The Financial Market Meltdown: Whatever Happened to Capitalism?

By

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U.S. financial markets are sometimes thought of as a bastion of capitalism, where investors, lenders, and borrowers mutually agree to deals ranging from the safe and secure to speculative ones with the potential of huge success but with the risk of failure. All the while, each party accepts the risks and rewards as part and parcel of their agreements in the marketplace. While this characterization may be true of many sectors of financial markets, it is decidedly not true of the mortgage markets that led the way into the present financial market meltdown, nor is it true of the present government policies that lead us in the opposite direction of this type of a marketplace. In our view, this is ill advised and bodes poorly for our economy. Major government interventions are a significant source of the current troubles and an even heavier hand of government control of financial markets will not promote a strong recovery from these problems. This is not capitalism. How about if we really give it a try?

The path away from capitalism in financial markets can be described by the now familiar phrase, "the privatization of profits and the socialization of losses," that aptly depict Fannie Mae and Freddie Mac. Fannie and Freddie constitute over half of the secondary mortgage market, i.e., they buy and/or insure mortgages from the banks and financial institutions that originate them. They raise the money to do so by selling securities on financial markets. Because they are backed by the full faith and credit of the U.S. government, any losses they suffer are absorbed by the government. This, of course, means taxpayers in our society. Thus the phrase, "the socialization of risk." Profits were kept by Fannie, Freddie, and its stakeholders.

This is a gross deviation from a marketplace where each investor accepts the risk of losses as well as any gain from profits. A serious problem resulting from this deviation is the perverse incentives it generates. From an investor's perspective, the temptation is to seek higher risk investments: much of the downside risk is offloaded to the taxpayer while the investors themselves benefit from the upside gain. In the case of Fannie and Freddie, this has played out in ways that have become grim.

Subprime mortgages are such a high risk investment. These are mortgages made under circumstances that would not normally justify a loan, e.g., the borrower has a poor credit history, unclear earnings potential, and makes only a minimal down payment. The heightened risk comes from that fact that continually rising housing prices are relied on in order for many of these loans to be repaid. In addition to providing a high-risk investment that the above described incentives proscribe, subprime mortgages offer a

decided political benefit . . . they make politicians look good. They often go to individuals who otherwise would not be a homeowner. Thus, Congress (and sometimes the administration) pushed Fannie and Freddie to promote subprime mortgages as a way to be seen as aiding "affordable housing" and attainment of the "American dream" of homeownership. Since the U.S. government provides Fannie and Freddie with their government sponsored status and position of near monopoly in the secondary mortgage market, they were eager to go along with it.

In the early-2000s, Fannie and Freddie devoted increasing funds to acquiring and insuring subprime mortgages. This required lowering their standards of the type of mortgages they accepted. In addition, there was encouragement and pressure on private-sector lenders to consider "flexible underwriting standards" that would enable many of the previously unqualified borrowers to obtain a mortgage. But flexible standards were, for the most part, a euphemism for lower standards. The private sector had already been engaged in this type of lending, but with the aid and encouragement of the federal government, the private lenders intensified subprime lending. A large share of these mortgages were sold, sliced up, and repackaged into mortgage-backed securities and spread through the economy and onto the balance sheets of many financial institutions.

As is often the case, good politics trumped good economics. Congress and assorted politicians get to look good, Fannie and Freddie maintain their dominate market share and profitability (to be used, in part, to "help out" supporters in Congress), while foisting more risk, little by little, onto millions of unwitting taxpayers. But, as we have seen, this arrangement was a financial time bomb set to go off when housing prices fell, throwing the risky loans into default.

Mistakes were made in the private sector as well. Given the emphasis on increasing homeownership and the relatively low interest rates produced by the Federal Reserve's easy money policy, many lenders overzealously pushed high-risk loans with little documentation. Loan originators were often paid fees that were not tied to loan performance. Credit rating agencies were lax in rating securities backed by subprime loans. Banks and other financial institutions increased the riskiness of these financial instruments by purchasing them with borrowed money. This risk was then spread to other sectors of the economy and the world through credit default swaps in which one investor purchases some of the risk held by another investor.

Under normal circumstances, imprudent lending practices and poor investment decisions in the private sector lead to losses and changes in firm behavior, a change in management, or even bankruptcy. Typically though, these consequences are limited to a single firm or sector. However, the combination of these large governmental entities putting an implied government seal of approval on high-risk mortgages, and the private sector belief that this approval reduced the riskiness of these assets, meant that once the engine that was driving these markets—rising housing prices—stopped running Fannie and Freddie were doomed to failure and they took a large part of the market with them.

Some claim that this fiasco is the result of some kind of deregulation. This is not true. The only major piece of financial market deregulation in the last decade was the Gramm-Leach-Bliley Act of 1999 that enabled commercial and investment banks to merge. This has nothing to do with the present crisis. It is true that new financial instruments, such as credit default swaps, were developed with no new regulation associated with them. However, the biggest and most important regulatory change in the past decade was an implicit one. It was the implicit mandate from Congress and various Administrations for Fannie, Freddie, and the private sector to undertake *more* risk in the form of subprime lending.

This move away from capitalism in financial markets toward the socialization of risk and the subtle politicization of investment is an important source of our present problems. But let's now consider the policies that are intended to deal with them. Unfortunately, what's been proposed is a further movement away from capitalism.

The initial policy response was a sporadic set of bailouts of various form, first of Bear Stearns, then of Fannie Mae, Freddie Mac, and AIG. This was accompanied by injections of currency into the banking system by the Fed. More recently, Congress passed and the President signed one of the largest financial bailouts in history. The Targeted Assets Relief Program (TARP) proposes a federal government purchase of poorly performing assets from financial institutions. The Capital Purchase Program (CPP) calls for direct U.S. Treasury purchases of stock in these institutions. These represent one of the largest increases in the government's role in the private sector since the Great Depression. In our opinion, this legislation has many problems that we fear will lead to much lower long term growth for the U.S. economy.

Implementation of the asset purchase plan presents many problems. The plan calls for the Federal Government to buy "nonperforming" assets on the books of financial institutions through a reverse auction. Of course banks are currently free to sell these assets anytime they want. The problem is that, given the uncertainty surrounding the value of some of these assets, no investor is willing to pay a price for these assets greater that banks are willing to accept. Since Treasury officials are no better at valuing these assets than private sector investors, the plan will have the intended effect only if the government pays a higher price for these assets than any other investor. In other words, the government pays more for the assets than they are worth, thereby transferring some of the losses associated with these assets from the owners of financial institutions to taxpayers. This is simply more socialization of risk and rewarding those institutions that took imprudent risk relative to those who played it safe. If Treasury pays the current market value of these assets, this could push the sellers into bankruptcy as easily as would happen in a private-sector transaction.

Perhaps in light of these problems, the Treasury has turned to the Capital Purchase Program to provide capital to financial institutions to prevent their bankruptcy. Treasury already has "persuaded" several banks to sell preferred stock to the government. But either form of bailout changes the government's role in the economy in a fundamentally negative way. The government becomes the guarantor of last resort for

risky investments, either through buying up investments that turned bad or directly owning the losses and covering them with tax dollars. If a company makes a very risky investment and it pays off, they keep the lion's share of the profits. However, if the investment fails and the company is teetering on bankruptcy, then government dollars are used to salvage the company. This is socialization of risk in spades, with the associated tilt toward ever riskier investments. The only way to prevent this is for the government to control the investment activity of firms . . . the ultimate politicization of the use of capital. In such a scenario, we surely would get many politically correct and feel-good investment projects. But they would be of highly questionable value and we'd consign ourselves to a negligibly growing economy, with stagnant wages and employment. Sadly, this danger seems to grow each day. There are now calls for government investment for broker-dealers, insurance companies, and auto manufacturers. And the Office of the Comptroller of the Currency seems to be dictating firm merger activity, with the latest example being the funding of PNC contingent on its purchase of National City Corporation. Essentially the government is now picking which banks will succeed and which will fail, which in turn means the government officials are deciding which set on investors will make money and which will lose money.

Because the immediate cause of financial market disarray stems from declining house prices and defaults on mortgages, some have suggested a government bailout for homeowners to enable mortgages to be paid and defaults avoided. Of course, this has a problem similar to that outlined above: the imprudent are rewarded with the consequent encouragement of excessive risk taking.

There has also been a growing call from politicians in both major political parties for "more regulation." This is a little like going to your doctor when you are sick and having the doctor tell you to "take more medicine." This advice is obviously silly because, while some medicine can cure you, other medicine will make you even sicker and may kill you. The trick is choosing the right medicine. At its basics, financial markets work by investors providing money to financial intermediaries that, in turn, lend the money to the ultimate borrowers. Investors, to a significant extent, rely on the good reputation of the intermediaries to identify solid borrowers and make sound investments. And, under normal conditions, lenders rely on the reputation of borrowers to repay. So the trick now is choosing regulation that can restore investor trust and confidence in markets. Regulation that increases the amount of information available to borrowers and investors, that produces more transparency in transactions, that increases penalties for fraudulent lending practices, that ensures that rating agencies are conducting independent evaluations of the riskiness of assets, are all regulations that will help restore confidence in the market and lead us back to a path of long-term financial growth. Regulations that limit the ability of market participants from contracting with each other, such as limitations on executive salaries, or regulating the types of assets financial intermediaries are allowed to sell, or that investors are allowed to buy, will not help restore confidence in the market. Nor will additional bailouts on the part of the government.

If there is one lesson to be learned from this financial crisis it is that unintended and often disastrous outcomes occur when we have large government entities transacting

in private markets and making decisions based on political rather than economic considerations. Long-term economic growth results from governments creating rules that are designed to enhance market efficient and then allowing private sector entities to transact based on these rules. In other words, the best solution to the current problem is a return to Capitalism.

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