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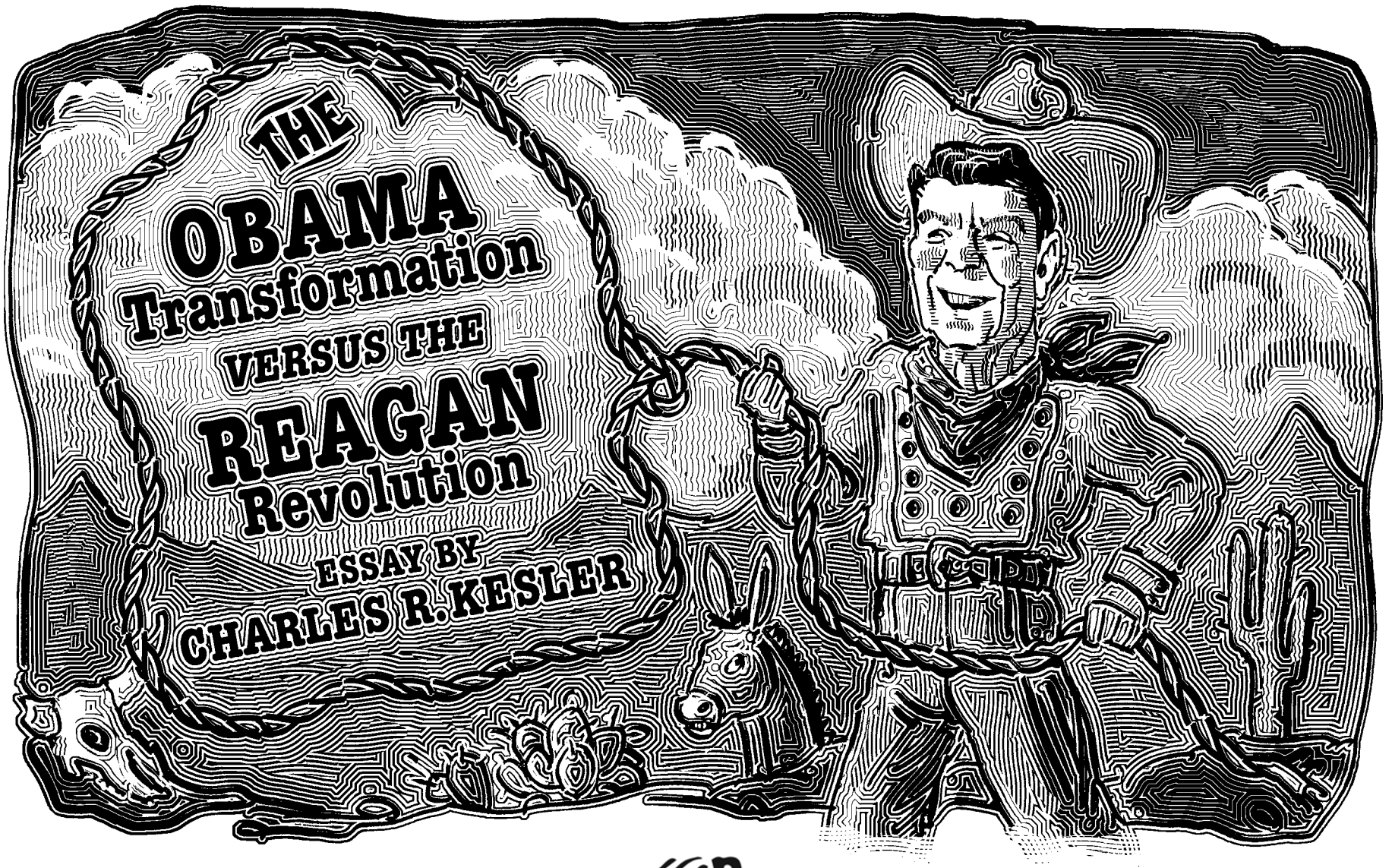

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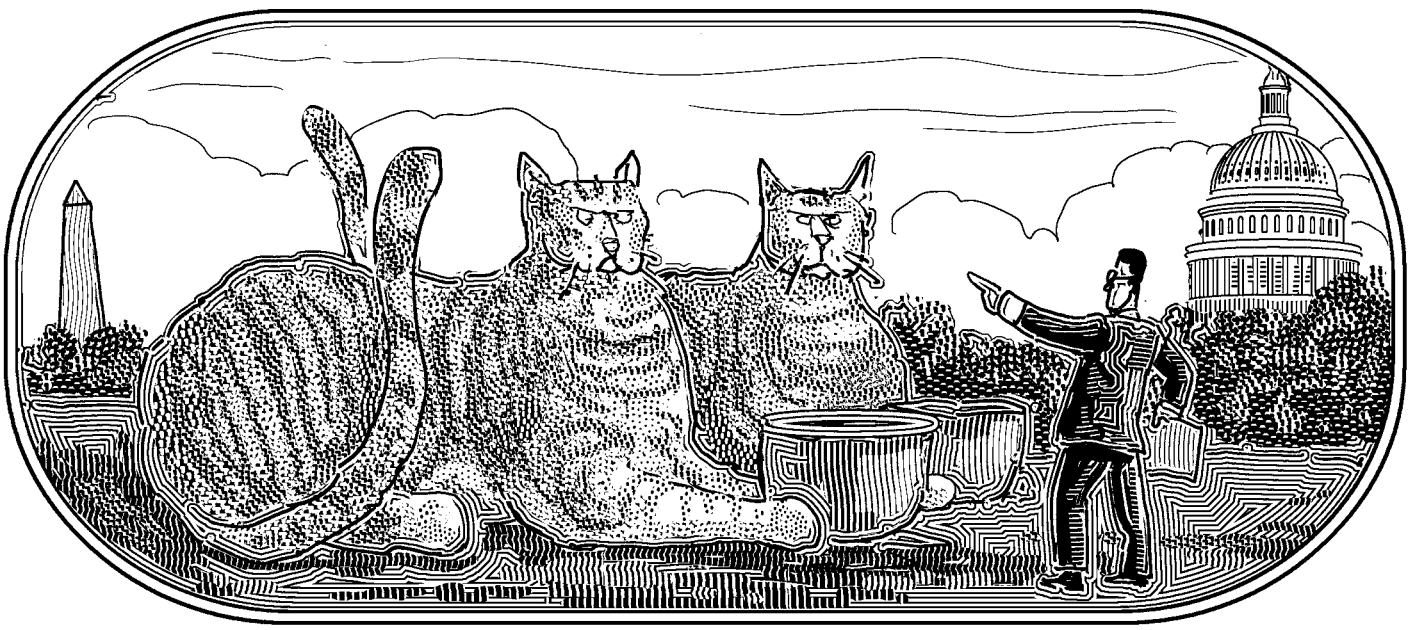
Book Review by James Grant

The Subprime Directive

Hidden in Plain Sight: What Really Caused the World's Worst Financial Crisis and Why It Could Happen Again, by Peter J. Wallison. Encounter Books, 432 pages, $27.99



Fannie and Freddie did the deed, according to Peter J. Wallison's mortgage-centric account of what really caused the Great Recession. No need to go searching for alternative explanations. The federally chartered behemoths are the guilty parties, they and no one else.

A former Reagan White House counsel and a longtime critic of the so-called government-sponsored enterprises, Wallison has drawn up a double indictment. The first fingers the government. The second assails any who would not blame the government.

This is a very good, very tendentious book. It maps the road to the quasi-socialization of American housing finance, in which condition we find ourselves today. It tells you where subprime mortgages came from and how they metastasized. It parses accounting controversies, explains how regulators favor and disfavor certain categories of investment assets, and chronicles the unnatural rise in house prices between the late 1990s and the mid-2000s.

An epigraph by Milton Friedman sets the ideological tone. "Far from being a failure of free-market capitalism," the late, great monetarist is quoted as saying of the 1930s,

> the Depression was a failure of government. Unfortunately, that failure did not end with the Great Depression.... In practice, just as during the Depression, far from promoting stability, the government has itself been the major single source of instability.

Echoing Friedman, Wallison argues that private actors, while hardly blameless in the events of 2007-09, did not precipitate them. The author rests his case against the government on the fact that, by mid-2008, "there were at least 31 million nontraditional mortgages (NTMs)—57 percent of all mortgages—in the U.S. financial system," and that three quarters of these securitized turkeys had alighted on federally chartered balance sheets. The comprehensive, persistent decline in mortgage lending standards wasn't the doing of private lenders, Wallison demonstrates. You may thank Congress and the Department of Housing and Urban Development for that.

The book has a backstory. The author served on the ten-member Financial Crisis Inquiry Commission that Congress created in 2009; he was one of four Republicans. Every inquest must proceed along some assumed line of causation. Speaker of the House Nancy Pelosi then being in the driver's seat, the Commission took on a liberal political cast. Under the chairmanship of Phil Angelides, a one-time Democratic candidate for governor of California, it adopted the hypothesis that the cause of our troubles was capitalism. It followed that more regulation was the solution. In the shape of the Dodd-Frank Act, as Wallison observes, regulation has become asphyxiating.

The author was estranged not only from the Democrats on the Commission but also from the other Republicans. Among the ten, he alone was prepared to assign not just some of the blame, not even most of it, but every last jot of it to federal policies, in particular to federal mortgage policy. He was his own personal faction.

The Federal National Mortgage Association, a.k.a. Fannie Mae, grandmother of the government-sponsored enterprises, came into the world in 1938. The Federal Home Loan Mortgage Corporation, a.k.a. Freddie Mac, followed in 1970. Between 1991 and 2003, as Wallison relates, Fannie, Freddie, and lesser federal agencies boosted their share of the American housing market to 46.3% from 28.5%. Along the way, the Washington mortgage creatures became big enough to disturb the world's financial equilibrium.

It happened this way. In 1992, the House and Senate directed the government-sponsored enterprises (GSEs) to meet a quota of mortgage loans to low- to middle-income borrowers. Thirty percent, the initial minimum, presently became 42%, then 50%, and finally—in 2008, the year Lehman Brothers failed—56%. Minimum down payments were

reduced, too, to nothing at all by 2000. Nor did the upper-income reaches of the mortgage market, a segment not directly served by Fannie and Freddie, remain untouched by this federally induced letting down of hair. Before long, well-to-do people were taking out "interest-only" loans that required no amortization of principal until their maturity date. By 2001, Alan Greenspan—then chairman of the Federal Reserve—was marveling at the "very substantial buffer of unrealized capital gains, which are being drawn upon through the home-equity market, through cash-outs, and through the turnover of existing homes, which has been, as you know, quite substantial despite the weakness in the economy." The single-family American house was on the way to becoming an automated teller machine.

Booms and busts are nothing very new. The National Bureau of Economic Research counts 33 such episodes since 1854. There were plenty before that arbitrary starting date, too—no one who lived through the panic years 1819 or 1837 would think to omit them from the cyclical roll call. Something must have caused the perturbations that preceded the coming of the GSEs.

Recessions and depressions have occurred with and without the hovering presence of a central bank, and with and without a preceding financial blowup. They have occurred in agricultural eras, industrial eras, and—in the case of 2007-09—a kind of post-industrial era. They have occurred with and without a dollar convertible on demand into gold or silver (since 1971, the greenback, either a slip of paper or a bunch of pixels, has been convertible into nothing).

Wallison makes as strong a case as anyone could make for an untenable thesis. Give him the fact that the government corrupted American mortgage finance—certainly, he has proven that much. Was that a necessary and sufficient cause of the debacle of 2008? It might have been the proximate cause. It is far from the animating remote cause.

Wallison seems to forget that money isn't humanity's best subject. You can satisfy yourself on this point with a simple calculation. One hundred dollars invested continuously at 2% interest since the year of Cleopatra's death would work out today to $5.3 billion for each of the world's 7.3 billion people. Of course, the average earthling is worth nothing like that much money. Banks fail, currencies are inflated away, thieves break through and steal.

Error is endemic in finance—people *will* buy high, and they *will* sell low. Given half a chance, they'll over-borrow, too. The incidence of error is all the greater when the incentives of law and regulation invite it. Wall Street was no Garden of Eden when financial responsibility rested chiefly with individuals—when, for instance, the general partners of Morgan Stanley were personally responsible for the debts of the firm they led. The Street is that much further from paradise since personal responsibility has given way to corporate responsibility—Morgan Stanley became a limited liability corporation in 1986—and, increasingly, to collective responsibility. Once upon a time, the stockholders of a bank were responsible for the solvency of the institution in which they held a fractional interest. To restore the solvency of the biggest banks in 2007-09, the taxpayers had to reach into their own pockets.

Wallison is prepared to pin exclusive blame on the government owing to one somewhat technical fact. The fact is that, in the prelude to the crisis, Fannie Mae and Freddie Mac withheld the full details of their overexposure to low-quality mortgages. In so doing, supposedly, they cheated the private sector of the information that would otherwise have enabled individuals to make appropriate, wealth-saving decisions. "[T]here was little understanding that a housing bubble of historic proportions had developed between 1997 and 2007," the author contends. "The fact is…that virtually everyone—regulators, investors, rating agencies, analysts, housing experts, and the management of financial institutions—failed to see the crisis coming," he also contends.

It's remarkable how little people can see when they choose to look away. To any who wished to see, it was obvious that house prices were much too high, that the securities fashioned from subprime mortgages were anything but creditworthy, and that some of the biggest Wall Street banks and brokerage houses were wobbling on their high stilts of debt. *Grant's Interest Rate Observer*, the financial publication that I own and edit, issued its first cautionary piece on runaway house prices in 2001, its first bearish analysis of subprime mortgage securities in 2006. We were far from alone.

The crackup of 2007-09 was a crisis of credit, of which mortgage debt constituted only one critical element. Credit was broadly mispriced. Lenders earned too little for the risks they bore in residential mortgages, commercial mortgages, short-dated corporate IOUs, and speculative-grade corporate bonds, among other kinds of debt obligations. Something or someone had lulled them to sleep.

Low interest rates were one sedative. Overconfidence born of the belief that the government would intervene to forestall a truly costly financial accident was another. To foster recovery from the collapse of the dot-com bubble, the Federal Reserve had pushed its policy interest rate down to 1% in 2004 from 6% in 2001. In most times and places, ultra-low interest rates tend to incite speculative risk-taking. Still, the titans of finance are paid to assess risk and reward. Wallison, citing a congressional study, claims that Wall Street was not over-extended on the eve of the failure of Lehman Brothers. He is wrong about that.

If I may again cite *Grant's*, the headline we hung over a page-one article in October 2006 was, "Over the cliff with Morgan Stanley." The eminent firm had by then built itself Wall Street's first $1 trillion balance sheet, in which equity capital (what the stockholders could claim as their own) amounted to only 3.2% of assets. These assets comprised all the then-fashionable, debt-intensive business lines—subprime mortgages, leveraged buyouts, speculative-grade corporate lending. Two years later, this accident-waiting-to-happen achieved the distinction of becoming the Federal Reserve's top supplicant. Nowadays, a chastened and—yes—over-regulated Morgan Stanley shows equity equivalent to 8% of its slimmed-down $801 billion in assets. Did this storied enterprise have it coming? Yes. Is American enterprise the poorer for the squadrons of governmental minders who, in keeping with the provisions of Dodd-Frank, now hover at the elbows of our once-haughty financiers? Yes, again.

There was no "perfect storm," the author insists, no constellation of causes that form a satisfactory explanation for the calamity of 2008. Those who would argue the multi-causal case confront the insuperable problem of not knowing when to stop listing causes. The more they cite, he insists, "the less we learn, and the less the theory can serve as a guide for policy makers in the future."

In the Isaiah Berlin world of hedgehogs (those with a single big idea) and foxes (those with many ideas), there was never such a hedgehog as Peter Wallison. His brief is thoroughly researched, clearly written. He anticipates his critics' likely objections to his mono-causal view of the crisis and attempts to answer each argument in turn.

He succeeds to the impressive extent that his point survives his own exaggerated telling of it—barely.

James Grant is the founder and publisher of Grant's Interest Rate Observer. *His latest book,* The Forgotten Depression: 1921, the Crash that Cured Itself *(Simon & Schuster) won the 2015 Hayek Prize of the Manhattan Institute for Policy Research.*