Moral Hazard and the Roots of the Financial Crisis

By Editor Test *Wed, Dec 22, 2010*

Which caused the financial crisis? A minority report from the Financial Crisis Inquiry Commission and a forthcoming book from economists at NYU try to explain.

Four members of the Financial Crisis Inquiry Commission have delivered a 13-page document tracing the causes of the so-called Great Recession of 2008-2009, thus meeting the December 15, 2010 deadline established by law in May 2009. But the document represents only their views and not the views of the entire commission.

The root cause of the crisis, in their somewhat partisan opinion, was the U.S. government's zeal in the late 1990s and 2000s to increase federally-insured mortgage lending to high-risk borrowers without adequate regard for—and without heeding repeated warnings about—the risks that policy would eventually introduce into the financial system.

"The government has always supported homeownership. But trying to get something for nothing—to subsidize homeownership without increasing the budget deficit—was a recipe for a crisis," the report said. "The government, in effect, encouraged the [Government Sponsored Entities] to run two enormous monoline hedge funds that invested exclusively in mortgages and were implicitly backed by the U.S. taxpayer."

The report goes on to name the reasons why this policy grew out of control, including such factors as low interest rates, a global savings glut and creative lending practices. But the problems in the mortgage arena wouldn't have become so huge, they argue, if investors, banks and credit rating agencies had not been lulled into under-pricing risk and leveraging up their holdings by a belief that housing prices wouldn't go down and that, even if they did, the federal government would bail everyone out.

A number of observers—including, apparently, the members of the FCIC who didn't endorse this report—disagree to varying degrees with this interpretation. According to competing theories, Fannie Mae and Freddie Mac followed rather than led private lenders like Countrywide Financial into the riskiest depths of the subprime market, and that the private sector recklessly exploited government housing policy, interest rate policy and federal guarantees.

The difference is a subtle one. One economist who has been studying the causes of the crisis, Viral Acharya of the Stern School at NYU, believes that the correct answer lies in between. In a forthcoming book on the crisis, *Guaranteed to Fail: Fannie, Freddie and the Debacle of Mortgage Finance* (Princeton University Press, 2011) he and his NYU co-authors avoid assigning blame. Rather, they describe a disastrous "race to the bottom" in risk-taking that private banks and GSEs both participated in.

In their view, moral hazard created by explicit or implied government guarantees of the GSE debt—coupled with a neglect to properly reserve, hedge or even account for those liabilities—did more to bring about the crisis than did the Clinton and Bush administrations' efforts to expand home ownership among riskier borrowers.

"Our view is indeed that their private-profits-with-socialized-risk [structure] was as big—if not a bigger problem—than their government mandate," Acharya told RIJ. "In the end, both interacted to produce a terrible outcome, along with race to the bottom with private sector in risk-taking."

He and his co-authors believe "government guarantees abound, not just to Fannie Mae and Freddie Mac but to much of the financial sector, and that it distorts the price of systemic risk. We think the primary distortion is the lack of government pricing of these guarantees to 'correct' the cost of capital faced by the financial sector," he said.

The U.S. is not the only country whose government has created moral hazard in its financial system, Acharya added. "There are many crises around the world where such distortions were not present. In a way, we are going after that common theme—of mispriced government guarantees and systemic risk externalities—rather than just what went wrong in this particular crisis."

In his weekly column in the *New York Times*, Joe Nocera took issue with the report's conclusion that the GSEs led the private sector into sub-prime morass. "Fannie and Freddie… spent most of the housing bubble avoiding subprime loans, because those loans didn't meet their underwriting standards," he wrote on December 17.

"When Fannie and Freddie finally did get into the business, it was very late in the game. But the motivation wasn't pressure from the government; it was pressure from the marketplace… By the mid-2000s, subprime underwriting and securitization had become so profitable… that Fannie and Freddie felt they had no choice but to dive in."

Guaranteed to Fail, co-written by Acharya, Matthew Richardson, Stijn Van Nieuwerburgh and Lawrence J. White, comes down somewhere between those two interpretations of the crisis.

"The strong growth in private-label subprime mortgage originations and securitizations had important consequences for the GSEs. First, their market share of originations fell dramatically between 2003 and 2006. Second, the loss in market share made it harder for them to meet their ever-increasing Congress-mandated quotas.

"To preserve the profit growth rates of the pre-2003 period and to simultaneously meet their quotas, the GSEs embarked on an all-in policy, which saw them dramatically ramp up the risks of their portfolio. This policy started as far back as 2000-2001 with the motivation that a stronger GSE presence in the subprime market would create lower priced mortgages for some subprime borrowers.

"While there is little doubt that the housing goals played an important role in shifting Fannie Mae and Freddie Mac's profile to riskier mortgage loans, it remains an interesting question whether Fannie Mae and Freddie Mac deliberately chose to increase the riskiness of the loans that they bought 2004 onward or whether they were forced to do so by the U.S. Congress, which wanted to promote home ownership.

"While the public/private nature of the GSEs leads to a moral hazard problem even in normal times, the question is whether moral hazard was exacerbated by the astronomical growth of the subprime market segment."