

Quantum of Failures; Forget the markets: massive government failure is behind world financial chaos

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In *Quantum of Solace*, the new James Bond movie due next month, our hero takes on the latest threat to mankind and the survival of the free world: a businessman. Of course!

So it has been in film for decades. Now, apparently, it is true in life. Businessman as scourge is the dominant ideology of our time. We all know that most people see market-driven bankers, brokers and corporate bosses as the root of evil, corrupted and greedy--even though we all ravenously consume the products produced by market-driven business.

The concept of corporate evil is embedded in the bones of our culture; it is now taken for granted that markets and capitalism are flawed in practice and must be regulated and controlled, if not destroyed. Even in 1960, in the deep freeze of the Cold War with communism and the Soviet Union, Ian Fleming's *Dr No* has James Bond taken captive on a Caribbean island. No statist Fidelistas on this island. As Bond enters the underground lair of Doctor No, he stops dead in his tracks: "It was the sort of reception room the largest American corporations have on the President's floor in their New York skyscrapers."

Economics is like the movies. It's filled with papers, text books and arcane treatises referencing market failure, the general idea being that unfettered capitalism inevitably generates unwanted outcomes and, in some cases, total disaster. It's a core Marxist theme, a staple of Keynesian economics, that permeates the work and thought of just about every economic school of the ideological spectrum.

From major league economists to top rank demagogues, the message from the current economic crisis is clear. "It is the end of capitalism," said Iran's President Mahmoud Ahmadinejad, as good an authority as any these days. To steal a famous phrase, it seems like "We're all Muslim extremists now."

This week, Alan Greenspan, of all people, joined the market-failure parade. He has his reasons, of course. Better the market should take the hit for creating the mortgage and financial crisis than anything he did to monetary policy as chairman of the U. S. Federal Reserve during the great U. S. housing boom. More about Mr. Greenspan later.

Bashing markets is fun, convenient and politically popular. But it also takes a certain willful disregard

of events and policy to reach the conclusion that capitalist failure brought the world economy to its knees. Only conscious effort and stubborn, even malicious, obtuseness could lead anyone to conclude that, on the basis of recent events, the sources of the financial meltdown are corporate, that big business made us do it.

The role of bankers and other market players in causing the current crisis is undeniable, but it is limited compared with the massive role played by governments. From U. S. housing policies to financial regulators to central bank actions all over the world, the evidence is overwhelming that the causes of today's turmoil can be traced to massive government failure.

This failure of policy, moreover, is now being compounded. From the G7 to the G20 and beyond, governments are scrambling to push through measures and policies that cannot possibly have been thought through or properly evaluated. Bad interventions are inevitably being poured on to extinguish the fires created by previous bad interventions.

How did we get to this perilous juncture? One starting point is as good as another. But if the proximate trigger for the financial meltdown was the U. S. subprime housing fiasco, the roots of that crisis offer pure examples of government failure and regulatory policy run amok.

The front page of *The New York Times* last Sunday told the story of Henry Cisneros, the top housing official in the Bill Clinton administration during the 1990s. As *The Times* described it, Mr. Cisneros "loosened mortgage restrictions so first-time home buyers could qualify for loans they could never get before." He then went on to join the boards of a major U. S. home builder and of Countrywide Financial, the mortgage lender at the epicentre of the U. S. subprime mortgage collapse. (For a list of some of the references used in the writing of this article, see www.financialpost.com/fpcomment.)

The Clinton administration set out to boost home ownership in the United States, then languishing at 64%. It began earnest work on the project under Mr. Cisneros, the first Hispanic to head the Department of Housing and Urban Development (HUD). As a direct result of HUD policy, families no longer had to prove five years of income. All they needed was three.

Lenders no longer had to interview borrowers face to face.

Reacting to these and other more significant policy changes, lenders such as Countrywide Financial in California set up units to service these so-called subprime borrowers. "We were trying to be creative," Mr. Cicernos told the Times.

Mr. Cicernos sat on Countrywide's board for years. He left last year, shortly before the mortgage giant, on the brink of bankruptcy, was taken over by Bank of America. It had \$170-billion in mortgage assets, most of them subprime. Countrywide CEO Angelo R. Mozilo is now the target of regulators, politicians and the media.

During Mr. Cicernos' time on the board he sat on Countrywide's regulatory committee, overseeing compliance with law and regulation, but he says he does not now recall seeing reports that one in eight of Countrywide's loans was "severely unsatisfactory" due to shoddy underwriting.

But Mr. Cicernos, the Clinton administration, Countrywide, and eventually the Bush administration, were merely vehicles for radical mortgage lending ideas promoted by housing activist groups and political operators. The full horror story of the regulation-induced breakdown in U. S. mortgage markets is to be told in a forthcoming new book, *Housing America: Building Out of a Crisis*, from the Independent Institute in Oakland, California.

The idea that the U. S. subprime mortgage collapse is the product of unscrupulous agents and lenders roaming the country in a deregulated market searching for ignorant buyers is overwhelmed by contrary facts. In "Anatomy of a Train Wreck: Causes of the Mortgage Meltdown" (a chapter in *Housing America*), University of Texas economics professor Stan J. Liebowitz documents the deliberate government policies that were brought in to destroy U. S. mortgage lending standards, pillage banks and socialize risk.

It begins with the idea, long held among activists, that U. S. mortgage lending practices prevented home ownership among low income and certain racial groups. Banks and other lenders, following normal and prudent lending standards, were accused of discrimination. The solution: Relax lending standards. One step along that road was the 1970 U. S. Community Reinvestment Act, forcing banks to lend equally to all geographic areas, regardless of risk.

A later pivotal event in the decline in lending standards, according to Prof. Liebowitz, came after 1992 when the Federal Reserve Bank of Boston conducted a study that purported to show that racial and income discrimination in mortgage lending continued to exist. It accused lenders of applying "arbitrary or unreasonable measures of creditworthiness."

Prof. Liebowitz says the study was based on

"horribly mangled data" and was riddled with errors. But it was politically correct, and it rose to become the basis for new national mortgage lending standards that ignored essential principles of mortgage lending. Lack of credit history should not be a negative factor. Traditional income-to-loan ratios of 28-to-36% should not apply to low-income individuals. Maybe 50% would do. Lenders should not discriminate against certain sources of income, such as short-term unemployment insurance benefits.

The new risk paradigm "comports completely with common sense," said Boston Fed President Richard Syron, a former head of Freddie Mac, the U.S. government mortgage backer.

The impact of these new "equal opportunity" lending guidelines - described as "flexible underwriting standards" --was dramatic, says Prof. Liebowitz. "As you might guess, when government regulators bark, banks jump. Banks began to loosen lending standards. And loosen and loosen and loosen, to the cheers of politicians, regulators and GSEs."

GSEs are Government Sponsored Entities, U. S. federal agencies charged with lending and insuring mortgages. Fannie Mae and Freddie Mac-- long charged with facilitating home ownership -- became out-of-control participants in the sub-standard lending explosion that followed. With the Boston Fed and other risk studies apparently showing that low-income mortgages issued under new lax standards were just as sound over time as prime mortgages, by 2001 and 2002 the U. S. housing market had become a subprime rampage.

Politicians in Congress fueled the explosion. The incestuous relationships between Congress and the GSEs is now well known, but still conveniently underplayed. For years, Fannie Mae and Freddie Mac-- right up to their multi-trillion-dollar bankruptcy and seizure by the U. S. government earlier this year -- roared out of control. They funded politicians' interests, kept mortgage interest rates low and became government-backed agencies for trillions of dollars in risky mortgage lending.

Between 1995 and 2007, the combined balance sheet of Fannie Mae and Freddie Mac, including Mortgage Backed Securities (MBS), rose from \$1.4-trillion to \$4.9-trillion, an annual increase of almost 15%. At \$4.9-trillion, the value of these risks in the two GSEs is slightly less than the total public debt of the U. S. government. About \$1-trillion dollars of Fannie/Freddie activity involved exposure to subprime and lower-grade mortgages. For an overview of the rise and fall of Fannie Mae and Freddie Mac, including their corrupt links to Congress, see *The Last Trillion-Dollar Commitment: The Destruction of Fannie Mae and Freddie Mac*, by Peter Wallison and Charles Calomiris, for the American Enterprise Institute.

In 2004, then Fed Chairman Alan Greenspan warned of the looming risk in the government-backed mortgage lenders. Fannie and Freddie, he said, were taking on trillions in mortgage assets without properly accounting for, or charging for, the risk

embedded in the new lax lending standards. In 2005, Mr. Greenspan explicitly warned of "systemic risk" if the two operations failed to change their ways.

Some tightening of Fannie and Freddie activity did occur, in part as a reaction to accounting scandals within the agencies, but growth exploded again in 2007. At the end of 2007, the two agencies accounted for 75% of new residential mortgage lending. James Lockhart, head of the Office of Federal Housing Enterprise Oversight, which regulates the two organizations, estimated they would soon be financing or guaranteeing 90% of new mortgages, a near monopoly.

On the surface, the mortgage push succeeded. Home ownership expanded from 65% to 69%, although most observers now believe the whole exercise was undesirable, an impossible extension of the American Dream. There inevitably must be essential financial and economic limits to home ownership. The apparent success was based on fundamentally unsound regulatory policy and massive amounts of government-backed funding.

The rapid and dramatic rise in ownership, fueled by mortgage credit, produced big increases in home prices. As prices rose, the risk flaws were overshadowed. This gave rise to even greater use of credit, as speculators and buyers piled onto a credit and ownership machine that seemed to offer no risk and guaranteed gains. No-down-payment mortgages or even 110% mortgages were easily obtained. Rising prices, fuelled by easy credit, spilled the housing bubble into the prime U. S. housing market.

Not all funding came via government and regulatory overreach. Hundreds of billions were raised through MBS and other risk-distribution vehicles by private players. But here too heavy doses of regulatory input and support played a significant role. The mortgages issued under new sloppy and risky lending standards were assembled and packaged and then sold as AAA-rated securities.

Rating agencies were given their power over investment and lending decisions by government. Government required financial institutions, such as insurance and investment funds, to invest in securities rated by National Recognized Statistical Rating Organizations, approved by the SEC. Only three met with SEC approval: S&P, Moody's and Fitch. Lack of genuine market competition in the ratings business, and its dependence on regulation for authority, have long been seen as hazards no regulator would take on.

The ratings firms, assured of business, fell into the lending assessment trap laid out by the Boston Fed and others. They became part of the social program. The new mortgage myth claimed that subprime mortgages issued under lax standards to low income Americans were no more risky than prime mortgages, especially when they were packaged into large agglomerations. Says Prof. Liebowitz: "Given that government-approved rating agencies were protected from competition, it might be expected that these agencies would not want to create political waves by

rocking the mortgage boat, endangering a potential loss of their protected profits." Ratings inflation ensued, with AAA and other high ratings accorded to all manner of high-risk mortgage products.

Investment houses became part of the regulatory imperative. A sales pitch from Bear Stearns, circa 1998, tells investors that the old mortgage lending rules have been replaced and that mortgages granted under Community Reinvestment Act provisions are as safe as prime mortgages. "Do we automatically exclude or severely discount...loans [with poor credit scores]? Absolutely not," said Bear Stearns.

This giant circle of risk, constructed around regulation and government policy, worked all too well. It worked, mostly, because of rising home prices that covered over the risk.

Crucial to the story is the role of another U. S. government agency, the Federal Reserve under Alan Greenspan. Mr. Greenspan's low-interest rate policy -which brought the Fed funds rate to 1% through much of 2003-- helped push home values up even higher. As values rose, the lax lending standards started to look even better. Look, Ma, no loan failures!

The new paradigm seemed to be working even better than expected, making rating agencies, Fannie, Freddie, investment dealers, bankers and MBS packagers and buyers even more aggressive and more confident that the new flexible lending standards--built on the premise of ever-rising home prices--were bulletproof. Countrywide Financial, whose board former HUD director Henry Cisneros sat on, was by 2007 the largest provider of loans purchased by the government-controlled Fannie Mae, accounting for 29% of its business.

Greenspan now downplays his role in propelling the mortgage boom or the economy and the risk profile of ever higher debt. He blames a mysterious "tsunami of risk" and, in testimony before a Congressional committee Thursday, market failure. He claimed "shocked disbelief" that bankers and institutions could have failed to properly assess risks in mortgage securities.

Blaming bankers gets Mr. Greenspan (author of last year's best-selling memoir, *The Age of Turbulence*) off the hook for what others clearly feel he bears much responsibility. That certainly is the view of Anna Schwartz, the 92-year-old coauthor with Milton Friedman of the 1963 classic *Monetary History of the United States*.

In an interview with *The Wall Street Journal* last Saturday, Ms. Schwartz noted that the house-price boom began with the very low interest rates in the early years of this decade under Mr. Greenspan. "Now," she said, "Alan Greenspan has issued an epilogue to his memoir." In it, Ms. Schwartz says Mr. Greenspan concedes "it's true that monetary policy was expansive. But there was nothing that a central bank could do in those circumstances. The market would have been very much displeased, if the Fed had tightened and crushed the boom. They would

have felt that it wasn't just the boom in the assets that was being terminated."

In other words, says Ms. Schwartz, Mr. Greenspan "absolves himself. There was no way you could really terminate the boom because you'd be doing collateral damage to areas of the economy that you don't really want to damage." Ms Schwartz adds, "I don't think that that's an adequate kind of response to those who argue that absent accommodative monetary policy, you would not have had this asset-price boom.",

The mortgage and financial crisis now sweeping the world is the product of a colossal build-up of unintended consequences brought on by government policy and regulation. Other regulatory rules accelerated the meltdown, including post-Enron mark-to-market accounting rules and international bank capital standards that were brought in without adequate thought or preparation.

What we are witnessing today, as governments pile on massive new rounds of intervention, is a growing pyramid of government failures. It will take more than James Bond to break the pyramid.