How Government Regulation Caused the Financial Crisis

Note: Last week I asked why conservative Christian outlets are increasingly promoting socialist ideas and policies. My friend Jake Meador weighed in to help provide some perspective on this trend. Jake himself is the editor of an online Christian magazine—Mere Orthodoxy—that would be described as traditionalist conservative. While he is not a socialist, he admits he is somewhat sympathetic to the "emerging leftism" of young Christians, especially those within Catholic and evangelical circles.

There's a lot to say in response to his article, "Young Christians and the Specter of Socialism." My initial post in response, "How Christian conservatives are breeding Bolsheviks," took a rather broad approach in explaining why it was not entirely the fault of young socialist sympathizers. In this post I want to address a single, narrow but substantive, point where I think Jake and many others are in error.

In his article Jake wrote: "We think, rightly or wrongly, that we lived through a fairly free market era. . . . We saw—and lived!—what a lack of regulation of banks did to the market."

If Only Government Would Intervene in the Market . . .

Here we are a decade after the start of the Subprime Mortgage Crisis of 2007 and many people still believe the primary cause was excessive freedom and a corresponding lack of government intervention in housing and financial markets. But is that belief warranted? Let's look at a handful of the ways the government did (and does) intervene in the housing market:

The government intervenes, through the Federal Reserve, to stabilize prices—including the price of housing—by managing the supply of money.

The government intervenes, also through the Federal Reserve, to influence interest rates, which affects the interest rates on

mortgages.

The government intervenes, through the tax code, by setting the home mortgage interest deduction, which induces homebuyers to buy more expensive houses than they otherwise would, thereby increasing indebtedness.

The government intervenes, through housing policy, to influence the types, number, and location of new homes, thereby reducing the supply of housing.

The government intervenes, through financial regulations, to protect fixed-amount creditors (e.g., banks) against loss should their financial institution fail because they've made bad loans to homebuyers.

The government intervenes, through the Federal Housing Administration (FHA), to guarantee mortgages of low-income borrowers.

The government intervenes, through the Government National Mortgage Association (Ginnie Mae), to sell securitized mortgage loans made by FHA in the credit market.

The government intervenes, through the government-sponsored enterprise known as the Federal National Mortgage Association (Fannie Mae), to increase the number of lenders in the mortgage market.

The government intervenes, through the government-sponsored enterprise known as the Federal Home Loan Mortgage Corporation (Freddie Mac), to buys mortgages on the secondary market, pools them, and sells them as a mortgage-backed security to investors.

The government intervenes, through housing regulation, to require lenders to give mortgage loans to people regardless of their ability to pay.

Is it really possible that the cause was a *lack of government intervention*?

Jake himself doesn't directly deny the government intervenes in the

housing market. His claim is that the "lack of regulation of banks" increased free markets in way that caused the crisis.

This is exactly backwards. As I'll show, it was *regulation* of banks (and other financial institutions) that caused the subprime mortgage crisis that sparked the broader financial crisis.

Subprime Problems Caused by a Subprime Government

In the thirty years prior to the financial crises, there was no significant deregulation of financial institutions. If the problem was lack of regulation, why did the problem not occur sooner? Because in reality it wasn't deregulation that caused the crises to occur but additional regulations.

In an attempt to increase home ownership, especially among the lower economic classes, the government imposed in 1992 a requirement on Fannie Mae and Freddie Mac to increase the number of subprime mortgages. Eventually, other private lenders covered by government regulation (especially the Community Reinvestment Act) were also required to issue more subprime loans.

A common misperception is that "subprime" refers to the interest rate on the loans. What subprime actually refers to is the credit score of the individual taking out the mortgage—the credit score is below ("sub") what would normally be required to secure a loan. A credit score is one type of signal that is used by sellers of mortgages to determine whether the buyer is willing and/or able to fulfill their payment obligation. What the government was therefore requiring through regulation was that the market not only *ignore* this risk signal but be forced by law to give mortgage loans to people who had a *documented history of being unable to pay lesser debts*.

While this regulation increased the number of risky subprime loans that could be issued, consumers with poor credit scores were still somewhat discouraged from buying homes because of the relatively high interest rates being charged for mortgages (from 1992 to 2011, the average national mortgage rate bounced between 6.5 and 9 percent). However, after the terrorist attacks in September 2011, the Federal

Reserve attempted to prop up the economy by lowering interest rates—a government intervention that affected the interest rates on mortgages.

Now that subprime borrowers could get a better rate, the government-influenced demand for such loans exploded. As this chart by Eric Petroff shows, "subprime mortgage originations grew from $173 billion in 2001 to a record level of $665 billion in 2005—an increase of nearly 300 percent.

Government regulations also required Fannie and Freddie to meet quotas when they bought loans from banks and other mortgage originators. In 1992, 30 percent of the loans had to be made to people at or below the median income in their communities. By 2007, the quota had almost doubled to 55 percent.

In a 2011 interview with *The Atlantic*, Peter Wallison, an appointee to the government's Financial Crisis Inquiry Commission, explained how this single government regulation set the financial crisis in motion:

> *"It is certainly possible to find prime mortgages among borrowers below the median income, but when half or more of the mortgages the GSEs [i.e., Fannie Mac, Freddie Mac] bought had to be made to people below that income level, it was inevitable that underwriting standards had to decline. And they did. By 2000, Fannie was offering no-downpayment loans. By 2002, Fannie and Freddie had bought well over $1 trillion of subprime and other low quality loans. Fannie and Freddie were by far the largest part of this effort, but the FHA, Federal Home Loan Banks, Veterans Administration and other agencies—all under congressional and HUD pressure—followed suit. This continued through the 1990s and 2000s until the housing bubble—created by all this government-backed spending—collapsed in 2007. As a result, in 2008, before the mortgage meltdown that triggered the crisis, there were 27 million subprime and other low quality mortgages in the US financial system. That was half of all mortgages. Of these, over 70% (19.2 million) were on the books of government agencies like Fannie and Freddie, so there is no doubt*

that the government created the demand for these weak loans; less than 30% (7.8 million) were held or distributed by the banks, which profited from the opportunity created by the government. When these mortgages failed in unprecedented numbers in 2008, driving down housing prices throughout the U.S., they weakened all financial institutions and caused the financial crisis."

To understand the significance of the government's role in the subprime mortgage crisis, let's compare how the housing market would function in a free market.

Free Markets vs. Government Influenced Markets

In a free market in which people buy and sell voluntarily, without legal compulsion, neither the quantities traded nor the price at which trade takes place are subject to control by third parties. In a perfectly free market this would mean the government didn't artificially determine such factors as interest rates or the supply of housing. But let's use a modified free market in which the government simply doesn't intervene in the process of mortgage underwriting, the process a lender uses to determine if the risk of offering a mortgage loan to a particular borrower under certain parameters is acceptable.

Without the government to bail out either the lender or the borrower, both parties would rely on time proven signals for creditworthiness. The mortgage underwriter would look at the borrower's credit history to see how they previously handled credit. They would look at the income level and ensure that the mortgage debt-to-income ratio was not too high (e.g., above 30 percent). They might even ask for a down payment to reduce the ratio of the loan to the value of the home and to ensure the borrower had "skin in the game."

Each of these factors would limit the number of mortgages that were approved, thereby reducing the demand for home ownership. This reduced demand would also prevent home prices from becoming artificially inflated, limiting the number of homeowners who suffered from a delusion that they were wealthy simply because the price of their homes had increased.

Now let’s look at how government regulation subverted the normal market process.

The government made it clear that they were willing to bail out both the borrower and the lender, creating moral hazard on both sides. Certain mortgage underwriters were told *not* to look at the borrower’s credit history to see how they previously handled credit, but to give them a mortgage even if they had a history of failing to repay their debts. They were also not only told to downplay income levels but were required to give half of all mortgage they had underwritten to people who were below the media income in their community. They were also told to forgo downpayments, thereby increasing the ration of loan to home value and ensuring borrowers would suffer no significant financial lose if they defaulted on their loans.

Each of these factors increased the number of mortgages that were approved, thereby increasing the demand for home ownership. This artificially increased demand led to the “housing bubble” where home prices were artificially inflated. It also lead to a widespread wealth delusion among homeowners who would take out loans backed by the equity of their artificially inflated home values.

As the [Federal Reserve points out](), the mortgage debt of U.S. households rose from 61 percent of GDP in 1998 to 97 percent in 2006. Now consider that half these mortgages—an equivalent of nearly half the GDP—were subprime loans and were bound to have a high default rate. Consider also that the government agreed to bail out not only the borrowers and the lenders but also the financial institutions that bought these securities because the American taxpayer was bearing the risk.

Too often defenders of government intervention focus on the non-government factors that contributed and exasperated the crisis. While those factors are significant, we shouldn’t overlook the fact that *there would have been no financial crisis without the government regulation and intervention that lead to the subprime mortgage crisis*.

Indeed, advocates of the free market were right all along when we

warned that it was all but inevitable that these government interventions would lead to a crisis.

This is but one reason why Christians sympathetic to socialism should reconsider their support for government intervention in economic affairs. In the next post we'll consider why they should be more willing to support free markets.

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