

**A Spiritual Response to the Financial Crisis?  
Making Decisions for the Really Long Run**

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## Introduction

When the Church of the Annunciation invited me to comment on the current financial crisis from a spiritual perspective I was hesitant. I am not a theologian, just a lay member of the Orthodox Church. I agreed partly because I was intrigued by the question and uncertain about what I would be able to say in response to it. I have studied financial crises most of my professional career, and since mid-2007 I have been busy researching, writing and speaking about the current crisis and the policy responses to it; but I had never considered the points of intersection between spirituality and financial crises.<sup>1</sup> I see my attempt here as a starting point for exploring those points of intersection.

## The Present Crisis

Let's begin with a review of where we are and how we got here.

During the economic expansion of 2003-2007, lenders the world over accumulated large portfolios of risky investments. One particularly large category of those investments (more than \$3 trillion) took the form of highly levered and unusually risky mortgage loans to US borrowers with poor credit histories and little or no downpayments. The profitability of this so-called "subprime" lending was heavily dependent on the continuing appreciation of houses and the continuing growth of the economy (to provide jobs for these risky borrowers); committing several trillions of dollars in subprime lending was a bet on both the economy and the housing market – if either stalled, mortgage defaults would rise dramatically and lenders would lose hundreds of billions of dollars on subprime lending.

The 2003-2007 boom saw new peaks in US stock prices, house prices, and wealth per capita, which supported new peaks in consumption and consumer debt, largely in the form of mortgage debt. The US also increasingly borrowed from other countries to fund its consumption boom. Many international

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<sup>1</sup> See Calomiris (2009a, 2009b, 2009c, 2009d, 2009e), and Calomiris and Wallison (2009).

economists regarded the burgeoning current account deficit that accompanied this consumption boom as an unsustainable increase, and worried that a severe decline in consumption might be required to repay that accumulated foreign indebtedness (the so-called “hard landing” worry).

Beginning in mid-2006, housing prices started to stall; by the middle of 2007 it was clear that subprime defaults would rise dramatically and that lenders would suffer significant losses. As losses mounted in 2007 and 2008, given the high leverage of the banks that had placed large bets on those loans (which included many of the largest financial institutions in the world), some lenders found that subprime losses threatened them with the possibility of insolvency.

As financial institutions scrambled to shore up their positions in response to those losses, the supply of credit contracted in all financial markets. The combination of recognized loss and the fear of further loss brought the global financial system to its knees.

Four categories of causal factors are generally agreed to have been the most important in precipitating the crisis: (1) monetary policy errors from 2002 to 2005 that promoted loose credit during the boom, (2) housing policy errors that encouraged homeowners to over-borrow during the boom, (3) the underestimation of subprime risk by some of the largest banks and other institutional investors, and (4) the regulatory failure to identify and respond to the first three errors.

**Monetary policy** set the stage for the boom and bust of 2002-2009 by making credit far too cheap for too long. The real (inflation-adjusted) fed funds interest rate (the main instrument of monetary policy controlled by the Federal Reserve) remained negative during 2002-2005. Only once before in the postwar era, during the high-inflation environment of 1975-1978, had the Fed targeted real fed funds interest rates at such low levels for so long.

From the standpoint of the “Taylor rule” (a mathematical formula that derives the appropriate fed funds rate as a function of the prevailing levels of unemployment and inflation), monetary policy persistently was excessively

accommodative throughout 2002-2005; a normal adherence to the Taylor rule would have implied interest rate levels substantially higher than those that prevailed throughout that period.

**Government “affordable housing” policy** was a substantial contributor to the crisis because it encouraged homeowners, especially those with low and risky incomes, to borrow excessively to buy homes. The US government subsidizes housing in many ways, all of which encourage homeowners to lever their houses to the hilt. The reason these policies encourage risk is simple: the subsidy you get as a homeowner is proportional to how much you are willing to borrow; the only way to get more subsidy is to borrow more.

These leverage subsidies include lending policies of the Federal Housing Administration, subsidized Federal Home Loan Bank advances to mortgage lenders, and most importantly, government backing (once implicit, now explicit) for the debts of the housing behemoths, Fannie Mae and Freddie Mac. Fannie and Freddie were the 800 pound gorillas in the housing market; not only did they dominate the market in terms of market share, they also provided liquidity to the market – that is, they bought and sold mortgages in secondary markets, and made other holders of these risky mortgages confident that someone would be willing to buy risky mortgages and mortgage-backed securities even if market conditions deteriorated (e.g., as Fannie and Freddie had done for the non-subprime mortgage market in 1998 and 2001). In fact, Fannie and Freddie remained in the market in 2006 and 2007 after many other market players left the market, continuing to provide support for the riskiest cohorts of subprime mortgage originations (namely, those originated in late 2006 and early 2007).

Why did Fannie and Freddie do this? Largely in response to Congressional pressures to increase their support for “affordable housing,” they decided in 2004 to relax origination standards and to substantially increase their investments in subprime mortgages and related securities, which led to a rapid acceleration of subprime originations in that year (Calomiris and Wallison 2009). Between 2004 and 2007, Fannie and Freddie came to own half of the \$3 trillion exposure in the subprime mortgage market. In December, I testified before Congress (Calomiris

2009e) about the role of Fannie and Freddie in the crisis. I was given access to emails between Fannie and Freddie’s risk managers and their CEOs during the critical decision moment of 2004. The emails are very revealing. Despite strongly voiced concerns from risk managers (some of whom lost their jobs for voicing those concerns), the CEOs pushed ahead with subprime buying, largely because of their desire to please Congress by demonstrating good “affordable housing” motivations. As the risk managers feared would happen, these two large lenders “made the market” in poorly underwritten, risky mortgages, and encouraged other market participants to view these as acceptable investments.

The story of the willingness of banks and other institutional investors to take on the huge risks of subprime lending are more complex and varied. That story is best understood as the result of a **deliberate underestimation of risk by some of the world’s most sophisticated buy-side market participants**. Not all banks participated (for example, JP Morgan Chase, Goldman Sachs, Bank of America, and Morgan Stanley avoided large exposures to subprime lending during the boom). Why did other banks decide to ride the subprime bubble created by loose monetary policy and relaxed underwriting standards at Fannie and Freddie?

The banks that took on the biggest risks relating to subprime mortgages – which was accomplished through a combination of owning subprime-related assets and insuring others against losses from subprime-related assets – seem to have consciously overpaid for those assets or established compensation incentives within their organizations that would lead others to consciously overpay for them. Other sophisticated buy-side investors (within pension funds, mutual funds, and insurance companies) also seem to have willingly participated in the underestimation of risk when buying assets.<sup>2</sup>

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<sup>2</sup> These sophisticated investors were aware that, despite their favorable ratings, subprime-related securities were highly risky. For example, collateralized debt obligations (CDOs) were an important contributor to subprime securitization growth, especially in 2006, when originations roughly doubled relative to 2005. But even as early as December 2005, experienced default probabilities for debt tranches of CDOs were substantially greater than comparably rated corporate debt instruments. For example, Baa (BBB) CDO tranches had ten times the five-year probability of default of similarly rated corporate bonds.

Such willfully unprofitable investment decisions can occur as the result of what are called “agency” conflicts in economics. Agents (e.g., bank CEOs) may consciously harm their “principals” (e.g., bank stockholders) because doing so benefits the agents (e.g., results in higher compensation for the agents). Decisions by “buy side” agents to harm principals (pensioners, and bank, mutual fund, and insurance company stockholders) reflect a lack of discipline by principals over agents. Short-term revenue and asset growth were rewarded by large bonuses within financial organizations without offsetting penalties in compensation that would have discouraged buy-side agents from taking on high risk.

The CEOs who established these guidelines got away with this for two reasons. First, the various laws and regulations that govern the market for corporate control in commercial banking make it virtually impossible for stockholders to discipline commercial bank CEOs (Calomiris 2009a). Second, complex statistical models based on limited prior experience with subprime lending during the 2001 recession (when booming house prices limited subprime losses) offered a factual basis, however distorted and inaccurate, for bank CEOs and other buy-side agents to pretend to believe that subprime risk was very low on a forward-looking basis. These unrealistic risk models will probably allow agents to avoid blame for subprime portfolio losses; by pointing to widespread low ex ante risk estimates by subprime asset buyers, buy-side agents will be able to argue that large ex post losses were not forecastable – a buy-side sequence of behavior I call the “plausible deniability equilibrium” (Calomiris 2009b).

Of course, regulators are also to blame, since they did nothing to stop Fannie, Freddie, banks, investment banks, or other buy side investors from taking on these excessive risks. During the subprime boom **regulation failed to identify substantial unrecognized increases in the risks associated with subprime lending**. The regulatory failure was particularly acute with respect to the regulation of risk taking by large commercial banks, which economists have long identified as the institutions most prone to taking on excessive risks because of the special implicit protection they are afforded by the government as the result of the so-called “too-big-to-fail” problem. The government safety net protects large banks more than other financial institutions because their failure is

perceived as having adverse consequences for the whole economy (through their complex linkages to other financial intermediaries and their central role in providing credit to all sectors of the economy).

Too-big-to-fail protection implies a special need for the regulators of large banks to control excessive risk taking in order to limit large banks' abuse of safety net protection. I want to emphasize that the regulatory failure here was not primarily about allowing commercial banks to locate assets off their balance sheets, although that did contribute to the problem; even if all of the subprime risk had been booked on commercial bank balance sheets, existing regulatory standards would not have required adequate budgeting of equity capital to absorb those risks. The key problem was a regulatory risk measurement system that relied (and still relies) on false measures of risk, especially on banks' own risk models, and on the opinions of rating agencies (who have every incentive to cooperate with incentive-conflicted buy-side investors in the underestimation of risk). Critics, including myself and many other academics, had been criticizing this regulatory approach to risk measurement for more than a decade.

***Note that all four of these causal factors have largely to do with government interventions into the economy that had bad unintended consequences for risk taking incentives, particularly with respect to mortgage lending.*** Note also that these errors were purposeful rather than accidental, and each had been the subject of substantial commentary prior to the onset of the current financial crisis. One could see that the Fed was violating the Taylor Rule throughout the 2002-2005 period. Government policies to promote highly levered subprime mortgages were well known, and market participants were aware of Fannie and Freddie's 2004 decisions to relax underwriting standards. The mispricing of risk and underrating of risks was commented on widely, as were the regulatory flaws that permitted the understatement of bank risk.

### The Policy Response To the Crisis

The financial system and the economy are still sinking, and it now appears that we will continue to sink until economic circumstances get bad enough to stir the political willingness to act more boldly than we have to date. The personal

consequences of the crisis already entail millions of lost jobs, millions of homes that either have been foreclosed or are likely to face foreclosure, and substantial losses of wealth.

The policy response to the crisis initially was bold in many respects (including unprecedented means of Fed lending to financial institutions, and unprecedented Treasury activism in seeking new means of assisting banks), but it has turned out to be not bold enough, especially in response to the accelerating financial collapse that began in mid-September, 2008. Washington has been willing to dribble some funds into banks, to offer limited guarantees against loss in support of some financial institutions, and to make occasional purchases of banks' risky assets. It has all been too little, too late. The current bank assistance plans proposed by the US Treasury are unlikely to work any better than the prior ones, and are widely regarded by the experts I talk with as designed more to give the appearance of action than to actually resolve our banking system's problems.

What is lacking is a willingness in Washington to stop the banking system's death spiral by intervening to systematically remove the extreme downside of toxic asset values that are held by banks. What is needed is a game-changing intervention that will make the prices of risky assets recover to sustainable long-run values, as they would if financial markets stopped worrying about the extreme downside.

In other words, any real recovery plan has to solve the problem of market underpricing of risky assets, which reflects the panic-induced scramble for liquidity by the holders of risky assets. Instead our government has been offering "pretend plans" that would buy assets at current prices or inject limited amounts of capital into banks, and following political imperatives imposed by Congress that the Treasury get a "good deal for taxpayers" in its assistance arrangements with banks. This cautious approach does not actually protect the interests of taxpayers because it is penny wise and pound foolish.

The key political problem that is keeping us from addressing our economic problems is the lack of political courage to do the necessary but unpopular thing: namely, for the government to *absorb significant downside risk* that currently

resides in bank portfolios. This idea is as unpopular with the public as it is necessary to restoring health to the economy. It is unpopular because of the understandable public outrage against banks, and because the public misunderstands how to account for the prospective incremental cost of an effective government policy to absorb downside risk. In other words, that cost seems higher than it actually is.

A proper measurement of the incremental cost of risk absorption should take two key factors into account: (1) a positive offset due to the huge preexisting taxpayer loss exposures that would be reduced by a comprehensive and effective intervention (recall that taxpayers already own half of subprime losses through their effective ownership of Fannie and Freddie alone), and (2) the fact that current prices of risky assets are far below long-term realistic expected recovery values, reflecting the impact of the liquidity crisis on pricing. An aggressive intervention would be largely self-financing through its effects in raising market valuations closer to recovery values, and avoiding losses on preexisting government exposures to loss.

For example, consider a portfolio of 2005 subprime mortgages that is currently worth only 0.35 now, but has a long-term recovery value conservatively estimated at 0.75. If the government were to offer the holder of these mortgages a put option at 0.55 for three years, that would raise the value of the portfolio to about 0.60 or higher *immediately*. It would also increase liquidity for the portfolio holder, since the holder could borrow 0.50 easily against the newly government-insured portfolio.

The raising of asset values and restoring of liquidity would begin the process of rebuilding stock prices and raising bank capital in the market (which I suggest should be required as a quid pro quo for participation in the put option assistance program – Calomiris 2009c, 2009d).

Of course, in addition to implementing effective crisis resolution measures, policymakers also need to address the long-term design flaws that led to the crisis, to reduce the vulnerability of the financial system going forward. It is worth emphasizing that policy makers throughout the world have failed repeatedly to

respond to crises adequately in the recent past, and that our continuing failure to redress financial system design problems has produced roughly 130 significant national banking crises around the world in the past thirty years, with increasing frequency and severity, several of which have given rise to major global crises, of which the current crisis is the worst.

Of course, financial crises, including banking crises relating to real estate booms and busts, have occurred for centuries. But that should not be taken as an indication that crises are an historical constant. The past 30 years have seen an unprecedented frequency and severity of financial crises around the world, driven by the increasing magnitude of the policy distortions affecting the incentives for risk taking that I described above. There has been a huge outpouring of research on this topic over the past two decades, which politicians have largely ignored.

Thus, the policy challenges for us as a country (and as a group of countries) trying to manage this crisis are twofold: first, to stop the downward spiral of risky asset prices, and second, to rewrite the rules of the game to prevent these costly crises from recurring. Meeting those challenges will require us (1) to find the political courage to absorb risk in the short run, and (2) to reform government policies toward housing finance, corporate governance of financial institutions, and regulation of the measurement and management of financial system risk. This is a challenging reform agenda; so far the political response of the United States and most other countries (the UK is the exception) has not been encouraging.

### A Spiritual Response to the Financial Crisis?

Crisis is a word derived from the ancient Greek *krinein*, which, according to the *Dictionary of Word Origins*, means "to sift, to separate, or to judge." In other words, ***crises are moments when circumstances force us to make important decisions.*** But why should our individual or collective decisions in response to financial crises have a spiritual component? How will spirituality make our decisions better?

The first and most obvious answer to these questions is an historical one. The Bible, after all, is itself largely a crisis chronicle. It might be best described as a recounting of a sequence of political, economic, and personal crises, which often coincide, and in which spiritual insights or errors prompted people to make important decisions, for better or worse, about their personal and societal futures. Adam and Eve, Moses, Gideon, David, Solomon, Jesus, and Paul, just to name a few, were all faced with crises that they had to manage. What these people did in response to crises is very instructive. I would even go so far as saying that the Bible could be used as a crisis management manual.

What do we learn from the Bible about crisis management? And more broadly, what do we learn from the spiritual approach to crises illustrated by the Bible?

In discussing Biblical accounts of spiritually informed responses of to crises I want to emphasize two aspects: Spiritually informed responses manifested on the *inside* (silent, internal learning), and those manifested on the *outside* (through actions taken in the presence of others).

Responding spiritually to a crisis in the right way on the inside involves reflection and prayer. Crises shake our world, but they also stop us in our tracks emotionally; and thus, amidst all the chaos that they entail they also create unique opportunities for reflection and prayer.

Crises also test our commitment to doing what is right because it is harder to do what is right during a crisis. What we do and say in the presence of others during crises can have profound effects on them; the survival of the Church through the ages is testimony to the lasting consequences of inspiring examples of faith displayed during crises. *Martyrdom*, an often misunderstood Greek word, simply means witnessing, and refers to these sorts of actions, which demonstrate to others one's relationship with God.

To illustrate these two aspects of spiritual responses to crises (internal learning and external witnessing) I will briefly discuss two of the books of the Old

Testament, those of Ruth and Job, traditionally viewed by theologians as two of the clearest models of crisis management.

The book of Ruth was written c. 1300 BC at a time of continuing political and economic crises in Israel. An economic crisis (in this case, a famine) causes Ruth's Israelite husband to move their family to Ruth's ancestral home, Moab. When her husband dies, Ruth makes a surprising choice: she chooses the difficult path of remaining loyal to her mother in law (who had released her from any requirement of care) and remaining loyal to Israel's God, rather than returning to an easier life among her own family in Moab. Her righteous actions lead ultimately to her happy remarriage in Israel, to Boaz. Ruth ends up becoming the great grandmother of King David.

Ruth's devotion to her mother in law and to God illustrate what is called in the Rabbinical tradition *chesed*, or steadfast love. That devotion made a profound impression on everyone around her, so much so that the Israelites named a book of their Bible after someone who was a woman and a foreigner. That was no small achievement.

Another non-Jew who managed to get a book in the Old Testament devoted to him was Job, the famously just man who is said to have lived around 1600 B.C. His personal trials (including the loss of his home, his wealth, his health, and his family) are the subject of his Biblical book.<sup>3</sup> Despite Job's patience and loyalty to God, he ultimately is driven to despair, and even wishes for his own death. Job and those that surround him are perplexed by the events that befall such a just man, and most of the book recounts attempts by Job's companions to explain the hidden reasons for his suffering. The litany of false interpretations offered by the three "experts" (TV talking heads beware!) is discredited at the end of the book by God Himself, who reminds them and Job of the limitations of their understanding. Job's suffering ultimately leads him to learn profound things – most importantly, about the need for humility, about the central role of faith in overcoming despair, and about the sanctity of life.

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<sup>3</sup> For a detailed account of the Orthodox interpretation of the story of Job, see Reardon (2005).

What do these and other Biblical stories about crises tell us about spiritually informed responses to the current crisis? During a crisis we are called on to decide important things. The quality of the decisions we make as individuals and as a society will depend on our capacity to learn from suffering, our humility in understanding and shaping our world, our ability to remain faithful and hopeful, and our commitment to act as true witnesses.

What are the most important lessons we should learn from the current financial crisis? I don't presume to know most of the answers to that question, especially since answers will differ across individuals and will be revealed more fully over a long period of time. Here is my list so far:

1. I think often these days about my father and mother, who were teenagers during the Depression, and who used to love to say: "Your generation is spoiled. I wonder if you could survive a real economic crisis." So far, in spite of the grief that many have suffered, people are showing their strength under pressure, and in the process we have already become stronger as a country. I would like to think that, like Job and his friends, we are learning some humility, too, as well as the importance of not surrendering to despair. And I would like to think that, in the process, we also are becoming less focused on what we have and more focused on who we are trying to become and what we are doing for each other.
2. I observe family members being drawn closer together these days, as they are forced to rely more on each other. I imagine that will be especially true in families where people are forced by circumstances to double up in houses. I think about grandchildren and grandparents living under the same roof, about the new dimensions added to old relationships.
3. The financial crisis offers lots of lessons for public policy, as I indicated before. These are lessons not only about specific policy mechanisms that need fixing, but more importantly perhaps, about the need for humility by our political leaders and our economists (myself included), if we are willing to learn that lesson. The four categories of policy mistakes that I

believe brought about this crisis not only offer an agenda for specific policy reforms, but also remind us that government grand designs often go wrong. This is a lesson we need to keep in mind as we set about fixing things, lest we do even more damage.

4. We are also reminded of the importance of coming together to address our problems. Politically, we have not come together yet, and I believe that is the primary cause of our continued suffering. As I pointed out before, and as Warren Buffett remarked recently, we need to find political courage to deal with our problems, to rise above seeking advantage as individuals or as members of political parties so that we can accomplish what is right for our country. How will we get there? The quality of our government and its actions reflects our national character, which is nothing more than the aggregation of our individual characters. It is up to us to press our political leaders to rise to the occasion, which means that first we as individuals must rise to the occasion, in ways big and small, in our families, in our communities, perhaps even at community events like this.

When it comes to making good decisions during a crisis we Americans have some great models to draw from, particularly from our country's distinguished history of financial leadership. Interestingly, the greatest financial leaders of our past are known not just, or even mainly, for what they did to manage financial crises, but rather for who they were as human beings, which became most vivid during crises.

Alexander Hamilton, perhaps our greatest financial mind, resolved our national debt crisis after the Revolution, founded the most important banks of his time, and established our public finances and coinage systems on sound bases. But he is known and revered for other actions: serving as aid-de-camp to General Washington at Valley Forge, writing an important speech for Washington that prevented a military coup at the end of the Revolution, firing his pistol into the air rather than taking aim at his dueling adversary, Aaron Burr, and admitting publicly to an adulterous relationship to avoid bringing any dishonor to the US Treasury.

JP Morgan during the Panic of 1907 called upon his banking colleagues to think about the collective good, not just their individual welfare, as they faced the worst crisis of the early twentieth century. At a critical moment during the Panic, he locked the door to his board room and would not let his colleagues leave until they had agreed on an effective approach to dealing with the crisis they were facing.

Andrew Mellon, while he was dying, and despite being vilified by his political opponents and falsely accused of being a tax cheat, focused in his dying days not on discrediting others or justifying himself, but rather on pursuing his dream of making a lasting contribution to his country. He founded and endowed our National Gallery of Art as a personal gift to us all, one that he never lived to see completed.

These financial leaders showed us that what matters in the really long run, what defines a human being ultimately, is what one chooses to learn and how one chooses to behave in a time of crisis.

In 33 AD, Rome suffered the world's first "global" financial crisis (gripping the entire Roman Empire). The crisis brought panic and depositor runs to the banks of the Via Sacra in Rome. Emperor Tiberius rose to the occasion and stopped the panic by loaning the banks money from the Imperial Treasury. This intervention is still regarded as one of history's most successful policy interventions in dealing with a financial crisis. And yet, Tiberius is not remembered much for his success. Around the same time as that first global panic, someone stole Tiberius's thunder, a Jew who was suffering through a crisis of his own in Jerusalem, one that the world would never forget. His willingness to make difficult decisions, His commitment to righteous witnessing, and His love for others remain an unequalled and inspiring model of good decision making during a crisis.

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