

# What Really Caused the Great Recession?

The Great Recession devastated local labor markets and the national economy. Ten years later, Berkeley researchers are finding many of the same red flags blamed for the crisis: banks making subprime loans and trading risky securities. Congress just voted to scale back many Dodd-Frank provisions. Does another recession lie around the corner?

## Overview

The Great Recession that began in 2008 led to some of the highest recorded rates of unemployment and home foreclosures in the U.S. since the Great Depression. Catalyzed by the crisis in subprime mortgage-backed securities, the crisis spread to mutual funds, pensions, and the corporations that owned these securities, with widespread national and global impacts. Ten years after the onset of the crisis, the impacts on workers and economic inequality persist. In a series of policy briefs, IRLE will highlight work by Berkeley faculty on the causes and long-term effects of the Recession. In this brief, we review research from IRLE faculty affiliate and UC Berkeley sociologist Neil Fligstein on the root causes of the Great Recession.

## What caused the banking crisis?

Fligstein and Adam Goldstein (Assistant Professor at Princeton University)<sup>1</sup> examine the history of bank action leading up to the market collapse, paying particular attention to why banks created and purchased risky mortgage-backed securities (MBSs) and collateralized debt obligations (CDOs) in the first place, and why they ignored early warnings of market failure in 2006-07.

*This brief reviews research by IRLE faculty affiliate and UC Berkeley sociologist Neil Fligstein on the causes of the Great Recession. Written by Erin Coghlan, a doctoral candidate at the Graduate School of Education at UC Berkeley, with Sara Hinkley of IRLE and Lisa McCorkell of the Goldman School of Public Policy.*

Conventional wisdom holds that the housing industry collapsed because lenders of subprime mortgages had perverse incentives to bundle and pass off risky mortgage-backed securities to other investors in order to profit from high origination fees. The logic follows that banks did not care if they loaned to borrowers who were likely to default since the banks did not intend to hold onto the mortgage or the financial products they created for very long.

Goldstein and Fligstein challenge this understanding. They find that financial institutions actually sought out risky mortgage loans in pursuit of profits from high-yielding securities (such as an MBS or CDO), and to do so, held onto high-risk investments while engaging in multiple sectors of the mortgage securitization industry. Until the early 2000s, engaging with multiple sectors of the housing industry through a single financial institution was highly unusual; instead, a specialized firm would perform each component of the mortgage process (i.e. lending, underwriting, servicing, and securitizing). This changed when financial institutions realized that they could collect enormous fees if they engaged with all stages of the mortgage securitization process.<sup>2</sup>

Large financial conglomerates including Bear Stearns, Lehman Brothers, Merrill Lynch, and Morgan Stanley became lenders of mortgages, creators of mortgage-backed securities and collateralized debt obligations (rather than outside investors), underwriters of securities, and mortgage servicers. They all also invested these securities on their own accounts, frequently using borrowed money to do this. This means that as financial institutions entered the market to lend money to homeowners and

became the servicers of those loans, they were also able to create new markets for securities (such as an MBS or CDO), and profited at every step of the process by collecting fees for each transaction.

Using annual firm-level data for the top subprime mortgage-backed security issuers, the authors show that when the conventional mortgage market became saturated in 2003, the financial industry began to bundle lower quality mortgages—often subprime mortgage loans—in order to keep generating profits from fees. By 2006, more than half of the largest financial firms in the country were involved in the nonconventional MBS market. About 45 percent of the largest firms had a large market share in three or four nonconventional loan market functions (originating, underwriting, MBS issuance, and servicing). As shown in Figure 1, by 2007, nearly all originated mortgages (both conventional and subprime) were securitized.

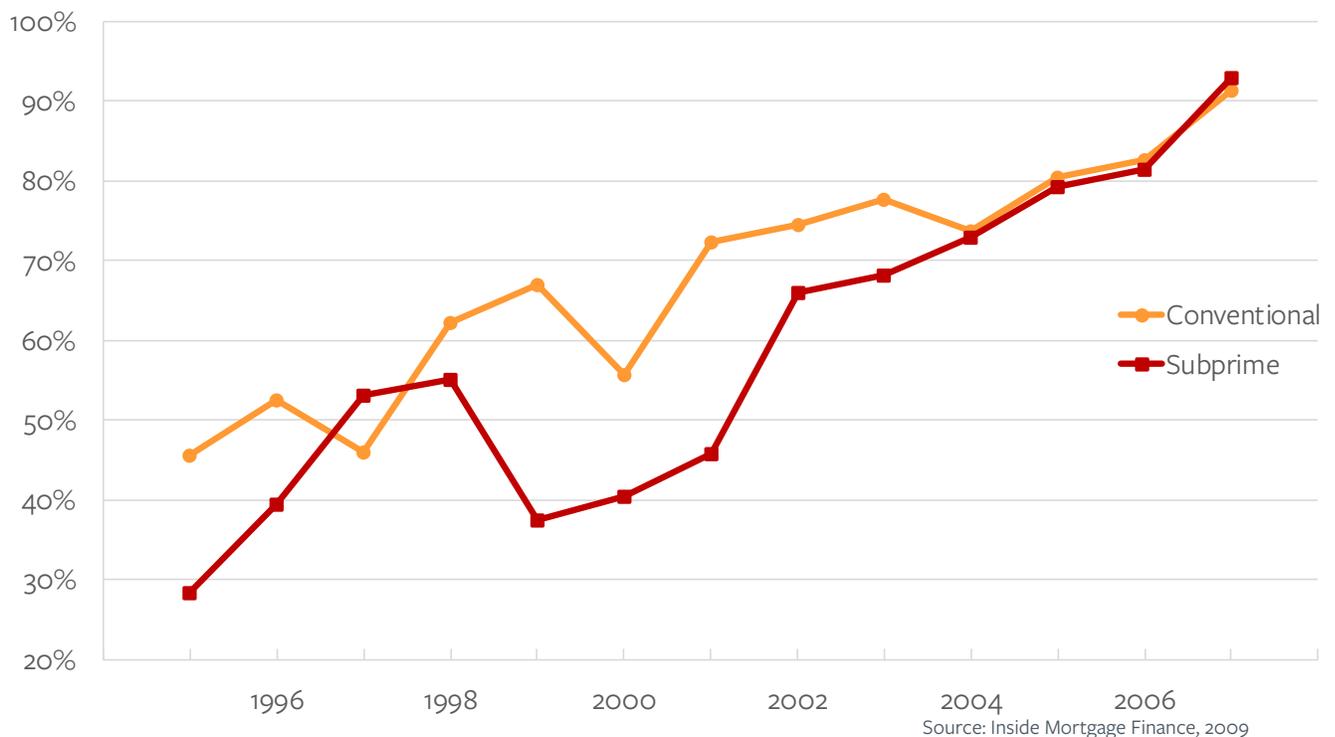
Financial institutions that produced risky securities were more likely to hold onto them as investments. For example, by the summer of 2007, UBS held onto \$50 billion of high-risk MBS or CDO securities, Citigroup \$43 billion, Merrill Lynch \$32 billion, and Morgan Stanley \$11 billion. Since these institutions were producing and investing in risky loans, they were thus extremely vulnerable when housing prices dropped and foreclosures increased in 2007. A final analysis shows that firms that were engaged in many phases of producing mortgage-backed securities were more likely to experience loss and bankruptcy.

## What caused predatory lending and securities fraud?

In a 2015 working paper, Fligstein and co-author Alexander Roehrkasse (doctoral candidate at UC Berkeley)<sup>3</sup> examine the causes of fraud in the mortgage securitization industry during the financial crisis. Fraudulent activity leading up to the market crash was widespread: mortgage originators commonly deceived borrowers about loan terms and eligibility requirements, in some cases concealing information about the loan like add-ons or balloon payments. Banks gave risky loans, such as “NINJA” loans (a loan given to a borrower with no income, no job, and no assets) and Jumbo loans (large loans usually intended for luxury homes), to individuals who could not afford them, knowing that the loans were likely to default. Banks that created mortgage-backed securities often misrepresented the quality of loans. For example, a 2013 suit by the Justice Department and the U.S. Securities and Exchange Commission found that 40 percent of the underlying mortgages originated and packaged into a security by Bank of America did not meet the bank’s own underwriting standards.<sup>4</sup>

The authors look at predatory lending in mortgage originating markets and securities fraud in the mortgage-backed security issuance and underwriting markets. After constructing an original dataset from the 60 largest firms in these markets, they document the regulatory settlements from alleged instances of predatory lending

**Figure 1. Percentage of all originated mortgages that were securitized, 1995-2007**



and mortgage-backed securities fraud from 2008 until 2014. The authors show that over half of the financial institutions analyzed were engaged in widespread securities fraud and predatory lending: 32 of the 60 firms—which include mortgage lenders, commercial and investment banks, and savings and loan associations—have settled 43 predatory lending suits and 204 securities fraud suits, totaling nearly \$80 billion in penalties and reparations.

Fraudulent activity began as early as 2003 when conventional mortgages became scarce. Several firms entered the mortgage marketplace and increased competition, while at the same time, the pool of viable mortgagors and refinancers began to decline rapidly. To increase the pool, the authors argue that large firms encouraged their originators to engage in predatory lending, often finding borrowers who would take on risky nonconventional loans with high interest rates that would benefit the banks. In other words, banks pursued a new market of mortgages—in the form of nonconventional loans—by finding borrowers who would take on riskier loans. This allowed financial institutions to continue increasing profits at a time when conventional mortgages were scarce.

Firms with MBS issuers and underwriters were then compelled to misrepresent the quality of nonconventional mortgages, often cutting them up into different slices or “tranches” that they could then pool into securities. Moreover, because large firms like Lehman Brothers and Bear Stearns were engaged in multiple sectors of the MBS market, they had high incentives to misrepresent the quality of their mortgages and securities at every point along the lending process, from originating and issuing to underwriting the loan. Fligstein and Roehrkasse make the case that the integrated structure of financial firms into multiple sectors of the MBS industry, alongside the marketplace dynamics of increased scarcity and competition for new mortgages, led firms to engage in fraud.

## Why didn't the Federal Reserve anticipate the oncoming crisis?

In a 2014 IRLE working paper by Fligstein with Jonah Stuart Brundage and Michael Schultz (both doctoral candidates at UC Berkeley),<sup>5</sup> the authors analyze 72 meeting transcripts from the Federal Reserve's decision-making body, the Federal Open Market Committee (FOMC), from 2000 until the 2008 market crash. FOMC members set monetary policy and have partial authority to regulate the U.S. banking system. Fligstein and his colleagues find that FOMC members were prevented from seeing the oncoming crisis by their own assumptions about how the economy works using the framework of macroeconomics.

### Key terms defined

- **Collateralized debt obligations (CDO)** – multiple pools of mortgage-backed securities (often low-rated by credit agencies); subject to ratings from credit rating agencies to indicate risk<sup>10</sup>
- **Conventional mortgage** – a type of loan that is not part of a specific government program (FHA, VA, or USDA) but guaranteed by a private lender or by Fannie Mae and Freddie Mac; typically fixed in its terms and rates for 15 or 30 years; usually conform to Fannie Mae and Freddie Mac's underwriting requirements and loan limits, such as 20% down and a credit score of 660 or above<sup>11</sup>
- **Mortgage-backed security (MBS)** – a bond backed by a pool of mortgages that entitles the bondholder to part of the monthly payments made by the borrowers; may include conventional or nonconventional mortgages; subject to ratings from credit rating agencies to indicate risk<sup>12</sup>
- **Nonconventional mortgage** – government backed loans (FHA, VA, or USDA), Alt-A mortgages, subprime mortgages, jumbo mortgages, or home equity loans; not bought or protected by Fannie Mae, Freddie Mac, or the Federal Housing Finance Agency<sup>13</sup>
- **Predatory lending** – imposing unfair and abusive loan terms on borrowers, often through aggressive sales tactics; taking advantage of borrowers' lack of understanding of complicated transactions; outright deception<sup>14</sup>
- **Securities fraud** – actors misrepresent or withhold information about mortgage-backed securities used by investors to make decisions<sup>15</sup>
- **Subprime mortgage** – a mortgage with a B/C rating from credit agencies. Common reasons to issue include: if the borrower has been delinquent two or more times in the last 12 months, has a low credit rating (below 660), or has filed for bankruptcy in the past 5 years<sup>16</sup>

Their analysis of meeting transcripts reveal that as housing prices were quickly rising, FOMC members repeatedly downplayed the seriousness of the housing bubble. Even after Lehman Brothers collapsed in September 2008, the committee showed little recognition that a serious economic downturn was underway. The authors argue that the committee relied on the framework of macro-

economics to mitigate the seriousness of the oncoming crisis, and to justify that markets were working rationally. They note that most of the committee members had PhDs in Economics, and therefore shared a set of assumptions about how the economy works and relied on common tools to monitor and regulate market anomalies. The meeting transcripts show that the FOMC tried to explain the rise and fall of housing prices in terms of fundamental issues of supply and demand, which was an inadequate frame to recognize the complexity of the changes taking place throughout the entire economy.

***“The fact that the group of experts whose job it is to make sense of the direction of the economy were more or less blinded by their assumptions about how that reality works, is a sobering result” (Fligstein et al., 2014, p.46).***

FOMC members saw the price fluctuations in the housing market as separate from what was happening in the financial market, and assumed that the overall economic impact of the housing bubble would be limited in scope, even after Lehman Brothers filed for bankruptcy. In fact, Fligstein and colleagues argue that it was FOMC members’ inability to see the connection between the house-price bubble, the subprime mortgage market, and the financial instruments used to package mortgages into securities that led the FOMC to downplay the seriousness of the oncoming crisis. These topics were often discussed separately in FOMC meetings rather than connected in a coherent narrative. This made it nearly impossible for FOMC members to anticipate how a downturn in housing prices would impact the entire national and global economy.

## Conclusion

When the mortgage industry collapsed, it shocked the U.S. and global economy. Had it not been for strong government intervention, U.S. workers and homeowners would have experienced even greater losses.

Observers are raising the alarm that many of the practices prevalent in 2006-2007 are making a comeback. Banks are once again financing subprime loans, particularly in auto loans and small business loans.<sup>6</sup> And banks are once again bundling nonconventional loans into mortgage-backed securities.<sup>7</sup>

More recently, President Trump rolled back many of the regulatory and reporting provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act for small and medium-sized banks with less than \$250 billion in assets.<sup>8</sup> Legislators—Republicans and Democrats alike—

argued that many of the Dodd-Frank provisions were too constraining on smaller banks and were limiting economic growth.<sup>9</sup>

This new deregulatory action, coupled with the rise in risky lending and investment practices, could create the economic conditions all too familiar in the time period leading up to the market crash. Fligstein and his co-authors suggest several options to avoid another disaster:

- Regulators should work to have a variety of perspectives in the room to help avoid another large-scale crises: e.g. include other backgrounds on the FOMC
- Restructure employee compensation at financial institutions to avoid incentivizing risky behavior, and increase regulation of new financial instruments
- Task regulators with understanding and monitoring the competitive conditions and structural changes in the financial marketplace, particularly under circumstances when firms may be pushed towards fraud in order to maintain profits.

### How bad was the Great Recession?

- The U.S. unemployment rate peaked at 10 percent in October 2009; rates were higher for African Americans (roughly 15 percent) and Hispanics (roughly 12 percent)<sup>17</sup>
- Of those unemployed, nearly half were unemployed for 27 weeks or more<sup>18</sup>
- The construction and manufacturing industries experienced double-digit losses in employment from December 2007 to June 2009<sup>19</sup>
- Between the onset of the crisis in December 2009 through its end in June 2009, real GDP fell roughly 4.3 percent<sup>20</sup>
- During the first quarter of 2009—the lowest point of the Recession—over 230,000 U.S. businesses closed<sup>21</sup>
- From 2007 to 2012, more than 450 banks failed across the country<sup>22</sup>
- Between 2006 and 2014, over 16 million homes foreclosed in the U.S., with nearly 3 million foreclosures each year at the peak of the crisis in 2009 and 2010<sup>23</sup>

## FEATURED RESEARCH

Fligstein, N., Brundage, J. S., & Schultz, M. (2014). Why the Federal Reserve failed to see the financial crisis of 2008: The role of “macroeconomics” as sense-making and cultural frame. IRLE working paper #111-14. <http://www.irle.berkeley.edu/files/2014/Why-the-Federal-Reserve-Failed-to-See-the-Financial-Crisis-of-2008.pdf>

(Subsequently published as “Seeing like the Fed: Culture, Cognition, and Framing and the Failure to Anticipate the Financial Crisis of 2008 [with Jonah Stuart Brundage and Michael Schultz]. *American Sociological Review*, 82: 879 – 909, 2017.)

Fligstein, N. & Goldstein, A. (2014). The transformation of mortgage finance and the industrial roots of the mortgage meltdown. IRLE working paper #133-12. <http://www.irle.berkeley.edu/files/2012/The-Transformation-of-Mortgage-Finance-and-the-Industrial-Roots-of-the-Mortgage-Meltdown.pdf>

(Subsequently published as “Financial markets as production markets: the industrial roots of the mortgage meltdown” (with Adam Goldstein). *Socio-Economic Review*, 15: 483–510, 2017.)

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(Subsequently published as “The Causes of Fraud in Financial Crises: Evidence from the Mortgage-Backed Securities Industry” (With Alex Roehrkasse). *American Sociological Review*, 81: 617 – 643, 2016.)

## NEXT IN THIS SERIES

This is the first of a series of policy briefs featuring IRLE faculty research on the Great Recession. The second brief will review employment and wage trends during and since the Great Recession. The third will explore the effects the downturn had on family life and well-being, and the fourth will look at strategies for regulating the recovery.

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Series editor: Sara Hinkley, Associate Director of IRLE.

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- 2 Fees can be charged when loans are disbursed to a homebuyer, when the mortgage is sold to a wholesaler or issuer, and when the loan is turned into a mortgage-backed security (MBS). Fees may also be collected when underwriting the MBS deal, selling the MBS to an investor, and servicing loans part of the MBS. For more information, see: Fligstein, N. & Goldstein, A. (2014).
- 3 Fligstein, N. & Roehrkasse (2015). The causes of fraud in the financial crises: Evidence from the mortgage-backed securities industry. IRLE working paper #122-15. <http://www.irlle.berkeley.edu/files/2015/The-Causes-of-Fraud-in-Financial-Crises.pdf>
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