# Mommy! The Government Made Me Do It!

## By John F. McGowan

**Version: 1.1**
**Start Date: January 13, 2009**
**Home URL: http://www.jmcgowan.com/Mommy.pdf**

***Many conservative, libertarian, and business sources blame the current financial crisis on the government. Here is why they are wrong.***

**Introduction**

The editorial "Show Us Where the TARP Money Is Going" in today's Investor's Business Daily (IBD, January 13, 2009) ends with the astonishing sentence:

More transparency will surely help, but letting **the federal government -- which caused the problem in the first place --** tighten its control over our financial system will bring us no good and may help slow our recovery.

(Emphasis Added)

Here we go again. *Mommy! The government made me do it!* Of course, this editorial is just one of many. In the wake of the housing bust, the mortgage backed securities debacle, and the Wall Street bailout, conservative, libertarian, and business writers, publications, and think tanks are rushing to blame the entire fiasco on the government. This is not unusual. Over the last thirty years, conservatives, libertarians, and business propagandists have used the same tactic to divert responsibility for previous fiascoes from prominent business leaders who probably sponsor their publications and institutes. For example, this same drumbeat of *"Mommy! The government made me do it!"* followed the savings and loan fiasco of the 1980's and the electricity market deregulation fiasco in California.

Of course, the banks and other financial institutions that are in trouble – Goldman Sachs, Morgan Stanley, Citigroup, AIG, Wachovia, Washington Mutual, and many others – and are surviving on government life support were private. They were not agencies of the federal government. They were not government sponsored enterprises (GSE's) like Fannie Mae and Freddie Mac. In general, the banking and finance sector has been increasingly deregulated over the last twenty years. The Bush administration has been hailed by most conservatives and business types as pro-business, pro free market. The Republicans controlled both Houses of Congress and the White House for six years from early 2001 to early 2007. So, what gives? How can it be all the government's fault?

Progressives and liberals are usually stunned when they encounter these *"Mommy! The government made me do it!"* arguments even though this has happened many times before. Probably, this reflects their lack of familiarity with conservative and libertarian thought. In fact, such arguments are not new but have been made in several previous fiascoes including the Great Depression, the savings and loan fiasco of the 1980's, and the electricity market deregulation in California in 2000. As in previous fiascoes, several different overlapping arguments for government responsibility are used. Although in this case each argument is flawed and should be rejected on the basis of common conservative, libertarian, and business principles, the multiplicity of claims makes counter-argument difficult.

What are the *"Mommy! The government made me do it!"* excuses and why are they wrong?

**Excuse 1: Alan Greenspan and the Federal Reserve kept interest rates artificially low too long and caused the bubble.**

This is the most common excuse. Alan Greenspan and the Fed did not force banks and other financial institutions to make bad loans. The directors, officers, and executives of banks and other financial institutions are highly paid, highly educated people often with advanced degrees and credentials (M.B.A.'s, J.D.'s, Ph.D.'s, C.P.A.'s, and so forth). They are supposed to have extensive skills and experience in evaluating investments and loans. There is extensive historical data on the risks and returns of home mortgage lending. Most of the banks that are in trouble, such as Citigroup, are huge banks with vast resources, able to perform extensive, detailed due diligence on investments. Even if the Federal Reserve had pushed rates down to 0% for years, these officials had a fiduciary responsibility to their shareholders or other investors to make sound loans that would be paid back. They obviously did not.

It is probably true that Alan Greenspan and the Federal Reserve contributed to the problem through easy credit and lax regulation. In Alan Greenspan's case, he actually advocated adjustable rate mortgages over fixed rate mortgages at a time when long term interest rates were at a very low level. Nonetheless, the officers, directors, and executives of private banks and institutions such as Citigroup, Goldman Sachs, Morgan Stanley, Wachovia, Washinton Mutual, and many others are responsible for their lending and investment decisions.

**Excuse 2: Fannie Mae and Freddie Mac caused the housing crash.**

Something certainly appears to have gone wrong at Fannie Mae and Freddie Mac. This is somewhat surprising since the government sponsored Fannie Mae and Freddie Mac were generally reported to maintain strict lending standards for so-called "conforming loans" such as 20% down-payments, verified income for borrowers, and so forth. This differs from the lax lending practices widely reported in the sub-prime lending sector. Clearly, a careful investigation of Fannie Mae and Freddie Mac's apparent problems is called for.

However, Citigroup, Goldman Sachs, Morgan Stanley, AIG, Wachovia, Washington Mutual, and many other banks and financial institutions that are in trouble are not Fannie Mae and Freddie Mac. As with Alan Greenspan and the Federal Reserve, Fannie Mae and Freddie Mac could not force the banks and financial institutions to make bad loans, purchase mortgage backed securities backed by bad loans, or make other bad investments.

**Excuse 3: Affordable housing activists used the Community Reinvestment Act (CRA) to force the banks to make bad loans to unqualified borrowers.**

Alone of the current crop of *"Mommy! The government made me do it!"* excuses, this excuse cannot immediately be dismissed as obvious nonsense. This excuse makes specific claims about how the government *forced* banks to make bad loans. Indeed, as the crisis has worsened, the *"Mommy! The CRA made me do it!"* drumbeat has risen, threatening to eclipse the obvious scapegoating of Alan Greenspan and the Federal Reserve.

According to the current version of the CRA excuse, government regulators used CRA scores to decide whether to approve bank mergers or opening of bank branches. The CRA scores were supposedly produced at least in part by community affordable housing groups such as ACORN. Apparently these liberal Democratic affordable housing groups had such influence in the Bush administration during the 2001 to 2007 period of total Republican dominance that they were able to *force* the banks to make trillions of dollars in bad sub-prime loans to poor minority, often black or Hispanic, borrowers. The CRA excuse often emphasizes the supposed ethnicity (black or Hispanic) of the bad loan recipients.

Of course, even as presented, the current CRA excuse is ludicrous. However, let us accept for the sake of argument that the claims are correct. Either ACORN and similar groups wielded enormous clout during the Bush administration or the sub-prime bubble loans were all made under Clinton when it is more plausible that ACORN had this kind of influence. Yes, most reports and data indicate most of the bad loans were made under Bush, but for the sake of argument, let's blame Clinton.

So what? Officers, directors, and executives of a bank have a fiduciary responsibility to their shareholders to evaluate whether a bank merger or branch opening will be profitable, will make money for the bank and its shareholders. If the government insists through CRA that the bank must take on bad loans that will break the bank for the merger to be approved or the new branch permitted, the bank officials have a fiduciary responsibility to decide against the merger or branch opening. End of story. That is their job. They must take into account regulations, however unreasonable, in their business decisions.

In fact, if banks such as Citigroup, Goldman Sachs, Morgan Stanley, and many others were being forced by the government to take on bad loans that would break the bank, they had a responsibility to vehemently oppose these policies, warn their shareholders, lobby for immediate repeal of these policies, and so forth. Of course, nothing of the kind happened.

It is important at this point to separate attacks on Fannie Mae and Freddie Mac from attacks on CRA. During the bubble, there were many attacks made on Fannie Mae and Freddie Mac in the *Wall Street*

*Journal* editorial page, *Barron's*, *IBD*, and many conservative, libertarian, and business publications. There were almost no attacks on CRA prior to the sub-prime crisis in 2007. Indeed, the *Wall Street Journal*, for example, carried numerous editorials extolling how the "private sector, free-market" mortgage backed securities were making housing available to the poor and underprivileged in contrast to the corrupt liberal dinosaurs at Fannie Mae and Freddie Mac. What is conspicuous in retrospect is the absence of editorials either by the editorial page staff or business leaders attacking CRA.

Again if the CRA required banks to make bad loans that would bankrupt the banks in order to get approval for mergers or branch openings, the bank officers, directors, and executives had a responsibility not to authorize the mergers or branch openings. They did not do their job.

**Excuse 4: The government sanctioned the credit ratings agencies through regulations and public law.**

One aspect of the crisis is that so-called credit rating agencies gave good credit ratings such as AAA to mortgage backed securities backed by extremely risky sub-prime loans. Some laws, regulations, and policies at the local, state, and federal level require that risk ratings be used in various ways in investment decisions. For example, some public pensions are limited to AAA or equivalent low risk bonds or other securities.

So what? The banks and financial institutions that are in trouble such as Citigroup, Goldman Sachs, Morgan Stanley, AIG, and many others had a fiduciary responsibility to their shareholders to perform due diligence on the mortgage backed securities. How should this be done? Untangle the mortgage backed securities. Request a list of the actual mortgage holders: John Doe, Joe Sixpack, Jane Smith, and so forth. A mortgage backed security is a pool of mortgages held by real people. The risk level of the mortgage backed security is an aggregation of the risk of the individual mortgages. With modern information technology, e-mail, the Internet, the World Wide Web, and so forth, it was and is easy to get such a list of actual mortgage holders and verify their credit on an individual case by case basis. This could be partially or fully automated using any of dozens of standard business software systems and business-oriented programming languages: Oracle, Sybase, SAP, Perl, Python, MySQL, Visual Basic, etc. All of the major banks swept up in the crisis had or could hire business experts and software developers with the necessary skills to perform such an analysis.

Extensive historical data dating back over fifty years exists for the risk level of home mortgages. Thus, the risk level for pools of home mortgages, however sliced or diced, should have been easy for the highly paid, highly credentialed, highly skilled officers, directors, and executives of the banks to determine directly without relying on the credit rating agencies.

**Trust but Verify**

To rely on the credit agency ratings of the mortgage backed securities, the banks needed to verify that the credit agencies were rating the securities correctly. Nearly all mortgage backed securities were new, sometimes very new types of securities. There was limited historical data on the accuracy of the ratings. Accordingly the banks needed to randomly audit at least some of the mortgage backed securities as pools of mortgages, going back to the individual mortgages and mortgage holders to ensure that the ratings assigned by the ratings agencies corresponded to the actual risk level based on the actual underlying mortgages.

**Stay Tuned: More Excuses on the Way**

All of the current main excuses for the fiasco are invalid, ironically on the basis of principles that conservatives, libertarians, and business people routinely invoke in other contexts. If the crisis worsens, new forms of *"Mommy! The government made me do it!"* will probably appear as in previous fiascoes.

The *"Mommy! The government made me do it!"* excuse that has the most truth, however, has rarely been used by conservatives, libertarians, and business people to date. It will probably be used at some point. This is the implicit "too big to fail" doctrine of the Federal Reserve and Treasury Department under both Bush and Clinton. This has been the policy of bailing out certain large politically well-connected banks such as Goldman Sachs. This did not start with the current Wall Street bailout. In particular, this occurred during the 1998 Long Term Capital Markets (LTCM) bailout by the Federal Reserve in which many of the same banks were protected from the failure of the LTCM hedge fund, allegedly without taxpayer funds but with Federal Reserve "intervention" and brokering of a bailout deal.

Of course, the de facto "too big too fail" doctrine does not force banks to make bad loans. The bank officials made the bad decisions.

**Free Market Rhetoric in a Rigged Market**

**"Behind every double standard lies a single hidden agenda."**

**Attributed to G.K. Chesterton**

Returning briefly to IBD's "Show Us Where the TARP Money Is Going" editorial (January 13, 2009), what is IBD using the *"Mommy! The government made me do it!"* excuse to argue for? Here it is:

House Banking Committee Chairman Barney Frank, D-Mass., **whose advocacy of forcing banks to be instruments of social justice helped cause the mess we're in,** is also pushing TARP reforms that would impose "the most stringent nontax executive compensation restrictions" — including forbidding golden parachute payments to executives and applying executive pay limits retroactively.

Unfortunately, this is what the lack of transparency and no clear strategy for exactly how the rescue money would be used has set us up for: The micromanaging from Washington of the biggest financial institutions.

We wonder: How many other businesses will Uncle Sam end up setting executive pay for, outside the wishes of the shareholders?

(Emphasis Added)

In a nutshell, the executives who have the ultimate authority over the decision to advertise in IBD might have to accept a pay cut. Hmmm. Shocking!

In reality, the United States has a highly rigged market, not a free market, in which the government is blatantly subsidizing certain large financial institutions such as Citigroup, Goldman Sachs, and Morgan Stanley at public expense. This is actually being justified by dubious claims that the government created the problem and the banks are blameless. Free market rhetoric is trotted out to oppose, often successfully, specific actions such as limits to executive pay or, for a while, the automobile industry bailout, that divert money from the leaders of these favored financial institutions.

In a hypothetical free market, *whether anything goes cowboy capitalism or a highly regulated welfare state*, the banks that have screwed up would go out of business. The banks that did not make bad loans or purchase bad mortgage backed securities, many of them apparently smaller regional banks, would expand and replace the failed megabanks. The executives of banks like Citigroup that are surviving on TARP funds would be laid off and probably have a lot of trouble getting another job, at least as a bank executive. The TARP funds may actually enable the banks that screwed up to purchase control over the smaller banks that did not.

The irony and the paradox is that rhetoric about the "free market", "personal responsibility", "accountability", "micromanagement", "picking winners and losers", "moral hazard", and other clichés in public discourse is being used to promote the opposite through extremely selective application of these principles. "Too big too fail", "Mommy! The government made me do it!", and "Oh My God! It could be another Great Depression!" arguments are invoked to justify handouts to certain favored firms. "Free market", "picking winners and losers", and "moral hazard" arguments are used to oppose handouts to disfavored firms and people.

**A Call to Action**

These Wall Street bailout policies do not benefit the vast majority of Americans: rich or poor, liberal or conservative, purple or polka dot. In fact, they may plunge the nation and the world into an echo of the Great Depression, a fear that the promoters of these policies have exploited to serve their ends. In reality, most people are losing money, sometimes their homes and jobs, due to these policies.

Americans of all persuasions need to see past this cynical framing of the issues in terms of government versus the private sector, regulation versus deregulation, and similar clichés. In fact, most conservatives, libertarians, and business people, outside of the small and shrinking Wall Street super-elite, do not benefit from these policies either. When you hear *"Mommy! The government made me do it!"* take firm hold of your wallet and start asking tough questions.

**About the Author**

John F. McGowan, Ph.D. is a software developer, research scientist, and consultant. He works primarily in the area of complex algorithms that embody advanced mathematical and logical concepts, including speech recognition and video compression technologies. He has many years of experience developing software in Visual Basic, C++, and many other programming languages and environments. He has a Ph.D. in Physics from the University of Illinois at Urbana- Champaign and a B.S.in Physics from the California Institute of Technology (Caltech). He can be reached at jmcgowan11@earthlink.net.