Letters to the Editor

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Letters to the editor in the February 28, 2008 Wall Street Journal ("Should Government That Twisted Markets Own Banks?") repeat the three major blame the government scapegoats for the current financial crisis. Here is why they are wrong.

Introduction

The Saturday, February 28, 2009 *Wall Street Journal* contains three letters to the editor under the header "Should Government That Twisted Markets Own Banks?" that repeat the three major blame the government scapegoats for the financial crisis: the Federal Reserve and Alan Greenspan, Fannie Mae/Freddie Mac, and the Community Reinvestment Act (CRA)[1]. All three letters are responses to a recent interview in the *Wall Street Journal* with NYU economist Nouriel Roubini, an early critic of the housing bubble, who argues for "bank nationalization", a rather ambiguous term that can refer to anything from the traditional legally mandated FDIC takeover of insolvent banks to even more government subsidies for giant banks.

Two of the big three government scapegoats for the financial crisis are obvious nonsense. It is something of a tribute to fallible human reasoning that they continue to be cited so frequently. The Federal Reserve and Alan Greenspan are accused of "causing" the housing bubble by keeping interest rates very low after the 2001 Internet/Telecom bubble crash. Low interest rates, even 0% interest rates, do not *force* banks to make loans that cannot be paid back. While it is clear that the government sponsored enterprises Fannie Mae (the Federal National Mortgage Association or FNMA) and Freddie Mac (Federal Home Loan Mortgage Corporation) have significant amounts of bad mortgages and mortgage-backed securities, the financial crisis involves ostensibly "private" banks[2] such as Citigroup with trillions of dollars in bad mortgages and mortgage-backed securities. Citigroup alone has received $45 billion in government bailout money and over $300 billion in guarantees for bad mortgage-backed securities. Fannie Mae and Freddie Mac had no authority to force ostensibly "private" banks to make bad loans or acquire bad mortgage backed securities.

The letters to the editor do claim that the government somehow *forced* banks to make bad loans, implicitly blaming the Community Reinvestment Act (CRA). For example:

Or does Mr. Roubini consider it a market failure that lenders were ***coerced [emphasis added]*** *by the government to make mortgage loans that never would have been made based on market-driven underwriting standards?*

Robert Drake
Lakewood Ranch, Fla.

This is almost certainly a reference to the Community Reinvestment Act (CRA) which was preserved but weakened by the now notorious Gramm-Leach-Bliley Act (GLB or GLBA) of 1999, also known as the Financial Services Modernization Act of 1999. The CRA in principle required federal regulators such as the Federal Reserve under Alan Greenspan and Ben Bernanke to deny approvals for bank mergers if the banks received less than a "Satisfactory" rating for CRA compliance. The implicit assertion is that federal regulators at the Federal Reserve, FDIC, and other agencies under the Bush Administration from 2001 to 2007 (when most of the bad housing bubble mortgages were made) with a Republican Congress used the CRA to "coerce" banks such as Citigroup by threatening to block mergers with unsatisfactory CRA ratings.

The CRA excuse peddlers may protest that the trillions of dollars in bad loans must have been made under President Clinton despite appearances. However, house prices have not yet fallen below 2001 levels; they are reportedly back to about 2004 levels as of this writing. Consequently the Clinton-era loans would have sufficient collateral to avoid a loss even in a complete default. The Clinton-era loans almost certainly cannot be the bad loans. The bad loans are mostly loans made during the height of the housing bubble between January 2001 and January 2007 under President Bush and the Republican Congress.

The bank executives had a clear fiduciary responsibility to their stockholders to refuse to make mortgages *that would bankrupt the bank*. If making a merger required that Citigroup, for example, make $300 billion in bad loans or acquire $300 billion in bad mortgage-backed securities, the business decision is and should have been crystal clear. Don't make the merger. End of discussion. That is not what happened.

It is important to keep in mind that one is not talking about a few million or billion dollars in token "help the poor people" loans that the banks made to get merger approvals – money they could afford to lose. Rather, it is claimed that the banks made trillions of dollars in bad loans to get the "satisfactory" CRA ratings.

As it stands, CRA did not have the power to force or coerce banks to make bad loans. Nor was this the stated purpose of CRA. CRA was supposed to induce banks to make sound loans to minorities and other groups *that were denied loans because of racial prejudice or other irrational reasons*.

For the sake of argument, let us assume that the Bush Administration somehow forced the banks to make bad loans or acquire bad mortgage-backed securities even though the CRA does not seem to provide an actual legal mechanism to *force* the banks to make bad loans. The bank executives had a fiduciary responsibility to their stockholders to fight the government and fight very hard. They also had a civic responsibility to oppose such a disastrous policy. It is quite evident that there was no political campaign against the bad loans by the banks from 2001 to 2007. There are many attacks on Fannie Mae and Freddie Mac in business, conservative, and libertarian sources during this period, but we are concerned with CRA and the use of CRA to allegedly *force* ostensibly "private" banks to make trillions of dollars in bad loans.

The "market-driven underwriting standards" in Mr. Drake's letter to the editor are somewhat mysterious. The federal government has been deeply involved in the housing and mortgage markets since the Great Depression when the government stepped in to stabilize the failing housing market. The fixed rate thirty-year mortgages that used to be the rule prior to the housing bubble were imposed by the government during the New Deal. The twenty percent down payment requirement that was often abandoned during the housing bubble was another government policy dating to the Great Depression. So-called "conforming mortgages" are mortgages that conform to the standards of the Federal National Mortgage Association, the much-maligned Fannie Mae. These conforming loans required a down payment, verification of borrower income, and other "conservative" precautions that were often abandoned during the housing bubble.

Conservative, libertarian, and business sources, especially the *Wall Street Journal* editorial page, have a long history of blaming the government for financial and economic fiascoes that followed the adoption of policies initially billed as "deregulation", "free market", or similar terms[3]. Often, on close examination, these policies turn out to be selective deregulation or simply changes in regulations that benefit certain firms and individuals. The fiasco is then often actually cited as evidence for further policies labeled as "deregulation", "free market", or similar terms. Conservative, libertarian, and business sources may sincerely believe their own claims. These blame the government excuses implicitly exonerate the leaders of various businesses that have made mistakes or may even be guilty of deliberate misconduct. In the current financial crisis, blame the government excuses are used to implicitly argue that the federal government *owes* the bank's the bailout money – no strings attached.

Did a hypothetical "free market" devoid of government regulation or intervention fail? Of course not. Such a market has certainly not existed since the Great Depression and probably has never existed. Did the real market fail as Professor Roubini asserts. Obviously. Did the bank executives now receiving billions of dollars in bonuses at taxpayer expense fail in their jobs? Almost certainly. Should the federal government stop subsidizing the failed mega-banks. Almost certainly. Should the government step in through the FDIC, write off the bad loans, and dismantle the failed mega-banks, chopping them up into smaller manageable pieces and restoring competition to the banking industry. Probably.

The Wall Street Journal editors appear to grudgingly concede this in a companion editorial "Your Citibank":

In a better world, Citi would have long ago have been put into bankruptcy. The FDIC could have taken over and disposed of the bank's assets, while protecting insured deposits as it always does. The profitable parts of Citigroup could then have been sold off to people who could better manage them.[4]

Unfortunately, it remains to be seen both whether the government will end the subsidies and shut down the failed mega-banks, and whether the "bankruptcy" or "bank nationalization" as Professor Roubini calls it, will be the needed measures or rhetorical cover for further disastrous public policies. The nation needs to watch closely and carefully.

One would feel better if officials and advisers such as Larry Summers, Treasury Secretary Timothy Geithner, and Robert Rubin involved in the genesis of the fiasco recused themselves from handling the crisis. One would feel better if strict laws to prevent former Treasury Department and Federal Reserve officials and regulators from taking jobs or receiving money in any form from banks and other financial institutions after leaving their jobs were enacted. The government should provide adequate pensions for government service. One would feel better if top officials like Federal Reserve Chairman Ben Bernanke were required to make full disclosures of their personal finances both in office and after leaving office to ensure that there are no conflicts of interest. Similar issues apply to Senators and Congressmen like former US Senator Phil Gramm, now vice chairman of UBS Investment Bank, involved in financial laws and regulations. One would feel better if the huge campaign contributions from the financial industry were halted immediately. In short, the revolving door between government and the major banks should be ended.

Let's write off the bad mortgages, reset the mortgage principal amounts to reasonable values based on rental rates, and move on. Let's work with China and other nations to build an international trade system in which China and other nations manufacture goods and provide services for their own rural populations first and not luxury goods for the US that we often don't need. Let's use the vast unused power of modern day computers to solve substantive problems and not trade stock options and dubious derivative securities – or reinvent the corporate bookkeeping system every five years. The nation needs to shake off the bubble mentality and focus on the real economy and real economic growth.

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.

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[1] Robert Drake, Joel Brandes, Dale Meyer, "Should Government That Twisted Markets Own Banks?", Letters to the Editor, *Wall Street Journal*, Saturday, February 28, 2009, Page A10

[2] "Ostensibly" private is used because many of the banks such as Citigroup seem to enjoy close relationships with the government. There seems to be a revolving door between some of the banks and the government. US Treasury Secretary Robert Rubin moved seamlessly from government service to Citigroup in 1999 shortly after the passage of the Gramm-Leach-Bliley (GLB) Act of 1999 that repealed the Depression era Glass-Steagall Act. GLB enabled many subsequent mergers that built Citigroup into the present apparently insolvent government-funded colossus. Is it proper to call these "private" banks as opposed to awful government sponsored enterprises such as Fannie Mae and Fredie Mac with awful political hacks like Franklin Raines running them? Maybe not.

[3] Conservative, libertarian, and business sources often use the terms "free market", "market based", "market friendly", "private", "private sector", "privatization", "deregulation", "laissez faire", "pro-business", and "free enterprise" interchangeably.

[4] "Your Citibank", *Wall Street Journal*, Saturday, February 28, 2009, Page A10