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What Caused the Financial Crisis?

Congress's inquiry commission is offering a simplistic narrative that could lead to the wrong policy reforms.

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By BILL THOMAS, KEITH HENNESSEY AND DOUGLAS HOLTZ-EAKIN

Today, six members of the Financial Crisis Inquiry Commission-created by the last Congress to investigate the causes of the financial crisis-are releasing their final report. Although the three of us served on the commission, we were unable to support the majority's conclusions and have issued a dissenting statement.

In a November 2009 article, Brookings Institution economists Martin Baily and Douglas Elliott describe the three common narratives about the financial crisis. The first argues that the primary cause was government intervention in the housing market. This intervention, principally through Fannie Mae and Freddie Mac, inflated a housing bubble that triggered the crisis. This is the view expressed by one of our co-commissioners in a separate dissent.

The second narrative blames Wall Street and its influence in Washington. According to this narrative, greedy bankers knowingly manipulated the financial system and politicians in Washington to take advantage of homeowners and mortgage investors alike, intentionally jeopardizing the financial system while enjoying huge personal gains. That's the view of the six maiority commissioners.

We subscribe to a third narrative-a messier story that emphasizes both global economic forces and failures in U.S. policy and supervision. Though our explanation of the crisis doesn't fit conveniently into the political order of Washington, we believe that it is far superior to the other two.

We recognize that the other two narratives have popular appeal: They each blame a clear entity, and thus outline a clear set of reform proposals. Had the government not supported housing subsidies (the first narrative) or had policy makers implemented more restrictive financial regulations (the second) there would have been no calamity.

Both of these views are incomplete and misleading. The existence of housing bubbles in a number of large countries, each with vastly different systems of housing finance, severely undercuts the thesis that the housing bubble was a phenomenon driven solely by the U.S. government. Likewise, the multitude of financial-firm failures, spanning varied organizational forms and differing regulatory regimes across the U.S. and Europe, makes it implausible that the crisis was the product of a small coterie of Wall Street bankers and their Washington bedfellows

We believe the crisis was the product of 10 factors. Only when taken together can they offer a sufficient explanation of what happened:

Starting in the late 1990s, there was a broad credit bubble in the U.S. and Europe and a sustained housing bubble in the U.S. (factors 1 and 2). Excess liquidity, combined with rising house prices and an ineffectively regulated primary mortgage market, led to an increase in nontraditional mortgages (factor 3) that were in some cases deceptive, in many cases confusing, and often beyond borrowers' ability to pay.

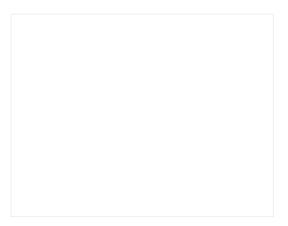
However, the credit bubble, housing bubble, and the explosion of nontraditional mortgage products are not by themselves responsible for the crisis. Our country has experienced larger bubbles-the dot-com bubble of the 1990s, for example-that were not nearly as devastating as the housing bubble. Losses from the housing downturn were concentrated in highly leveraged financial institutions. Which raises the essential question: Why were these firms so exposed?



Failures in credit-rating and securitization transformed bad mortgages into toxic financial assets (factor 4). Securitizers lowered the credit quality of the mortgages they securitized, credit-rating agencies erroneously rated these securities as safe investments, and buyers failed to look behind the ratings and do their own due diligence. Managers of many large and midsize financial institutions amassed enormous concentrations of highly correlated housing

risk (factor 5), and they amplified this risk by holding too little capital relative to the risks and funded these exposures with short-term debt (factor 6). They assumed such funds would always be available. Both turned out to be bad bets.

These risks within highly leveraged, short-funded financial firms with concentrated exposure to a collapsing asset class led to a cascade of firm failures. The losses spread in two ways. Some firms had large counterparty credit risk exposures, and the sudden and disorderly failure of one firm risked triggering losses elsewhere. We call this the risk of contagion (factor 7). In other cases, the problem was a common shock (factor 8). A number of firms had made similar bad bets on housing, and thus unconnected firms failed for the same reason and at roughly the same time



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A rapid succession of 10 firm failures, mergers and restructurings in September 2008 caused a BACK TO TOP financial shock and panic (factor 9). Confidence and trust in the financial system evaporated, as the health of almost every large and midsize financial institution in the U.S. and Europe was questioned. The financial shock and panic caused a severe contraction in the real economy (factor 10). We agree with our colleagues that individuals across the financial sector pursued their self-interest first, sometimes to the detriment of borrowers, investors, taxpayers and even their own firms. We also agree that the mountain of government programs supporting the housing market produced distorted investment incentives, and that the government's implicit support of Fannie Mae and Freddie Mac was a ticking time bomb WSJ.com Account: About: But it is dangerous to conclude that the crisis would have been avoided if only we had Mv Account News Licensing regulated everything a lot more, had fewer housing subsidies, and had more responsible Subscriber Billing Info Advertising bankers. Simple narratives like these ignore the global nature of this crisis, and promote a Conferences Create an Account: simplistic explanation of a complex problem. Though tempting politically, they will ultimately Subscriptions Register for Free Buy the Newspaper lead to mistaken policies. Subscribe to WSJ.com About Dow Jones Mr. Thomas is a former Republican congressman from California. Mr. Hennessey served as Sign up for WSJ Professional Privacy Policy - Updated director of the White House National Economic Council in 2008. Mr. Holtz-Eakin is a former Subscriber Agreement & Terms of Use - Updated Help & Information Center: director of the Congressional Budget Office. Copyright Policy Help MORE IN OPINION Jobs at WSJ.com Customer Service Future Leadership Program Contact Us 🖂 Email Printer Friendly Crder Reprints New on WSJ.com Tour the new Journal 📘 🐏 와 🍪 🕒 😼 투 💇 🛅 🚽 🐝 Share: 228 likes. Sign Up to see what your friends like. Like WSJ.com: Site Map Home World 2011 Top Gold Stock: SMNG US Why Investors Consider It "The Vietnamese Gold Rush". Invest today. www.AsianGoldReports.com Business Markets Penny stocks soaring 900% Market Data Come experience penny stock gains with our free & accurate newsletter Tech www.PennyStocksUniverse.com Personal Finance Sprint[™] Official Site Life & Style First Is 4G, But Plays Nicely W/ 3G. The First 4G Phone. HTC EVO™ 4G! Opinion www.Sprint.com/Firsts Autos Dell's 4G Tablets Careers Experience Dell's Perfectly Sized, Android-Based Tablets at Dell.com! Real Estate www.Dell.com/Tablet Small Business Corrections Add a Comment JOURNAL COMMUNITY We welcome your thoughtful comments. Please comply with our Community rules. All comments will display your real name Tools & Formats Want to participate in the discussion? Today's Paper **Digital Network** Video Center REGISTER FOR FREE WSJ.com Graphics Marketwatch.com Or log in or become a subscriber now for complete Journal access Columns Barrons.com Bloas Track replies to my comment SmartMonev.com Go to Comments tab Topics AllThingsD.com Share articles and post your comments Guides Login with Facebook on Facebook What's this? FINS: Finance, IT jobs, Sales jobs Alerts BigCharts.com Newsletters Virtual Stock Exchange Mobile **Related Stories Related Videos** Tablet Edition WSJ Radio Podcasts **Review & Outlook: The End of Fannie Mae** WSJ U.S. Edition 12/17/2010 Opinion Journal: Crisis Commission 10 hrs ago RSS Feeds WSJ Asia Edition Journal Community Michael J. Boskin: The Time for Spending WSJ Europe Edition Crack-Up -- Douglas Holtz-Eakin explains Cuts Is Now 2/11/2011 WSJ on Twitter WSJ India Page the partisan split WSJ on Facebook O'Grady: Honduras's Experiment With Free-Market Cities 10 hrs ago Foreign Language Editions: 1/27/2011 WSJ on Foursquare **Opinion Journal:**

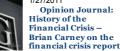
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