insiders to siphon cash from each property transfer. The transactions involved many of the nation’s largest lenders. One house, for example, was listed for sale for \$565,000, and was recorded as selling for \$605,000 with 100% financing, though the real estate agent told Crabtree that it actually sold for \$535,000. Crabtree realized that the gap between the sales price and loan amount allowed these insiders to pocket \$70,000. The terms of the loan required the buyer to occupy the house, but it was never occupied. The house went into foreclosure and was sold in a distress sale for \$322,000.⁶⁷

Crabtree began calling lenders to tell them what he had found; but to his shock, they did not seem to care. He finally reached one quality assurance officer at Fremont

Investment & Loan, the nation's eighth-largest subprime lender. "Don't put your nose where it doesn't belong," he was told.⁶⁸

Crabtree took his story to state law enforcement officials and to the Federal Bureau of Investigation. "I was screaming at the top of my lungs," he said. He grew infuriated at the slow pace of enforcement and at prosecutors' lack of response to a problem that was wreaking economic havoc in Bakersfield.⁶⁹

At the Washington, D.C., headquarters of the FBI, Chris Swecker, an assistant director, was also trying to get people to pay attention to mortgage fraud. "It has the potential to be an epidemic," he said at a news conference in Washington in 2004. "We think we can prevent a problem that could have as much impact as the S&L crisis."⁷⁰

Swecker called another news conference in December 2005 to say the same thing, this time adding that mortgage fraud was a "pervasive problem" that was "on the rise." He was joined by officials from HUD, the U.S. Postal Service, and the Internal Revenue Service. The officials told reporters that real estate and banking executives were not doing enough to root out mortgage fraud and that lenders needed to do more to "police their own organizations."⁷¹

Meanwhile, the number of cases of reported mortgage fraud continued to swell. Suspicious activity reports, also known as SARs, are reports filed by banks to the Financial Crimes Enforcement Network (FinCEN), a bureau within the Treasury Department. In November 2006, the network published an analysis that found a 20-fold increase in mortgage fraud reports between 1996 and 2005. According to FinCEN, the figures likely represented a substantial underreporting, because two-thirds of all the loans being created were originated by mortgage brokers who were not subject to any federal standard or oversight.⁷² In addition, many lenders who were required to submit reports did not in fact do so.⁷³

"The claim that no one could have foreseen the crisis is false," said William K. Black, an expert on white-collar crime and a former staff director of the National Commission on Financial Institution Reform, Recovery and Enforcement, created by Congress in 1990 as the savings and loan crisis was unfolding.⁷⁴

Former attorney general Alberto Gonzales, who served from February 2005 to 2007, told the FCIC he could not remember the press conferences or news reports about mortgage fraud. Both Gonzales and his successor Michael Mukasey, who served as attorney general in 2007 and 2008, told the FCIC that mortgage fraud had never been communicated to them as a top priority. "National security . . . was an overriding" concern, Mukasey said.⁷⁵

To community activists and local officials, however, the lending practices were a matter of national economic concern. Ruhi Maker, a lawyer who worked on foreclosure cases at the Empire Justice Center in Rochester, New York, told Fed Governors Bernanke, Susan Bies, and Roger Ferguson in October 2004 that she suspected that some investment banks—she specified Bear Stearns and Lehman Brothers—were producing such bad loans that the very survival of the firms was put in question. "We repeatedly see false appraisals and false income," she told the Fed officials, who were gathered at the public hearing period of a Consumer Advisory Council meeting. She urged the Fed to prod the Securities and Exchange Commission to examine the

quality of the firms' due diligence; otherwise, she said, serious questions could arise about whether they could be forced to buy back bad loans that they had made or securitized.⁷⁶

Maker told the board that she feared an "enormous economic impact" could result from a confluence of financial events: flat or declining incomes, a housing bubble, and fraudulent loans with overstated values.⁷⁷

In an interview with the FCIC, Maker said that Fed officials seemed impervious to what the consumer advocates were saying. The Fed governors politely listened and said little, she recalled. "They had their economic models, and their economic models did not see this coming," she said. "We kept getting back, 'This is all anecdotal.'"⁷⁸

Soon nontraditional mortgages were crowding other kinds of products out of the market in many parts of the country. More mortgage borrowers nationwide took out interest-only loans, and the trend was far more pronounced on the West and East Coasts.⁷⁹ Because of their easy credit terms, nontraditional loans enabled borrowers to buy more expensive homes and ratchet up the prices in bidding wars. The loans were also riskier, however, and a pattern of higher foreclosure rates frequently appeared soon after.

As home prices shot up in much of the country, many observers began to wonder if the country was witnessing a housing bubble. On June 18, 2005, the *Economist* magazine's cover story posited that the day of reckoning was at hand, with the headline "House Prices: After the Fall." The illustration depicted a brick plummeting out of the sky. "It is not going to be pretty," the article declared. "How the current housing boom ends could decide the course of the entire world economy over the next few years."⁸⁰

That same month, Fed Chairman Greenspan acknowledged the issue, telling the Joint Economic Committee of the U.S. Congress that "the apparent froth in housing markets may have spilled over into the mortgage markets."⁸¹ For years, he had warned that Fannie Mae and Freddie Mac, bolstered by investors' belief that these institutions had the backing of the U.S. government, were growing so large, with so little oversight, that they were creating systemic risks for the financial system. Still, he reassured legislators that the U.S. economy was on a "reasonably firm footing" and that the financial system would be resilient if the housing market turned sour.

"The dramatic increase in the prevalence of interest-only loans, as well as the introduction of other relatively exotic forms of adjustable rate mortgages, are developments of particular concern," he testified in June.

To be sure, these financing vehicles have their appropriate uses. But to the extent that some households may be employing these instruments to purchase a home that would otherwise be unaffordable, their use is beginning to add to the pressures in the marketplace. . . .

Although we certainly cannot rule out home price declines, especially in some local markets, these declines, were they to occur, likely would not have substantial macroeconomic implications. Nationwide banking and widespread securitization of mortgages makes it less likely

that financial intermediation would be impaired than was the case in prior episodes of regional house price corrections.⁸²

Indeed, Greenspan would not be the only one confident that a housing downturn would leave the broader financial system largely unscathed. As late as March 2007, after housing prices had been declining for a year, Bernanke testified to Congress that “the problems in the subprime market were likely to be contained”—that is, he expected little spillover to the broader economy.⁸³

Some were less sanguine. For example, the consumer lawyer Sheila Canavan, of Moab, Utah, informed the Fed’s Consumer Advisory Council in October 2005 that 61% of recently originated loans in California were interest-only, a proportion that was more than twice the national average. “That’s insanity,” she told the Fed governors. “That means we’re facing something down the road that we haven’t faced before and we are going to be looking at a safety and soundness crisis.”⁸⁴

On another front, some academics offered pointed analyses as they raised alarms. For example, in August 2005, the Yale professor Robert Shiller, who along with Karl Case developed the Case-Shiller Index, charted home prices to illustrate how precipitously they had climbed and how distorted the market appeared in historical terms. Shiller warned that the housing bubble would likely burst.⁸⁵

In that same month, a conclave of economists gathered at Jackson Lake Lodge in Wyoming, in a conference center nestled in Grand Teton National Park. It was a “who’s who of central bankers,” recalled Raghuram Rajan, who was then on leave from the University of Chicago’s business school while serving as the chief economist of the International Monetary Fund. Greenspan was there, and so was Bernanke. Jean-Claude Trichet, the president of the European Central Bank, and Mervyn King, the governor of the Bank of England, were among the other dignitaries.⁸⁶

Rajan presented a paper with a provocative title: “Has Financial Development Made the World Riskier?” He posited that executives were being overcompensated for short-term gains but let off the hook for any eventual losses—the IBGYBG syndrome. Rajan added that investment strategies such as credit default swaps could have disastrous consequences if the system became unstable, and that regulatory institutions might be unable to deal with the fallout.⁸⁷

He recalled to the FCIC that he was treated with scorn. Lawrence Summers, a former U.S. treasury secretary who was then president of Harvard University, called Rajan a “Luddite,” implying that he was simply opposed to technological change.⁸⁸ “I felt like an early Christian who had wandered into a convention of half-starved lions,” Rajan wrote later.⁸⁹

Susan M. Wachter, a professor of real estate and finance at the University of Pennsylvania’s Wharton School, prepared a research paper in 2003 suggesting that the United States could have a real estate crisis similar to that suffered in Asia in the 1990s. When she discussed her work at another Jackson Hole gathering two years later, it received a chilly reception, she told the Commission. “It was universally panned,” she said, and an economist from the Mortgage Bankers Association called it “absurd.”⁹⁰

In 2005, news reports were beginning to highlight indications that the real estate market was weakening. Home sales began to drop, and Fitch Ratings reported signs that mortgage delinquencies were rising. That year, the hedge fund manager Mark Klipsch of Orix Credit Corp. told participants at the American Securitization Forum, a securities trade group, that investors had become “over optimistic” about the market. “I see a lot of irrationality,” he added. He said he was unnerved because people were saying, “It’s different this time”—a rationale commonly heard before previous collapses.⁹¹

Some real estate appraisers had also been expressing concerns for years. From 2000 to 2007, a coalition of appraisal organizations circulated and ultimately delivered to Washington officials a public petition; signed by 11,000 appraisers and including the name and address of each, it charged that lenders were pressuring appraisers to place artificially high prices on properties. According to the petition, lenders were “blacklisting honest appraisers” and instead assigning business only to appraisers who would hit the desired price targets. “The powers that be cannot claim ignorance,” the appraiser Dennis J. Black of Port Charlotte, Florida, testified to the Commission.⁹²

The appraiser Karen Mann of Discovery Bay, California, another industry veteran, told the Commission that lenders had opened subsidiaries to perform appraisals, allowing them to extract extra fees from “unknowing” consumers and making it easier to inflate home values. The steep hike in home prices and the unmerited and inflated appraisals she was seeing in Northern California convinced her that the housing industry was headed for a cataclysmic downturn. In 2005, she laid off some of her staff in order to cut her overhead expenses, in anticipation of the coming storm; two years later, she shut down her office and began working out of her home.⁹³

Despite all the signs that the housing market was slowing, Wall Street just kept going and going—ordering up loans, packaging them into securities, taking profits, earning bonuses. By the third quarter of 2006, home prices were falling and mortgage delinquencies were rising, a combination that spelled trouble for mortgage-backed securities. But from the third quarter of 2006 on, banks created and sold some \$1.3 trillion in mortgage-backed securities and more than \$350 billion in mortgage-related CDOs.⁹⁴

Not everyone on Wall Street kept applauding, however. Some executives were urging caution, as corporate governance and risk management were breaking down. Reflecting on the causes of the crisis, Jamie Dimon, CEO of JP Morgan testified to the FCIC, “I blame the management teams 100% and . . . no one else.”⁹⁵

At too many financial firms, management brushed aside the growing risks to their firms. At Lehman Brothers, for example, Michael Gelband, the head of fixed income, and his colleague Madelyn Antoncic warned against taking on too much risk in the face of growing pressure to compete aggressively against other investment banks. Antoncic, who was the firm’s chief risk officer from 2004 to 2007, was shunted aside: “At the senior level, they were trying to push so hard that the wheels started to come off,” she told the Commission. She was reassigned to a policy position working with gov-

ernment regulators.⁹⁶ Gelband left; Lehman officials blamed Gelband's departure on "philosophical differences."⁹⁷

At Citigroup, meanwhile, Richard Bowen, a veteran banker in the consumer lending group, received a promotion in early 2006 when he was named business chief underwriter. He would go on to oversee loan quality for over \$90 billion a year of mortgages underwritten and purchased by CitiFinancial. These mortgages were sold to Fannie Mae, Freddie Mac, and others. In June 2006, Bowen discovered that as much as 60% of the loans that Citi was buying were defective. They did not meet Citigroup's loan guidelines and thus endangered the company—if the borrowers were to default on their loans, the investors could force Citi to buy them back. Bowen told the Commission that he tried to alert top managers at the firm by "email, weekly reports, committee presentations, and discussions"; but though they expressed concern, it "never translated into any action." Instead, he said, "there was a considerable push to build volumes, to increase market share." Indeed, Bowen recalled, Citi began to loosen its own standards during these years up to 2005: specifically, it started to purchase stated-income loans. "So we joined the other lemmings headed for the cliff," he said in an interview with the FCIC.⁹⁸

He finally took his warnings to the highest level he could reach—Robert Rubin, the chairman of the Executive Committee of the Board of Directors and a former U.S. treasury secretary in the Clinton administration, and three other bank officials. He sent Rubin and the others a memo with the words "URGENT—READ IMMEDIATELY" in the subject line. Sharing his concerns, he stressed to top managers that Citi faced billions of dollars in losses if investors were to demand that Citi repurchase the defective loans.⁹⁹

Rubin told the Commission in a public hearing in April 2010 that Citibank handled the Bowen matter promptly and effectively. "I do recollect this and that either I or somebody else, and I truly do not remember who, but either I or somebody else sent it to the appropriate people, and I do know factually that that was acted on promptly and actions were taken in response to it."¹⁰⁰ According to Citigroup, the bank undertook an investigation in response to Bowen's claims and the system of underwriting reviews was revised.¹⁰¹

Bowen told the Commission that after he alerted management by sending emails, he went from supervising 220 people to supervising only 2, his bonus was reduced, and he was downgraded in his performance review.¹⁰²

Some industry veterans took their concerns directly to government officials. J. Kyle Bass, a Dallas-based hedge fund manager and a former Bear Stearns executive, testified to the FCIC that he told the Federal Reserve that he believed the housing securitization market to be on a shaky foundation. "Their answer at the time was, and this was also the thought that was—that was homogeneous throughout Wall Street's analysts—was home prices always track income growth and jobs growth. And they showed me income growth on one chart and jobs growth on another, and said, 'We don't see what you're talking about because incomes are still growing and jobs are still growing.' And I said, well, you obviously don't realize where the dog is and where the tail is, and what's moving what."¹⁰³

Even those who had profited from the growth of nontraditional lending practices said they became disturbed by what was happening. Herb Sandler, the co-founder of the mortgage lender Golden West Financial Corporation, which was heavily loaded with option ARM loans, wrote a letter to officials at the Federal Reserve, the FDIC, the OTS, and the OCC warning that regulators were “too dependent” on ratings agencies and “there is a high potential for gaming when virtually any asset can be churned through securitization and transformed into a AAA-rated asset, and when a multi-billion dollar industry is all too eager to facilitate this alchemy.”¹⁰⁴

Similarly, Lewis Ranieri, a mortgage finance veteran who helped engineer the Wall Street mortgage securitization machine in the 1980s, said he didn’t like what he called “the madness” that had descended on the real estate market. Ranieri told the Commission, “I was not the only guy. I’m not telling you I was John the Baptist. There were enough of us, analysts and others, wandering around going ‘look at this stuff,’ that it would be hard to miss it.”¹⁰⁵ Ranieri’s own Houston-based Franklin Bank Corporation would itself collapse under the weight of the financial crisis in November 2008.

Other industry veterans inside the business also acknowledged that the rules of the game were being changed. “Poison” was the word famously used by Countrywide’s Mozilo to describe one of the loan products his firm was originating.¹⁰⁶ “In all my years in the business I have never seen a more toxic [product],” he wrote in an internal email.¹⁰⁷ Others at the bank argued in response that they were offering products “pervasively offered in the marketplace by virtually every relevant competitor of ours.”¹⁰⁸ Still, Mozilo was nervous. “There was a time when savings and loans were doing things because their competitors were doing it,” he told the other executives. “They all went broke.”¹⁰⁹

In late 2005, regulators decided to take a look at the changing mortgage market. Sabeth Siddique, the assistant director for credit risk in the Division of Banking Supervision and Regulation at the Federal Reserve Board, was charged with investigating how broadly loan patterns were changing. He took the questions directly to large banks in 2005 and asked them how many of which kinds of loans they were making. Siddique found the information he received “very alarming,” he told the Commission.¹¹⁰ In fact, nontraditional loans made up 59% percent of originations at Countrywide, 58% percent at Wells Fargo, 51% at National City, 31% at Washington Mutual, 26.5% at CitiFinancial, and 18.3% at Bank of America. Moreover, the banks expected that their originations of nontraditional loans would rise by 17% in 2005, to \$608.5 billion. The review also noted the “slowly deteriorating quality of loans due to loosening underwriting standards.” In addition, it found that two-thirds of the nontraditional loans made by the banks in 2003 had been of the stated-income, minimal documentation variety known as liar loans, which had a particularly great likelihood of going sour.¹¹¹

The reaction to Siddique’s briefing was mixed. Federal Reserve Governor Bies recalled the response by the Fed governors and regional board directors as divided from the beginning. “Some people on the board and regional presidents . . . just wanted to come to a different answer. So they did ignore it, or the full thrust of it,” she told the Commission.¹¹²

The OCC was also pondering the situation. Former comptroller of the currency John C. Dugan told the Commission that the push had come from below, from bank examiners who had become concerned about what they were seeing in the field.¹¹³

The agency began to consider issuing “guidance,” a kind of nonbinding official warning to banks, that nontraditional loans could jeopardize safety and soundness and would invite scrutiny by bank examiners. Siddique said the OCC led the effort, which became a multiagency initiative.¹¹⁴

Bies said that deliberations over the potential guidance also stirred debate within the Fed, because some critics feared it both would stifle the financial innovation that was bringing record profits to Wall Street and the banks and would make homes less affordable. Moreover, all the agencies—the Fed, the OCC, the OTS, the FDIC, and the National Credit Union Administration—would need to work together on it, or it would unfairly block one group of lenders from issuing types of loans that were available from other lenders. The American Bankers Association and Mortgage Bankers Association opposed it as regulatory overreach.

“The bankers pushed back,” Bies told the Commission. “The members of Congress pushed back. Some of our internal people at the Fed pushed back.”¹¹⁵

The Mortgage Insurance Companies of America, which represents mortgage insurance companies, weighed in on the other side. “We are deeply concerned about the contagion effect from poorly underwritten or unsuitable mortgages and home equity loans,” the trade association wrote to regulators in 2006. “The most recent market trends show alarming signs of undue risk-taking that puts both lenders and consumers at risk.”¹¹⁶

In congressional testimony about a month later, William A. Simpson, the group’s vice president, pointedly referred to past real estate downturns. “We take a conservative position on risk because of our first loss position,” Simpson informed the Senate Subcommittee on Housing, Transportation and Community Development and the Senate Subcommittee on Economic Policy. “However, we also have a historical perspective. We were there when the mortgage markets turned sharply down during the mid-1980s especially in the oil patch and the early 1990s in California and the Northeast.”¹¹⁷

Within the Fed, the debate grew heated and emotional, Siddique recalled. “It got very personal,” he told the Commission. The ideological turf war lasted more than a year, while the number of nontraditional loans kept growing and growing.¹¹⁸

Consumer advocates kept up the heat. In a Fed Consumer Advisory Council meeting in March 2006, Fed Governors Bernanke, Mark Olson, and Kevin Warsh were specifically and publicly warned of dangers that nontraditional loans posed to the economy. Stella Adams, the executive director of the North Carolina Fair Housing Center, raised concerns that nontraditional lending “may precipitate a downward spiral that starts on the coast and then creates panic in the east that could have implications on our total economy as well.”¹¹⁹

At the next meeting of the Fed’s Consumer Advisory Council, held in June 2006 and attended by Bernanke, Bies, Olson, and Warsh, several consumer advocates described to the Fed governors alarming incidents that were now occurring all over the

country. Edward Sivak, the director of policy and evaluation at the Enterprise Corp. of the Delta, in Jackson, Mississippi, spoke of being told by mortgage brokers that property values were being inflated to maximize profit for real estate appraisers and loan originators. Alan White, the supervising attorney at Community Legal Services in Philadelphia, reported a “huge surge in foreclosures,” noting that up to half of the borrowers he was seeing with troubled loans had been overcharged and given high-interest rate mortgages when their credit had qualified them for lower-cost loans. Hattie B. Dorsey, the president and chief executive officer of Atlanta Neighborhood Development, said she worried that houses were being flipped back and forth so much that the result would be neighborhood “decay.” Carolyn Carter of the National Consumer Law Center in Massachusetts urged the Fed to use its regulatory authority to “prohibit abuses in the mortgage market.”¹²⁰

The balance was tipping. According to Siddique, before Greenspan left his post as Fed chairman in January 2006, he had indicated his willingness to accept the guidance. Ferguson worked with the Fed board and the regional Fed presidents to get it done. Bies supported it, and Bernanke did as well.¹²¹

More than a year after the OCC had begun discussing the guidance, and after the housing market had peaked, it was issued in September 2006 as an interagency warning that affected banks, thrifts, and credit unions nationwide. Dozens of states followed, directing their versions of the guidance to tens of thousands of state-chartered lenders and mortgage brokers.

Then, in July 2008, long after the risky, nontraditional mortgage market had disappeared and the Wall Street mortgage securitization machine had ground to a halt, the Federal Reserve finally adopted new rules under HOEPA to curb the abuses about which consumer groups had raised red flags for years—including a requirement that borrowers have the ability to repay loans made to them.

By that time, however, the damage had been done. The total value of mortgage-backed securities issued between 2001 and 2006 reached \$13.4 trillion.¹²² There was a mountain of problematic securities, debt, and derivatives resting on real estate assets that were far less secure than they were thought to have been.

Just as Bernanke thought the spillovers from a housing market crash would be contained, so too policymakers, regulators, and financial executives did not understand how dangerously exposed major firms and markets had become to the potential contagion from these risky financial instruments. As the housing market began to turn, they scrambled to understand the rapid deterioration in the financial system and respond as losses in one part of that system would ricochet to others.

By the end of 2007, most of the subprime lenders had failed or been acquired, including New Century Financial, Ameriquest, and American Home Mortgage. In January 2008, Bank of America announced it would acquire the ailing lender Countrywide. It soon became clear that risk—rather than being diversified across the financial system, as had been thought—was concentrated at the largest financial firms. Bear Stearns, laden with risky mortgage assets and dependent on fickle short-term lending, was bought by JP Morgan with government assistance in the spring.

Before the summer was over, Fannie Mae and Freddie Mac would be put into conservatorship. Then, in September, Lehman Brothers failed and the remaining investment banks, Merrill Lynch, Goldman Sachs, and Morgan Stanley, struggled as they lost the market's confidence. AIG, with its massive credit default swap portfolio and exposure to the subprime mortgage market, was rescued by the government. Finally, many commercial banks and thrifts, which had their own exposures to declining mortgage assets and their own exposures to short-term credit markets, teetered. IndyMac had already failed over the summer; in September, Washington Mutual became the largest bank failure in U.S. history. In October, Wachovia struck a deal to be acquired by Wells Fargo. Citigroup and Bank of America fought to stay afloat. Before it was over, taxpayers had committed trillions of dollars through more than two dozen extraordinary programs to stabilize the financial system and to prop up the nation's largest financial institutions.

The crisis that befell the country in 2008 had been years in the making. In testimony to the Commission, former Fed chairman Greenspan defended his record and said most of his judgments had been correct. "I was right 70% of the time but I was wrong 30% of the time," he told the Commission.¹²³ Yet the consequences of what went wrong in the run-up to the crisis would be enormous.

The economic impact of the crisis has been devastating. And the human devastation is continuing. The officially reported unemployment rate hovered at almost 10% in November 2010, but the underemployment rate, which includes those who have given up looking for work and part-time workers who would prefer to be working full-time, was above 17%. And the share of unemployed workers who have been out of work for more than six months was just above 40%. Of large metropolitan areas, Las Vegas, Nevada, and Riverside–San Bernardino, California, had the highest unemployment—their rates were above 14%.

The loans were as lethal as many had predicted, and it has been estimated that ultimately as many as 13 million households in the United States may lose their homes to foreclosure. As of 2010, foreclosure rates were highest in Florida and Nevada; in Florida, nearly 14% of loans were in foreclosure, and Nevada was not very far behind.¹²⁴ Nearly one-quarter of American mortgage borrowers owed more on their mortgages than their home was worth. In Nevada, the percentage was nearly 70%.¹²⁵ Households have lost \$11 trillion in wealth since 2006.

As Mark Zandi, the chief economist of Moody's Economy.com, testified to the Commission, "The financial crisis has dealt a very serious blow to the U.S. economy. The immediate impact was the Great Recession: the longest, broadest and most severe downturn since the Great Depression of the 1930s. . . . The longer-term fallout from the economic crisis is also very substantial. . . . It will take years for employment to regain its pre-crisis level."¹²⁶

Looking back on the years before the crisis, the economist Dean Baker said: "So much of this was absolute public knowledge in the sense that we knew the number of loans that were being issued with zero down. Now, do we suddenly think we have that many more people—who are capable of taking on a loan with zero down who we

think are going to be able to pay that off—than was true 10, 15, 20 years ago? I mean, what's changed in the world? There were a lot of things that didn't require any investigation at all; these were totally available in the data."¹²⁷

Warren Peterson, a home builder in Bakersfield, felt that he could pinpoint when the world changed to the day. Peterson built homes in an upscale neighborhood, and each Monday morning, he would arrive at the office to find a bevy of real estate agents, sales contracts in hand, vying to be the ones chosen to purchase the new homes he was building. The stream of traffic was constant. On one Saturday in November 2005, he was at the sales office and noticed that not a single purchaser had entered the building.

He called a friend, also in the home-building business, who said he had noticed the same thing, and asked him what he thought about it.

"It's over," his friend told Peterson.¹²⁸