

The “markets vs. government” debate in the recent U.S. financial crisis

The recent financial crisis in the United States is an interesting example of the necessary equilibrium between markets and government to achieve satisfactory social and material progress.

Since centuries commercial and investment banking have been promoting significant growth around the world by pooling savings and lending money to consumers and investors in need of financing. “Securitization” – a financial tool introduced by bankers in the early 1990’s – is the action of pooling a large number of individual receivables (called “the underlying assets”) and entrusting the pool to the repayment of (a set of) newly issued, standardized securities.

Pooling a bunch of credit receivables does not reduce the individual risk of each one, but by arranging the newly issued securities in different “tranches” with varying levels of “seniority” or “subordination”, the aggregate or total risk (of the pool) is reallocated in a such way that makes the investment suitable to a wide set of market participants with different risk tolerance¹. Risk-averse will be attracted by the securities boasting the highest “seniority” at the cost of a relatively lower return. Risk-takers will seek the securities belonging to the “junior” or “subordinated” tranches, obviously boasting higher expected returns. “Securitization”, thus, allows investors to buy financial instruments that fall mid-way between the traditional “time deposit” and a direct loan made to an individual company or person. The return will be somewhat higher than that of the time deposit and the risk, lower than that of an individual loan.

It is important to note that the desired reallocation of risks will only be achieved if the individual risk of the pooled, underlying assets is not **highly correlated** or collectively vulnerable to the same scenario. A high correlation of those individual risks may result in even the “senior” tranches going astray. In the case of **standard** mortgage debtors the low-correlation condition is met because the default risk of these borrowers does not depend on the home price cycle, but on the employment cycle. A standard mortgage debtor will not default his loan as long as he remains employed, but even in a phase of growing unemployment only a fraction of these debtors will be fired and not necessarily all at once.

This was not the case of the **subprime** debtors²:

- The abnormally high risk ratios (loan-to-value and service-to-income) carried by the loans made to these borrowers meant that they were only able to meet their obligations while the loans accrued a misleading extremely low initial “teaser” rate (typically 2% p.a.).
- When after two years interest rates were “reset” to market levels payments ballooned, making it impossible for most subprime debtors to meet them.

¹ The “seniority” or “subordination” of a security will reflect the privilege or preference in being paid. A security is “senior” relative to another one (“junior” or “subordinated”) when it enjoys the privilege of being paid first. The junior or “subordinated” security will be repaid only when the “senior” one has been fully honored.

² The word “subprime” denotes a debtor with a poor credit story and/or sub-standard risk indicators.

- In order to avoid default their only option was to refinance their mortgages. But a massive and continuing refinancing of subprime mortgages would only have been possible in an utopian scenario of ever-growing home prices.
- These hard facts mean that in a world of falling home prices the individual risk of default among subprime borrowers can be expected to be **highly correlated**.

Misleading low-income borrowers by means of “teaser” rates was only a part of the scam³. The bankers needed to mislead regulators and investors, as well. And they did it by having their subprime-related securities insured against the risk of default by a top-rated insurer such as AIG and triple A-rated by well known credit rating agencies (such as Moody’s, Standard & Poor’s and Fitch). It is difficult to accept that these leading Wall Street firms – and their well staffed regulators – could have ignored such hard facts of the subprime mortgage lending boom⁴.

The outcome is well known: When home prices started to decline in mid-2006 (after tripling over a decade) the losses resulting from the onslaught of defaulting subprime mortgages not only wiped out the “safety cushions” (default insurance contracts, securities of the “junior” tranches, banks’ equity or capital, etc.), but bloated the creditworthiness of the higher rated, low-return “senior” securities. When news of the wave of subprime defaults hit the market (August 2007) a full-fledged bank run ensued: Investors and savers wanted to get rid of everything, save for currency and T-Bonds. Were it not for Fed’s and the Treasury’s massive rescue operations of 2008, a depression resembling the one suffered from 1930 through 1933 might have ensued.

Pro-market ideologues argue that the innovative scam – stemming from the greed of bankers – allowed millions of poor Americans to reach home ownership, the fallout of the financial crisis (including the several hundred of thousands currently being evicted from their homes) being the natural, unavoidable and even necessary “collateral damage” of “social learning”. They argue that nothing could have been expected from more stringent regulations, as regulators themselves might be greedy and not necessarily smarter than market participants.

The truth of the matter, however, is that market efficiency and fair competition do need a “level and transparent playing field” set up by rules and governmental enforcement. This is the more so in banking, an industry that owing to its key role enjoys a singularly high degree of government guarantees. This is not to say that government intervention will always eliminate the business cycle, but surely it will tame it. With stringent regulation and more enforcement less subprime borrowers would have been misled by “teaser” interest rates, home prices would not have tripled in a decade, investors would have enjoyed better information about the individual and aggregated risks of their underlying assets, the world would have been saved from a massive financial crisis and a recession and... yes, less poor Americans would have gained home ownership... but less, also, would have suffered the pains of foreclosures and evictions...

³ Although the subprime credit boom had began earlier, by holding the Fed Funds rate below inflation during 2003 and 2004, Greenspan’s Fed played a key role in accelerating it.

⁴ Default insurance contracts (know as “credit default swaps”) and triple A credit ratings were the “enhancements” used by banks to sell their subprime-related securities not only to individuals, but to institutional investors, as well. Lacking those enhancements, pension funds, for instance, would have never invested in these securities.