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Fraught Finance and the Future

Introduction

The financial crisis of 2008 has become a finger pointing fiasco between both politicians looking to score political points and take advantage of the rare opportunity to achieve ideological goals, and Wall Street businessmen looking to salvage their egos and careers, while protecting the multi-billion dollar revenue pipelines suddenly at risk post-crisis. Finger pointers have publicly blamed the collapse of the financial markets on corporate greed, liquidity issues, deregulation, predatory lending, overleveraging, and more. Surely, all of these played some sort of role in the ensuing mess. However, in order to fully understand and diagnose the crisis, one must examine its very root causes. Additionally, one must investigate how that root cause managed to spread its eventual destruction to an entire industry that would put the national and global economy at risk like almost never before.

Argument

In this paper I will argue that government intervention in the housing market fundamentally altered the restraints previously imposed on home lending and buying. This alteration subsequently led to the housing boom that lies at the root of the recent crisis. In order for the housing crisis to spread like a contagious disease throughout the entire global financial market, however, there must have been another enabler. Here, I will argue that the ratings agencies failed in their most basic mission, which was to assess the fundamental risk inherent in financial instruments in an unbiased manner. Thus, the

woes of a single industry were allowed to spread across markets and across the globe in an unheard of manner.

Homeownership

Homeownership has long been a figment of the American imagination. From the Founding Fathers focus on private property rights, to westward expansion in the 1800s, to the modern era, Americans have sought to own a piece of property of their own. In the past, homeownership was more of a personal goal and associated with achieving the American Dream. Beginning in the 1990s and extending into the 2000s, however, homeownership became a political goal as well.

The politicization of homeownership came about for numerous social reasons, including civil rights and family values. Under the Clinton administration, housing statistics showing stark disparities in homeownership rates for whites and minorities became a public concern. Seeking to please a significant part of his voting base, President Clinton and his staff began to investigate ways in which minority home ownership could increase, which will be discussed later.

Starting in 2000 under the Bush administration, homeownership took on more of a family values role, as was appropriate with the times and the election of a “compassionate conservative”. President Bush and his allies argued that homeownership was likely to lead to healthier, more stable family environments that would subsequently lead to better communities and enhanced economic participation. Thus, both administrations sought to make homeownership available to groups and people previously denied the opportunity to enter the housing market.

Mortgages and Mortgage Risks

Given the fact that purchasing a single-family home with cash is unfeasible for the vast majority of Americans, mortgages have existed as a form of financing for centuries. Up until only a few decades ago, mortgages were generally created and maintained by local banking institutions, which often knew their customers on a personal basis. These relationships were important because of the inherent factors in mortgages that make them relatively unattractive investments for originators.

Mortgages are susceptible to various types of risk including interest rate risk, prepayment risk, and default risk. Interest rate risk occurs when market interest rates rise, meaning that banks could be earning a higher percentage of interest if the money loaned in the mortgage was invested elsewhere. Prepayment risk means that the originators only experience the downside of interest rate changes. If interest rates fall, customers are likely to take out new loans at lower rates and pay off the higher interest rate mortgage, meaning the bank doesn't enjoy the new spread in rates. Finally, default risk accounts for the possibility that a customer will become unable or unwilling to pay off his or her debts to the originator, leading to a costly and time-consuming legal process and the headache of repossessing a home or property.

Historical Mortgage Trends

Mortgages in recent memory were plain vanilla in fashion. Homebuyers faced the reality of a fifteen or thirty year fixed rate mortgage with a ten to twenty percent down payment. The existence of a down payment was an important tool for the banks to protect against default risk. In the rare case that a homeowner lost his or her job and couldn't afford mortgage payments or if housing prices fell, the down payment was enough for the bank to cover the expenses of selling the foreclosed home and the

potentially lower value. After all, a drop in the real estate market of more than ten to twenty percent was unfathomable. The terms of such plain vanilla mortgages put homeownership out of reach for many Americans, especially minority groups. Many of those unable to purchase couldn't afford the interest payments, couldn't afford the substantial amount of cash needed up front to purchase a home, or didn't meet the strict lending requirements banks held in order to protect their mortgage investments.

The Beginning

In 1977 the United States Senate and House of Representatives passed the Community Reinvestment Act (CRA) with a combined single day of floor debate, affecting commercial banks and thrifts. The Act instructed “each appropriate Federal financial supervisory agency to use its authority when examining financial institutions, to encourage such institutions to help meet the credit needs of the local communities in which they are chartered consistent with safe and sound operation of such institutions”.¹ Section 804 of the bill noted that the regulatory agency's findings should be taken into account when determining the institution's ability to open a new branch or merge with or acquire another institution.² In hindsight, the vague wording of the bill should have caused concern for Congress. After all, the needs of a local community, a bank's attention to those needs, and “safe and sound operations” are three highly debatable statistics and measures.

Community Reinvestment in the 1990s

¹ Sowell, Thomas. *The Housing Boom and Bust*. New York: Basic, 2010. 36. Print.

² "FDIC Law, Regulations, Related Acts - Consumer Protection." *FDIC: Federal Deposit Insurance Corporation*. Web. 14 May 2010. <<http://www.fdic.gov/regulations/laws/rules/6500-2515.html>>.

In 1992, the Federal Reserve Bank of Boston released a study purporting to show higher rates of mortgage denial for blacks and Hispanics when compared with whites. This report caused widespread uproar in the media and put pressure on Congress to act in order to right the “injustice” (which was later proven to be a misuse of statistical data rather than simple discrimination).³ The Clinton administration stepped up pressure to pursue banks thought not to be in compliance with CRA, while the Federal Reserve took action against banks like Shawmut National Corporation, which was not allowed to acquire New Dartmouth Bank in December 1993. The bank was then under fire based on statistics from the 1992 Boston Federal Reserve study and was not allowed to acquire New Dartmouth Bank until it agreed to pay an almost \$1 million settlement to be used towards helping the minority applicants allegedly wrongly turned down by the bank.⁴ Additionally, Attorney General Janet Reno often appeared at high-profile media announcements of bank settlements dealing with CRA violations. In January 1994 at such a conference, Reno stated, “Today’s actions demonstrate that we will tackle lending discrimination wherever and in whatever form it appears. No loan is exempt, no bank is immune. For those who thumb their nose at us, I promise vigorous enforcement”.⁵

In 1995 President Clinton directed that a bank’s CRA rating be made more public, clear, and quantitative. Institutions were now to be rated as Outstanding, Satisfactory,

³ Sowell, Thomas. *The Housing Boom and Bust*. New York: Basic, 2010. 104. Print.

⁴ McKinley, Vern. "Community Reinvestment Act: Ensuring Credit Adequacy or Enforcing Credit Allocation?" *Regulation* 4 (1994): 28. *Cato Institute*. Web. <<http://www.cato.org/pubs/regulation/regv17n4/vmck4-94.pdf>>.

⁵ McKinley, Vern. "Community Reinvestment Act: Ensuring Credit Adequacy or Enforcing Credit Allocation?" *Regulation* 4 (1994): 30. *Cato Institute*. Web. <<http://www.cato.org/pubs/regulation/regv17n4/vmck4-94.pdf>>.

Needs to Improve, or Substantial Noncompliance.⁶ Additionally, “the new regulations de-emphasized subjective assessment measures in favor of strictly numerical ones. Bank examiners would use federal home-loan data, broken down by neighborhood, income group, and race, to rate banks on performance. There would be no more A’s for effort”.⁷

What had previously been a relatively ignored law hidden from the spotlight since President Jimmy Carter’s signing in 1977 was suddenly front-and-center in the mind of the banking and lending industry. An administration had finally found a social crusade worthy of the vague language of the CRA.

Fannie Mae and Freddie Mac

Fannie Mae and Freddie Mac are government-sponsored enterprises designed to purchase mortgages from lending institutions and securitize them, allowing for a constant availability of funds for the United States mortgage market.⁸ As government-sponsored enterprises, Fannie Mae and Freddie Mac are believed to have the implicit guarantee of the federal government, meaning that they would not be allowed to fail in the event of a crisis. Because of the implied lower or nonexistent risk of failure, the institutions are allowed to borrow funds at lower rates than the market would otherwise allow and then use those funds to buy up mortgages from originating institutions. Additionally, the institutions receive favorable tax status that saves hundreds of millions of dollars each year. In 2001, the Congressional Budget Office estimated that such government-

⁶ "FRB: Testimony--Braunstein, The Community Reinvestment Act--February 13, 2008." *Board of Governors of the Federal Reserve System*. Web. 14 May 2010. <<http://www.federalreserve.gov/newsevents/testimony/braunstein20080213a.htm>>.

⁷ "The Trillion-Dollar Bank Shakedown That Bodes Ill for Cities by Howard Husock, Winter 2000." *City Journal*. Web. 14 May 2010. <http://www.city-journal.org/html/10_1_the_trillion_dollar.html>.

⁸ "About Us - Learn More about Fannie Mae and How We Can Help You | Fannie Mae." Web. 14 May 2010. <<http://www.fanniemae.com/kb/index?page=home&c=aboutus>>.

sponsored enterprises had a borrowing advantage of 41 cents per \$100 of debt issued.⁹

Fannie Mae and Freddie Mac were vital to the creation of the secondary market for mortgages and forever altered the entire mortgage market. At one point, sixty percent of all mortgages passed through the hands of Fannie Mae and Freddie Mac.¹⁰

Fannie Mae and Freddie Mac in the 1990s

In the last days of the first Bush administration, Fannie Mae and Freddie Mac became regulated by the Department of Housing and Urban Development (HUD). Once under HUD, Fannie Mae and Freddie Mac were forced to take on specific numerical goals aimed at increasing homes purchased by middle- and low-income families. President Clinton's HUD set the target at 50%, while President Bush's HUD raised the rate to 56% in 2004.¹¹ Caught up in the race and new government pressure to serve previously underserved mortgage applicants, Fannie Mae announced its Trillion Dollar Commitment in May 1994, aiming to help ten million families achieve homeownership by the end of 2000.¹²

Throughout the 1990s Fannie Mae and Freddie Mac continued to reap record profits as the companies securitized more and more mortgages, while seemingly going

⁹ "Testimony on Federal Subsidies for the Housing GSEs." *Congressional Budget Office - Home Page*. Web. 14 May 2010. <<http://www.cbo.gov/doc.cfm?index=2839&type=0>>.

¹⁰ "Behind the Fannie and Freddie Fears - TIME." *Breaking News, Analysis, Politics, Blogs, News Photos, Video, Tech Reviews - TIME.com*. Web. 14 May 2010. <<http://www.time.com/time/business/article/0,8599,1822014,00.html>>.

¹¹ "How HUD Mortgage Policy Fed The Crisis - Washingtonpost.com." *Washingtonpost.com - Nation, World, Technology and Washington Area News and Headlines*. Web. 14 May 2010. <http://www.washingtonpost.com/wp-dyn/content/article/2008/06/09/AR2008060902626_2.html>.

¹² "Fannie Mae." *CSR Globe - ICCA's Global CSR Directory*. Web. 14 May 2010. <http://www.csrglobe.com/login/companies/fannie_mae.html>.

about their social missions to serve underserved segments of the population.¹³ In 1995, Fannie Mae and Freddie Mac's experience with sub prime mortgages began. At that time, HUD agreed to count sub prime mortgages towards Fannie Mae and Freddie Mac's 50% housing targets. After all, sub prime mortgage applicants were most likely members of the population that Fannie Mae and Freddie Mac were looking to serve. It was assumed that the two government-sponsored enterprises would hold the mortgage originators of these sub prime loans to their own relatively strict, government imposed lending standards.

Mistake?

In 2000, HUD realized its mistake and stopped blindly crediting sub prime loans towards Fannie and Freddie's quota for fear that the majority of loans were predatory in nature. However, HUD didn't ban the two from outright purchasing the sub prime loans. In 2005, at their peak, the two purchased \$169 billion in sub prime loans.¹⁴

Market Reaction

The federal government's use of the Community Reinvestment Act and government-sponsored enterprises to achieve social homeownership goals in the 1990s drastically affected the overall market for mortgages. As Fannie Mae and Freddie Mac were pressured by HUD and commercial banks were intimidated by the perceived public pressure to abide by minority lending rules, the incentives to lower lending standards came into reality. Loans that previously would not have made economic sense were

¹³ "Fannie Mae -- Company History." *Connecting Angel Investors and Entrepreneurs*. Web. 14 May 2010. <<http://www.fundinguniverse.com/company-histories/Fannie-Mae-Company-History.html>>.

¹⁴ "How HUD Mortgage Policy Fed The Crisis - Washingtonpost.com." *Washingtonpost.com - Nation, World, Technology and Washington Area News and Headlines*. Web. 14 May 2010. <http://www.washingtonpost.com/wp-dyn/content/article/2008/06/09/AR2008060902626_2.html>.

approved because, all of a sudden, there was a secondary market for those risky loans. Brought on by the creation of Fannie Mae and Freddie Mac and now a booming industry in itself, the secondary mortgage market was willing to buy these lower quality loans. The purchases of such loans removed the risk from the books of the mortgage originators and created huge revenue streams for securitization companies like Fannie Mae, Freddie Mac, and most of the Wall Street giants, who could then charge fees to slice up the revenue streams of the mortgages and sell them off in packages to other investors across the globe.

In September 1999, after Fannie Mae announced that it would ease credit restrictions on loan purchases, *The New York Times* noted the correlation between Fannie Mae and Freddie Mac's lending goals and the private sector's thirst for ever more risky lending. Steven Holmes wrote, "Fannie Mae has been under increasing pressure from the Clinton Administration to expand mortgage loans among low and moderate income people and felt pressure from stock holders to maintain its phenomenal growth in profits. In addition, banks, thrift institutions, and mortgage companies have been pressuring Fannie Mae to help them make more loans to so-called sub prime borrowers".¹⁵

Once again, it is shown that the existence of Fannie Mae and Freddie Mac as implicitly backed government-sponsored enterprises created an unnatural change in the market for lending. Without the support of these institutions, banks of all types didn't feel comfortable or able to make these risky loans to "underserved" segments of the

¹⁵ Holmes, Steven A. "Fannie Mae Eases Credit To Aid Mortgage Lending - NYTimes.com." *The New York Times - Breaking News, World News & Multimedia*. 30 Sept. 1999. Web. 14 May 2010. <<http://www.nytimes.com/1999/09/30/business/fannie-mae-eases-credit-to-aid-mortgage-lending.html>>.

population. The implicitly backed institutions created an implicit understanding in the market that these types of loans were safe and worthy of investment.

Home Prices

Historically low interest rates set by the Federal Reserve in accompaniment with loose lending standards spawned by government intervention in the mortgage market quickly began to fuel a housing boom. Suddenly, there were millions of buyers who had previously been unable to purchase homes looking to buy. With the increase of buyers, prices increased dramatically. From 2000 to 2005, the median sales price of a single-family home in the United States jumped from \$143,600 to \$219, 600- more than 50%. Other parts of the country, which are especially hurting today, saw even greater increases. New York, Los Angeles, and San Diego single-family home prices rose 79%, 110%, and 127%, respectively, during that time period.¹⁶

Additionally, because of rising prices, first-time or previously underserved homebuyers weren't the only ones altering the housing market. Buyers began to buy homes for investment purposes, using their primary homes as collateral for the mortgage and then quickly reselling the investment property as the home price rose in value. Often the investor simply painted the walls or refurbished the kitchen of a "fixer-upper" and was able to sell the house in the not too distant future for much more than the original cost of investment and repairs. Such practices continued to increase the demand for housing, thus putting upward pressure on house prices.¹⁷

Mortgage Laboratory

¹⁶ Sowell, Thomas. *The Housing Boom and Bust*. New York: Basic, 2010. 1. Print.

¹⁷ Sowell, Thomas. *The Housing Boom and Bust*. New York: Basic, 2010. 24. Print.

As David Souter, author of *The Housing Boom and Bust*, states, “Lenders did not spontaneously begin lending to people who would not have qualified for loans under the traditional criteria that had evolved out of years of experience in the market”. In fact, in order to conform to the pressures being induced upon the market to increase loans to customers who would have been previously denied and the undeniable temptation to reap the enormous fees and high interest rates associated with the business, lenders created all sorts of new loan products.

Newfangled loans required lower down payments, or sometimes no down payment at all. Adjustable rate mortgages became popular, which involved an interest rate that moved with the rate set by the Federal Reserve. Such loans also often included “teaser” rates, or artificially low interest rates for the early years of the mortgage, which later reset to much higher rates. These later rates drastically altered the loan payments required of the homeowner. 90% of sub prime loans made by 2006 were such mortgages.¹⁸ Additionally, interest only mortgages actually allowed borrowers to only pay the interest on their loan for a period of time before beginning to pay down the principle on the home. In 2002, fewer than 10% of originated mortgages were interest-only. But by 2005, the number had skyrocketed to 31%.¹⁹

In step with the economic and social incentives to issue loans, application processes became almost laughable. Ads by companies such as LendingTree.com and other websites shot across the airwaves and television screens, promising easy money to almost anyone. Loans in which applicants listed their supposed incomes without proof of

¹⁸ Sowell, Thomas. *The Housing Boom and Bust*. New York: Basic, 2010. 18. Print.

¹⁹ Sowell, Thomas. *The Housing Boom and Bust*. New York: Basic, 2010. 20. Print.

a pay stub or salary deposit also become popular. Such loans accounted for more than half of all sub prime loans in 2006.²⁰

As lenders continued to get more and more creative with financing methods for home mortgages, the entire housing industry stepped closer and closer to the edge of a cliff.

Wake Up Call

The housing market peaked in 2005 and began to fall in late 2006, as the Federal Reserve set the federal funds rate at 5.25%.²¹ All of a sudden, homeowners and speculators were unable to either refinance or sell their homes for a higher price when the interest rates of their fancy mortgages reset after teaser rates expired or after the effects of the Federal Reserves rate raises were taken into account. Mortgages had suddenly become much more expensive for homeowners, and hundreds of thousands of homes were “underwater”, meaning that families owed more to the banks than the houses were worth. As mortgage payments rose and home values simultaneously fell, homeowners began to default on their mortgages by either not paying or walking away from the houses. In the first half of 2007, Federal Reserve Chairman Ben Bernanke reported that 320,000 foreclosures had been initiated so far that year, up 100,000 from the average over the past six years. Over fifty percent of those foreclosures came from sub prime loans.²² Hundreds of thousands of formerly “underserved” individuals were now in serious financial trouble, never mind the fact that they were suddenly homeless.

Criticism

²⁰ Sowell, Thomas. *The Housing Boom and Bust*. New York: Basic, 2010. 18. Print.

²¹ Sowell, Thomas. *The Housing Boom and Bust*. New York: Basic, 2010. 58. Print.

²² Sowell, Thomas. *The Housing Boom and Bust*. New York: Basic, 2010. 62. Print.

Many critics argue against the idea that government intervention by means of the Community Reinvestment Act and government-sponsored enterprises like Fannie Mae and Freddie Mac lead to the housing crisis, which then lead to the financial crisis. They point to statistics showing that Fannie Mae and Freddie Mac held far fewer sub prime mortgages than the big investment banks like Goldman Sachs and JP Morgan. Liberal bloggers David Goldstein and Kevin Hall of McClatchy Newspapers write, “During those same explosive three years, private investment banks- not Fannie and Freddie- dominated those mortgage loans... In 2005 and 2006, the private sector securitized almost two thirds of all U.S. mortgages, supplanting Fannie and Freddie, according to a number of specialty publications that track this data”.²³

However, this argument oversimplifies Fannie Mae and Freddie Mac’s role in the market. First, the two government-sponsored enterprises are limited in the mortgage purchases they can make. Jonathan Laing of *Barron’s* writes, “Fannie requires a layer of credit insurance on much of its high-loan-to-value mortgages. The GSEs have long insisted on higher underwriting standards on the loans they purchase in the secondary market”. So, without the restrictions placed on the enterprises, it is more than likely that the two would be in the same positions as the private investment banks fighting for market share in the formerly-lucrative mortgage backed security market.

Secondly, the fact that Fannie Mae played such an important role in the formation of a secondary market for mortgages *and* is implicitly backed by the full faith and credit of the United States means that it is a market maker. The years leading up to the housing crisis and ensuing financial crisis were characterized by the invention of hundreds of new

²³ Goldstein, David. "Private Sector Loans, Not Fannie or Freddie, Triggered Crisis | McClatchy." *McClatchy | Homepage*. Web. 14 May 2010. <<http://www.mcclatchydc.com/2008/10/12/53802/private-sector-loans-not-fannie.html>>.

financial tools and procedures that many on Wall Street didn't fully understand, as noted by John Cassidy in the Alphabet Soup chapter of *How Market's Fail*. Fannie Mae and Freddie Mac's simple participation in the market for billions of dollars of risky mortgages gave the greater private market a signal that the activity was prudent. So, despite the fact that Fannie Mae and Freddie Mac held "only" about a third of U.S. mortgages during that time period as compared to their multiple private sector competitors, their mere presence encouraged the market's ways.

The Result

Thus, cities like Detroit were quickly defined by the deserted, dilapidated houses lining the streets. Families, many of them black or Hispanic, were forced to find new housing and deal with demolished credit scores, further hampering future economic participation. Builders and construction workers saw jobs evaporate into thin air. Banks grappled to deal with foreclosed homes and lost revenues. The housing market was in shambles.

Contagion

The housing crisis was just the beginning of a wider crisis about to take place, however. In 2008, the beginnings of the infamous financial crisis took shape, with the previously mention housing crisis to blame. Stalwarts of Wall Street began to fail and the government was forced to step in to stave off widespread financial panic. So, how is it that a crisis in one industry of the United States economy was able to spread so quickly and so far across the world?

The Spread

Mortgage securitization companies repackaged and resold mortgages to the wider

world economy on the idea that they had been able to diversify away the inherent riskiness of the underlying mortgages. All sorts of banks, companies, and funds from dozens of countries invested in such securities. The risk had now been one step further removed from the originating institutions. More new products that no one truly understood continued to enter the market. Credit default swaps, for example, acted as insurance on the mortgage backed securities and provided huge revenue streams for companies like AIG for what was thought to be very little risk. The spread continued.

Why?

If the mortgages at the base of this huge industry were so shaky, taken out by customers who could not realistically afford them in the case of the slightest downturn in the market, how did their effect manage to spread so far and so fast? Who advised these investors that purchasing mortgage backed securities and credit default swaps was a sensible idea?

It turns out that Standard & Poor's (S&P) and Moody's Investors Services were labeling these financial products with favorable credit ratings, often triple-A. On its website, Moody's claims to use their "commitment and expertise to contribute to stable, transparent, and integrated financial markets, protecting the integrity of credit".²⁴ What subsequently happened was far from that mission statement.

Most investors don't have the time or the resources needed to investigate the depths of the securities they invest in. Instead, these supposedly unbiased ratings agencies are charged with painting a realistic picture of the risks associated with the product to the investor.

²⁴*Moody's.com*. Web. 14 May 2010.

<http://www.moodys.com/moodys/cust/AboutMoody's/AboutMoody's.aspx?topic=intro&redir_url=/cust/AboutMoody's/staticRedirect.asp>.

What Happened

Unfortunately for the ratings agencies, business schools' top talent tends to choose Wall Street banks over the ratings agencies, meaning a smarter pool of employees for the banks. Experience at Georgetown itself, where dozens of students scramble to secure spots at top Wall Street firms like Goldman Sachs and Morgan Stanley, and common Wall Street knowledge lends proof to this.²⁵

The best and brightest of Wall Street were quickly able to discover cracks in the agencies' credit ratings formulas and take advantage of those cracks to sell their products. Michael Lewis, author of *The Big Short*, states, "Wall Street bond trading desks set out to coax from the brain-dead guys the highest possible ratings for the worst possible loans. They quickly figured out, for instance, that the people at Moody's and S&P didn't actually evaluate the individual home loans, or so much as look at them".²⁶ Instead, they used averages, which, as every high school statistics teacher teaches, can be easily manipulated by outliers.

Moody's and S&P, for example, relied heavily on average FICO scores, which give a shaded view of an applicant's ability to pay back a loan because of the fact that the score doesn't take factors like employment or income into account. Low FICO scores could be hidden with a few uncharacteristically high FICO scores in a mortgage pool. Or, FICO scores could be artificially raised by using applicants with thin credit scores or recent good credit history. It was a race to find the holes in the rating agencies' models. Lewis states, "Every time some smart Wall Street mortgage bond packager discovered

²⁵ Lewis, Michael. *The Big Short: Inside the Doomsday Machine*. W W Norton & Co Inc, 2009. 98. Print.

²⁶ Lewis, Michael. *The Big Short: Inside the Doomsday Machine*. W W Norton & Co Inc, 2009. 99. Print.

another example of the rating agencies' idiocy or neglect, he had himself an edge in the marketplace: Crappier pools of loans were cheaper to buy than less crappy pools".²⁷

Beyond Formulas

Beyond the guilt rating agencies' hold for relying so blindly on numerical formulas that could be so easily abused, their business practices raised serious questions about conflict of interest. *The Wall Street Journal* recently detailed the controversy in an article about proposed new regulations on the industry. The author wrote, "Bond issuers choose ratings agencies and pay for ratings, meaning raters' revenues depend on the very firms whose bonds they are asked to judge".²⁸ Thus, in order to keep revenues rolling and to not offend some of their biggest customers, ratings agencies were tempted to turn a blind eye to the faults in their ratings formulas or take the words of the securitizing firms for truth and give unreasonably high ratings.

At one point in *The Big Short*, Michael Lewis recounts the experience of an investor at a ratings agency conference in Las Vegas. Stunned by their ignorance, he writes, "To judge from their behavior, all the ratings agencies cared about was maximizing the number of deals they rated for Wall Street investment banks, and the fees they collected from them. The surest way to attract structured finance business was to accept the assumptions of the structured finance industry".²⁹ Sure enough, the ratings agencies were all too happy to do so, ignoring the fact that home prices could stop rising

²⁷ Lewis, Michael. *The Big Short: Inside the Doomsday Machine*. W W Norton & Co Inc, 2009. 100. Print.

²⁸ "Rating Agencies Face Curbs - WSJ.com." *Business News & Financial News - The Wall Street Journal - WSJ.com*. Web. 14 May 2010. <http://online.wsj.com/article/SB10001424052748704635204575242472908973624.html?mod=WSJ_hps_LEFTWhatsNews>.

²⁹ Lewis, Michael. *The Big Short: Inside the Doomsday Machine*. W W Norton & Co Inc, 2009. 157. Print.

and fall substantially in their risk analysis. After all, “Moody’s and S&P stuck a triple-B rating on sub prime bonds that went bad when losses in the underlying pools of home loans were just eight percent”.³⁰

Result

With the help of inadequate models and cozy relationships with Wall Street, ratings agencies charged with the mission of informing investors were able to mask the true identities of the securities beneath. Highly rated securities opened up a vast market of potential investors like pension funds, which are usually restrained from purchasing excessively risky investments. With this, the poison continued to spread across institutions and across the world.

What Now?

Commentators and the politicians mentioned earlier who see the perfect opportunity to use the financial crisis for preexisting ideological goals claim that enhanced and increased regulations are the simple solution to avoid such a crisis from happening again in the future. However, one must realistically remember that the private sector will always be one step ahead of the government and its regulators. As mentioned in regards to the ratings agencies, Wall Street attracts the absolute best and brightest who, upon the introduction of new regulation, will be dispatched en masse to find each and every loophole in the law. As David Souter argues, “Those who call for more or better regulation ignore the fact that the problem of determining the risk of new and exotic securities was no easier for government regulators, who had no special source of knowledge or wisdom denied to rating agencies that had been successful for years with

³⁰ Lewis, Michael. *The Big Short: Inside the Doomsday Machine*. W W Norton & Co Inc, 2009. 66. Print.

their rating of other kinds of securities”.³¹

In order to prevent another financial crisis, the government should not turn to enhanced regulation. Members of Congress are not financial experts by any means, and the idea of such ill-informed politicians shaping legislation that could have profound unintended consequences to such a vital market is unappealing, if not terrifying. Instead, the government should work to remove the false signals it inserts into the market and focus on enforcing existing laws that would prevent risky mortgages from being made in the first place.

The existence of Fannie Mae and Freddie Mac as powerhouses in the secondary mortgage market should end, as the two enterprises play at an unfair advantage by being able to borrow money at below-market rates. Additionally, the movement of mortgages off the books of lenders who make loans only provides incentive for lenders to continually make bad loans. Banks and lenders at all levels should be required to hold a higher percentage of their liabilities on their books in order to give investors a better idea of the true risk level of the company. Thought should be given to the way many mortgages are handled in Europe, where “banks and other lenders retain the credit risk on home mortgages they have made, but sell bonds backed by those mortgages to outside investors, thus off-loading interest rate risk”.³²

At the more personal level, those who purchase mortgages for homes should be head liable for the information that they present to lenders. Likewise, lenders should be held accountable to existing fraud and abuse legislation such as the Truth in Lending Act

³¹ Sowell, Thomas. *The Housing Boom and Bust*. New York: Basic, 2010. 142. Print.

³² "Life After (the Old) Fannie and Freddie - Barrons.com." *Financial Investment News - Stock Investing News - Investment News - Barrons.com*. Web. 14 May 2010. <<http://online.barrons.com/article/SB122126783361530999.html>>.

and the Real Estate Settlement Procedures Act in order that they don't use their positions to knowingly mislead buyers into loans they cannot afford or do not understand.³³ Based on the stories of countless homeowners, lenders clearly abused their role as financial consultants. Many homeowners are at fault as well, though. These homeowners either misstated their income or lied about other aspects of their financial and credit situations in order to get approved for loans that they knew were unaffordable.

Additionally, the incentives and conflicts of interest in credit agencies need to be fully examined. At the time of writing, the Senate is debating ways to institute change in the rating process. Senator Al Franken (D-MN) recently proposed an amendment to the ongoing financial overhaul bill that was passed with bipartisan support 64-35 on Thursday, May 13th. The amendment would create a credit rating board under the Securities and Exchange Commission that would "act as a middleman between issuers seeking ratings and the ratings agencies. The board would select which agency provides the "initial rating" for certain securities known as structured bonds".³⁴ This is an admirable step forward that might prevent favoritism in the rating industry between big banks and the major agencies. However, the SEC has continually showed its inability to effectively regulate and understand the market. Giving the SEC yet another duty doesn't seem likely to be efficient or successful.

Perhaps the government should look into making the credit ratings agencies

³³ "Mortgage Laws And Regulations To Protect The Consumer: (A Mortgage Article from CityTownInfo)." *City Town Info - U.S. Cities, Jobs and Careers, and College Search*. Web. 14 May 2010. <http://www.citytowninfo.com/mortgage-articles/mortgage-process/mortgage_laws_and_regulations_to_protect_the_consumer>.

³⁴ "Rating Agencies Face Curbs - WSJ.com." *Business News & Financial News - The Wall Street Journal - WSJ.com*. Web. 14 May 2010. <http://online.wsj.com/article/SB10001424052748704635204575242472908973624.html?mod=WSJ_hps_LEFTWhatsNews>.

hybrid non-profits. Such a non-profit would be allowed to pay highly competitive salaries in order to attract the best talent- something that hasn't happened thus far in the agencies existence. In this scenario, the agencies would be less likely to blindly focus on the generation of revenue in order to please stockholders. Like the non-profit Consumer Reports of the Consumers Union of the United States, the agencies could then focus on identifying the true risk associated with bank products.

Conclusion

Unnatural market forces that altered the traditional housing market lead to a severe housing crisis beginning in 2006. As the crisis deepened and the failures of ratings agencies became known, the extent of the crisis' havoc on national and world markets became apparent. The adoption of such practices mentioned above will help to prevent the next bubble from spreading across the entire global financial industry.

Bubbles have become a reality of free markets and will surely continue into the future, as investors and citizens fall victim to disaster myopia, leading them to forget or wish away the lessons learned from past crises. Enhanced regulation will only encourage future crises, as crafty businessmen look for ways to exploit the naturally slow ways of the government, fueling investment into dark corners of the national and global economy. Instead, government leaders, regulators, and businesspeople must come together to rededicate themselves to the rules and ways of doing business that worked well for decades before the most recent lapse from sanity.