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"FINANCIAL CRISIS" OR HEALING PROCESS?

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Abstract in original language:
Are we really facing "financial crisis" or is the current economic downturn just a natural healing process that is to help economy to recover from unsuitable interference? The author of this article acquaints reader especially with an approach of Professor Liebowitz, who claims that the governmental affirmative policies were at the roots of the "crisis". Should government set artificial requirements on mortgage-underwriting standards? Further, the author ponders over some of the consequences that some similar "protective" regulations might bring with them.

Key words in original language:
Economic Downturn; Community Reinvestment Act; Freddie Mac; Fannie Mae; Equal Credit Opportunity Act; Mortgage-Underwriting Standards; Homeownership Rate; Financial Instruments; Governmental Interfering; Bubbles; Minimum Wage Laws.

"Perhaps the greatest scandal of the mortgage crisis is that it is a direct result of an intentional loosening of underwriting standards – done in the name of ending discrimination, despite warnings that it could lead to wide-scale defaults."
Stan Liebowitz[1]

Introduction

There is no doubt economic downturns affect most of people. There are two general types of root causes of such downturns: (1) natural; and (2) human made. This article deals with the latter. As Professor Liebowitz shows on the current example, some of the economic "crises" were caused by humans having enacted bad regulations. The goal of this article is to outline Liebowitz's approach pinpointing that some of the bad "protective" regulations might have contributed to the ongoing "crisis". Further, taking the Liebowitz's statements into consideration, it will be shown that the "crisis" might be looked at as a natural market process of recovering from such bad regulations. Next, I will briefly ponder over the reason why there have been too many risky mistakes done by investors purchasing pools of mortgages with new "flexible underwriting standards" and, finally, I will show that there are many similar laws, which, in spite of looking beneficial, should be reconsidered because of their possible inefficiency.

Has the Community Reinvestment Act Done its Job?

Notwithstanding the immediateness of the current economic downturn, we should keep in mind that this is not the first and largest "crisis" people have faced. Next to many minor ones such as the "dot-com" bubble (1995-2001), one should not forget especially times of the Great

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[1] Liebowitz, S. J. New York Post web: The Real Scandal [cited on 4. 5. 2009]. Available at: http://www.nypost.com/seven/02052008/postopinion/opedcolumnists/the_real_scandal_243911.htm?page=0

Depression. Professor Liebowitz reminds us, there was a profound decline on mortgage markets during the Great Depression too.[2] Having been aware of possible insolvency of mortgagees and being "cash strapped", the lending financial institutions were giving just short duration loans in the United States in 1930s. Trying to jump up the slow activities on the real estate markets, the government created the Federal Housing Administration (FHA), which was supposed to "guarantee mortgages against default".[3] Four years later in 1938, Fannie Mae was formed to buy FHA mortgages. These two governmental steps may be deemed for the very first bigger intervention of government into mortgage markets. However, these initiatory interventions were deepened in 1970s when the mortgage-related anti-discrimination laws were enacted.

In 1977, the Community Reinvestment Act (CRA) was passed. According to Federal Financial Institutions Examination Council (FFIEC), its purpose has been to "encourage depository institutions to help meet the credit needs of the communities in which they operate, including low- and moderate-income neighborhoods."[4] In other words, this law forced banks to give loans to low-income borrowers, especially than, by "requiring banks to conduct business across the entirety of the geographic areas in which they operated, thus preventing them from doing business in suburb."[5]

The CRA supplemented the Home Mortgage Disclosure Act (HMDA) of 1975. This law, having been amended in 1991, has required banks to expose detailed information about the mortgage applications they have been dealing with. There were a couple of studies made by news organizations that claimed that "minorities were denied mortgages at a rate far higher than that for whites".[6] These independent studies were later supported by the Federal Reserve Bank of Boston (Boston Fed), which came up with its own analysis in 1992. Despite, as Professor Liebowitz claims, having provided wrong and inaccurate data,[7] this analysis was often cited by politicians and media, which made discrimination of minorities a topic of political talks.

Consequently, in 1998, Fannie Mae and Freddie Mac were forced by Congress to increase purchases of mortgages for low- and moderate-income mortgagees. According to Schwartz: "In 1996, HUD, the department of Housing and Urban Development, gave Fannie and Freddie and explicit target: 42 percent of their mortgage financing had to go to borrowers with incomes below the median income in their area. The target increased to 50 percent in 2000 and 52 percent in 2005. For 1996, HUD required that 12 percent of all mortgage purchases by

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[2] Liebowitz, S. J. Anatomy of the Train Wreck. Causes of the Mortgage Meltdown. Oakland : The Independent Institute, 2008, p. 5.

[3] Ibid.

[4] FFIEC, FFIEC web: Background and Purpose [cited on May 3rd, 2009]. Available at: http://www.ffiec.gov/CRA/history.htmhttp://www.ffiec.gov/CRA/history.htm.

[5] Liebowitz, S. J. Op. Cit.

[6] Ibid.

[7] Professors Liebowitz and Ted Day carefully studied the analysis and have found out there have been many inaccuracies and false information. Op. Cit.

Fannie and Freddie had to be "special affordable" loans, typically to borrowers with incomes less than 60 percent of their area's median income. That number was increased to 20 percent in 2000 and 22 percent in 2005. The 2008 goal was to be 28 percent. Between 2000 and 2005 Freddie and Fannie met those goals every year, and funded hundreds of billions of dollars worth of loans, many of them subprime and adjustable-rate loans made to borrowers who bought houses with less than 10 percent down."[8] Thus, the governmental interference into the natural process of loan making, where lenders always carefully evaluated all the risks that they might face in the future, was rather disturbed.

The government's idea of guaranteeing mortgages to low income borrowers was accompanied by a goal to increase home ownership in the United States. Even though this target might seem beneficial for all the ones who participate in mortgages markets, i.e. mortgagors, mortgagees - buyers, sellers of homes, builders, developers, realtors, etc., this aim, as Professor Liebowitz reminds us, had a huge side effect: intentional weakening of the traditional mortgage-lending standards.[9] The proven system of lending money only to those who can give sufficient guarantees of having enough funds to pay installments was destroyed. Since there was this practice that forced banks to provide most of applicants with mortgages, loans were often granted with no money down and without proper credit check and examination of employment history. Supposing the banks did not provide a sufficient number of low-income applicants with mortgages, they could be labeled "discriminatory" and could face law suits for failing to comply with the Equal Credit Opportunity Act (ECOA). "Liability for punitive damages can be as much as $10,000 in individual actions and the lesser of $500,000 or 1 percent of the creditor's net worth in class actions."[10]

In respect to the ECOA rules it is important to keep in mind that any form of unreasonable deny to extend credit to particular applicants would be unproductive for the bank itself because it would lose a potential client. It has always been in the best interest of the bank to make a reasonable screening while considering who to extend credit to.

Having the abovementioned facts in mind, let's move to the other problem, related to the "mortgage crisis". If there were a price drop, i.e. value of a home got below the amount owed, the owners of such properties might start considering whether or not to keep on paying their mortgage payments. The bigger the price drop is, the bigger the probability that they quit making their payments is. Thus, especially the often called "100% financing" mortgages might have been at the rise of homeowners defaulting on their installments. The decision to stop on making mortgage payments might have been supported, in some cases, even by the rising APR (annual percentage rate) of the ARMs (adjustable rate mortgages).

Let's take a quick look at the situation couple years ago. Everything was looking well, the number of low-income homeowners was on the rise and the increase of homeownership was followed by growing price. However, the artificial governmental interference into the natural

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[8] Schwartz, A. J. Origins of the Financial Market Crisis of 2008. Cato Journal, Vol. 29, No. 1 (Winter 2009). Cato Institute, p. 20.

[9] Liebowitz, S. J. Op. Cit. p.4.

[10] The Federal Reserve Bank of Boston (Rodburg, S. E. and Walker, R. C.) A Guide to Equal Opportunity Lending, Available at: www.bos.frb.org/commdev/commaff/closingt.pdf In: Liebowitz. Op. Cit. p.9.

market process of setting prices of homes created so-called "bubble". In natural conditions, price for and availability of mortgages can be only set be the supply and demand relations. Failing to follow the nature order has only one possible consequence: the artificially made bubbles sooner or later shrink. Therefore, one might ask: Is the economic downturn with all its consequences we facing now really a natural market crisis or are the natural market forces just getting back to normal?

Notwithstanding that there are many elements forming the "bubbles", the policies supporting an increase of homeowners have contributed to the current situation. Looking at Figure 1, we can see that the dramatic price increase took place in the middle of 1990s when the new policies occurred.

Figure 1: Yearly Home Ownership Rates (U.S. Census)[11]

Hence, although the idea of making sure that even the low-income clients may obtain mortgages at affordable price, which would not be set according to the actual risk but rather by guaranteeing their solvency by governmental institutions and by forcing financial institutions to provide such loans, might seem beneficial and high-minded, the actual consequences could be extremely risky for society and the entire economy.

There have been many laws that are very similar to the ones whose consequences were just described. Especially, the laws "protecting" consumers and employees might have very similar effects and, in the times of crises, such laws should be reconsidered. However, before

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[11] Federal Reserve Bank of San Francisco web: Economic Research Data. Available at: http://www.frbsf.org/publications/economics/letter/2006/el2006-30.html

I try to outline the consequences of some of these laws, there is one more question that should be mentioned: Why did the investors buying the pools of mortgages underestimate the risks?

Generally, anyone who is to make an investment considers its profitability, i.e. they look at the amount they are about to put in and compare it with the anticipated earnings. By doing so, they have to include in the price an "insurance" (simply determined by asking whether or not the investment will be still profitable if something goes wrong and what is the possibility of such failure) for possible risks that they might face. Why have not the investors consider carefully the risks of the mortgages that had been granted with a lack of reasonable underwriting standards?

What Caused the Incautiousness of Investors?

The investors simply were not aware of dangers connected with such investments. We can either blame them or the rating agencies that were providing them with inaccurate date or both of them. Schwartz explains that markets were not aware of flaw in the design of the new financial instruments, which have not been easy to evaluate: "The design of mortgage-backed securities collateralized by a pool of mortgages assumed that the pool would give the securities value. The pool, however, was an assortment of mortgages of varying quality."[12] Thus, the value and risk determination was something new that the rating agencies were not really aware of. "They assigned ratings to complex securities as if they were ordinary corporate bonds and without examining the individual mortgages in the pool."[13] Next to that if the rating agencies had shown that the mortgages given to low-income borrowers were much more risky than the prime-mortgages, they could have been labeled "prejudiced" by the same interest groups that had pushed the CRA in the first place.

In respect to this problem, professor Liebowitz pinpoints the fact that the government approved rating agencies "were protected from free 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 losses".[14] However, not only the rating agencies should be blamed. The system of granting mortgages which had been adjusted by laws relaxing underwriting standards made the investors think that if there is everything is in compliance with these laws, nothing can go wrong.

Are the Minimum Wage Laws Really Protecting Employees?

Let's take a quick look at some other "protective" regulations that are very similar to those having been talked about above. I will focus on showing that some of the statutory provisions, on the general level, whose purpose is to protect employees, bring many negative and unintended consequences and, next to that, these laws might even hurt both the subjects that are to be protected and the economy.

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[12] Schwartz, A. J. Op. Cit. p.29.

[13] Ibid. Bold print by author.

[14] Liebowitz, S. J. Op. Cit. p. 12. Bold print by author.

"The bad economist sees only what immediately strikes the eye; the good economist also looks beyond. The bad economist sees only the direct consequences of a proposed course; the good economist looks also at the longer and indirect consequences. The bad economist sees only what the effect of a given policy has been or will be on one particular group; the good economist inquires also what the effect of the policy will be on all groups."[15]

Henry Hazlitt

An idea of setting a minimum wage via laws is of very similar nature as the affirmative laws described above. By looking at minimum wage laws from a theoretical point of view, one can probably agree that, generally, these laws interfere with the principle of "autonomy of the will". Their goal is to protect a "weaker party" in its legal connection. Supposing we forget the principle of "autonomy of the will", we could state that such protection of "weaker party" really helps to such party and, thus, it shall be supported. I would definitely go along with this approach if it were really helpful. However, such laws might be very inefficient in supporting employees, which I try to show on a couple of examples.[16]

First of all, as Professor Murphy reminds us, the minimum wage laws are often justified by assertion that "had the government not stepped in and declared a "civilized" floor less than which no decent person could pay another human being, capricious employers would outdo each other in a race to the bottom … the hapless low-skilled workers have no bargaining power (they have to eat, after all) and hence would be forced to accept whatever crumbs they were offered."[17] However, on the markets where there is a relatively free chance for everybody to join such markets as a new competitor, the abovementioned fear may not take place, because were the workers paid less than what their labor is worth, it would be an impetus for new competitors seeing a possibility of extremely high profits to join the particular market area. Having started participating in the relatively high-profit markets, the new competitors would be in need of workers. How would they get them? The new competitors would have to offer the workers higher salaries (or benefits) than what the other competitors (employers) do offer. "The process would continue until the workers were being paid what they were generally worth."[18]

Next to that, the minimum wage laws might even "discriminate" on low-skilled workers. To follow my point, just imagine yourself being an owner of a restaurant who is to hire a couple of new employees. You need to hire a person who will be taking care about accountings (job A) and a new cook (job B). However, you cannot spend more than $100 a day on their salaries. Now, imagine that there are three applicants who came for an interview. First person is willing to work as a cook just for $45 a day (job B), because he or she does not have a high

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[15] Hazlitt, H. Economics in One Lesson. New York : Pocket Books, Inc., 1952, p. 4.

[16] The following example gathers from: Murphy, R. P. The Politically Incorrect Guide to Capitalism, Washington DC : Regnery Publishing, Inc, 2007, p.23.

[17] Ibid. p. 24.

[18] Ibid.

experience. The second person would accept the accounting job for $40 (job A). It is a young mom who just needs to make some money on side. The third person that came is an experienced cook who was running own business for a while. Hence, he or she has the basic experience in accounting too. However, he or she is not willing to work for less than $90 a day (job A and B).

If we do not take into consideration that having rather one person than two might bring special pros and cons, we can see that $85 for the first two applicants would cost $5 less that $90 that the third applicant asks for. Thus, the choice would be probably made for the first two (even thought the less experience cook would need some time to learn the ropes). Now imagine, in the light of the same conditions, there is a minimum wage law that sets a limit of $55 as daily minimum pay. Who would you choose now?

From another point of view, if there is a company which has been already giving jobs to 1000 employees that were each given $8 an hour, what happens if government decides to set a minimum wage of $10 to punish anyone who hires workers for less than that? In respect to this, Professor Murphy comments: "Will the company decide to kick in the difference and lose $2 per hour on the worker in question? Of course not. The company will lay off workers until the remaining ones are more productive."[19] Thus, especially in the times of economic downturns, the regulations that might hurt employees by causing unemployment should be repealed.

Principally, there are a number of laws that resemble the abovementioned one. Notwithstanding that their purpose might seem very beneficial, they may be failing on achieving their goals and next to that they may be putting a redundant burden on the entire economy. In present days, we are facing a serious economic downturn, which was probably caused by bad regulations, thus, we should reconsider efficiency of such burdens. As it was shown on the example of minimum wage laws, some of the artificial regulations might even hurt those who they were intended to protect.

In the first example above, the minimum wage law would force the entrepreneur to hire one person instead of two (if there were progressive taxation, the government might even support this option) and the second example has shown that such law might pressure employers to dismiss some of their employees and to request higher efficiency from the remaining ones.

Conclusion

Generally, the ongoing economic downturn may by looked at from many different points of view. There may be all kinds of approaches to what caused the "crisis" and, surely, there are even more approaches to what should be done to fight the consequences of it. My purpose is not to evaluate and rate all the different ideas, but to show that there are many approaches to the roots and solutions of the current economic situation. The idea of letting the natural market forces run their course should be at least taking into consideration. In Professor Rothbard's words: "If government wishes to alleviate, rather than aggravate, a depression, its only valid course is laissez-faire – to leave the economy alone. Only if there is no interference, direct or threatened, with prices, wage rates, and business liquidation will the

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[19] Ibid.

necessary adjustment proceed with a smooth dispatch".[20] Further, it is important to keep in mind the fact that prices of homes were boosted up by artificial (i.e. non-market) forces and, hence, we should not blame the market for the contemporary price drop. My last point is that there are many laws that might seem the same beneficial as the ones that were at the roots of this "crisis" and we should always be aware that these laws, especially those with are trying to limit the fundamental principal of "autonomy of will", might not be that great as they might appear at the very first sight.

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