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Recommended Citation

Moss, Robert A. III. (2018). How America Permitted the Great Recession. In *BSU Honors Program Theses and Projects*. Item 421. Available at: https://vc.bridgew.edu/honors_proj/421

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How America Permitted the Great Recession

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Submitted in Partial Completion of the Requirements for
Commonwealth Honors in Accounting and Finance

Bridgewater State University

December 20, 2018

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Many people have thrown out many ideas as to how the Great Recession happened. Some blame the banks, some blame the system, and others blame the lawmakers. The truth is much more complicated, and many different events lined up to make it happen. The essential fact is that there would likely have been a recession in the 2000s as a result of the commodities price recession of the 90s. What made the recession bad enough to be called the Great Recession was the gradual de-regulation that occurred after Glass-Steagal. Primarily, this paper will deal with the laws surrounding the banking and finance industry, as these are the controls on how finance is managed in the country and how America permitted the Recession to happen, with a couple of moments to define key elements of the workings of how this is going on.

The Great Recession was an economic collapse triggered by the collapse of the housing market. A restrictive monetary policy triggered a recession in 1990, which lasted almost a year.¹ This caused a drop in prices for the rest of the 90s, causing consumers to buy larger and larger amounts of goods. In response, businesses expanded to match the new supply needs. In time, this would simply have balanced itself out with a minor recession. However, at the same time, the government was pushing to get families, especially lower income families, to buy homes. This combined with low interest rates in the 2000s caused a rapid swelling of the housing market, with financial institutions and investors putting large amounts of money into land. Consumers borrowed freely from the value of the house, and continued to purchase, creating a bubble. Eventually, like all bubbles, the housing market collapsed, taking all the investments to disappear.

The road to greatness started in 1927 with the McFadden Act. Most people know the McFadden Act for making the Federal Reserve permanent and granting the Federal banks the ability to open branch banks and subsidiaries according to the laws of the individual state.² It also imposed limits on branch

¹ "1990-92 Early 1990s Recession."

² "McFadden Act of 1927."

banking that would be removed in the Riegle-Neal Act of 1994.³ What few people know is that the McFadden Act also allowed banks to invest in real estate.⁴

Banks have been able to, and have been, investing in real estate since 1927 as this clause was never repealed or altered. This is where mortgages and commercial development loans come from; before this clause, only standard (not land secured) loans could be issued for these scenarios. Once this clause was passed, the land could be used as a security for the loan, thereby allowing mortgages and commercial development loans to become easier to get, as land was seen as a “sure thing”. The McFadden Act also allowed banks to make larger loans to corporations, which included commercial development loans.⁵

It is important to take a moment to explain loans. In brief, a loan is an amount given by the lender to the borrower. The borrower must repay the money given as well as some extra. The extra is known as interest, the “profit” of the loan for the lender, and the motive for lending in the first place. Loans are typically paid back in monthly payments, which usually consist of two parts: the interest and the amortization, which is the payment of the original borrowed amount, called the principal.

As decades of perfectly fine land-secured loans prove, this is not a substantial problem. Banks rarely directly invest in land, just make loans secured by land, and generally the ability to secure a loan using land or other real estate works as intended. However, a few other laws were passed that made this dangerous. The first was the Community Reinvestment Act (henceforth shortened to the CRA) of 1977. This law required banks to list in what neighborhoods loans were being given, and for a certain

³ “McFadden Act of 1927.”

⁴ Ibid

⁵ Ibid

amount of a bank's loans to be to subprime borrowers or neighborhoods. This is still used today to pressure banks to provide mortgages to subprime borrowers.⁶

It is important to briefly define what a subprime borrower is; a subprime borrower is typically borrower with a bad credit history.⁷ The CRA expanded this definition to include borrowers who make only 80% or less of the median income of the area in which the borrowers live. As a brief example, low-income households in America in 2000 were defined as making \$17,603 or less, unless the household was over eight people, in which case the low-income definition amount was \$35,060.⁸ In other words, a family making less than \$20,000 a year could qualify for a loan of tens of thousands of dollars. If banks failed to comply with the CRA and failed to provide a sufficient number of subprime loans, there were heavy consequences, from large fines to an acquisition or merger being blocked.⁹ Thus, numerous banks were willing to lend to subprime borrowers even if the likelihood of default was high, should the numbers not be high enough for the CRA.

The pressure to offer mortgages to subprime borrowers was not heavy until the 1999, when Fannie Mae demanded that banks not practice red lining, or refusing mortgages based on area.¹⁰ The reason red lining happened originally was because some areas were more hazardous based on the people living in that area. Hazardous neighborhoods were defined as having either a large minority, poor population or having older houses. After some equality laws were passed, hazardous areas were redefined as areas with low income or older housing. When Fannie Mae demanded the cessation of redlining, banks now had pressure to lend to high-risk borrowers, which normally is very risky.

⁶ *The Fed - Money Stock and Debt Measures - H.6 Release*

⁷ "What Is Subprime Borrower? | LendingTree Glossary."

⁸ "A Profile of the Working Poor, 2000."

⁹ *The Fed - Money Stock and Debt Measures - H.6 Release*

¹⁰ "How Subprime Mortgages Helped Cause a Crisis."

To resolve this risk, Fannie Mae and Freddie Mac offered to buy all subprime mortgages,¹¹ to the extent of issuing debt to purchase the mortgages.¹² Even private investment companies were frequently willing to buy and pool these mortgages.¹³ Banks were perfectly willing to sell these mortgages to Fannie Mae and Freddie Mac, as then the risk was shifted to Fannie Mae and Freddie Mac. Further, the sale of the mortgages was almost pure profit for the banks, especially as the high interest rates on the subprime mortgages made these mortgages sell at a premium. The combination of pressure to give subprime mortgages and the combined removal of the risk and payment for these mortgages made banks sloppy about giving out mortgages.¹⁴

Of course, subprime mortgages must start with low payments to help qualify these borrowers, and thus adjustable rate mortgages (ARMs) were heavily used. With an adjustable interest rate banks could start the borrower low and then increase the interest rate each year, eventually compensating for the risk. The problem with is that the low initial payments on most ARMs can cause the payment to increase when the interest goes up. Considering the already high risk of default, this would eventually cause many subprime borrowers to become unable to pay the monthly payment and default. This is highly risky, but as mentioned earlier, these subprime mortgages were pooled with prime mortgages to mitigate the risk.

Fannie Mae and Freddie Mac pooled these subprime mortgages with prime mortgages and securitized these pools by selling securities based off the payments received from these pools.¹⁵ The reason for pooling the mortgages was twofold: first, the likelihood of all the mortgages of a pool failing at the same time was considered highly improbable. These securities were actually rated according to

¹¹ "How Subprime Mortgages Helped Cause a Crisis."

¹² "Subprime Mortgage Crisis."

¹³ "How a 'Perfect Storm' Led to the Economic Crisis."

¹⁴ "How Subprime Mortgages Helped Cause a Crisis."

¹⁵ "Subprime Mortgage Crisis."

the risk of the prime mortgages.¹⁶ This allowed the securities formed from the pools to be considered low-risk. The second reason for the pooling was allowing for securities to be generated.

The ability of banks to purchase stocks and securities was a result of the Financial Services Modernization Act (or the Gramm-Leach-Bliley Act, which will be shortened to FSMA) of 1999.¹⁷ Gramm-Leach-Bliley repealed Glass-Steagal¹⁸, the primary point of Glass-Steagal being to prevent banks from investing in stocks and securities.¹⁹ This was a reaction to the Great Depression, which was caused, in short, by the collapse of the stock market bubble.²⁰ The repeal of Glass-Steagal once again allowed banks to purchase securities, including those formed from the pooled subprime mortgages that were being created by the banks. Banks were even permitted to borrow money from the Federal Reserve to invest with, including stocks and securities,²¹ and get a tax credit.²² Besides repealing Glass-Steagal, it also allowed banks, trading companies, and insurance companies to form conglomerates known as financial holding companies (FHCs).²³ While banks had been involved with insurance and security underwriting through subsidiaries even under Glass-Steagal,²⁴ Gramm-Leach-Bliley allowed banks to become members of a holding company that could own banks, investment banks, and insurance companies.²⁵ The express intent of passing the FSMA was to make mortgages easier to acquire for would-be homeowners, and now conglomerates could profit off of the insurance sold to the subprime mortgages as well as the mortgages directly, and further to invest in the mortgage backed securities.²⁶

¹⁶ "Subprime Mortgage Crisis."

¹⁷ "Financial Services Modernization Act of 1999, Commonly Called Gramm-Leach-Bliley."

¹⁸ "Banking Act of 1933 (Glass-Steagal)."

¹⁹ Ibid

²⁰ *Great Depression History*

²¹ *To Promote Prosperity: US Domestic Policy in the Mid-1980s*, pg. 261

²² Ibid pg. 279

²³ "Financial Services Modernization Act of 1999, Commonly Called Gramm-Leach-Bliley."

²⁴ "Banking Act of 1933 (Glass-Steagal)."

²⁵ "Financial Services Modernization Act of 1999, Commonly Called Gramm-Leach-Bliley."

²⁶ Ibid

Why were these securities so popular among investors? In order to justify a lender taking a risk on a subprime borrower, a higher interest rate is charged. This is to allow the lender to make as much profit as possible in case of default. However, these low-income borrowers would normally not be able to qualify for mortgages, especially with these higher interest rates, so banks relied on adjustable interest rates. Once the mortgages are sold, pooled, and securitized, the increasing interest rates of the mortgages ensured high payments to the investor, in a similar vein as stock dividends, but even safer because it was land. The prime mortgages were theoretically strong enough that even should the subprime mortgages in a pool fail, the securities would only pay out a bit less.

Another reason these subprime mortgages were popular was the housing boom of the early 2000s. Housing prices increased drastically in the first half of the 2000s, caused by the ease of many families in acquiring mortgages, as discussed earlier. This encouraged investors to invest heavily in real estate with the idea that these investments would result in major profits. Homeowners would even take out second mortgages on the property to acquire more money to either invest with or splurge on luxuries.²⁷ Before the end of the decade, the gradual increase in interest would cause increasing amounts of the subprime mortgages to collapse via inability to make the payments.²⁸ Due to the law of supply, this caused housing prices to drop, making the security for other mortgages drop in value and causing those mortgages to collapse, and the cascade continued even into prime mortgages.

Why did the interest rate increase so dramatically? Because of a side effect of making loans. Each time a loan is created, that much money enters the economy. Again, according to the law of supply, the more money created, the less valuable it is. This is known as inflation, and interest is changed by the Fed to reflect that. The higher the inflation, the more interest must rise to keep investments paying out the same value. A side effect of raising the interest rate, however, is the

²⁷ "What Caused the Mortgage Crisis?"

²⁸ "First Republic: Historical Interest Rates."

increased cost of loans, including mortgages. This is particularly a problem with adjustable rate subprime mortgages, as the interest rate on these mortgages continuously climbed from 2001 to 2006, from 1% to 5%.²⁹

Why did banks want to provide these subprime mortgages as opposed to other sources of income? Besides the “easy” profits to be made from the previously mention system surrounding subprime mortgages, the primary reason banks turned to loans in general was Regulation Q. Regulation Q was a part of Glass-Steagal and prohibited banks from offering interest on checking accounts.³⁰ Unlike the rest of Glass-Steagal, Regulation Q was not repealed with FSMA.³¹ This drove potential funds away from the banks and into investments that would either make money or at least counter inflation. This forced banks to look for other ways of acquiring funds, which made loans the only option for income, at least under Glass-Steagal.³² While eventually banks were permitted to create other types of accounts that did offer interest in 1986,³³ it was only in 2011 that Regulation Q was repealed by the Dodd-Frank Act.³⁴

Why is land considered such a safe investment, to the point of throwing so much money into it? There are a few reasons. First, land itself is a physical thing, unlike most investments that are not, such as bonds and stocks which diversifies the portfolio.³⁵ Second, land can be insured, which is something that cannot be done with most other investments (such as homeowners insurance).³⁶ Third, land is a permanent fixture and will always exist, even if other investments cease to do so.³⁷ This in turn makes

²⁹ “First Republic: Historical Interest Rates.”

³⁰ “Banking Act of 1933 (Glass-Steagall).”

³¹ “Financial Services Modernization Act of 1999, Commonly Called Gramm-Leach-Bliley.”

³² “Banking Act of 1933 (Glass-Steagall).”

³³ *To Promote Prosperity: US Domestic Policy in the Mid-1980s*

³⁴ “Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.”

³⁵ “Why Real Estate Investing Is the Safest Investment Option | Mashvisor.”

³⁶ “5 Reasons Why Real Estate Is a Great Investment.”

³⁷ “Why Land Is One of the Safest Places to Invest Money.”

the real estate market considerably more stable than other investments, at least most of the time. These are the three main reasons. A few other reasons are that the value of land tends to outpace inflation, making land a great shield against inflation.³⁸ Further, if the investor already lives somewhere, the land could be rented out, providing a regular source of income.³⁹ Finally, land value never drops to zero, and usually comes with tax benefits.⁴⁰

The reason land normally increases in value over time is the increase in demand from a growing global population and the limited supply of land on Earth. Even if the value of land temporarily drops, it will eventually recover. The main problem with this particular idea is that should land drop far enough, then homeowners are now saddled with a large loan which is essentially no longer secured. If this happens on a large enough scale, a large quantity of mortgages can collapse, leaving the finance industry with a lot of useless mortgages on hand, and a lot of money simply gone as mortgages have to be written off as being uncollectable.

What does all this have to do with the Great Recession directly? To summarize, it began with the housing boom of the early 2000s. This boom was directly caused by the creation of the CRA encouraging the creation of subprime loans. To offset the risk and get banks on board, Fannie Mae and Freddie Mac bought and pooled the mortgages, then sold the securities, thereby distributing the effects of the crash to investors of all kinds from all over the globe. It was foreign investing in these securities that made the Great Recession impact the rest of the world as strongly as it did, rather than simply through the ripple effect of intertwined economies.

Banks would normally be immune to this risk, except the repeal of the Glass-Steagal allowed banks to invest in securities again. Because the mortgage pools offered the highest returns, naturally

³⁸ "Why Real Estate Investing Is the Safest Investment Option | Mashvisor."

³⁹ Ibid

⁴⁰ "5 Reasons Why Real Estate Is a Great Investment."

banks invested in these securities. To encourage the creation of more securities, the banks created more and more subprime mortgages. This caused inflation, which drove up the interest rates. This made the securities pay out more as the interest rates from the mortgages these securities were based on grew. Because these securities were paying out more dividends, these securities became even more popular, fueling more subprime loans.

This continued until house prices began to drop. The prices on housing dropped for two reasons: gradually decreasing demand as people were buying houses, and the large amount of construction across the country in efforts to capture some of this escalating housing market.⁴¹ This construction was funded by banks with commercial investment loans, essentially a prime mortgage to a business for developing a property. Eventually, the amount of property available exceeded the demand for property, and prices began dropping. When borrowers started defaulting due to the escalating interest rates on the ARMs, the banks could not sell the property to recoup the losses. Banks, and the related institutions bonded to banks by FHCs, began bleeding money, and stopped lending to each other and to business. Without cash flow, the economy ground to a halt, triggering the Recession of 2008-2009.

But why did this housing market collapse take the entire economy with it? America has had other housing crashes before that did not destroy the economy. Well, a combination of factors besides the housing market were in effect in the preceding decade. First, a minor recession in 90 and 91 dropped the prices of goods.⁴² The economy began recovering, but it was only in the early 2000s that business began to expand, due to the low interest rates early in the decade. Businesses expanded more than would be normal for a recovery, however, because people were buying more due to taking out mortgages based on the rising housing prices.

⁴¹ The Supply Side of the Housing Boom and Bust of the 2000s”

⁴² “1990-92 Early 1990s Recession.”

When consumers stopped spending because of the collapse of the housing market, all that previous expansion meant excess supply. This dropped prices and left a lot of the expansion of the past decade or so useless. These locations were shut down, causing a sharp rise in unemployment as the workers were “let go” as the term was at the time. This triggered less consumer spending, as people began saving in case of being “let go”, or already had been and could not afford to spend except when necessary.

The Great Recession should not have been so great. Economies function in cycles: first there’s a rise, then a fall. A fall in 1990 meant a rise throughout at least the rest of the decade before falling again. The reason the Great Recession occurred was through de-regulation and new policies. America has consistently had economic problems whenever banks are permitted to invest in stocks and securities: the Great Depression, the recession in the 90s, and the Great Recession are all linked by a common factor. That factor is banks were heavily investing in stocks and/or securities at the time. The creation of the CRA encouraged the creation of subprime mortgages. The promise of money for these mortgages and pooled securities from Fannie Mae and Freddie Mac encouraged banks to provide a glut of these mortgages.

Most deadly of all, however, is the belief that land will always appreciate. It was this belief that drove numerous investors, banks especially, to invest in the mortgage backed securities. The core of the belief is not wrong; land is guaranteed to appreciate, but that guarantee is exclusively for the long-term. Land still contains risk, of the short-term variety, as the Great Recession proves. But if Glass-Steagal was never repealed, banks would not have had a motive to create as many subprime loans as possible, as the banks would not have been able to invest in the profits of the very product that the banks were selling; subprime mortgages.

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