The Subprime Mortgage Crisis: An Instance of the Longer Cycle of Decline

Joseph Cioni
Carroll School of Management
Boston College

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I. Introduction

In this paper, I will attempt to identify some of the ways in which general and group bias contributed to the emergence of the subprime mortgage crisis – an instance of the longer cycle of decline. In order to build this case, I will begin by defining Lonergan's notions of group bias, general bias, and the longer cycle of decline. The next section will be divided into two parts, both of which will consist of applying the notion of general bias to the subprime mortgage crisis. In the first part of this section, I will briefly discuss a less severe subprime mortgage crisis that invited – but ultimately failed to give rise to – meaningful oversight of what was then a budding subprime lending industry in the late 1990's. In the second part of this section, I will examine how, in the early 2000's, general bias distorted the decision-making processes of many of the significant parties involved in the housing market. Under the sway of general bias, these parties seem to have leapt to the conclusion that house prices would inevitably continue to rise, since they had been, for the most part, steadily increasing for at least the previous four decades.[1]

In the final section of the paper, I will contend that group bias was also operative leading up to and during the subprime mortgage crisis. The emphasis in this section will be on instances

[1] According to the U.S. Census Bureau, both the median and average house prices for new homes sold in the country only declined twice (1969-1970; 1990-1991) on a year-over-year basis from 1963 to 2007. (United States Census Bureau, "Median and Average Sales Prices of New Homes Sold in the United States," *available at* http://www.census.gov/const/uspriceann.pdf).

of "co-opted" group bias, or arrangements in which different parties cooperated with one another in mutually advantageous ways in the short-term, but to the detriment to society at large in the longer term. These biased group relationships, coupled with key oversights that were endorsed by general bias, created conditions that were rife for the emergence of the subprime mortgage crisis.

II. Group bias, General Bias, and the Longer Cycle of Decline

A potentially useful way of beginning to analyze the subprime mortgage crisis, which arguably began when American house prices dropped in July of 2006, is to consider it as an instance of Lonergan's notion of the longer cycle of decline. In chapter 7 of *Insight*, Lonergan discusses this notion, which he argues is originated by the general bias of common sense[2] and can combine with, or be reinforced by, group bias.[3] As biases, general and group bias are blocks or distortions of intellectual development,[4] interferences to which all human beings are subject.

Lonergan points out that general bias involves not only the dismissal of theoretical ideas that could be potentially profitable in the future, it also involves actively and willingly refusing to entertain - and having disdain for - those same ideas. Common sense's "complacent practicality" banishes ideas that fail to address the satisfaction of immediate desires or the alleviation of present fears.[5] Lonergan provides a snapshot of this pernicious attitude in *Insight*:

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[2] Bernard Lonergan, *Insight, The Collected Works of Bernard Lonergan*, Vol. 3, Ed. Frederick E. Crowe and Robert M. Doran (Toronto, University of Toronto, 2000), 252. The general bias of common sense consists of the indiscriminate privileging and exalting of the immediate, practical, and concrete. Common sense is a specialization of human intelligence that focuses on these areas. It is a valid, though limited, form of human knowing, for while it is practical, capable of getting things done, it "is very, very weak at paying attention to long-term results and consequences." (Bernard Lonergan, *Early Works on Theological Method I, The Collected Works of Bernard Lonergan*, Vol. 22, Ed. Robert M. Doran, Robert C. Croken (Toronto: University of Toronto, 2010), 508). Individuals that are afflicted by general bias come to cherish the illusion that common sense is omnicompetent and foster the conviction that "that other forms of human knowledge are useless or doubtfully valid." (*Insight*, 251).

[3] *Insight*, 251.

[4] Bernard Lonergan, *Method in Theology* (New York: Herder and Herder, 1973), 231.

[5] *Insight*, 253.

> To advance common sense is to restrain the omnivorous drive of inquiring intelligence and to brush aside as irrelevant, if not silly, any question whose answer would not make an immediately palpable difference… [T]he man of common sense (and nothing else) is ever on his guard against all theory, ever blandly asking the proponent of ideas what difference they would make, and if the answer is less vivid and less rapid than an advertisement, then solely concerned with thinking up an excuse for getting rid of the fellow. After all, men of common sense are busy. They have the world's work to do.[6]

Group bias, on the other hand, prevents practical intelligence, which strives to understand and intelligently address concrete problems and challenges, from being truly practical. When this bias is functioning, groups are not completely content with the criteria of an insight squarely meeting the demands of the concrete situation. Instead, biased groups are predisposed to sort through pools of practical insights in an effort to determine which serve their interests and which do not. Consequently, truly practical insights "have to be divided into operative and inoperative; both satisfy the criteria of practical intelligence; but the operative insights alone go into effect for they alone either meet with no group resistance or else find favor with groups powerful enough to overcome what resistance there is."[7] Groups can offensively strike down practical plans of action that serve the common good, or defensively protect the status quo in the face of practical insights that "reveal [the group's] well-being to be excessive or its usefulness at an end."[8] Lonergan notes that group bias is particularly potent when it comes to changes in economic and political institutions.[9]

Biased decisions and actions have important practical consequences. Human intelligence, marred by bias, threatens and disrupts social progress. According to Lonergan, social progress is a "cyclic and cumulative process that results when situations give rise to insights revealing new

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[6] Ibid., 201-202.
[7] Ibid., 249.
[8] Ibid., 248.
[9] Ibid., 251.

possibilities."[10] These new possibilities, when grasped and implemented, lead to new courses of action. The new courses of action, in turn, produce new situations, and those new situations give rise to further insights that reveal additional possibilities.[11] In theory, social change would be characterized by social progress: "a succession of insights, courses of action, changed situations, and fresh insights."[12]

General and group bias mute the guidance of theoretical, creative, disinterested, detached, and unrestricted intelligence. As a result, the human social situation, rather than progressing intelligently, deteriorates cumulatively.[13] This is what Lonergan calls the longer cycle of decline. In contrast to the shorter cycle of decline, which "creates the principles for its own reversal,"[14] the more pervasive, intractable longer cycle of decline consists of a general "neglect of ideas to which *all* groups are rendered indifferent."[15] Regardless of whether one is part of a dominant or depressed group, insofar as one is afflicted with general bias, one will exhibit a certain apathy, if not hostility, toward those theoretical ideas that suppose a long view. This neglect accumulates over time as each generation inherits an increasingly unintelligible social situation that is composed of "quick fix" solutions and "arbitrary fragments," which the previous generation's biased common sense used to palliate the symptoms of the social situation that they inherited. The situation can be likened to hammering shingles over the holes found in the rotting roof of the

[10] Bernard Lonergan, "The Human Good," *Philosophical and Theological Papers 1965-1980, Collected Works of Bernard Lonergan*, Vol. 17, Ed. Robert C. Croken and Robert M. Doran (Toronto, University of Toronto, 2004), 344.
[11] Ibid.
[12] *Insight*, 249.
[13] Ibid., 254.
[14] Ibid., 249. As a shorter cycle of decline unfolds, eventually the social situation deteriorates to the point where "there is no need to call upon experts and specialists to discover whether anything has gone wrong, nor even to hit upon a roughly accurate account of what can be done." It becomes blatantly obvious that things have gone awry. The neglected groups will come to discover and later champion the practical insights and ideas that were shunned or ignored by the favored groups. (Ibid., 249-250).
[15] Ibid., 252. Italics mine.

house that one inherited from one's parents, and then passing on this same house to one's offspring.

General bias sets up an underlying opposition between "the decisions that intelligence and reasonableness would demand and the actual decisions, individual and common, that are made."[16] Remote and, to some extent, uncertain future payoffs discourage the implementation of intelligent and reasonable courses of action, especially when those courses of action place demands on the biased subject's time.[17] To the extent that "the courses of action that men choose reflect either their ignorance or their bad will or their ineffectual self-control, there results the social surd."[18] The social surd, which Lonergan also calls a "social dump,"[19] is a "tangled skein of intelligibility and absurdity in concrete situations."[20] What Lonergan means by a surd is "something that lacks the intelligibility one would expect an object to have."[21]

One may expect the social situation to be an object that reflects the wheel of progress: moving forward "through the successive transformations of an initial situation in which are gathered coherently and cumulatively all the insights that occurred along the way."[22] But when the social situation becomes a dump "in which are heaped up the amorphous and incompatible products of all the biases of self-centered and shortsighted individuals and groups," the likelihood of occurrences of fruitful insights decreases.[23] Without occurrences of fruitful insights, the subsequent cumulative social development becomes characterized by a lack of intelligibility. One cannot abstract from the unintelligibility embedded in the biased social

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[16] Ibid., 651.
[17] One would think that claims on the biased subject's money would, too, be an unattractive part of a proposed course of action.
[18] *Insight*, 711.
[19] Bernard Lonergan, "Healing and Creating in History," *A Third Collection*, Ed. Frederick E. Crowe (Mahwah: Paulist Press, 1985), 105-106.
[20] *Insight*, 712.
[21] *Early Works on Theological Method I,* 298.
[22] Bernard Lonergan, "Healing and Creating in History," 105.
[23] Ibid.

situation if one wants to consider the facts as they are.[24] Such is the gauntlet thrown down by the longer cycle of decline.

As an instance of the longer cycle of decline, the subprime mortgage crisis contributed to the emergence of a number of negative consequences. In 2011, 11.1 million American households owed more on their mortgages than their homes were worth.[25] CoreLogic, a data analysis firm, glumly estimates that there were approximately 3 million completed foreclosures over the course of 2009-2011.[26] From 2008 to the end of 2012, there were 465 bank failures. To put the magnitude of these bank failures in perspective, there were only 27 bank failures over the entire course of 2000-2007.[27] By the end of 2008, all five of the largest arrangers were no longer independent investment banks.[28] By 2010, over 90% of subprime mortgage-backed securities issued in 2006 and 2007 and originally rated AAA had been downgraded to junk status by Moody's and S&P.[29] AIG, the "subprime risk-taker of last resort,"[30] ultimately ended up receiving $182.4 billion in aid from the Federal Reserve and the Treasury Department.[31] Fannie Mae and Freddie Mac, once highly profitable companies, were taken over by the federal

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[24] *Insight*, 255.
[25] The Joint Center for Housing Studies of Harvard University, *The State of the Nation's Housing 2012* (Cambridge: Joint Center for Housing Studies, 2012), *available at* http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/son2012.pdf, 1.
[26] Ibid., 11.
[27] Federal Deposit Insurance Corporation, "Failed Bank List," (January 30, 2013), *available at* http://www.fdic.gov/bank/individual/failed/banklist.html.
[28] Bear Stearns was acquired by JPMorgan in March of 2008, Merrill Lynch was acquired by Bank of America in September of 2008, Lehman Brothers filed for bankruptcy protection in September of 2008, and Morgan Stanley and Goldman Sachs became bank holding companies in September of 2008. As acknowledged in a sober September 22, 2008 article in the *Wall Street Journal*, those steps effectively marked "the end of Wall Street as it's been known for decades." Jon Hilsenrath, Damian Paletta, and Aaron Lucchetti, "Goldman, Morgan Scrap Wall Street Model, Become Banks in Bid to Ride Out Crisis," *The Wall Street Journal* (September 22, 2008).
[29] United States Senate Permanent Subcommittee on Investigations, *Wall Street and the Financial Crisis: Anatomy of a Financial Collapse* (April 13, 2011), *available at* http://hsgac.senate.gov/public/_files/Financial_Crisis/FinancialCrisisReport.pdf, 267.
[30] Michael Lewis, "The Man Who Crashed the World," *Vanity Fair* (August 2009), 139.
[31] Congressional Oversight Panel, *March Oversight Report: The Final Report of the Congressional Oversight Panel* (March 16, 2010), *available at* http://www.gpo.gov/fdsys/pkg/CHRG-112shrg64832/pdf/CHRG-112shrg64832.pdf, 109.

government on September 8, 2008 and received a combined $188 billion in aid to stay afloat.[32] I will now attempt to map out some conditions that were in place that helped give rise to this troubling social situation.

III. Two Ways That General Bias Contributed to the Subprime Mortgage Crisis

III.A. The Original Subprime Crisis: Consigned to Oblivion by General Bias

One of the more disheartening characteristics of the subprime mortgage crisis is that it was preceded by a lesser-known, less severe subprime crisis that took place in the late 1990's. This original subprime boom and bust serves as an exemplary instance of general bias because it should have served as a clarion call to regulators of and participants in the subprime mortgage market in the early 2000's. A few details of this crisis are worth mentioning.

Beginning in 1994, in the wake of the Savings and Loan Crisis clean-up efforts, the number of applications for both conventional mortgages[33] and conventional mortgage refinances dropped precipitously in the United States.[34] Market interest rates increased by more than 2% during the first six months of 1994 alone.[35] Someone who had recently obtained a mortgage prior to this sudden increase in market interest rates would likely now be discouraged from refinancing at a higher rate, while someone who was in the market for a mortgage might find the new mortgage rates to be unattractive enough to delay purchasing a home. This is borne out by the fact that from 1993 to 1995 total mortgage originations dropped by a glaring 36%.[36] Many mortgage lenders during this period were scrambling to find ways to broaden their market base

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[32] "Federal National Mortgage Association," *New York Times Business Day* (January 7, 2013), *available at* http://topics.nytimes.com/top/news/business/companies/fannie_mae/index.html.
[33] Orla O'Sullivan, "Lenders Grapple With Subprime Refi's," *ABA Banking Journal*, Vol. 90, No. 5, (May 1998), 70.
[34] *The Handbook of Nonagency Mortgage-Backed Securities*, Ed. Frank J. Fabozzi, Chuck Ramsey, and Michael Marz (New Hope: Frank J. Fabozzi Associates, 2000), 16.
[35] Ibid.
[36] Ibid.

as the conventional mortgage market dried up.[37] This was a significant moment for the initial growth of the subprime mortgage market in the United States.[38]

Another factor that accounted for subprime lending's growth in the 1990's[39] was the veritable explosion of outstanding consumer debt and personal bankruptcy filings during this period. According to data provided by the Federal Reserve, at the end of January of 1990, outstanding consumer debt in America totaled $797.7 billion.[40] By the end of December of 1999, the amount of outstanding consumer debt ballooned to $1.53 trillion, an increase of nearly 92%.[41] As for the surge in personal bankruptcy filings, there were a little over 700,000 consumer bankruptcy filings in 1990, a figure that grew to over 1.2 million by the end of 1999, an increase of over 78%.[42]

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[37] Ibid.

[38] Arthur E. Wilmarth, Jr. argues in his magnificent article, "The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation, and Increased Risks," that lending margins in general, not just those limited to conventional mortgage lending, "declined substantially" for banks in 1993 and many lenders "found it increasingly difficult to improve their profits simply by making more loans." (Arthur E. Wilmarth, Jr., "The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation, and Increased Risks," *University of Illinois Law Review*, Vol. 2002, No. 2, (2000), 242).

[39] The United States Department of Housing and Urban Development (HUD) noted in an April 2000 report that there was "a monumental growth in subprime lending" from 1993-1998. Subprime refinance loans alone increased nearly 900% over this five year span from 80,000 in 1993 to 790,000 in 1998. (United States Department of Housing and Urban Development, "Unequal Burden: Income and Racial Disparities in Subprime Lending in America," (April 2000) *available at* http://www.huduser.org/Publications/pdf/unequal_full.pdf, 1-2). Two months later, HUD issued a joint report with the United States Treasury Department titled, "Curbing Predatory Home Mortgage Lending." In this report, the two government agencies document that subprime mortgage originations totaled around $35 billion in 1994 and rose to $150 billion by 1998, an increase of 328%. (United States Department of Housing and Urban Development, and the United States Treasury Department, "Curbing Predatory Home Mortgage Lending," (June 2000) *available at* http://www.huduser.org/publications/pdf/treasrpt.pdf, 29).

[40] Federal Reserve System, *Statistical Release: Consumer Credit* (February 7, 2011), *available at* http://federalreserve.gov/releases/g19/hist/cc_hist_sa.txt. To put this number in perspective, outstanding consumer debt in America, at the end of January of 1960, 1970, and 1980 was, respectively, $56.01 billion, $127.8 billion, and $350.4 billion. Outstanding consumer debt in America, over a 30 year period from the end of January of 1960 to the end of January of 1990, increased an astonishing 1,324%.

[41] Ibid.

[42] American Bankruptcy Institute, *Annual Business and Non-Business Filings by Year (1980-2009)*, *available at* http://www.abiworld.org. These figures are important because the increase in subprime lending that took place in the 1990's was not caused by a mere unilateral phenomenon, i.e. by mortgage lenders, discouraged by the profit potential in the conventional mortgage market, aggressively entering into the subprime market. Instead, these opportunistic lenders were "greeted" in their search for profits by a newly minted influx of borrowers with impaired credit. In other words, although there was an increase in supply of subprime mortgage credit in the 1990's, this supply "encountered" an ever-growing customer base that could not qualify for prime mortgages.

Despite the fact that "Wall Street had been mesmerized by the rapid growth of the subprime sector"[43] throughout 1995 and 1996, with subprime mortgage lenders experiencing "two phenomenal years,"[44] critics of this expansion became progressively concerned over the stability of the subprime mortgage market by 1997 and early 1998. With an annual average unemployment rate under 5% in 1997 and 1998,[45] the median average household income increasing for the third and fourth consecutive year,[46] and house prices rising,[47] some economists were alarmed by the growth of consumer debt, personal bankruptcy filings, and, in 1998, subprime delinquencies.[48] One economist declared, "We've got an extraordinary debt problem, especially in what should be glowing expansion."[49] Another warned that "an inevitable recession, with a drop in real estate prices, would be fatal for the subprime sector."[50]

As these portents anticipated, and similar to what occurred in the more recent and serious subprime mortgage crisis, the tremendous growth of the subprime mortgage market in the mid-1990's could not be sustained for an extended period of time. Two events that culminated and converged in August of 1998, according to The Financial Crisis Inquiry Commission,[51] contributed to a market disruption that came to be known as "The Panic of 1998." The two

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[43] Barnaby J. Feder, "A Risky Business Gets Even Riskier; Big Losses and Bad Accounting Leave 'Subprime' Lenders Reeling," *The New York Times* (February 12, 1997), *available at* http://www.nytimes.com/1997/02/12/business/big-losses-and-bad-accounting-leave-subprime-lenders-reeling.html.
[44] Heather Timmons, "Ballooning Subprime Market Runs Risk of Bursting in 1997," *The American Banker* (May 6, 1997), 2.
[45] Bureau of Labor Statistics, *Annual Average Unemployment Rate, Civilian Labor Force 16 Years and Over*, (February 3, 2011), *available at* http://www.bls.gov/cps/prev_yrs.htm.
[46] Carmen DeNavas-Walt, Bernadette D. Proctor, and Jessica C. Smith, "Income, Poverty, and Health Insurance Coverage in the United States: 2009," *Current Population Reports: Personal Income* (September 2010), *available at* http://www.census.gov/prod/2010pubs/p60-238.pdf, 33.
[47] Standard and Poor's, *S&P/Case-Shiller Home Price Indices* (January 2011), *available at* http://www.standardandpoors.com, 2.
[48] Howard Schneider, "Key Trends in Subprime," *Mortgage Banking*, Vol. 58, No. 7, (April 1998), 14.
[49] Heather Timmons, "Ballooning Subprime Market Runs Risk of Bursting in 1997."
[50] Ibid.
[51] The Financial Crisis Inquiry Commission was an independent, ten-member panel created to "examine the causes of the current financial and economic crisis in the United States. The Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States*, (January 2011), *available at* http://fcic.law.stanford.edu/report, xi.

events were The Russian Default Crisis and the near-collapse of the hedge fund firm, Long-Term Capital Management. Those two events wreaked havoc on the stock market in general[52] and on the subprime lending sector in particular.

To get a better sense of the magnitude of subprime lending-related losses during this period, it may be useful to examine *National Mortgage News*' list of publicly traded subprime lenders before "The Panic of 1998" erupted. As of April 21, 1997, there were twenty-three publicly traded companies that were devoted to subprime lending.[53] By the end of 1999, four of those companies filed for bankruptcy protection,[54] five were acquired by another firm,[55] and two changed their name.[56] One should note that, by the end of 2001, three more of those subprime

[52] For example, on August 31, 1998, the Dow Jones Industrial Average plummeted 513 points. In a span of a little over six weeks, the Dow lost about 20% of its value, tumbling from the 9,500 range to around 7,700. (Eric Avidon, "It Could Have Been a Lot Worse for Mortgage Industry Stocks," *National Mortgage News* (September 7, 1998)).
[53] "Publicly Traded 'Subprime' Lenders," *National Mortgage News* (April 21, 1997). These 23 companies were: Aames Financial, American Business Financial Services, Advanta, Associates First, Amresco, Beneficial Finance, ContiFinancial, Cityscape Financial, Delta Funding, Emergent Mortgage, First Alliance, FirstPlus Financial, Green Tree Financial, Household Finance, IMC Mortgage, Imperial Credit Mortgage, Mego Mortgage, Money Store, Ocwen Financial, Pacific America, Southern Pacific Funding, TransAmerica, and United Companies.
[54] Cityscape Financial filed for bankruptcy protection in October of 1998. ("Metro Business; Cityscape Chapter 11 Plan," *The New York Times* (October 8, 1998), *available at* http://www.nytimes.com/1998/10/08/nyregion/metro-business-cityscape-chapter-11-plan.html). Pacific America filed for bankruptcy protection in November of 1999. (Office of the Inspector General, "Material Loss Review - The Failure of Pacific Thrift and Loan Company," (June 7, 2000), *available at* http://www.fdicoig.gov/reports00/00-022.pdf, 6). Southern Pacific Funding filed for bankruptcy protection in October of 1998. ("Company News; Goldman Sachs in $35 Million Deal For Subprime Lender," *The New York Times* (May 13, 1999), *available at* http://www.nytimes.com/1999/05/13/business/company-news-goldman-sachs-in-35-million-deal-for-subprime-lender.html). United Companies filed for bankruptcy protection in March of 1999. ("United Cos Financial Says It Plans to Seek Chapter 11 Protection," *The Wall Street Journal* (March 2, 1999)).
[55] Beneficial Finance was acquired by Associates First in 1998. (Dennis Slocum, "U.S. Giant Buys Beneficial Finance Associates; Continues Canadian Expansion," *The Globe and Mail* (February 11, 1998)). Green Tree Financial was acquired by Conseco, Inc. in 1998. (Jeff Bailey, "Conseco Agrees to Acquire Green Tree," *The Wall Street Journal* (April 8, 1998)). IMC Mortgage was purchased by Citigroup in November of 1999. (Jeff Harrington, "Mortgage Lender Will be Sold to Citigroup," *The St. Petersburg Times*, (November 13, 1999)). Money Store was acquired by First Union in 1998. (Timothy O'Brien, "First Union to Acquire Money Store for $2.1 Billion," *The New York Times* (March 5, 1998), *available at* http://www.nytimes.com/1998/03/05/business/first-union-to-acquire-money-store-for-2.1-billion.html). TransAmerica was acquired by Aegon in 1999. (Marianne Curphey, "Aegon Joins Superleague with $ 9.7bn US Purchase," *The Times* (February 19, 1999)).
[56] Emergent Mortgage changed its name to HomeGold Inc., later renamed HomeGold Financial, Inc., in March of 1998. Mego Mortgage changed its name to Altiva Financial in 1999.

lenders filed for bankruptcy protection,[57] one ceased its subprime lending operations,[58] and three were acquired by other companies.[59]

Four deposit-taking institutions that had significant involvement in subprime lending also failed in the late-1990's.[60] At a February 8, 2000 hearing before the United States House of Representatives' Committee on Banking and Financial Services, the Chairman of the Federal Deposit Insurance Corporation (FDIC) testified that subprime lending without prudential lending standards was a leading cause of the failure of three of those banks.[61] These three bank failures cost the government a total of approximately $1 billion.[62] At the same hearing, the Director of the Office of Thrift Supervision (OTS) likewise noted that the fourth bank's "failed subprime lending strategy" was the primary reason behind its collapse.[63]

Reflecting upon the failures of the four deposit-taking institutions, the Chairman of the hearing, Congressman James Leach, astutely observed:

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[57] Amresco filed for bankruptcy protection in July of 2001. ("In Brief: Bankrupt Amresco Plans to Sell Assets," *The American Banker* (July 5, 2001)). ContiFinancial filed for bankruptcy protection in May of 2000. (Michael Gregory, "Conti Bankrupt, Bonds Look OK," *The New York Times* (May 22, 2000)). First Alliance, after "facing a host of lawsuits accusing it of deceptive sales practices," filed for bankruptcy protection in March of 2000. (Diana B. Henriques, "Troubled Lender Seeks Protection," *The New York Times* (March 24, 2000)).

[58] Altiva, formerly Mego Mortgage, made this announcement in June of 2000. ("Westmark, Altiva End Subprime Lending Operations," *Origination News*, Vol. 9, No. 9, (June 2000), 42).

[59] Advanta was acquired by Chase Manhattan in February of 2001. (Michael Gregory, "Chase Says Fraud; Advanta Stunned," *Asset Securitization Report* (August 6, 2001)). Associates First was acquired by Citigroup in September of 2000. (Patrick McGeehan, "Citigroup to Buy Associates First for $31 Billion," *The New York Times* (September 7, 2000), *available at* http://www.nytimes.com/2000/09/07/business/citigroup-to-buy-associates-first-for-31-billion.html). FirstPlus was acquired by Barclays in 2000. (Katherine Griffiths, "Barclays Stops Loans at FirstPlus," *The Daily Telegraph* (July 9, 2008)).

[60] James A. Leach, "Hearing on the Recent Bank Failures and Regulatory Initiatives Before the United States House of Representatives' Committee on Banking and Financial Services," (February 8, 2000), *available at* http://commdocs.house.gov/committees/bank/hba62680.000/hba62680_0f.htm, 26. The four banks were: BestBank, First National Bank of Keystone, Pacific Thrift and Loan Company, and Oceanmark Bank.

[61] Donna Tanoue, "Testimony on the Recent Bank Failures and Regulatory Initiative Before the United States House of Representatives' Committee on Banking and Financial Services," (February 8, 2000), *available at* http://commdocs.house.gov/committees/bank/hba62680.000/hba62680_0f.htm, 16.

[62] Kathleen Day, "Raising the Roof on Riskier Lending; 'Subprime' Mortgage Practices by Banks and Finance Firms Draw Federal, State Scrutiny," *The Washington Post* (February 6, 2000). The three banks were BestBank, First National Bank of Keystone, and Pacific Thrift and Loan Company.

[63] Ellen Seidman, "Testimony on the Recent Bank Failures and Regulatory Initiative Before the United States House of Representatives' Committee on Banking and Financial Services," (February 8, 2000), *available at* http://www.financialservices.house.gov/banking/2800sei.shtml. Seidman notes in her testimony that Oceanmark Bank's failure cost the government around $1.3 million.

> It strikes me that we are looking at a billion dollars in failure in the last year. These have been strikingly strong economic times, and these failures involve very small banks. So we have a billion dollars in failures in good times with very, very small banks, and so the question that seems to me particularly relevant is, in terms of coordination, do we not only have adequate coordination with small banks, but what about larger banks and what about situations where instruments at issue may be much more sophisticated?[64]

Congressman Leach's concern has proven to be hauntingly prescient. The subprime lending debacle at the end of the 1990's was mostly confined to publicly traded non-depositories. Only four federally regulated depository institutions that were significantly involved in subprime lending failed during this time. What would happen if larger banks moved into subprime lending, creating "more sophisticated" subprime products? Was the federal regulation structure in place robust enough to oversee larger banks that had elected to participate in subprime lending? More generally, should there happen to be a severe economic downturn, one that would be even more serious than "The Panic of 1998," how well would subprime participants weather the storm? The general bias of common sense likely underestimated the importance of questions of this sort.

III.B. General Bias and the Myth of Inevitably Rising House Prices

Leading up to the financial crisis, common sense indicated that house prices would inevitably continue to rise. Common sense also grasped that when house prices continually rise, money can be made from mortgages that were historically considered below-prime. Under these conditions, seemingly all parties involved had something to gain (Figure 1, below): (1) borrowers were approved to live in houses that they would have otherwise been unable to afford,

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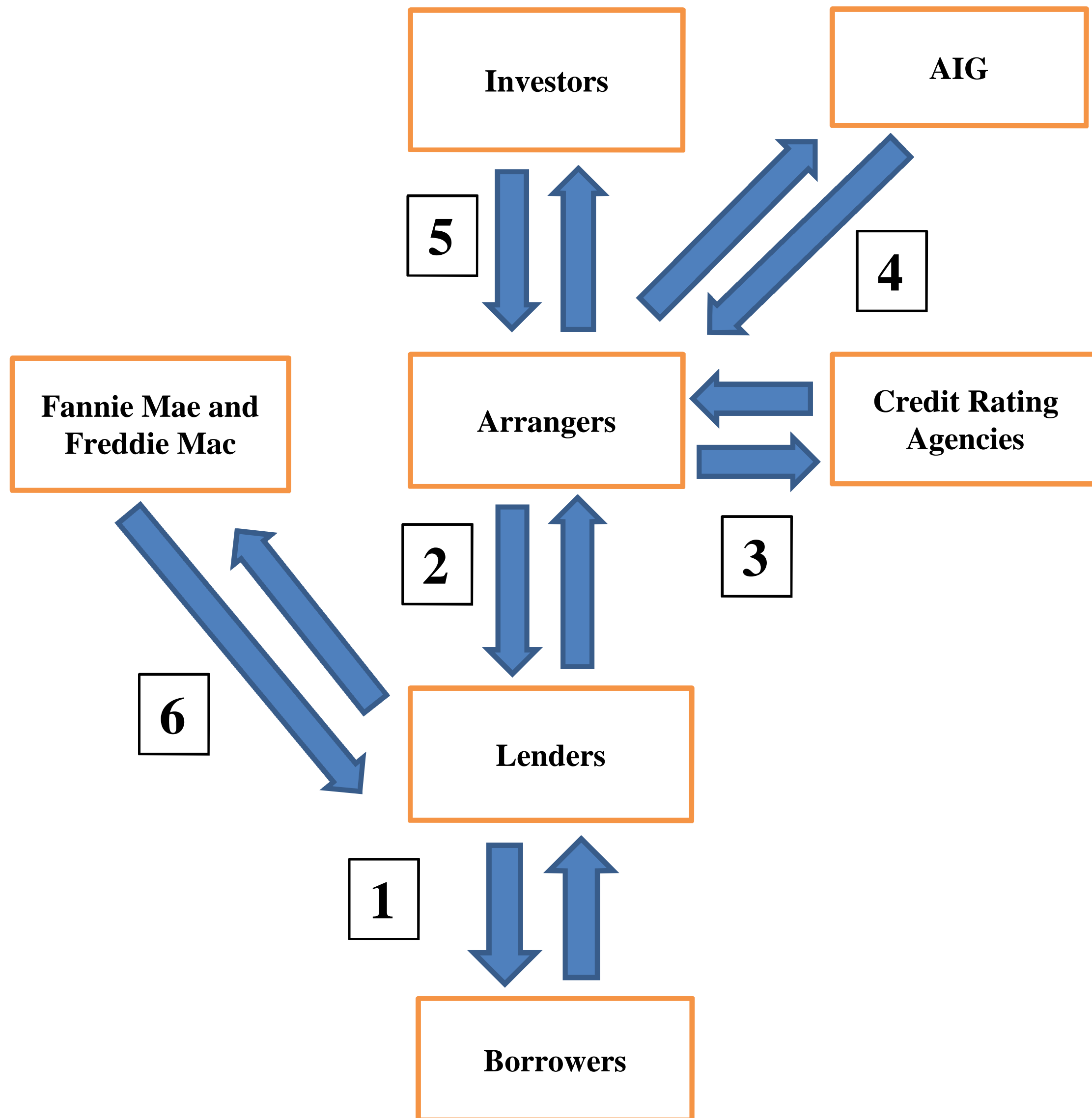
[64] James A. Leach, "Hearing on the Recent Bank Failures and Regulatory Initiatives Before the United States House of Representatives' Committee on Banking and Financial Services," 26. It is worth mentioning that Leach continued his statement by affirming, "The subprime lending problem is self-evident in several of these failures, but as risky as subprime lending may be, it still is a straightforward, unsophisticated kind of product. And so the question I would pose to each of you is of a little different nature than what has been testified to, and that is: *Are you confident of adequate coordination, and are there any problems of coordination with the larger banks in the country; and in particular, are there procedures in place that may be able to deal with economic times that are a little more difficult than those that have existed over the last half decade*?" (Ibid. Italics mine).

while lenders received origination fees from those borrowers; (2) lenders also received fees from arrangers for originating mortgage loans, regardless of whether the loan applications accurately reflected the borrower's credit risk or not; (3) arrangers securitized those mortgages and submitted them to the credit rating agencies, whose dependence on arranger-supplied fees incentivized them to inflate their ratings of these products; (4) AIG was happy to sell, for a fee, excessive credit protection on subprime-related securities to arrangers; (5) arrangers issued, for a fee, those highly rated securities to institutional investors; (6) even Fannie Mae and Freddie Mac, the stalwarts of the secondary mortgage market who specialized in prime, conforming mortgages, purchased subprime mortgages from lenders for a fee.[65]

[65] Fannie Mae and Freddie Mac could also retain those securities in their own portfolios, which was a profitable venture in the short run.

Figure 1.[66]



Considering (1), it is important to note that when the value of one's house goes up, one's loan-to-value ratio[67] drops, typically making one more eligible to refinance. Or, alternately, one

[66] The idea for this chart came from: Adam Ashcraft and Til Schuermann, "Understanding the Securitization of Subprime Mortgage Credit," *Federal Reserve Bank of New York Staff Reports*, No. 318 (March 2008), *available at* http://www.newyorkfed.org/research/staff_reports/sr318.pdf, 3.

could potentially be a position to attempt to sell the home for a profit. In either case, under the assumption that house prices will inevitably rise, lenders came to expect that there was a high likelihood that borrowers would be able to "repay" their loans by way of refinancing or selling their homes.[68] From the perspective of a borrower, mortgages that required one to put little or no money down offered the opportunity to buy a house with little risk. If the price of one's house rose, one could sell at a profit. In the event that house prices dropped and one could no longer afford the monthly mortgage payment, one could walk away with minimal out-of-pocket expenses. With such an attractive upside and a tolerable downside, borrowers were tempted to fail to take seriously the further pertinent questions that could have, and indeed should have, emerged as they were deliberating over whether it was worthwhile to purchase a given house.[69]

In terms of (2), since several arrangers, including Merrill Lynch, Bear Stearns, and Morgan Stanley, were among those that suffered the heaviest subprime-related losses, one could argue that they, too, were swept away by the mistaken expectation that house prices would unceasingly rise.[70] Arrangers were typically the ones that were "most closely associated with the origination and securitization of mortgages."[71] Rather than using this knowledge to ultimately pocket the most money or at least incur the smallest losses among the participants in the

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[67] The ratio of the loan amount to the value of the property.

[68] Christopher L. Foote, Kristopher S. Gerardi, and Paul S. Willen, "Why Did So Many People Make So Many *Ex Post* Bad Decisions? The Causes of the Foreclosure Crisis," *Federal Reserve Bank of Boston: Public Policy Discussion Paper*, No. 12-2 (April 2012), *available at* http://www.bos.frb.org/economic/ppdp/2012/ppdp1202.pdf, 7.

[69] The counterposition that house prices will perpetually rise, in other words, interfered with a borrower's ability to deliberate over the question of value, "How much *should I* save for my house down payment?" As articulated in a popular home buying book, *Insider Secrets to Home-Buying Success*, which was published in July of 2007, this is a central question of value for a home buyer. With house prices perceived to be continually rising, the authors highlight how "valuable time is ticking away" for borrowers as they attempt to save for their down payment, which could result in house prices and interest rates rising to unaffordable levels. This undesirable scenario, the two authors note, "could leave you with an even larger monthly payment" than if you would have put less than 20% down sooner. (Joseph M. Farella and Earl Myers, *Insider Secrets to Home-Buying* (Lincoln: iUniverse Books, 2007), 16.

[70] Christopher L. Foote, Kristopher S. Gerardi, and Paul S. Willen, "Why Did So Many People Make So Many *Ex Post* Bad Decisions? The Causes of the Foreclosure Crisis," 18-19.

[71] Ibid., 18.

subprime mortgage market, however, many of these arrangers chose to hold onto these securitized subprime-related products and endured incredible losses.[72]

Many of the arrangers that resisted the allure of the counterposition[73] of continually rising house prices still fell victim to the general bias of common sense because they reluctantly entered the subprime market out of a panicked desire to remain competitive. For example, in 2006, Lehman Brothers' management team adopted a new business strategy that involved acquiring real estate assets, including subprime mortgage-backed securities (MBSs), and holding on to them, treating them as long-term investments. The Lehman Brothers management team determined that that these investments "were highly profitable relative to their risk" in the booming economic environment, and that they were "missing out on significant opportunities" that other arrangers were already exploiting.[74]

As for (3), Moody's, Standard and Poor's, and Fitch issued credit ratings,[75] which are opinions of the likelihood that a debt instrument will default, as well as of the severity of loss should that debt instrument, in fact, happen to default. These three credit rating agencies (CRAs)

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[72] Ibid. Goldman Sachs is arguably an exception.

[73] According to Lonergan, both positions and counterpositions have to do "with one's own personal development and… one's learning from others." They also have to do with "a conversion of the subject that judges." (Bernard Lonergan, "Method in Catholic Theology," *Philosophical and Theological Papers 1958-1964, Collected Works of Bernard Lonergan*, Vol. 6, Ed. Robert C. Croken, Frederick E. Crowe, and Robert M. Doran (Toronto, University of Toronto, 1996), 36-37; 40). Every human discovery "can formulated either as a position or as a counterposition." Whereas positions invite development, counterpositions invite reversal. (*Insight*, 712-713).

[74] Anton R. Valukas, "Southern District of New York, United States Bankruptcy Court: Lehman Brothers Holdings, Inc., et al, Volume 1,"(March 11, 2010), *available at* http://lehmanreport.jenner.com/VOLUME%201.pdf, 59-60.

[75] Moody's defines a credit rating as "an opinion regarding the creditworthiness of *an entity*, a debt or financial obligation, debt security, preferred share or other financial instrument, or of *an issuer* of such a debt or financial obligation, debt security, preferred share or other financial instrument, issued using an established and defined ranking system of rating categories." (Moody's Investors Service, *Code of Professional Conduct* (June 2011), *available at* http://www.moodys.com/uploadpage/Mco%20Documents/Documents_professional_conduct.pdf, 6). As opposed to having investors perform time-consuming, costly, and duplicative research on the credit risk of issued securities, credit rating agencies can improve the efficiency of the securities market by equipping investors with pertinent information that may factor into the decision of how to allocate their capital. Arrangers who issue securities can, by way of credit ratings, make investors more confident in the quality of their products. (Steven L. Schwarcz, "Private Ordering of Public Markets: The Rating Agency Paradox," *University of Illinois Law Review*, No.2 (February 2002), 12.

failed to accurately assess the risk that many subprime-related securities contained. The CRAs used financial models to make credit risk assessments and, leading up to the subprime mortgage crisis, these models featured the built-in assumption that house prices would continue to rise. As Sean Egan, the head of Egan-Jones Ratings Company, noted, "The core problem in the case of the mortgage-backed securities was [the assumption] that housing prices would increase. In fact, they embedded an acronym… the House Appreciation Rate (HPA), which is somewhat ironic because it doesn't account for the fact that sometimes houses deflate, decline."[76]

Turning to (4), the insurance giant, AIG, was likewise blinded by general bias, as its financial products unit (AIGFP) sold far more credit protection on subprime-related products than it could ever hope to cover, should house prices decline and the value of those products drop. Heavily relying upon computer models developed by Gary Gorton, a professor at Yale University's School of Management, AIGFP believed that it could prudently enter into credit-default swap (CDS)[77] contracts with counterparties that wanted to purchase credit risk protection

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[76] Sean Egan, "Testimony Before the House Committee on Oversight and Government Reform," (October 22, 2008), *available at* http://www.gpo.gov/fdsys/pkg/CHRG-110hhrg51103/html/CHRG-110hhrg51103.htm. J. Kyle Bass, a subprime fund manager, affirmed, "At least one of the NRSROs was using HPA assumptions of +6-8% for 2006, 2007 and 2008 in their models for securitizations underwritten in 2006 and in the first quarter of 2007." (J. Kyle Bass, Testimony Before the House Committee on Financial Services, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises," (September 27, 2007), *available at* http://democrats.financialservices.house.gov/hearing110/bass.pdf, 6). Please see also: Office of the Special Inspector General for the Troubled Asset Relief Program, *Quarterly Report to Congress* (October 21, 2009), *available at* http://www.sigtarp.gov/Quarterly%20Reports/October2009_Quarterly_Report_to_Congress.pdf, 136-137.

[77] CDSs are contracts whose structures and values are derived from underlyings, which are, quite broadly, "anything that interests markets" ranging from cash instruments (such as stocks and bonds) to tangibles (such as commodities) to even intangibles (such an interest rates, currency rates, or the credit quality of institutions). Please see: Norman Menachem Feder, "Deconstructing Over-the-Counter Derivatives," *Columbia Business Law Review*, Vol. 2002, No. 3 (2002), 681. As *credit* derivatives, CDSs are contracts in which two parties, a "protection buyer" and a "protection seller," isolate and place a value on the credit risk that self-selected, referenced underlyings carry with them. (Ibid., 706-707). As part of a CDS contract, the protection buyer is purchasing credit protection from the protection seller. In exchange for a periodic fee, the protection buyer is able to offload the credit risk that accompanies a given reference obligation and transfer it to the protection seller. What is being swapped, then, in a CDS contract is money in exchange for credit risk protection. (William K. Sjostrom, Jr., "The AIG Bailout," *Washington and Lee Law Review*, Vol. 66, No. 3 (2009), 947-948).

on various tranches of collateralized debt obligations (CDOs).[78] Importantly, regardless of how well Gorton's models measured the credit risk accompanying various tranches of CDOs, those same models *did not* assess the risk that the tranches themselves would decline in value.[79] While AIGFP was aware of this omission,[80] the unit's Chief Financial Officer at the time, Joseph Cassano, believed that the tranches would be downgraded only in the unlikely event that house prices in the United States declined all at once. As reported by Michael Lewis, "Cassano set out on a series of meetings with Morgan Stanley, Goldman Sachs, and the rest - all of whom argued how unlikely it was for housing prices to fall all at once. 'They all said the same thing,' says one of the traders present. 'They'd go back to historical real-estate prices over 60 years and say they had never fallen all at once.'"[81]

Investors (5), for their part, also suffered from mistaken house price expectations. In an April 2012 paper, two senior economists at the Federal Reserve Bank of Boston and one research economist at the Federal Reserve Bank of Atlanta note, "[I]f investors think that house prices can rise 11 percent per year, expected losses [on their investments] are minimal."[82] Gretchen Morgenson, a journalist for the *New York Times*, nicely captures the spirit of many investors of subprime-related securities leading up to the crisis. She writes, "It's amazing how long it can take investors to see that the wheels are coming off a prized investment vehicle. Denial, after all, is a powerful thing. But when an imperiled favorite happens to be a pool of asset-backed

[78] "CDO" is the generic term for a type of security that can be backed by any type or combination of types of debt. For example, CDO's can be backed by subprime mortgage-backed securities. Janet M. Tavakoli, *Structured Finance and Collateralized Debt Obligations* (Hoboken: John Wiley and Sons, 2008), 2.
[79] William K. Sjostrom, Jr., "The AIG Bailout," *Washington and Lee Law Review*, Vol. 66, No. 3 (2009), 957.
[80] Carrick Mollenkamp, Serena Ng, Liam Pleven, and Randall Smith, "Behind AIG's Fall, Risk Models Failed to Pass Real-World Test," *The Wall Street Journal* (October 31, 2008).
[81] Michael Lewis, "The Man Who Crashed the World," 137. When house prices dropped and the CRA's began downgrading the ratings of many CDO's in the summer of 2007, the tranches of those CDO's began to lose value. AIG was suddenly confronted by a tidal wave of protection buyer collateral calls, which ultimately caused the troubled insurance company to run out of cash. See generally: William K. Sjostrom, Jr., "The AIG Bailout."
[82] Christopher L. Foote, Kristopher S. Gerardi, and Paul S. Willen, "Why Did So Many People Make So Many *Ex Post* Bad Decisions? The Causes of the Foreclosure Crisis," 32-33.

securities - especially those involving home mortgages - *denial can be compounded by outright blindness to the real risks of that investment*."[83] Morgenson argues that investors "flocked to the mortgage-backed market" because they were "chasing the buzz of higher yields."[84] Once again, the counterposition of endlessly rising house prices lodged itself into a decision-making horizon, this time in the sense that subprime-related investments were portrayed as having huge upsides with little risk of experiencing any downsides.

Fannie Mae and Freddie Mac (6) also succumbed to the counterposition of endlessly rising housing prices. Endowed with government privileges, the two housing GSEs were enlisted by Congress to serve as mortgage alchemists: transforming the luxurious good of homeownership into an affordable good, converting illiquid mortgage loans into liquid securities, and creating a stable secondary market for a product that is plagued with credit, prepayment, and other latent risks.

As privately owned companies, Fannie Mae and Freddie Mac had the additional challenge of performing those tasks while maximizing shareholder returns. This tension, between a congressionally-mandated mission to the public and a fiduciary duty to shareholders, was mostly masked when housing prices were rising and the conventional mortgage market was growing.[85] Evidence suggests, however, that the two housing GSEs' growth surpassed the

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[83] Gretchen Morgenson, "Will Other Mortgage Dominos Fall?," *The New York Times* (February 18, 2007), *available at* http://www.nytimes.com/2007/02/18/business/worldbusiness/18iht-morgenson.4633573.html. Italics mine.
[84] Ibid.
[85] More specifically, I think the fundamental tension that was disguised as the housing market was expanding and housing prices were increasing was between the two housing GSEs' felt urgency for chasing profitability and their responsibility to create conditions for a *stable* secondary mortgage market. The two other government mission-related objectives of providing liquidity to the secondary mortgage market and making mortgage credit more affordable nicely harmonized with the objective of maximizing returns to shareholders. As long as the two housing GSEs could continually churn out profits, they could consistently be in a position to provide a favorable rate of return to shareholders as well as appear to be credible issuers of bonds to investors. (Peter J. Wallison, "Private Profits, Public Risks," *The Wall Street Journal* (March 24, 2008)).

consumer demand for conventional, 30-year, fixed-rate mortgages,[86] and thus led to a profit-driven initiative to take on greater risks.[87]

As for the impact that the two housing GSEs had on subprime lenders, two scholars at the American Enterprise Institute observe, "[Fannie Mae and Freddie Mac's] buying patterns and interests were followed closely in the markets. If Fannie and Freddie wanted subprime or Alt-A

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[86] It is necessary to pause for a moment and recall that, prior to the eruption of the subprime mortgage crisis, Fannie Mae and Freddie Mac's area of expertise was purchasing single-family mortgages with origination balances within the conforming loan limit, securitizing these mortgages, and then either issuing them to investors with guarantees, or holding them in their retained portfolios. From 1982-1994, the American homeownership rate was approximately 64%. From 1994-2000, this homeownership rate increased over 3% to 67.5%. Then, from 2000-2006, there was yet another increase in the homeownership rate, an increase of 1.7% to 69.2%. One of the more significant features of this two decade-plus increase in American homeownership is that from 2001-2006, conventional mortgage originations sharply *dropped*, from 57.1% of all mortgage originations in 2001 to 33.1% in 2006. Although there was an increase in the percentage of Americans that owned a home during this time, there was eventually a marked decrease in the percentage of homeowners who were receiving conventional mortgages. (Peter J. Wallison and Edward J. Pinto, "A Government-Mandated Housing Bubble," *Forbes* (February 16, 2009); Peter J. Wallison, "Cause and Effect: Government Policies and the Financial Crisis," *AEI Outlook Series* (November, 2008) *available at* http://www.aei.org/outlook/29015).

[87] One of the most compelling pieces of evidence to support this claim surfaced during a December 9, 2008 hearing before the House of Representatives' Committee on Oversight and Government Reform. Congressman John Tierney, as part of his interrogation of then-Fannie Mae CEO Daniel Mudd, presented a document that was found in Fannie Mae's internal files. The title of the document was "A single family guarantee business facing strategic crossroads." It was dated in June of 2005 and, as Tierney states, was listed as "confidential" and "highly restricted." One of the headings of the document was: "The risk in the environment has accelerated dramatically." Underneath the heading, listed in bullet-points, was recognition that there had been "a proliferation of higher-risk alternative mortgage products… a growing concern about housing bubbles… a growing concern about borrowers taking on increased risk and higher debt, and lenders… [having] engaged in aggressive risk layering." Additionally, there is also mention in the document of "the growth in adjustable-rate mortgages" continuing at "an aggressive pace," as well as "emphasis on the lowest possible payment" and homes "being utilized more like an ATM." With this acknowledgement of the heightened risk that was circulating throughout the mortgage business at the time, the document continues: "We are at a strategic crossroads, and we face two stark choices. One is stay the course, and the other is meet the market where the market is." The benefits of staying the course, of focusing on "the more secure fixed-rate mortgages" were, according to the document, that Fannie Mae would maintain its "strong credit discipline, it would protect the quality of the book, it would intensify [its] public voice on concerns about the housing bubble and accelerating risk, and, most importantly, it would preserve capital." The benefits of meeting the market where the market is, conversely, were that Fannie Mae would be able to "meet current consumer and customer demands for alternative mortgage products" and consequently would be able to take advantage of "a revenue opportunity and a growth area." The document also lists the downsides of both courses. If Fannie Mae stays the course, they would "have lower revenues and slower growth," but if they meet the market where it is they would "have increased exposure to unknown risks." The final quote that Congressman Tierney read from the document was omnious: "If we do not seriously invest in these underground-type efforts [to dedicate resources and funding to develop a subprime infrastructure], we risk becoming a niche player, becoming less of a market leader, and becoming less relevant to the secondary market." (United States House of Representatives Committee on Oversight and Government Reform, "The Role of Fannie Mae and Freddie Mac in the Financial Crisis," (December 9, 2008), *available at* http://www.hsdl.org/?view&doc=113105&coll=public, 60-61).

loans, the markets would produce them."[88] Fannie Mae and Freddie Mac's demand for subprime mortgages signaled to the lenders in the primary market to accelerate their originations of these loans.

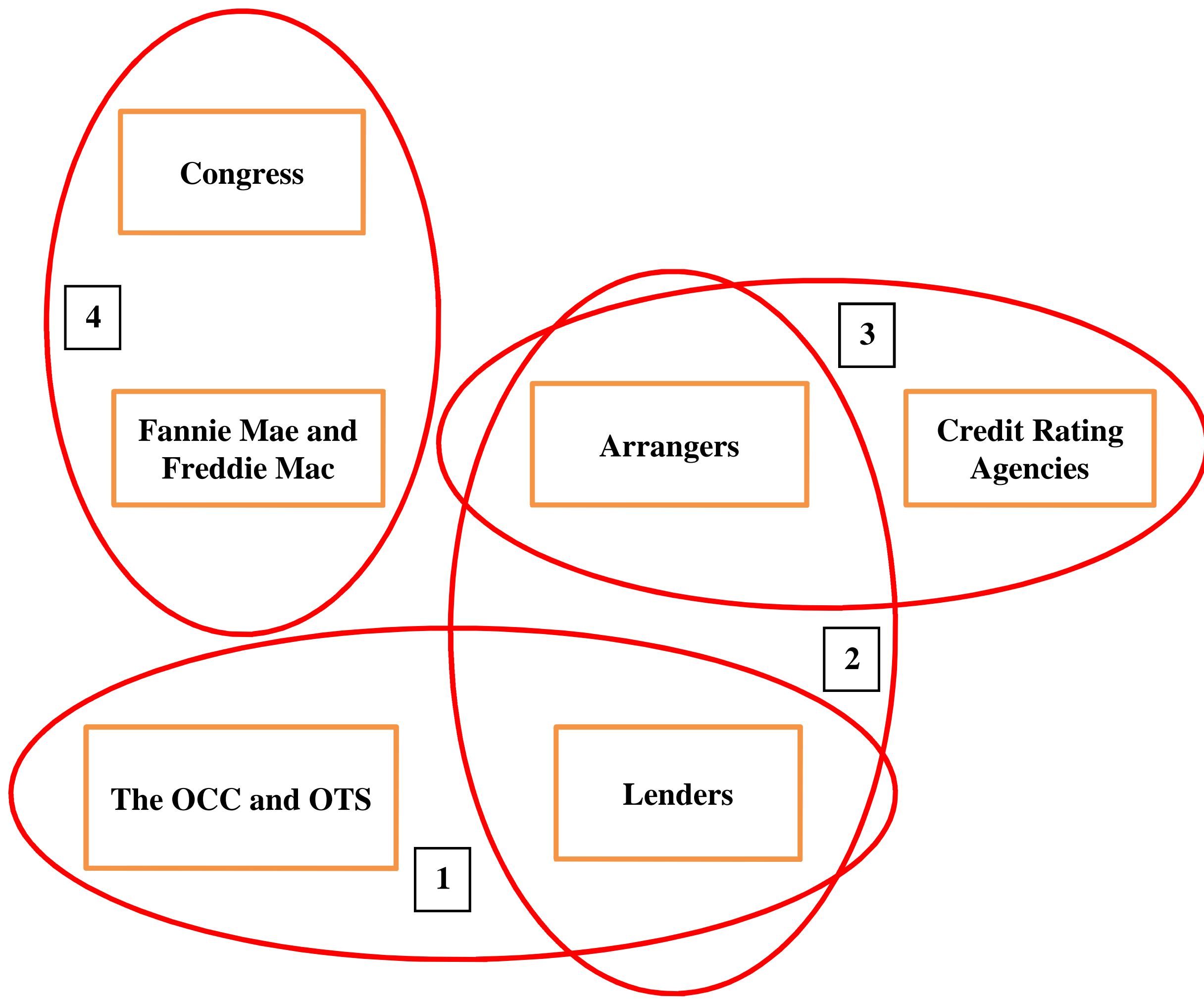
In sum, general bias arguably afflicted many of the major players in the subprime mortgage market leading up to the crisis. Adhering to the counterposition of endlessly rising housing prices likely distorted these players' deliberation efforts, ranging from whether one should make a 20% home down payment to whether one should invest in subprime-related instruments. Clinging to that counterposition also probably undermined different individuals' judgments of fact, most notably judgments centering on the probability and severity of an impending crisis.

IV. Four Institutional Relationships Stained by Group Bias

In addition to the argument that general bias dominated the orientation of several central players in the subprime mortgage crisis, one should also note that group bias was prevalent as well. In this section, I will explore four broad institutional relationships that were characterized by group bias. (Figure 2).

[88] Peter J. Wallison and Charles W. Calomiris, "Blame Fannie Mae and Congress for the Credit Mess," *The Wall Street Journal* (September 23, 2008).

Figure 2.



(1) An absence of a concerted federal regulation effort and the phenomenon known as "charter shopping" created conditions for inadequate oversight of many subprime lenders. In the short term, subprime lenders, which were often enshrouded in immense financial holding companies, benefited from a fragmented federal regulatory apparatus that forced each regulator into its own silo. Part of the Gramm-Leach-Bliley Act of 1999 (GLBA) contained a provision that legally "wedged" those federal regulators into different silos, "keeping each regulator's silo

off limits to other regulators."[89] GBLA also designated the Federal Reserve as "the super-regulator of financial holding companies,"[90] which presumably authorized it to oversee *all* of the firms contained within a given holding company. Perhaps true in theory, this was arguably not the case in practice. Congress told the Fed to rely upon "bank and thrift examination reports by other state and federal banking regulators to the fullest extent possible" instead of examining "those banks and thrifts itself."[91] This created a "catch-22" situation in the sense that the Fed needed to make a case that certain lenders were posing risks to the financial system *before* they could get access to the very reports that could confirm that these companies were, in fact, posing those risks.[92]

Effective oversight of these lenders was also undermined by a phenomenon known as "charter shopping,"[93] which arguably incited the OCC and OTS to give a light touch to their regulatory efforts in exchange for lender-paid fee revenue and a heightened perception of relevance. Among the most devastating of these deregulatory decisions was the one that enabled

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[89] Kathleen C. Engel and Patricia A. McCoy, *Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps* (Oxford: Oxford University, 2011), 204.
[90] Ibid.
[91] Ibid.
[92] Sheila Bair, Chairman of the FDIC, made a similar point in a different context when she claimed that the OTS resisted efforts by the FDIC to examine the ailing thrift holding company, Washington Mutual, before its collapse. The FDIC was the so-called secondary regulator of Washington Mutual, while the OTS was its primary regulator. Please see: The United States Senate Permanent Subcommittee on Investigations, "Hearing on Wall Street and the Financial Crisis: The Role of Bank Regulators," (April 16, 2010), *available at* http://www.gpo.gov/fdsys/pkg/CHRG-111shrg57320/html/CHRG-111shrg57320.htm.
[93] In general, depositories face relatively low charter-switching costs. This put them in a position to "exploit differences in [federal] agency policy by seeking to be chartered by the agency with the most relaxed regulations." (Colin Provost, "Another Race to the Bottom? Venue Shopping for Regulators in the American Financial System," *Paper Prepared for the Third Biennial Conference of the Standing Group on Regulatory Governance, Dublin, Ireland* (June 2010), *available at* http://regulation.upf.edu/dublin-10-papers/7A3.pdf, 3). On average, both the OTS and OCC charged their chartered institutions higher fees than individual state regulators because the latter are subsidized by the FDIC and the Fed. Unable to compete with state governments on the amount that they charged their "customers" in fees, the OTS and OCC potentially established their competitive advantage by making their regulations uniform (applicable in all states) and expanding the scope of their chartered institutions' permitted activities. (Kathleen C. Engel and Patricia A. McCoy, *Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps,* 158; Wookbai Kim, "A Study on How Regulatory Capture Caused the Subprime Mortgage Crisis and What To Do For Robust Consumer Protection," (December 2009), 30-33).

the OCC and OTS to preempt state consumer protection laws.[94] The OTS and OCC generally failed to ensure the safety and soundness of many of the largest subprime lenders that they supervised, including Chase Home Finance (OCC),[95] Wells Fargo Home Mortgage (OCC),[96] and Washington Mutual (OTS).[97]

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[94] In 1996, the OTS "promulgated a sweeping preemption rule declaring that henceforth federal savings associations did not have to observe state lending laws." As Patricia McCoy explains, "Following adoption of the OTS preemption rule, federal thrift institutions and their subsidiaries were relieved from having to comply with state consumer protection laws." McCoy notes that, while the rule "had little practical effect" at first, the "stakes rose" once the dangers of subprime lending became increasingly apparent in the early 2000's. Individual states began issuing anti-predatory lending laws in response to those dangers. In 2003, the OTS preempted Georgia and New York's state anti-predatory lending laws, and the OCC responded by proposing a regulation that eventually went into effect on January 7, 2004. (Patricia McCoy, "Statement before the U.S. Senate Committee on Banking, Housing, and Urban Affairs," (March 3, 2009), *available at* http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=40666635-bc76-4d59-9c25-76daf0784239, 14). Similar to what the OTS had achieved, this OCC regulation preempted "*all* state predatory lending laws… as applied to national banks" and their operating subsidiaries. As an aside, it is important to note that ensuring the safety and soundness of national banks and thrifts, protecting them from failure, was the original, congressionally-granted responsibility assigned to the OCC and the OTS. Congress never authorized either of the federal regulators to serve as consumer protection agencies (Colin Provost, "Another Race to the Bottom? Venue Shopping for Regulators in the American Financial System," 14; Nicholas Bagley, "The Unwarranted Regulatory Preemption of Predatory Lending Laws," *New York University Law Review*, Vol. 79 (December 2004), 2284; National Consumer Law Center, "Comments to the Office of the Comptroller of the Currency," (October 6, 2003), *available at* http://www.lls.edu/academics/faculty/documents/NCLCComments.pdf, 3).

[95] A former regional vice president at Chase Home Finance confessed, "If you had some old bag lady walking down the street and she had a decent credit score, she got a loan" at Chase. (Nicholas D. Kristof, "A Banker Speaks, With Regret," *The New York Times* (November 30, 2011), *available at* http://www.nytimes.com/2011/12/01/opinion/kristof-a-banker-speaks-with-regret.html). Various community organizations expressed concern that Chase Home Finance's NINA (No Income No Asset documentation) loans were "arranged by mortgage brokers whose only incentive is to close the loan," as opposed to ensuring that the borrowers could actually repay the loan in full. In response to these concerns, the OCC affirmed that it had "previously determined that the system of checks and balances, fraud detection, and audit procedures" in place at Chase were "satisfactory and provide an adequate level of protection to the bank with regard to this product." (The Office of the Comptroller of the Currency, "CRA Decision #136," (September 15, 2006), *available at* http://www.occ.gov/static/interpretations-and-precedents/oct06/crad136.pdf, 6-7. I discovered this example from: Kathleen C. Engel and Patricia A. McCoy, *The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps*, 170). By the end of 2007, Chase announced that they would no longer finance any NINA loans as part of their effort to tighten their underwriting standards, having suffered losses totaling $1.2 billion from non-performing mortgages that year. (Jeff Manning, "Chase Mortgage Memo Pushes 'Cheats & Tricks'," *The Oregonian* (March 27, 2008)).

[96] On October 9, 2012, the United States filed a civil mortgage fraud lawsuit against Wells Fargo. As the lawsuit notes, Wells Fargo had been a participant in the Direct Endorsement Lender (DSL) program since 1986. As an authorized DSL, Wells Fargo had "the authority to originate, underwrite, and certify mortgages for FHA insurance." The lawsuit alleges that between May 2001 and October 2005, Wells Fargo "certified that over 100,000 retail FHA loans met HUD's requirements and therefore were eligible for FHA insurance," while knowing that "a very substantial percentage of those loans – nearly half in certain months – had not been properly underwritten, contained unacceptable risk, did not meet HUD's requirements, and were ineligible for FHA insurance." The lawsuit claims that "the extremely poor quality" of Wells Fargo's loans "was a function of [its] management's nearly singular focus on increasing the volume of FHA originations – and the bank's profits – rather than on the quality of the loans being originated." (The United States Attorney's Office, Southern District of New York, "Press Release: Manhattan U.S.

2) Arrangers either purchased subprime lenders of their own[98] to acquire subprime mortgages or otherwise financed and purchased subprime mortgages from lenders. Incentives were in place for subprime lenders to adopt irresponsible lending practices since arrangers placed emphasis on volume and not on quality. To substantiate this latter point, it is important to note that arrangers were responsible for hiring due diligence firms to confirm that their purchased loans met the lenders' underwriting standards and procedures.[99] One would think that the rapid expansion of the subprime mortgage market in the early 2000's, accompanied by the proliferation of novel and complex mortgage products during this time, would have been sufficient for inciting arrangers to pay due diligence firms larger sums of money in order to more thoroughly scrutinize lenders' loan portfolios and borrowers' loan applications. A striking 2008 article in the *New York Times*, however, revealed that due diligence firms' reviews of mortgage

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Attorney Files Mortgage Fraud Lawsuit Against Wells Fargo Bank, N.A. Seeking Hundreds Of Millions Of Dollars In Damages For Fraudulently Certified Loans," (October 9, 2012), *available at* http://www.justice.gov/usao/nys/pressreleases/October12/WellsFargoLawsuitPR.html).

[97] Kathleen C. Engel and Patricia A. McCoy, *Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps,* 205. Nearly half of all of Washington Mutual's loan originations between 2003-2007 were Option ARMs. Roughly 70% of these loans were of the NINA variety. From 2004-2008, the OTS identified over 500 serious operational deficiencies at Washington Mutual, but permitted the lender to self-monitor how well it complied with its regulations. On September 27, 2008, Washington Mutual filed for bankruptcy protection – the largest depository bankruptcy in United States history. It had $307 billion in assets at the time. (Eric M. Thorson, "Statement Before the United States Senate Permanent Subcommittee on Investigations," (April 16, 2010), *available at* http://hsgac.senate.gov; Robin Sidel, David Enrich, Dan Fitzpatrick, "WaMu is Seized, Sold Off to J.P. Morgan, in Largest Failure in U.S. Banking History, *The Wall Street Journal* (September 26, 2008)).

[98] The biggest arrangers, Lehman Brothers, Merrill Lynch, Goldman Sachs, Morgan Stanley, and Bear Stearns, purchased subprime lenders, which afforded them the opportunity to more efficiently streamline the subprime mortgage origination process into their own securitization operations. (The Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States*, (January 2011), *available at* http://fcic.law.stanford.edu/report, 88). According to Paul Muolo and Mathew Padilla, it was a "well-kept secret" that arrangers originated their own residential mortgages because of the potential for reputational damage. (Paul Muolo and Mathew Padilla, *Chain of Blame: How Wall Street Caused the Mortgage and Credit Crisis* (Hoboken: John Wiley & Sons, 2008), 191). Lehman Brothers purchased First Alliance, Finance America, and BNC Mortgage Corp.; Merrill Lynch purchased First Franklin Financial Corp.; Bear Stearns purchased EMC Mortgage Corp. and Encore Credit Corp.; Morgan Stanley purchased Saxon Capital and Crescent Real Estate Equities; Goldman Sachs purchased Southern Pacific Funding Corp. and Senderra Funding.

[99] Kathleen C. Engel and Patricia A. McCoy, *The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps*, 45.

loans declined an average of over 80% from 1995 to 2005.[100] Arrangers had to pay due diligence firms roughly $350 for each loan that they inspected, so commissioning the firms to review less loans saved the arrangers significant sums of money.[101]

A concrete example of an arranger/lender relationship can be found in a July 5, 2011 lawsuit filed on behalf of Allstate Insurance Company against Morgan Stanley. This lawsuit contains a wealth of information on the arranger's relationship with New Century, a notorious subprime lender.[102] As the lawsuit explains, a conflict of interest came to plague the arranger/lender relationship in general, and the Morgan Stanley/New Century relationship in particular.[103] When an arranger extends a warehouse line of credit[104] to a lender, the idea is that the latter will originate loans that meet certain arranger-specified standards. As early as late-2005 and into 2006, Morgan Stanley began to realize that the quality of New Century's loans was

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[100] Vikas Bajaj and Jenny Anderson, "Inquiry Focuses on Withholding Data of Loans," *The New York Times* (January 12, 2008), *available at* http://www.nytimes.com/2008/01/12/business/12lend.html.

[101] Ibid. One should also note that the effectiveness of due diligence reviews was undermined by the dramatic increase of low- and no-doc loan originations. Without paystubs or tax returns on hand to verify a given borrower's stated income or employment history, due diligence firms could not assess that borrower's actual ability to repay the loan and, hence, whether that borrower should have been approved for the loan in the first place. Kathleen C. Engel and Patricia A. McCoy, *The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps*, 46.

[102] Bernstein, Litowitz, Berger, & Grossmann LLP, "Supreme Court of New York County of New York: Allstate v. Morgan Stanley," (July 5, 2011), *available at* http://www.lowenstein.com/files/Uploads/Documents/CapitalMarkets/Allstate%20v.%20Morgan%20Stanley%20Complaint.pdf.

[103] Ibid., 74.

[104] When an arranger extends a warehouse line of credit to a lender, the former typically gives the latter funds on a day-to-day basis for the sake of originating a desired amount and type of mortgage loans. Lenders draw on that line of credit until the arranger has determined that the number and quality of loans are sufficient for being securitized. This is a significant point because arrangers that offer warehouse lines of credit to lenders most likely have a better conception of those lenders' daily operations – and the quality of their loans – than those arrangers that merely buy loans in bulk and securitize them. As one anonymous source said about Lehman Brothers' warehouse lines of credit to lenders, "The argument would go that Lehman, as warehouse lender, would have reason to have a much greater level of knowledge about what the substance of those loans was actually like… You're giving [lenders] money basically to go out and buy assets, as opposed to merely packaging them as an agent, and selling them as bonds on the Street." Indeed, when a San Francisco-based law firm, Jenkins & Mulligan, filed a lawsuit against First Alliance in 2000 for its predatory lending practices, Lehman Brothers was listed as a co-defendant, in part because it extended a $150 million warehouse line of credit to the lender. As a result of this relationship, Lehman Brothers was accused of "having knowledge of First Alliance's fraudulent practices, and thereby tacitly or expressly approving those practices in its financing of the lending operations." (Michael Gregory, "Lehman to Take Fall for Predatory Lender," *Asset Sales Report* (May 8, 2000); Ibid., "The Predatory Lending Fracas: Wall Street Comes Under Scrutiny in the Subprime Market as Liquidity Suffers and Regulation Looms," *Investment Dealers Digest* (June 26, 2000)).

progressively deteriorating. Interestingly, when Morgan Stanley reacted by rejecting more and more of New Century's loans, the lender allegedly "began to complain to Morgan Stanley about its rejection rate… [and suggested] that it would begin to shift its business to other buyers."[105] In response to this threat, "Morgan Stanley relented in order to maintain its access to a steady flow of New Century mortgages available for securitization."[106]

From that point on, Morgan Stanley routinely purchased immense quantities of defective subprime loans from New Century for the sake of preserving their mutually profitable relationship. One former Morgan Stanley employee who had "intimate knowledge of Morgan Stanley's loan purchasing and due diligence operations"[107] stated that when the arranger would purchase loans that it knew violated its own stated policies, his team would refer to the decision as a "business decision" or "BD" for short. According to this employee, the team's use of the term "BD" was a "funny way of saying, 'Let's do something that we shouldn't'."[108]

3) Leading up to the outbreak of the subprime mortgage crisis, the three largest CRAs were confronted by an arranger demand for triple-A-ratings. In an interesting, though problematic twist, the primary *users* of credit ratings, the investors, did not compensate the CRAs for their service. Instead, it is the arrangers who pay the CRAs to produce their ratings.[109] Since the CRAs were not compensated for the accuracy of their credit ratings, but for the sheer

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[105] Bernstein, Litowitz, Berger, & Grossmann LLP, "Supreme Court of New York County of New York: Allstate v. Morgan Stanley," 69.
[106] Ibid.
[107] Ibid., 4.
[108] Ibid., 69. In a recent study, three scholars studied the "misrepresentation of asset-quality that consist of securities collateralized by residential mortgages that are originated without government guarantees (non-agency RMBS) - representing a $2 trillion market in 2007." Focusing only on two types of misrepresentations, the authors found that more than 9% of the loans that they examined were misrepresented to investors. (Tomasz Piskorski, Amit Seru, and James Witkin, "Asset Quality Misrepresentation by Financial Intermediaries: Evidence from RMBS Market," (February 2013), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2215422, 3).
[109] The arranger-pays model is still in place today.

volume of ratings that they could produce, they had an incentive to give their paying customers, the arrangers, the type of rating that they wanted most: those of the triple-A variety.[110]

The CRAs, therefore, were confronted by a dilemma in the early 2000's. Since the arrangers wanted their products to be triple-A-rated, and the CRAs were compensated by the arrangers, rating subprime-related products lower than triple-A would be tantamount to biting the hands that fed them. Arrangers were also able to "shop" for ratings, browsing to see which of the credit rating agencies would give the highest rating to their products. Similar to the regulatory race to the bottom that characterized the relationship between federal regulators and subprime lenders, the three largest CRAs competed in a ratings race to the bottom: those credit rating agencies that produced the highest, though unjustified, ratings stood to make the most money.[111]

4) Since the time that Fannie Mae and Freddie Mac each came into existence, Congress had the authority to pass meaningful housing GSE reform legislation.[112] Following the Freddie

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[110] Arrangers were enamored with triple-A ratings because once one of the "big three" CRAs gave that rating to their securities, they typically did not need to pay the other two CRAs to rate those same securities. (Bethany McLean and Joe Nocera, *All the Devils are Here: The Hidden History of the Financial Crisis* (Penguin: New York, 2010), 117). Significantly, triple-A-rated subprime securities were frequently *more profitable* for arrangers to issue because they could pay out a lower interest rate to investors on the basis that they were supposedly safer products. (Steven L. Schwarcz, "Private Ordering of Public Markets: The Rating Agency Paradox," 12).

[111] For example, a May 25, 2004 e-mail from a Managing Director at Standard and Poor's, with the subject of "Competition with Moody's," voiced concern over how they "just lost a huge Mizuho RMBS deal to Moody's due to a huge difference in the required credit level." The Managing Director learned from the arranger of the residential mortgage-backed security, the Japanese "mega bank" Mizuho, that the credit support level at Standard and Poor's "was at least 10% higher than Moody's" enabling the latter to rate the security higher (less riskier) than the former. Losing deals to competing CRAs because of "criteria issues" was, according to this employee, "so significant that… [S&P] need[s] to address this now in preparation for the future deals." ("E-mail from Yo-Tsung Chang to Joanne Rose, et al.," (May 25, 2004), *available at* http://oversight-archive.waxman.house.gov/documents/20081022120406.pdf).

[112] Since the turn of the century, Congress did, in fact, discuss possible reforms of Fannie Mae and Freddie Mac. The first bill to appear in the 2000's came from Congressman Richard Baker, who introduced H.R. 3703, the "Housing Finance Regulatory Improvement Act," on February 29, 2000. H.R. 3703 contained provisions for establishing a single regulator for Fannie Mae and Freddie Mac and also for eliminating their respective lines of credit with the United States Treasury Department. Although hearings were held discussing the bill, H.R. 3703 never made it to the House of Representatives for a vote. On July 15, 2002, Congressman Ron Paul introduced a bill, H.R. 5126, to the House Committee on Financial Services. The bill was entitled the "Free Housing Market Enhancement Act" and it sought to "prohibit the provision of Federal funds to the housing-related government-sponsored enterprises and to remove certain competitive advantages granted under law to such enterprises." This bill was referred to the House Subcommittee on Capital Markets, but it too was never voted upon, so it failed to become a law as well. (H.R. 5126, 107th Congress, 2nd session, (July 15, 2002), *available at* http://ftp.resource.org/gpo.gov/bills/107/h5126ih.txt.pdf).

Mac and Fannie Mae's accounting scandals in 2003 and 2004, respectively, Congress was in a prime position to create timely regulations that could have made the two housing GSEs safer and sounder institutions before the subprime mortgage crisis began to unfold. Yet, Congress was in an uncomfortable position when it came to regulating the two housing GSEs. Patrick Barta, writing for the *Wall Street Journal*, frames the dilemma quite well: "Do they look the other way, because of all the good that Fannie and Freddie do? Or do they rein in the companies, reducing the likelihood of future problems but also possibly driving up mortgage rates and pushing some potential homeowners out of the market?"[113]

Congressional fear of public backlash is one potential reason why the House of Representatives and the Senate failed to adequately oversee Fannie Mae and Freddie Mac. The cultural climate in America promoted homeownership not only as a good, but, by and large, as an *unassailable* good. One of Fannie Mae's slogans was "We're in the American Dream Business," while one of Freddie Mac's was "Opening the Doors to Homeownership."[114] It would be difficult to deny that Fannie Mae and Freddie Mac attempted to capitalize on the value that many Americans placed on homeownership, whether in their efforts to resist legislation that they perceived to be unfavorable or in their advertisements.[115]

A flurry of other congressional bills seeking to regulate the two housing GSEs also surfaced around the time of the Freddie Mac scandal in 2003, including H.R. 2022 (sponsored by Congressmen Christopher Shays and Edward Markey), H.R. 2803 (sponsored by Congressman Ed Royce), and H.R. 2117 (sponsored by Congressman Fortney Stark). All three bills were referred to the appropriate committees, but the House of Representatives never voted on any of them.

[113] Patrick Barta, "Critics Snipe at Freddie Mac and Fannie Mae's Over-the-Top Success," *The Wall Street Journal* (July 30, 2000).

[114] Peter J. Wallison, "Are Fannie and Freddie Meeting Their Obligations," *AEI Event on Fannie Mae & Freddie Mac* (June 9, 2003), *available at* http://www.aei.org/speech/17662.

[115] Predictably, the good of homeownership was the centerpiece of many of Fannie Mae and Freddie Mac's advertisements. In 1996, the Internal Revenue Service ruled that Fannie Mae's television advertisements, like ones featuring "families or young couples struggling with housing and credit issues," were consistent with its chartered mission of increasing homeownership. One of those advertisements depicted "a woman on a bus dreaming about the wonderful life she would have if she could afford to buy the Victorian-style home she is passing on her way downtown." Another advertisement featured "puppies gambol[ing] in the yard as families beam proudly outside new homes acquired with capital" from Fannie Mae. John Buckley, then-senior vice president of communications at

The important point is that members of Congress had a powerful disincentive to pass legislation that would have strengthened the regulation of the two housing GSEs prior to the subprime mortgage crisis: perceived popular public dissent. Acting in a way that hindered how Fannie Mae and Freddie Mac conducted business ran the risk of being perceived or portrayed as impinging upon the value of homeownership and, hence, as acting against the will of American voters. Members of Congress that made the decision to show unconditional support for the housing GSEs as they were structured before the subprime mortgage crisis likely faced few, if any, immediate negative consequences.[116]

Fannie Mae, explained that the company devotes so much money to advertising because it is "vital to us to make sure people understand that if we weren't there, there would be higher mortgage rates and a significantly less consumer-oriented mortgage finance system." (Mary Jacoby, "Critics Question Fannie Mae's Influence," *St. Petersburg Times* (July 17, 2000); Thomas Fogerty, "Critics: Fannie, Freddie Grip Mortgage Market," *USA Today* (May 21, 2002); Patrick Barta, "Fannie Mae, Freddie Mac Counter Critics," *The Wall Street Journal* (July 19, 2000)). In late 1999, Fannie Mae sponsored a series of advertisements that targeted their critics, portraying them as "a cabal of anonymous executives plotting to drive up mortgage rates." One print advertisement in particular consisted of "an overhead photo" that showed "a half-dozen people sitting around a table drinking coffee" with the caption: "Can you believe it? They're actually organizing the Coalition for Higher Mortgage costs." In another Fannie Mae print advertisement, "the critics are shown as dark silhouettes, furtively plotting to 'roll back products that cut consumers' costs'." (Patrick Barta, "Fannie Mae, Freddie Mac Counter Critics").

[116] Indeed, congressionally supporting the housing GSEs during this time was much more likely to be politically advantageous. Nicholas Kulish and Jacob M. Schlesinger mention in a 2001 article, written in the *Wall Street Journal*, how Fannie Mae won "the gratitude of politicians by staging local events with them, often to 'announce' its plans to buy local mortgages." As the two authors note, these publicity stunts were "invaluable" for the politicians, for they were able to "bask in the glow and score points with voters." Yet, the authors call attention to the strangeness of the relationship between Fannie Mae and members of Congress, as though "Ford or Microsoft could allow politicians to gain some credit with voters for every Escort or Windows package sold in their districts." One of the unique features of Fannie Mae and Freddie Mac's "product" is that politicians can publicly endorse homeownership without alienating any significant portion of voters. The near-universal American support for homeownership created a powerful incentive for members of Congress to avoid or delay investing any energy in reforming Fannie Mae and Freddie Mac in any substantial way prior to the outbreak of the subprime mortgage crisis. Former Congressman Jim Leach beautifully expressed the spirit of this point when he noted that Fannie Mae and Freddie Mac "put their power to use protecting their vested interest, and it so happens that their vested interest in large, but not complete, measure is the *public* interest." Former Fannie Mae CEO, Franklin Raines, conveyed this point even more concisely when, in describing his company, he stated, "We are what people have asked for." (Nicholas Kulish and Jacob M. Schlesinger, "Great Escape: How Fannie Mae Gave the Slip to Adversaries Seeking to Rein It In," *The Wall Street Journal* (July 5, 2001); Richard W. Stevenson, "The Velvet Fist of Fannie Mae," *The New York Times* (April 20, 1997); Patrick Barta, "Loan Stars: Why Calls Are Rising To Clip Fannie Mae's, Freddie Mac's Wings --- The Worry Is Economic Risk As They Buy Own Debt And Subprime Mortgages --- Hard to Argue With Success," *The Wall Street Journal* (July 14, 2000)).

The two housing GSEs, meanwhile, enjoyed steady profits leading up to the subprime mortgage crisis.[117] By 2008, however, concerns arose over their ability to meet its $1.2 trillion in bond obligations and $3.7 trillion in MBSs that they had guaranteed.[118] From 2008 to 2011, Fannie Mae posted a combined total of over $161 billion in losses, while Freddie Mac posted losses totaling over $90 billion.[119] At the end of 2011, the two housing GSEs held a combined $102.1 billion in risky MBSs.[120]

V. Conclusion

The product of a staggering accumulation of biased decisions over time, the subprime mortgage crisis was an avoidable outcome. With house prices on the rise and reliable profits to be earned, subprime mortgage market participants were tempted, with the aid of the general bias of common sense, to leap to the irresistible conclusion that house prices would *interminably* rise and profits could, therefore, be *inexhaustibly* mined from this historically risky segment of the market. This biased perception of the profit potential of the subprime mortgage market was the central and defective cog around which certain flawed institutional relationships were built. It

[117] Before 2006, Fannie Mae had not posted an annual loss since 1985, while Freddie Mac had not posted an annual loss since it went public in 1989. (N. Eric Weiss, "Fannie Mae's and Freddie Mac's Financial Status: Frequently Asked Questions," *CRS Report for Congress* (September 27, 2012), *available at* http://www.fas.org/sgp/crs/misc/R42760.pdf, 4). Looking at Fannie Mae's yearly profits beginning in 2001, the company announced that it had made $5.89 billion in 2001, $4.62 billion in 2002, $7.9 billion in 2003, $4.98 billion in 2004, $6.29 billion in 2005, and $4.1 billion in 2006. Freddie Mac reported that it made $4.15 billion in 2001, $5.76 billion in 2002, $4.82 billion in 2003, $2.83 billion in 2004, $2.13 billion in 2005, and $2.21 billion in 2006.
[118] N. Eric Weiss, "Fannie Mae's and Freddie Mac's Financial Status: Frequently Asked Questions," 1.
[119] Ibid., 3.
[120] Ibid., 4. This includes MBSs backed by both subprime and Alt-A mortgages. Jason Thomas and Robert Van Order maintain that they did not find "evidence that [Fannie and Freddie's] crash was due much to government housing policy or that they had an essential role in the development of the subprime mortgage-backed securities market." Nevertheless, the two scholars discovered a surge Fannie Mae and Freddie Mac's acquisition of risky loans, which they attribute to the two housing GSEs' "decision to follow the market and buy back market share lost to private label securitization of both subprime and Alt-A loans from 2003 to 2005." The riskiness of this strategy was compounded by the implicit government guarantee of their debt obligations, which enabled them to "continue borrowing at low rates despite ramping up risk." (Jason Thomas and Robert Van Order, "A Closer Look at Fannie Mae and Freddie Mac: What We Know, What We Think We Know, and What We Don't Know," (March 2011), *available at* http://business.gwu.edu/creua/research-papers/files/fannie-freddie.pdf, 1; 11)).

can be argued that the combination of group bias with general bias triggered the subprime mortgage crisis, an instance of Lonergan's notion of the longer cycle of decline, which is a process that results in the cumulative deterioration of the social situation.[121] Mass foreclosures, a disturbingly high unemployment rate, widespread wealth destruction, and a growing popular resentment of what has come to be labeled "the 1%" could all be viewed as manifestations of this distorted social situation.

[121] *Insight*, 254.