

# Anatomy of a Meltdown

## The Subprime Crisis

by David A. Hartman

At the close of 2007, the bloated inventories and declining prices of residential housing confirmed that the real-estate bubble had burst. This was triggered by losses on collateralized mortgage obligations (CMOs), which are based on pools of “subprime” mortgage collateral. Residential prices have not yet fallen below the levels of 2001 (when the bubble began) and, for the moment, remain above recession-level prices. The meltdown, however, is on.

Over the last several years, our soaring trade deficits have filled our foreign competitors’ coffers, causing them to seek investments that are more attractive than U.S. Treasury bills. Because the large commercial investment properties they prefer have been priced very high, U.S. financiers began selling them the derivatives of residential mortgage pools. The adjustable-rate mortgage (ARM) pools offer investors the largest source of inflation-adjustable securities, along with the protection of insurance against default and the prospect of higher average interest rates over the life of the securities.

Ever since the Great Depression, Congress has created federal agencies that accept or insure mortgages. Government-sponsored agencies multiplied after World War II, as insurance providers for the home mortgages of returning veterans. Savings and loans, also sponsored by Washington, were the principal investors in these insured home mortgages until the 1980’s, when Congress deregulated deposit interest rates and the S&Ls crumbled.

Today, eight different federal agencies accept or insure mortgages for lower- or middle-priced houses, led by Fannie Mae and Freddie Mac. Each is a “government-sponsored agency”: The agency alone, not the federal government, offers the guarantee, but each is considered a federal guarantor and, therefore, “too big to fail.” The Federal Home Administration (FHA) and the farm-home agencies who insure mortgages for lower-income homes are government agencies, and their insurance policies are claims on the federal government. These are joined by private insurers, such as MBIA, Ambac, and ACA, who insure “unqualified” mortgages. Banks also offer direct uninsured mortgages for lower-risk loans, good customers, and “jumbos”—mortgages that exceed federal size limits. In recent years, federal regulators have sought to reduce

Fannie Mae’s and Freddie Mac’s domination of buying, insuring, and (especially) holding home mortgages.

Mortgage bankers originate the mortgages sold to insurers. The insurers then sell pools of mortgages, grouped together by characteristics such as geographical location, size, and credit rating, to investment bankers. The bankers divide the cash flows of these CMOs into “tranches,” which provide the right to first or last collections of cash flows, to separation of interest *versus* principal payments, or to other derivatives designed to serve as investment products. These tranches are then rated by agencies such as Standard & Poor’s or Moody’s. Compared with normal debt securities, some mortgage derivatives are difficult to rate, because of the complexities of economic events and their effects on repayment. Still, the more conservative mortgage pools have been a reliable source of customized securities.

Three factors have destabilized the successful replacement of S&Ls with CMOs, precipitating the meltdown. First, for adventurous investors, CDOs (collateralized debt obligations) became attractive. They provide potentially more profitable alternatives to CMOs, from pools of quality CMOs to credit cards, automobile loans, commercial loans, and other debt obligations of various credit quality—some, with potentially higher interest rates. Until recently, CDOs had been reasonably predictable and successful in collecting debts, thanks to good times and good underwriting—both of which have changed. Second has been the introduction of subprime home mortgages, which have proved hard to rate accurately, as they lack both long-term default experience and, increasingly, diligent underwriting. Both the Clinton administration and the Bush administration have pressured lenders to offer subprime ARMs to borrowers with lower incomes and/or poor credit histories. The risk of subprime pools was amplified by incompetent or fraudulent underwriting by mortgage bankers. Finally, the commercial and investment bankers funded the subprime mortgages through “structured investment vehicles” (SIVs), which are clandestine off-balance-sheet units with no appreciable reserves to stand behind the pools and their tranches—a carbon copy of the source of the Enron fiasco. What investors—foreigners awash in dollars, in particular—failed to realize is that garbage in a fancy bag is still garbage.

The total book value of mortgages on U.S. residences is \$14 trillion, of which \$2.5 trillion is currently “guesstimated” to be subprime. The potential losses to financial

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institutions have been estimated from \$100 to \$400 billion; but the estimated losses of just a few of the major commercial and investment banks have already surpassed the \$100-billion mark. Standard & Poor's estimate of \$265 billion seems reasonable, which would put the subprime mortgage crisis in the same ballpark as the S&L crisis. But that estimate fails to take into account the problematic CDO pools. For commercial loans, which total \$300 billion per year, the lowest-rated now account for 32 percent of new lending, compared with 20.9 percent in 2006, the previous peak. The whole industry colluded in packaging the derivatives of subprime CMOs and CDOs; mortgage bankers, insurers, rating agencies, and bankers (along with their hedge funds and SIVs) will share in liabilities for these losses.

**A**t the root of this crisis is excessive liquidity—an inflated money supply—which invariably promotes speculation and low-grade lending. The greatest villain in this drama is the Federal Reserve, as mismanaged by Alan Greenspan and his protégé, Ben Bernanke. From his appointment in 1987, Greenspan's all-purpose solution was excessive injections of liquidity. No matter how overvalued the stock market, commodities, and real-estate prices, Greenspan's Fed has attempted to shield financiers from the painful losses necessary to restore the stability of mortgage markets and the value of the dollar.

With a bleak outlook for housing, shrinking auto production, and a declining manufacturing sector, more liquidity and deficits will, at best, result in stagflation. What is needed are real remedies—implementing border-adjusted tax reform, reestablishing regulation of all financial institutions, reforming the financing of social insurance, closing trade and fiscal deficits, and restoring the value of the dollar as a store of value, which promotes personal saving.

The growth of highly leveraged innovations—particularly hedge funds and SIVs—has been unchecked by the Federal Reserve. As Greenspan admitted in his recent book, *The Age of Turbulence*, these vehicles have created trillions of dollars of liquidity that are not publicly visible and, therefore, are excluded from any effective measure of the money supply. By and large, the banks and the rest of the financial sector have enjoyed unprecedented and unsustainable profits. The cost of the present meltdown to American citizens has yet to be calculated. One thing is certain: It will be painful.

As of this writing, the Federal Reserve has purchased \$130 billion in additional Treasury notes as emergency support for the security markets. In his 2008 State of the Union Address, President Bush proposed a \$150-billion “economic stimulus” package, which has been approved by Congress. The package comprises tax rebates and tax reductions along with relief for subprime mortgagees. Both moves are short-term fixes aimed at avoiding an inevitable recession; neither will put Americans back on the road to solvency.

Once again, the Federal Reserve Bank has failed to exer-

cise its role as an independent overseer of financial institutions; it has failed to restrain the growth rate of the money supply, which is necessary to promote the stable growth of the economy; and it has failed to defend the dollar as a stable store of value. Since Greenspan's appointment as Fed chairman, the dollar has declined 42 cents in value, as measured by the GNP deflator. In the years following World War I, the Federal Reserve Board mismanaged the money supply, helping to cause the Great Depression. Following the reflation of price levels caused by World War II, the dollar's purchasing power has declined to nine cents in 1946 dollars. Nothing has changed: The “Debt Supercycle” continues its hyperinflation, thanks to the President's and Congress's excessive spending and growing deficits—which are always justified by contrived calamities—while the Fed responds obligingly by flooding the economy with liquidity. Instead of serving as the “lender of last resort” to the commercial banks, the Federal Reserve has been the banker of crisis (big or small). Its top priority is the profit of the Wall Street speculators; its last priority is the preservation of the value of the savings and pensions of the disappearing middle class.

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The parallels between the circumstances of the current financial dilemma and those at the onset of the Great Depression are striking. In the decade leading up to the Depression, individual debt had increased 43 percent relative to disposable incomes, financing a period of false prosperity and excessive consumption. Similarly, the decade from 1997 to 2007 saw a 49-percent increase in household debt compared with incomes, as Americans spent their money on imports and unaffordable residences. During the 20's, the distinguished investment bankers were “watering the stocks” of the utilities, railroads, and industrials, while the “bear raiders” were shorting weak stocks, taking control, and stripping their working capital; both then sold the stocks stripped of cash and loaded with debt. Bank-holding trusts pyramided assets on inadequate capital. In recent years, investment bankers, hedge funds, and global banks and their SIVs have been indulging in the same unrestrained pillage and greed.

The combination of an inflated money supply and excess indebtedness always results in unworthy credit, which undermines the economy. When the day of reckoning arrived in 1930, the government and regulators made all the wrong moves. Do we have any reason to believe that our current utopians will do any better? 