A failure of government, not capitalism…

With 2008's mortgage meltdown, the failures of Bear-Stearns, Lehman Brothers, AIG, Fannie Mae and Freddie Mac, and the massive federal bail-outs that followed, the media was quick to argue that "capitalism had failed." Joining in that parade were many Democrats, eager to garner additional support for their anti-capitalist Presidential candidate, Barack Obama. But their argument is invalid. What we have witnessed is not a failure of capitalism, but a failure of government. Critics of capitalism use comparisons of the current economic crisis to the Great Depression of the 1930s to bolster their argument. But there, again, they are incorrect. The Great Depression was also a failure of government, not capitalism.

The economy was booming in the 1920s – the "Roaring Twenties." One of Herbert Hoover's Presidential campaign slogans was, "A chicken in every pot and a car in every garage." Money was being made in the stock market, hand over fist, and it seemed logical that to make everyone rich all that had to be done was to make it easier for more people to get into the stock market. The solution? Buy stock "on margin," which simply meant buying stock for pennies on the dollar. Typically the up-front requirement was only 10 per cent, so that a person could give a broker $10 and purchase $100 worth of stock.

Of course, the buyer eventually had to come up with the remaining $90, but that wasn't difficult – all he had to do was wait until the stock value went up, sell enough shares to pay the broker the $90 he was owed, and sit back and watch the remaining shares go up in value. As long as the stock market kept going up, you'd keep making money.

The problem was that stock prices were going up not because the underlying values of the companies they represented were going up, but because of speculation. (Price-earnings ratios were seriously inflated, as they were during the "tech bubble" of the 1990s.) Buyers simply assumed stock values would keep going up, so they kept buying. They bought anything, often without looking into the soundness of the company they were buying. Money was flying around so freely that unwise (and many incredibly stupid) investments were becoming common. As an example, railroads were constructed between towns that didn't really need a connecting railroad – but people bought stock in those railroads anyway. (There were a lot of "bridges to nowhere" being sold.) It seemed that everyone had a "hot tip" on a new stock, yet few probably knew what they were buying, let alone doing.

Eventually things startled to unravel. The stock market finally started reflecting the real value of those speculative stocks, and their prices fell dramatically. When that happened, the brokers started making "margin calls," that is, they called their investors who paid $10 for $100 worth of stock and said, "Remember that $100 of ABC Railroad stock you bought last month? Well, it's now worth only $5 – and

you still owe me $90." The more people sold off their stocks to pay their brokers, the lower the stock prices went. The last people to act were in the worst position, holding worthless stocks but still owing their brokers.

The trend downward started in early September of 1929. The wealthiest investors tried to buy up stocks to keep prices from falling, but it was too little and too late. The worst decline in stock prices came on "Black Friday," October 29, 1929, which signaled the start of the Great Depression. Investors lost millions, brokerage firms went out of business, banks were depleted of assets and failed, and not a small number of investors leaped to their deaths from Wall Street windows.

At that point, the federal government should have done almost nothing. Yes, investors lost money – but they were the ones who had made the poor investments in the first place. People who owned stock in sound companies eventually saw their stocks regain their value. Yes, there would have been a difficult recession, but it wouldn't have been a depression. What made it worse? The single most aggravating factor was probably the passage of the Smoot-Hawley tariff bill, which placed extraordinarily high tariffs on foreign goods. The law was intended to protect American businesses from global competition. Its result was, of course, immediate retaliation by other nations – which passed their own high tariffs on imported American goods, causing firms in the United States to go out of business.

Had the free market been allowed to work, America would have suffered a tough but possibly brief recession – and certainly not a 10 year depression! By imposing high import tariffs, the federal government caused the recession to develop into a full depression. Reciprocal actions by other nations then extended the depression to Europe, where economic miseries helped propel Adolph Hitler to power.

This is not to argue that a totally free market does not often have ups and downs, peaks and valleys, winners and losers. But the downs and the valleys tend to be short-lived, and the losers tend to deserve their losses. No one in 1929 forced anyone else to buy stock in a railroad whose existence could not be justified by market conditions in the first place.

Government, by trying to insulate American businesses from foreign competition, made the situation infinitely worse and caused misery for millions who did not deserve it – Americans who had not been caught up in the market, who had not bought stock in foolish businesses, and who had not risked their meager savings in an effort to "get rich quick."

Franklin D. Roosevelt easily won the Presidency in November of 1932, promising to balance the federal budget and cut taxes. He immediately broke his promises, raising taxes and engaging in deficit spending that left a national debt that is still

unpaid. Further, FDR continued some of the faulty practices engaged in by Herbert Hoover, including industry bailouts, price controls, wage controls, government programs, trade restrictions, and strict regulations on the capital markets.

FDR started program after program in an effort to “make work” for unemployed Americans, but each program was paid for by raising taxes, essentially causing unemployment somewhere else. Roosevelt’s primary “brilliance” was funding projects that required inordinate amounts of manpower. If he could find a way to hire 50 people to do the work of five, that was sufficient reason to embark on the project – even though it cost the taxpayers 10 times more than it was worth. When the Supreme Court found some of FDR’s ludicrous schemes unconstitutional, he tried to resolve that by “packing” the Court with more liberal members. (Even his fellow Democrats wouldn’t let him do that.)

FDR continually tinkered with programs and taxes, leaving everyone in wonderment as to what he would do next. As a result, businesses were reluctant to do anything risky. That stifled business growth at a time when it was most needed. FDR pretty much did everything wrong, and unemployment at the end of 1941 wasn’t much better than it was when he took office. It was not Roosevelt, but the start of World War II and the end of high tariffs in order to enable Europe to arm itself against Hitler, which ended the Depression.

Flash forward to the current mortgage meltdown and the federal government’s intervention in the market to rescue failed banks and investment firms. What caused the crisis, capitalism or government?

The Community Reinvestment Act was passed in 1977 and signed into law by Jimmy Carter. The purpose of the law was to encourage Fannie Mae and Freddie Mac to lend in minority communities, and prohibit “redlining” - a practice where banks ignored high-risk neighborhoods and refused to provide home loans for their residents. (“How dare you refuse to give mortgages to poor people simply because they can’t afford to pay you back!”) In 1995 and 1999, Bill Clinton toughened the regulations to force more loans to low and moderate-income businesses and homebuyers. The Clinton rule changes made it more difficult for lenders to get a satisfactory CRA rating. Banks were given quota targets and their loan portfolios were reviewed for “diversity.” The result was loans being made solely on the basis of race, to keep the federal reviewers satisfied. The revisions to the regulations also made it easier to make subprime loans, partly by the expansion of the secondary mortgage market (where mortgages are bundled and sold off to investors other than the banks that originated the loans).

During the 1990s, regulations and legislation kept getting churned out of Washington for the sole purpose of increasing home ownership among the poor – regardless of their ability to pay back a mortgage. “Affordable housing” was the goal, even if no one could really afford it. Lenders who opposed were labeled

“racists” who were “encouraging discrimination,” and were told to use “flexible underwriting standards.” The Federal Reserve’s lending guidelines included the statement, "Policies regarding applicants with no credit history or problem credit history should be reviewed" and even urged lenders to include as income "welfare payments and unemployment benefits" when considering loan approvals. Changes to the laws in 1995 led to an astounding 80 per cent increase in bank loans to low and moderate-income families. In 1996, the Clinton Administration ordered Fannie Mae and Freddie Mac to assist home purchases by low-income earners by buying subprime mortgages, *requiring* that 12 percent of Fannie's and Freddie's mortgages assist low-income home purchasers in higher-income neighborhoods. In 2000, Clinton increased that to 20 percent. In 1997, Andrew Cuomo, Clinton’s Secretary of Housing and Urban Development, proposed that a full 50 per cent of Fannie Mae’s and Freddie Mac’s portfolio be made up of sub-prime loans to low and moderate-income borrowers. Cuomo stated, "GSE presence in the subprime market could be of significant benefit to lower-income families, minorities, and families living in underserved areas..."

In other words, the government was telling banks, Fannie Mae, and Freddie Mac to loan money to people in order for them to buy houses they couldn’t afford, even though common-sense business practices told them not to. Home ownership was paramount; get everyone into a house and everyone can be wealthy. At the same time, of course, the government expected the same loosening of standards for the non-poor, in the interests of fairness and equality.

During the 1990s, groups like ACORN intimidated banks into approving “Ninja” loans (“no income, no job, no assets”) when the applicants clearly were unqualified to get a mortgage. ACORN would stage demonstrations and sit-ins at banks, protest in bank lobbies, and even picket the homes of bank executives to garner public support and sympathy for poor people, in order to shame the banks into making risky loans. Barack Obama, it should be noted, was hired by ACORN to train community organizers in such tactics; *that* was one of his jobs as a “community organizer.” (For more information, check the history of ACORN’s involvement with Chicago’s Bell Federal Savings and Avondale Federal Savings.) ACORN tactics included a 1991 two-day “sit-in” at the House Banking Committee room.

Where banks had followed strict lending guidelines concerning the percentage of income that a buyer should apply to mortgage payments, the government said they should lower those standards because “many lower-income households are accustomed to allocating a large percentage of their income toward rent." Smaller down payments and closing costs should be considered because saving for them is “…often a significant barrier to homeownership by lower-income applicants." (To the government, the fact that someone has no money to buy a house shouldn’t be held against him when selling him one.)

The lenders saw the lunacy in these practices, but they "no longer held the paper" of the mortgages. As soon as the mortgage was granted, the loans were bundled and sold off to other investors – like Fannie Mae, Freddie Mac, Lehman Brothers, and AIG. The banks essentially said, "If they're willing to accept the risk, let them."

The banks also had little choice. If they were tough on lending requirements, the accusations of discrimination came down on them and they were threatened with exorbitant fines and penalties. Under the Equal Credit Opportunity Act, or "Regulation B" of federal lending guidelines, lending discrimination can result in punitive damages as high as $10,000 in individual actions and the lesser of $500,000 or one percent of the creditor's net worth in class actions. Lenders, therefore, had the choice of being prudent and paying heavy fines for "discriminating against poor people," or making high-risk loans they immediately sold in order to avoid the financial exposure. Guess which path they followed.

Fannie Mae and Freddie Mac, being "government sponsored entities," were susceptible to the pressures of Congressmen and their congressional committees that kept encouraging them to keep buying sub-prime mortgages to increase home ownership among the poor. (A high-ranking Democrat even telephoned Fannie Mae executives and demanded that they purchase more loans from low-income borrowers.) With an "implied guarantee" of the federal government behind Fannie and Freddie, no one seemed to care about the consequences of risky behavior. Add to the mix a fair amount of Enron-like "creative accounting" at both enterprises, and all the ingredients for a disaster are present.

Rules changes made during the Clinton Administration also allowed Fannie Mae and Freddie Mac to hold a mere 2.5 per cent of capital to back their assets, rather than the 10 per cent required of banks. Fannie and Freddie could thus have $100 billion in outstanding loans with just $2.5 billion in reserves.

In 1999, the Los Angeles Times praised the Democrats and the Clinton Administration for their efforts in expanding lending to the poor: "It's one of the hidden success stories of the Clinton era" and "…Congress mandated that Fannie and Freddie increase their purchases of mortgages for low-income and medium-income borrowers. Operating under that requirement, Fannie Mae, in particular, has been aggressive and creative in stimulating minority gains. It has aimed extensive advertising campaigns at minorities that explain how to buy a home and opened three dozen local offices to encourage lenders to serve these markets." The Times continued, "Most importantly, Fannie Mae has agreed to buy more loans with very low down payments – or with mortgage payments that represent an unusually high percentage of a buyer's income. That's made banks willing to lend to lower-income families they once might have rejected." *Apparently the Los Angeles Times didn't stop to wonder why banks thought it was prudent to reject those loans.*

Reckless lending and accounting practices by Fannie Mae and Freddie Mac ultimately lead to their demise and to economic problems for the entire nation. Former Fannie Mae CEOs James Johnson and Franklin Raines were major proponents of relaxing lending standards. (Both have worked as advisors for the Obama campaign, and despite having been in the Senate only a few years, Obama is behind only Christopher Dodd in the amount of lifetime campaign contributions received by Fannie Mae executives. According to OpenSecrets.org, first-term Senator Obama has collected almost $300,000 per year from Goldman Sachs, Lehman Brothers, Bear Stearns, Fannie Mae, Freddie Mac, AIG, Countrywide Financial, and Washington Mutual. In less than four years in the Senate Obama has received a total of $1,093,329.00 from those eight companies and their employees.)

In April of 2001, barely three months after George W. Bush had been sworn in, his administration's Fiscal year 2002 budget warned that the growing size of Fannie Mae and Freddie Mac was "a potential problem" and any problems with them would "…cause strong repercussions in the financial markets, affecting Federally insured entities and economic activity." In May of 2002 the President produced a 19-point plan for corporate responsibility to apply to Fannie Mae and Freddie Mac. Gregory Mankiw, chairman of the Council of Economic Advisors, warned that the "implicit subsidy" of Fannie and Freddie was risky and could cause problems throughout the entire financial system. Congressman Barney Frank (D-MA), who had no "concern about housing," condemned Mankiw. The New York Times, no friend of the Bush Administration, complained that the GSEs were "under heavy assault by the Republicans," but those Democrat allies of the GSEs could withstand those attacks.

In January of 2003, Freddie Mac had to restate its financial results for the prior three years; problems were already seeing the light of day. The Bush Administration sensed some of the dangers inherent in the sub-prime structure and, in 2003, recommended a significant overhaul of housing industry regulations, including closer supervision of Fannie Mae and Freddie Mac. His suggestions were fiercely opposed, generally along party lines, and they failed to be passed into law. As an example of the criticism, Congressman Barney Frank (D-MA) said, "Fannie Mae and Freddie Mac… are not facing any kind of financial crisis, the more people exaggerate these problems, the more pressure there is on these companies, the less we will see in terms of affordable housing." Congressman Mel Watt (D-NC) complained the changes would only lead to a "…weakening (of) the bargaining power of poorer families and their ability to get affordable housing." Frank also criticized the chairman of the President Bush's Council of Economic Advisers, Greg Mankiw, because he was "…worried about the tiny little matter of safety and soundness rather than 'concern about housing.'"

The National Association of Home Builders and many Congressional Democrats were opposed to Bush's 2003 recommendations, which would have been the most significant regulatory overhaul in the housing finance industry in 10 years. Democrats expressed the fear that the tighter regulations would "…sharply reduce their commitment to financing low-income and affordable housing."

In September of 2003, Treasury Secretary John Snow recommended to the House Financial Services Committee that it enact "legislation to create a new federal agency to regulate and supervise the financial activities of (the) housing-related government sponsored enterprises" (GSEs, meaning Fannie Mae and Freddie Mac) and set prudent minimal capital requirements. Snow was warning Congress that Fannie and Freddie didn't have enough capital for all the high-risk loans they had been making. One month later, Fannie Mae admits a $1.2 billion accounting error.

In November of 2003, Council of the Economic Advisors Chairman Greg Mankiw discusses the need for additional regulation and powers to reduce "systemic risk" in the GSEs, including authority to set minimum capital standards.

In 2004, the President's FY 2005 budget again brings up the risks of low levels of capital in the GSE and suggests additional regulation. In February, Mankiw warns Congress not to take the strength of the financial markets for granted. In June of 2004, Deputy Secretary of the Treasury Samuel Bodman highlights GSE risks and calls for more regulation and oversight and funding minimums. Congress does nothing in response to the warnings of the Bush Administration.

Exacerbating the problem was the Federal Reserve Board, which was doing its best to keep interest rates low to stimulate the economy. While this made sense immediately following the terrorist attacks of September 11, 2001, in order to prevent the United States from falling into a severe recession or even a depression, the practice went on far too long. Higher interest rates would have put a powerful damper on the rampant lending to unqualified buyers.

Because banks were making loans to people who couldn't afford houses in the first place, more home buyers entered the housing market. That artificially raised the prices of homes, as more buyers bid for the limited number of houses available. The inflated prices encouraged otherwise reasonable people to take chances they would not ordinarily take. "I know that house isn't really worth $350,000, but if we need to we can always sell it next year for $400,000 to someone else and pocket $50,000 in profit."

Blowing further air into the balloon to help lead to its eventual bursting was the widespread practice of using home equity loans to pay off credit cards or to finance car purchases. Americans had been over-relying on credit cards for a long time. In the past, interest on credit cards had an allowable income tax deduction. That tax deduction was eventually phased out, making the cost of credit card interest intolerable for many - yet not so intolerable that they would

cut up their credit cards and throw them away. When the chance came to pay off that high-interest debt with lower-interest home equity loans, people took advantage of the opportunity. But borrowing against a home's equity assumes it will retain that equity, and most borrowers neglected to consider that home prices aren't always guaranteed to rise.

Federal Reserve Board Chairman Alan Greenspan told Congress in 2005 it needed to act. He warned that "If Fannie and Freddie ``continue to grow, continue to have the low capital that they have, continue to engage in the dynamic hedging of their portfolios, which they need to do for interest rate risk aversion, they potentially create ever-growing potential systemic risk down the road… We are placing the total financial system of the future at a substantial risk."

Some in Washington listened to Greenspan. To his credit, John McCain co-sponsored and argued on behalf of the "Federal Housing Enterprise Regulatory Reform Act of 2005," and warned against disastrous consequences if it was not passed. In defense of his bill, McCain said, *"…this week Fannie Mae's regulator reported that the company's quarterly reports of profit growth over the past few years were "illusions deliberately and systematically created" by the company's senior management, which resulted in a $10.6 billion accounting scandal.*

The Office of Federal Housing Enterprise Oversight's report goes on to say that Fannie Mae employees deliberately and intentionally manipulated financial reports to hit earnings targets in order to trigger bonuses for senior executives. In the case of Franklin Raines, Fannie Mae's former chief executive officer, OFHEO's report shows that over half of Mr. Raines' compensation for the 6 years through 2003 was directly tied to meeting earnings targets. The report of financial misconduct at Fannie Mae echoes the deeply troubling $5 billion profit restatement at Freddie Mac.

The OFHEO report also states that Fannie Mae used its political power to lobby Congress in an effort to interfere with the regulator's examination of the company's accounting problems. This report comes some weeks after Freddie Mac paid a record $3.8 million fine in a settlement with the Federal Election Commission and restated lobbying disclosure reports from 2004 to 2005. These are entities that have demonstrated over and over again that they are deeply in need of reform.

For years I have been concerned about the regulatory structure that governs Fannie Mae and Freddie Mac--known as Government-sponsored entities or GSEs--and the sheer magnitude of these companies and the role they play in the housing market. OFHEO's report this week does nothing to ease these concerns. In fact, the report does quite the contrary. OFHEO's report solidifies my view that the GSEs need to be reformed without delay.

I join as a cosponsor of the Federal Housing Enterprise Regulatory Reform Act of 2005, S. 190, to underscore my support for quick passage of GSE regulatory reform legislation. If Congress does not act, American taxpayers will continue to be exposed to the enormous risk that Fannie Mae and Freddie Mac pose to the housing market, the overall financial system, and the economy as a whole.

I urge my colleagues to support swift action on this GSE reform legislation."

That bill, which could have prevented the current economic crisis, did not pass. The bill, prevented by a Democrat party-line vote, did not even make it out of the Senate Banking Committee (chaired by Christopher Dodd). As a result, Fannie and Freddie continued to accept risky loans in 2006, 2007, and 2008, with each one increasing the likelihood of a financial collapse.

According to a Harvard study, from 1999 to 2005 an astounding 49 per cent of 12.5 million new homeowners were members of minorities. Clearly, the Clinton Administration's rule changes to encourage, if not force, lending to minorities "worked." But those rule changes never addressed the ability of the new homeowners to pay back their loans, which were often granted with recklessly loose documentation and income requirements.

In July of 2007 two Bear Stearns hedge funds collapse; they were heavily invested in mortgage securities. In August, President Bush again calls on Congress to pass a Fannie Mae/Freddie Mac reform bill. "Congress needs to get them reformed, get them streamlined, get them focused."

The handwriting was on the wall, but no action is taken by Congress. In fact, it makes things worse. Representative Maxine Waters (D-CA) introduced HR 1852, the "Expanding American Homeownership Act," which expanded mortgage insurance programs under the National Housing Act, enabled the Federal Housing Administration to "use risk-based pricing to more effectively reach underserved borrowers," raised the maximum amount that may be approved for multi-family mortgage insurance by the FHA to 170 percent in normal cost areas and 215 percent in high cost areas, and established a pilot program to allow mortgagors with insufficient credit histories to obtain an alternative credit rating based on rent, utilities, and insurance payment histories. In other words, the bill made it even easier for people who couldn't afford to buy a house to buy a house.

In December of 2007 the president again warns Congress. "These institutions provide liquidity in the mortgage market that benefits millions of homeowners, and it is vital they operate safely and operate soundly. So I've called on Congress to pass legislation that strengthens independent regulation of the GSEs – and ensures they focus on their important housing mission. The GSE reform bill passed by the House earlier this year is a good start. But the Senate has not

acted. And the United States Senate needs to pass this legislation soon." The Senate did not act.

Throughout the first six months of 2008 the Administration warns Congress several times about the risks inherent in the GSEs and requests action. The warnings are not heeded. Between 2001 and 2008, the Bush Administration had tried 18 times to place controls on Fannie Mae and Freddie Mac.

Eventually the bubble had to burst, as the stock market crashed in 1929. Just as it was foolish in 1929 for someone to spend money he didn't have on stocks that were grossly overpriced, it was foolish in 2007 to pay $350,000 for a house that was worth only $250,000 on the assumption that someone even more foolish would pay $400,000 for it in 2008.

A majority of Americans would probably say that those who made the poor decisions should suffer. If someone loses a house that he shouldn't have bought in the first place, too bad – dust yourself off and consider it a learning experience. The problem is that a horrendously large number of those loans were made, and many Americans had unknowingly invested in them through their mutual fund purchases, 401(k) accounts, and retirement plans. (Americans mistakenly assumed that their brokers and the people on Wall Street knew what they were doing.)

If the situation had been recognized earlier, several banks and investment firms could have been allowed to fail, and Fannie Mae and Freddie Mac would have been made to tighten up their standards. But the situation was not recognized in time, and to allow all the culpable firms to fail now would result in a catastrophe of enormous proportions. By mid-2008, Fannie Mae alone owned more than $388 billion in high-risk mortgage investments. Had real estate values continued to appreciate, much of the risk would have been removed from those loans. But, of course, real estate values declined as soon as people started realizing those values were artificially inflated and did not reflect the actual worth of the properties. Had the monsters of Fannie Mae and Freddie Mac never been created in the first place, the crisis would never have occurred.

Has the mortgage meltdown and the collapse of several of America's major financial institutions been a failure of capitalism? No. The blame can be shared by Presidents Clinton and Bush, both parties in Congress, the Federal Reserve Board, Fannie Mae and Freddie Mac, and all who supported their "we can make everyone wealthy without incurring any risk" policies. The Democrats kept demanding that Fannie Mae and Freddie Mac purchase risky loans, and the Bush Administration didn't do much to stop the practices. (A President can always veto unwise legislation, even though the media will ostracize him for "refusing to help the poor.")

In an effort to “help the poor” buy houses, the government has destroyed hundreds of billions of dollars of wealth. After the dust settles, a federal bailout of perhaps $900 billion will be added to the national debt (costing every man, woman, and child in the United States about $3,000), and foreclosures will force many of those poor out of their houses anyway - but the CEOs of Fannie Mae and Freddie Mac will still have retained most of their millions in executive bonuses, and Dodd and Obama will still have their massive Fannie and Freddie campaign contributions. All of that will have been caused by Democrat legislation that required lenders to act against common sense and their own financial interests, and Republicans who went along with it out of fear of being called racists or “anti-poor.”

It is not racist or anti-poor to say that a person with $30,000 in annual income cannot afford a $300,000 house, it is economic reality. Create an environment where business thrives and jobs are created by a free market, and the poor will find good jobs that help them to afford houses. But you cannot eliminate the middleman of the good job and go directly from poverty to homeownership. The ironic result of 30 years of government interventions in the mortgage industry is that the economy will now be even less able to create the jobs needed to help people work their way out of poverty.

Capitalism is (or should be) synonymous with a free market. To the extent there are restrictions on the market, there are restrictions on capitalism. In a truly free market, fewer risky loans are made (because they are not subsidized by government), and when they are made and proven unsuccessful, those who suffer the losses are only the immediate investors and lenders… not every citizen of the United States. Capitalism cannot be blamed for the current economic crisis; it is the result of forcing lenders to make risky loans, and a government that believes it can avoid fundamental laws of economics by legislative fiat. But just as government cannot prevent the law of gravity from causing apples to fall from trees, government cannot turn bad credit risks into good credit risks with a law. That’s simple common sense… but that’s never stood in the way of Congress in the past, and it isn’t likely to change now.

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