The James Madison Institute

Point of View

(850) 386-3131 P.O. Box 37460, Tallahassee, FL 32315

September 2008

# Government Policies Encouraged Wall Street's Risky Business

*By Dr. Randall G. Holcombe*

For going on two years now the economy has been sinking ever-deeper into a financial crisis started by a meltdown in the subprime mortgage market. Many observers argue this crisis is a result of the breakdown of private markets, but a more careful look shows that it was government policy that, step by step, led us to the current crisis. Here are the main factors.

First, Fannie Mae and Freddie Mac were created to help provide mortgages for people who did not qualify for conventional mortgages. Fannie Mae, established by the federal government in 1938, was spun off as a "government sponsored enterprise" (GSE) in 1968. Freddie Mac was created in 1970 as another GSE to create competition for Fannie Mae.

Fannie and Freddie were run as private businesses but supported by the financial backing of the federal government. This allowed them to borrow money more cheaply than private lenders, and therefore lend more cheaply, to further the goal of increasing home ownership. As GSEs they grew phenomenally, to the point where their debt was nearly half the size of the federal government's debt.

As long as housing prices kept rising, they had assets to support their debt, but when housing prices turned down, they rapidly became insolvent. This was not a surprise: Many observers had warned that those GSEs were too highly leveraged and poised to collapse, but low interest home loans to poorly qualified buyers were too popular in Congress to rein in those lenders.

In part their popularity with Congress was due to their mortgage activities, but it was also due to the GSEs using the profits generated from their favored setting in the "market" to lobby, make campaign contributions to members of Congress, and to offer high-paying jobs to congressional staffers. They purchased political support.

A related problem began with the Community Reinvestment Act (CRA) of 1977, which required mortgage lenders to offer loans throughout their entire market area, prohibiting them from "redlining" (excluding) poorer neighborhoods. The CRA was the result of pressure to provide affordable housing to all Americans, not just to wealthier Americans. It meant that if lenders wanted to expand their lending activities, they had to balance their loans to financially secure buyers with loans to buyers who did not meet the conventional criteria to qualify for a mortgage.

The push to extend mortgages to less qualified buyers was amplified by the Home Mortgage Disclosure Act (HMDA), originally passed in 1975 and expanded in 1991 to require lenders to report rejection rates by race. There were racial differences in rejection rates, and a 1992 study by the Federal Reserve Bank of Boston concluded that even after adjusting for other factors, minorities were turned down more often for mortgages. Virtually every academic study disputed this conclusion, but lenders nonetheless were put on notice that their mortgage-lending practices would be examined for the possibility of discrimination, with violators facing the possibility of fines as high as $500,000.

Mortgage standards were relaxed industry-wide, and prior to its failure, Countrywide was praised as one of those lenders that allowed more flexible underwriting criteria to extend mortgages to those who would not qualify under more traditional criteria. Subprime mortgages were largely the result of the federal government's push in a number of dimensions to open the possibility of home ownership to people who would not have qualified under the old rules.

The CRA was broadened in 1995, allowing the securitization of subprime mortgage loans, which began in 1997. Securitization combines a large number of loans into a security that can then be sold on the market. The idea was that while some loans might default, most would not, so the securities would spread the risk and make it safe to hold portfolios of sub-prime loans.

An obvious problem with this is that the originating lenders have little incentive to think about the long-term prospects of the mortgages they are making, because the originators hold them only a short time before they are sold off and securitized. However, at the time this was perceived as a benefit because it enabled people who would otherwise not qualify for a mortgage to get one and live in an owner-occupied home.

A third factor leading to the current crisis was easy-money policy adopted by the Federal Reserve Bank (Fed) at the beginning of this decade. The Federal Funds Rate (a short-term interest rate) was slashed from 6.25 percent in 2000 to below 2 percent by 2002. The Fed's stated goal was to mitigate the effects of an incipient recession exacerbated by the after-effects of the September 11, 2001 terrorist attacks.

Low interest rates meant lower-cost mortgages, further enabling people to buy houses. Indeed, commentary at the time was that the booming housing market was the main factor keeping the economy from sliding more deeply into a recession, and the Fed's easy-money policy was the engine that drove that boom.

But the increased demand for housing pushed housing prices up, and many buyers would not have qualified for mortgages were it not for the relaxed standards brought about by the CRA and the GSEs.

To make matters worse, people were buying these higher-priced houses with variable-rate mortgages when rates were held artificially low by the Fed. Everybody knew that the rates had to rise at some point, but the thought was that in a rising housing market, owners who could not afford to refinance could always sell and reap a capital gain.

As long as interest rates remained low and housing prices continued to rise, the symptoms of the coming collapse were hidden. Loans remained affordable, and houses could be sold for more than their owners paid for them.

From 2004 to 2006 the Federal Reserve ratcheted up the Federal Funds rate to 5.25 percent, pushing up mortgage rates and bringing the artificial housing boom to an end. Those mortgage-backed securities that had looked attractive when the Fed kept interest rates low and when housing prices were rising lost their luster quite abruptly when conditions changed. The firms that held a lot of them – including now-familiar names such as Bear Stearns, Lehman Brothers, and Merrill Lynch – found themselves in financial difficulty. AIG, which insured those mortgages, found itself with liabilities far outweighing its assets, and has been effectively nationalized.

The current crisis has two fundamental causes. First, there was the federal government's policies – through Fannie, Freddie, and the CRA – that tried to extend home ownership to people who formerly would not have been financially qualified to obtain mortgages. This vastly increased the riskiness of mortgages. This risk was hidden because the originators of the mortgages were able to resell them quickly, where they were bundled and "securitized." As long as interest rates were low and housing prices were rising, those mortgages appeared safer than they really were.

Second, the Fed's policy of holding interest rates artificially low in the first part of this decade enabled the mortgage-backed security market, which only started in 1997, to grow substantially.

Government policy, not the workings of the free market, created much of the foundation for the current financial crisis. The push to extend mortgages to less-qualified borrowers, the existence of Fannie and Freddie to operate as GSEs, and the easy monetary policy of the Fed in the early part of the decade were prime contributors.

Market participants are not blameless, however. While most of the government policies and regulatory moves cited above interfered with markets, altering the CRA to allow securitization of subprime mortgages amounted to a degree of deregulation, allowing the financial markets opportunities (and along with opportunities, risks) that were not previously available.

Nobody forced Wall Street's large investment banks to participate in that market or to take such big risks themselves. Those firms willingly accepted those risks in the pursuit of larger profits, and taking the risk means accepting the losses as well as profits that might result.

Now we stand at an important crossroads. Should the federal government support those firms that made risky bets that went bad? To do so would forever change the nature of financial markets. Financial markets can only work if firms that accept risk in the pursuit of profit also suffer the loss if the market turns against them. The market cannot work if private firms can profit when their risks pay off, but pass their losses on to the federal government, and ultimately the taxpayers, when they take losses. A bailout at this point means a move toward socializing our financial industry.

When Japan faced a financial crisis in the 1990s, its government propped up technically insolvent financial institutions rather than have them suffer from their bad investments. The Japanese economy stagnated for a decade, and has yet to rebound to its former strength.

Propping up our failing firms could risk a similar outcome. Both profits and losses are necessary for the market to work. Market advocates were justly critical of Congress last summer when, in response to rising oil prices, it proposed a windfall profits tax on the oil industry. Bailing out firms that take losses is a windfall profits tax in reverse. For the market to work, firms must be just as free to take losses when their activities do not pay off as to receive their profits when they do.

To favor bailing out the firms that made risky bets and lost would mean, at best, supporting managed capitalism and at worst nationalization of financial markets. The long term harm to the capitalist system would be far greater than any short-term financial stability that a bailout would bring.

*Randall G. Holcombe is DeVoe Moore Professor of Economics at Florida State University and Senior Fellow of The James Madison Institute, a non-partisan policy center based in Tallahassee.*