What is Going on with our Economy

Tom Campbell
The financial crisis through which our country is suffering had its origin in the easy money policy of the Federal Reserve, during the administrations of both President Clinton and President Bush. The Federal Reserve, under the chairmanship of Alan Greenspan, attempted to soften the effects of a modest downturn by keeping interest rates lower than they otherwise would have been. It was an attempt to moderate the effects of a normal business cycle, which, within reason, would otherwise have circled through periods of faster and slower growth.

In lowering interest rates to offset declining economic growth, Chairman Greenspan also caused mortgage rates to stay low. The effect was to keep the demand for housing high—indeed, unnaturally high. Consider, as an illustration, whether you might bid on a house priced at $500,000. If the mortgage interest rate was 7%, and 20% was required for a down payment, the decision to bid would depend on whether the family could afford to pay $2,333 every month. Make the interest rate 5%, however, and the family can afford to buy if it can come up with $1,666 a month. The effect of a small change in the interest rate, therefore, is a huge change in those willing to bid on a house. A bubble in the price of houses resulted.

Over this same period, President Clinton, and then President Bush, urged banks to make more mortgages to lower income applicants. They also encouraged the two great reinsurance mortgage purchasers, Fannie Mae and Freddie Mac, to buy such loans from the banks, reducing the banks’ risk almost to zero, and dulling the natural caution that would otherwise have been applied to lending to those with lower incomes. Both administrations did this, explicitly, to assist in meeting targets for minority race home own-
ership. Congressional committees reinforced this policy by regularly inquiring of Fannie Mae and Freddie Mac officials how their purchases of mortgages had been advancing the cause of minority home ownership. Implicit, and sometimes explicit, was the threat that Congress could change the law and make Fannie Mae and Freddie Mac official federal agencies (with substantially lower salaries for their top management), if the results were not what Congress wanted. The Community Reinvestment Act was also part of this effort; it was used by the banking regulators to encourage more lending to minority race mortgage applicants. Banks without a sufficiently high number of such mortgages risked receiving a negative report from their regulators, with the consequence of not being permitted to merge, or take advantage of other business opportunities that required regulatory approval.

In 1999, at the end of the Clinton Administration, a new law was passed that repealed the restriction on commercial banks being affiliated with investment banks. The new law, called Gramm-Leach-Bliley, allowed holding companies to own both commercial and investment banks. The Clinton Administration, and the Congress (then under Republican control), supported the law as a means of allowing American banks to become bigger, believing their international competitiveness depended on achieving larger size. I recall, as a Member of Congress, at the time, that the list of the world’s 10 largest banks did not include any American banks. (I am happy to report that I voted against Gramm-Leach-Bliley, one of only 6 Republicans in the House to do so.)

Mortgages were offered by banks, then purchased by Fannie Mae and Freddie Mac, then purchased in turn from them by investment banks. The investment banks, some of whom now had commercial bank interests as well, bundled these mortgages into packages. It seemed to make sense that a package of different mortgages, from different parts of the country, would have lower risk of default than any single mortgage. It was a way of diversifying, it seemed: to hold some mortgages in Georgia, some in California, some in Illinois, etc. The investment banks then sold these bundled mortgages to individual investors, pension funds, insurance companies, and foreign banks (notably, banks in Iceland figured prominently as purchasers). The investment banks kept some of the mortgage backed securities on their own books. Many investment banks took out an insurance policy against the risk that the mortgage backed security would decline in value—though it was considered a small risk—by entering into contracts with other financial institutions. AIG was the big actor here. AIG would take a fee, and promise to cover the downside risk if the mortgages underlying the bundled security went bad.

AIG was acting like a casualty insurer. We all take out fire insurance on our homes; no one expects a fire, and as long as there is none, our insurance company simply pockets the premiums we pay. We don’t mind paying; it gives us peace of mind.

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The one difference, which became critical, however, was that the insurance company that sells us the policy to protect our homes against fire, is obliged by state law to maintain reserves adequate to pay the actuarially predicted annual losses from fire. AIG, by contrast, was not a state regulated insurance company. It didn’t buy or sell securities, either, so it didn’t come with federal (SEC) regulation. It was simply the other party on a contract with the owner of a mortgage backed security.

In gambling terms, AIG pretended to be the house, but nobody checked whether the house had enough money to pay out on a dozen sequentially progressive bets on the roulette wheel. Indeed, with the rating agencies, Moody’s, Standard & Poor’s, and Fitch’s, saying the mortgage backed securities were good as gold, there seemed to be no need to take out insurance, let alone double check the depth of finances of the insurer.

This is not as strange as it seems in hindsight. Many contracts that we enter into every day are with parties that might not be financially able to perform if things go badly for them. We contract for auto repair; but there’s some risk the mechanic will walk off the job and leave for another country while our car is still in the shop, engine pieces all strewn upon the floor. We take that risk, and if we lose, we’re worse off, but no one else is. Indeed, it’s the rare case where the government provides a back-stop to protect us from our own commercial choices. One of those rare cases is the commercial banking industry, where the consequences of a run on any one bank can be a run on all banks, and an inability to pay out on depositors’ accounts. To prevent that, “fractional reserve” banking is regulated by state and federal agencies. Banks can’t make any money if they reserve all the money their depositors give them; only a “fraction” can be reserved. So we have to have a system to cover the case when all depositors come asking for their deposits at the same time. And we do.

That system worked well for commercial banks, in the days before Gramm-Leach-Bliley, when the Glass Steagall Act was in force. The FDIC, Federal Reserve, Controller of the Currency, and Office of Thrift Supervision each stood behind the commercial bank or savings & loan. In return, no commercial bank or savings & loan could make excessively risky investments or loans.

All that changed with Gramm-Leach-Bliley. The holding company that owned the commercial bank could also own an investment bank, and the investment bank could invest in whatever it chose. And they chose mortgage backed securities. They thought their risk was minimized by buying an insurance policy (the “credit default swap”) from companies like AIG. Before Gramm-Leach-Bliley, if an investment bank purchased a mortgage, or a mortgage backed security, and it went bad, and its “insurer” didn’t have the funds to cover the loss, the investment bank was out the money; but there was no consequence for the fractional reserve commercial banking system. After Gramm-Leach-Bliley, there was.
The housing bubble, like all commodity bubbles, burst. It had to—we know now in hindsight. A system of ignoring borrowers’ ability to make mortgage payments because the price of the house would forever rise, allowing refinancing to take out equity, to pay off the old mortgage, eventually had to collapse.

When it did, the mortgage backed securities plummeted in value. Some investors (individuals as well as institutions) who had purchased mortgage backed securities that had a higher percentage of riskier mortgages (the “sub-prime” mortgage that required the lender to pay above the average interest, in light of the borrower’s riskier finances), lost immediately. Others who had purchased mortgage backed securities that bundled mortgages with a variety of risks thought they could escape. They were wrong, because even though different parts of the country and different financial conditions of mortgages, presented the appearance of diversification, the underlying cause of the bubble (easy money causing energetic bids on homes) collapsed all the mortgage markets in the same way. And the large holders of mortgage backed securities who had tried to protect themselves from just this kind of risk by entering into credit default swaps with AIG, found AIG had over extended itself and couldn’t pay off on its side of the bet.

In the frenzy of selling mortgage backed securities, and writing the mortgages that underlay them, many instances have now come to light of taking advantage of vulnerable mortgagees and vulnerable investors. Some lower income mortgagees, sometimes of minority race, were steered into mortgages at higher interest rates than the market really required. And some investment banks, in selling some of their inventory of mortgage backed securities, created slices with higher risk (and somewhat higher rate of return), but with internal memoranda now coming to light showing they thought the slices they were selling were junk. I do not make light of any of those aspects of this crisis. However, it is fundamentally erroneous to blame the crisis on “greedy” mortgagees writing mortgages to vulnerable low-income minorities at exorbitant rates, and “unscrupulous” investment banks selling junk and calling it gems. The real focus must be on what caused the junk to exist in the first place. That is, why were there so many mortgages that went bad? The answer is the bubble. A bubble is bound to burst. An investment based on a bubble is potentially junk—just as soon as the bubble bursts. So the real focus has to be on the Federal Reserve that kept interest rates abnormally low for too long, and the Presidents, Congress, Fannie Mae, Freddie Mac, and federal bank regulators who enforce the Community Reinvestment Act, who urged more mortgages be granted to individuals unable to pay for them, except on the bet of an ever-rising home price market.

When the collapse of the bubble occurred, the investment banks turned to AIG, and found the insurance pool was insufficient. This jeopardized the finances of the investment banks. Lehman Brothers collapsed. Bear Stearns was on the verge of collapse. Citibank was threatened. And, because of Gramm-Leach-Billey, what might have been contained as a crisis of investment banks was now a challenge to the soundness of the commercial banks with which they were affiliated.

The Congress passed the Targeted Asset Relief Program to buy the mortgage backed securities and take them off the books of the banks before they collapsed. Then Secretary of the Treasury Henry Paulson, in collaboration with then N.Y. Federal Reserve Bank President Timothy Geitner, and Federal Reserve Chairman Ben Bernanke, injected the money instead directly into the investment banks, taking IOUs in payment. This happened under President Bush. Two thirds of that team remains in control of this process today, under President Obama. Same players, same policy.

Congress also passed the Dodd-Frank bill, casting the federal regulatory review authority over all the actors in the above described story. Commercial banks were already regulated; now investment banks would be. So also would be those who sold credit default swaps. So also would Standard & Poor’s, Moody’s, and Fitch’s, who got the value of mortgage backed securities so wrong, and then defended themselves by claiming they were only issuing an “opinion.” Individual brokers who advised clients to buy junk will now be subjected to federal regulation. Their defense had been that they had no “fiduciary” duty to those who bought the junk; even if the purchasers were also recipients of investment advice from their same companies. The approach of Dodd-Frank was to regulate potentially everybody. A new agency was created to patrol how financial products would be offered—even products that played no role in the economic collapse, like student loans and pay-day loans. Another new regulatory body, composed of representatives from the six major agencies that regulate financial institutions, was created to decide what other companies and industries, not yet regulated, ought to be regulated. A fund was created to bail out any of those companies that posed “systemic risk.” The solution, in other words, to a system of incomplete regulation, was complete regulation.

Two factors drive every economy on earth: the confidence of their consumers, and the technological ability of their production facilities. We’re presently lacking consumer confidence. If the systems put in place to ameliorate the financial crisis are believed to be working, then consumer confidence might begin to be restored. However, if those steps are perceived to be detrimental to the economy’s productive efficiency, because of their excessive regulatory burden, the good effect will be offset. In the case of the Dodd-Frank bill, that result is a distinct risk. Financial institutions are scared to lend. They are encouraged not to act in an “unfair” way; but the law’s broad phrases are not yet explicated in detailed regulations. Indeed, it’s distinctly possible that a bank will be incentivized to make more loans to low-income, minority race borrowers so as not to be perceived as “unfair,” thereby repeating one of the causes for the original collapse. Further, there is the risk that by creating a bailout mechanism, and explicitly stating it can be extended to cover any institution deemed by the Financial Services Oversight Counsel to be a “systemic risk,” the Dodd-Frank bill might have enshrined “too big to fail,” with a result that encourages financial institutions to grow in order to get the explicit guarantee from the federal government.

Nevertheless, this is the solution we’ve chosen: under a Democratic President and a Democratic Congress. A Republican House is now openly challenging whether it was the right way to go, but it can do nothing until and unless there’s a Republican President and a Republican Senate willing to undo Dodd-Frank’s major provisions. For a Republican alternative approach, however, to be successful, it has to convince consumers that it will more surely lead to recovery. That is very hard to do, especially as the Republican Presidential nominee is not yet known, let alone the details of what any Republican Presidential candidate would offer as an alternative.

Let me close with one suggestion for such
an alternative, offered with a caveat. The warning is that it may likely be too late to embrace this alternative. Psychology being such an important part of economics, it might be best for consumer confidence, on which recovery hinges, not to roll the solution chosen to this financial crisis by Presidents Bush and Obama, Fed Chief Bernanke, and Timothy Geitner. Dodd-Frank, and TARP, may have been flawed; but they certainly are comprehensive and present the reality of an engaged federal government. It might be best to let them continue until, eventually, the economy is vibrant again.

However, it would be very worthwhile to analyze the alternative approach, for possible application in future crises. It would start with restoring Glass-Steagall by repealing Gramm-Leach-Bliley. Leave the commercial banking system untainted by common ownership of investment banks and commercial banks. Abolish Fannie Mae and Freddie Mac. They were created to compete with the private sector, with an implicit government guarantee that has now become explicit. The private market of mortgage reinsurance should be allowed to flourish instead. Announce often that the U.S. really does believe in free, competitive markets. No taxpayer got to benefit from the extraordinary run-up in value of the investment banks. So, no taxpayer should have to participate in the cost of bailing them out. Freedom to succeed is also freedom to fail. We do recognize the need for government back-stopping of the commercial banking industry. The logic, however, of protecting every other financial institution from the folly of its own investments, is itself bankrupt.

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