

Living in a Bubble

How Speculative Mania in
Home Mortgages Underwrote
the Great Recession

Roger Lowenstein

Market crashes are inevitably followed
by rounds of fingerpointing.

Who was responsible and what went wrong?

The crash of 2008 was no exception.



Even in the terrible week in which Lehman Brothers failed and AIG was forced to seek a bailout, the second-guessing began. Then and in the ensuing months, the commentary focused on the government's response *during* those fateful days. Was the Treasury Secretary, Hank Paulson, right to have bailed out Bear Stearns in the spring of '08? Should he have bailed out Lehman, too? Did AIG get off too easy?—and so on. This emphasis suggested that “Lehman week” was *the* pivotal moment. Even the headlines that followed shortly after—“The Weekend That Wall Street Died,” “Three days that shook the world,” “Eight Days That Shook the World,”—suggested that Wall Street might have avoided its dying or shaking had only it been better managed during the third week of September. My own view was identical, and varied only in its designation of *six days* as the critical period. (The initial title for the book that now appears as *The End of Wall Street was Six Days that Shook the World*.)

However, as I began to research the Street's debacle, starting in late September, events did not oblige. History continued to unfold: banks kept failing, markets trembling, governments intervening, and in seemingly ever-larger doses. If the pivotal period had passed, why was Wall Street, and for that matter the world, still feeling the shakes?

Two remedies suggested themselves. The first was to update the title, and perhaps my hypothesis, as events warranted (thus *Six Days That Shook* could yield to *Three Weeks* of shaking, then *Three Fortnights*, and so forth). The other was to assume that everything that followed Lehman—the runs on preeminent banks such as Washington Mutual and Wachovia, the credit freeze of October, the near-collapse and rescue of Citigroup, the bankruptcy of most of the American auto industry, the leveling of the American workplace in the Great Recession, the sickening and seemingly endless drop in the stock market, and the epochal responses of the federal government—were triggered, even “caused,” by Lehman’s demise. This put a heavy burden on Sept. 15, the day that Lehman failed.

As I researched more, I decided that the trouble with loading all onto Lehman week was not that so much followed Lehman, but that so much preceded it. By Sept. 15, 2008 the U.S. housing market, the singular driver of the U.S. economy, had utterly collapsed. Home prices had been falling nationwide for nine consecutive quarters. The rate of mortgage delinquencies, for both subprime loans and conventional mortgages, had, over the preceding three years, trebled. In August, the month before Lehman failed, 303,000 homes were foreclosed on (up from 75,000 three years prior), and in the week before Lehman, the Feds had seized both Fannie Mae and Freddie Mac, the mainstays of the mortgage industry.

The crisis in subprime mortgages had been percolating for more than a year—granted the regulators did not give it their proper attention—and the leading purveyors of such mortgages, having started to tumble early in 2007, were all, by the following September, either defunct, seized, acquired, or on the seriously critical list. Also, the subprime mortgage crisis had fully bled into Wall Street. Literally hundreds of billions of dollars of mortgages had been carved into exotic secondary securities, which had been snugly (or so it had been reckoned) stored on the books of the leading Wall Street banks, not to mention in investment portfolios around the globe. By September 2008, these securities had collapsed in value—and with them, the banks’ equity and stock prices. Goldman Sachs, one of the *least*-affected banks, had lost a third of its market value, Morgan Stanley had been cut in half.



Moreover, the Wall Street crisis had bled into Main Street. Total employment had fallen by 1.1 million jobs *before* Lehman toppled (if one assumes that September's job losses were unaffected by an event in mid-month, the total rises to nearly 1.5 million). Steel, aluminum and autos were all contracting. The National Bureau of Economic Research would conclude that the recession began in December 2007—no less than nine months prior to the fateful days of September.

So if by September of '08 the cake were nearly baked, the roots of the crisis were germinated long before. Among the causes were low interest rates, an incompetent and corrupt credit-rating industry, a blank check from the government for Fannie Mae and Freddie Mac, which led to distortions in the housing market, leverage on Wall Street, regulatory neglect. The interplay of these factors forms the meat of *The End of Wall Street*. It also forms the essential backdrop to the deliberations in Congress, as it tries to reform the U.S. financial system. In a short adaptation such as this, I won't assign precise weightings to these various causes. But I would like to pinpoint the one area where the trouble began. It started with a massive bubble in home mortgages—the type of speculative mania that we have seen many times, and yet whose magnitude this time has, I think, not been fully appreciated.

Many Americans remember the frothiness of the dot.com bubble, when scores of Internet companies, soon to be proven worthless, briefly made billionaires of their twenty-something founders. But the delusions that developed during the mortgage bubble were equally fantastic. The bubble began at the dawn of the 21st century, and fed off the elixir of ultra-low interest rates. Low rates had been orchestrated by the Fed chairman, Alan Greenspan, with the steadfast support of his then-fellow Fed governor, Ben Bernanke. With credit cheap, Americans flocked to refinance their homes and to bid up the prices of new ones. This much was predictable. But the mortgage boom of the early 2000s was unlike others. A wave of unorthodox lenders sought to lure customers whose credit was judged to be less than prime—that is, subprime. These eager lenders were hailed as suburban Johnny Appleseeds, planting a mortgage in every backyard. Instead of a mere boom, they incited a social upheaval, much as did the dot.com promoters a decade earlier.

To appreciate the magnitude of the bubble—the sheer irrationality of the loan origination mechanism—it will help to focus on a particular player. Angelo Mozilo, the cofounder of the California lender Countrywide Financial, was emblematic of the breed. Mozilo was an archetypal promoter, part visionary, part super-salesman. Son of an Italian immigrant, he answered to a distinctly American yearning for a capitalism that was democratic and (supposedly) high-minded. Thus, he stated, “Expanding the American dream of home ownership[will] make our country a better place.” Indeed, he preached that *every* American was entitled to a mortgage—even those who could not put money down. However alluring, the notion of purchasing a home without making any investment was a capitalism stripped of its fundamental truth—that one needed capital to pursue it.

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Born in the Bronx, Mozilo had started in mortgages at age 14, when he left his father’s butcher shop to work as a messenger at Lawyers Mortgage and Title in Manhattan. He worked there while attending night school and, after paying his dues, cofounded Countrywide in 1969. Mozilo came to understand, better than most, that the mortgage industry was evolving in one key respect. By the 1980s and ‘90s, Wall Street was acquiring many of the mortgages that lenders originated. This opened vast new possibilities. No longer did a lender have to hold a mortgage for 30 years; now, it could package the loan to Fannie Mae—or even to Lehman Brothers—and recoup its capital overnight.

This affected a subtle change of the lender's assessment of the risks. They did not overly worry about whether their mortgages were sound, since loans (or so they believed) could always be sold or refinanced. By turns, they came to believe that no matter how *unsound* a mortgage customer was, some other party would always bail them out. Lenders thus succumbed to the theory of the greater fool.

By the early 2000s, Mozilo and Countrywide were making it happen: homes with no money down, that is, 100% financing. So were a bevy of competitors. In the hothouse environment of the mortgage bubble, lenders outdid each other to lessen standards and push money out the door. By far the riskiest of their products was the option ARM, an appealingly affordable mortgage with a diabolical twist. Borrowers had the option of reducing their monthly payments at will—though their loan balances, of course, would necessarily rise. Thus, instead of steadily reducing their indebtedness, as in traditional mortgages, the homeowner was month after month sinking deeper into the morass. It was typical to see the interest rate on option ARMS start at 4% and jump to something like 9%, meaning that the payment would double. Some loans began with teaser interest rates of as low as 1%. Customers started with monthly payments of \$125 a month—subject, after the first year, to an astronomical leap to \$876 a month. Countrywide brokers were incentivized to peddle such loans with free trips for volume producers to Las Vegas and Hawaii. They were trained to court customers with a seductive pitch, beginning, “I want to be sure you are getting the best loan possible.” In fact, brokers sold whatever was their highest-commission product—even when it left the borrower short of funds for food and clothing.

Countrywide—whose practices, again, were replicated by much of the industry—also relaxed the terms for granting “stated” loans, on which borrowers stated their income but were not asked to document it. It was widely believed among the staff that stated borrowers brazenly lied (employees referred to these loans as “liar loans”). But underwriters were discouraged from scrutinizing their applications. A company manual stated plainly, “We always look for ways to make the loan rather than turn it down.” It is hard to escape the conclusion that Countrywide preferred not to know.



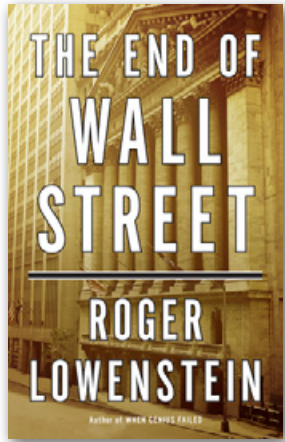
Underwriters believed they were supposed to “paper the file” to give the appearance of scrutiny. This paper trail was necessary for Countrywide to sell the loan in the secondary market—and as long as the loan could be sold, its mission was fulfilled. In one case, a borrower applied for a jumbo loan for what was purportedly a primary residence. A Countrywide trainee, not yet versed in company procedures, pointed out that the borrower also owned three other homes, all of which were financed by Countrywide as well. Perhaps they should check to see if this residence were truly “primary”? The supervisor shot the suggestion down, noting “We don’t try to investigate.”

Remarkably, customers who had been rejected after documenting their income were urged to re-apply, this time on a no-doc basis. Accord to former employees, Countrywide loan officers would assist them—in short, coach them to lie—whereupon the loans were approved. One highly productive loan officer in Massachusetts simply cut and pasted files from the Internet to concoct a fraudulent verification of an applicant’s employment.

Dishonest homebuyers were, of course, as culpable as lenders. If the mortgage bubble was pushed forward by the lenders (Countrywide and others), it was pulled ahead by individual customers, who greedily chased credit like a narcotic, often for the purpose of buying multiple homes (with little or no money down) and quickly flipping them. Conferences on how to buy real estate with little or no money down drew audiences of thousands. Books with titles such as “Real Estate Debt Can Make Your Rich” assaulted the best-seller lists. With prices rising at double-digit rates, people bought homes as they had once bought stocks—not to live in but to trade. Larry Pitkowsky, a mutual fund manager, discovered this on a mission to investigate a new housing development in South Jersey. Waiting on line at a Dunkin’ Donuts, he asked the woman at the counter if she had heard of the “Royal Oaks” development. A man in line interjected, “I know the place; I own three units.” Pitkowsky was learning that people were buying multiple units—not, of course, to live in or even to own for any length of time, but to flip.

From Jersey to New England and west to California, home prices became divorced from incomes—that is, from what buyers could truly afford. This was the basis of bubble. Regulators such as Bernanke knew that housing eventually would cool, yet they were anything but prepared. He and others predicted that home prices would taper off while the economy, overall, continued to grow. Why were they so wrong? Why, when the bubble burst, did Wall Street crash and, indeed, why was the ordinary economy made to suffer the worst recession in 75 years? The answers are inextricably bound in the fact that mortgages, as we have seen, weren't kept by the lenders but were, rather, bundled into securities and sold to banks and institutions throughout the financial economy. To simplify (grossly), when mortgages crashed, Wall Street and the entire financial economy crashed. In the book, I dwell on this dynamic, and in particular on the dramatic, and calamitous, weeks of September and October '08, when big banks nearly all toppled or came close to toppling. As gripping as that story is, we should remember that the crash of '08 was not a creature of Wall Street or high finance alone. Its origins lay in a speculative mania in a market (home mortgages) familiar to most every American. It lay, that is, in stupendously irrational loans by lenders, buttressed by greed (and fraud) on the part of many borrowers. Put differently, while officials in government neglected to regulate and made many mistakes, and while the authorities' handling of the various bank crises was inconsistent, the original sin was committed in private markets. No official made lenders lend or borrowers borrow. Ultimately, private markets failed. Indeed, they were swept up in a bubble of historic proportion. This should not be forgot in the debates on financial reform underway now. **Given the failure of the private market, it is unlikely that merely returning markets to private control will avoid such trouble in the future.** 📖





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Roger Lowenstein, author of the bestselling *Buffett: The Making of an American Capitalist* and *When Genius Failed: The Rise and Fall of Long-term Capital Management*, reported for the *Wall Street Journal* for more than a decade and wrote the Journal's stock market column "Heard on the Street" and also its "Intrinsic Value" column. He now writes for the *New York Times Magazine* and Bloomberg. He lives in Newton, Massachusetts.

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