Why the American housing credit crisis is worse than you think.

Fear *and* Greed

BY LAWRENCE B. LINDSEY

As most homeowners know by now, it's a buyer's market in residential real estate. With the correction still underway, this could turn into the largest sustained decline in nationwide home prices since the 1930s. For students of credit cycles and housing, the last few years have been like watching an inevitable train wreck in slow motion. At this point there is still time to avoid real carnage. But there is every indication that all of those involved, particularly the political and regulatory leadership of the country, are following business-as-usual rules when what is really needed is some creative behavior.

Today we are witnessing the end of a fifteen-year expansion in the housing credit cycle. Cycles, by definition, go round-trip and this period of ever-easier credit terms will be followed by a tightening of such terms. Walter Bagehot, an editor of the London magazine *The Economist*, famously commented on the preferred policy reaction to credit cycles 130 years ago with the line "lend freely at a penalty rate." By this he meant that the central bank (our Fed, his Bank of England) should let the credit market correct itself in an unfettered fashion, provide ample liquidity for the market to do so, but charge market participants for the privilege, using the price of money and not heavy-handed regulation as a way of restoring some discipline.

Bagehot's recommendation was a contrarian point of view 130 years ago, and still is today. The more standard incentive for policymakers in charge is to let markets go to ever higher extremes without supervision on the way up. That way those in charge enjoy the popularity of a world in which everyone is making money. Then, when the cycle goes into reverse and things fall apart, they jump in and blame the market participants, sharply tighten regulations, and in the process drive the market down further. America did this in the stock market bubble of the 1990s letting all of the excesses happen with no regulatory interference on the way up, while our politicians claimed that we were in a new era in which the business cycle

THE INTERNATIONAL ECONOMY
THE MAGAZINE OF
INTERNATIONAL ECONOMIC POLICY
888 16th Street, N.W.
Suite 740
Washington, D.C. 20006
Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com

Lawrence B. Lindsey was a Governor of the Federal Reserve Board and a Chairman of the Neighborhood Reinvestment Corporation during the 1990s. He is currently President and CEO of the Lindsey Group.

was repealed and an age of endless affluence was upon us, thanks to their sound policies. Then, when the market crashed they "rounded up the usual suspects," jailed some, and passed tough new rules so that "it will never happen again." We already know that the effect of those new rules has been to drive the financial services industry out of New York and overseas to London, and to a lesser extent places like Hong Kong and Singapore. True to form, some of the very politicians who brought the new regulatory environment into play are complaining the loudest about the results.

If we are not careful, the same sort of cycle will occur in housing. But with homeownership much more widespread and more integral to both our economy and our social fabric, the implications of simply replaying this process could be more profound. To begin, consider how we got where we now are.

The Price of Money

Walter Bagehot (1826–77), an editor of the London magazine *The Economist*, famously commented on the preferred policy reaction to credit cycles 130 years ago with the line "lend freely at a penalty rate." By this he meant that the central bank (our Fed, his Bank of England) should let the credit market correct itself in an unfettered fashion, provide ample liquidity for the market to do so, but charge market participants for the privilege, using the price of money and not heavy-handed regulation as a way of restoring some discipline.

—L. Lindsey

OUR FIFTEEN-YEAR HOUSING BOOM

The current mortgage credit cycle began almost two decades ago in the wake of the collapse of the savings and loan industry and the enactment of two pieces of legislation—FIRREA in 1989 and FDICIA in 1991—that restructured the industry. The S&L industry had provided the financing that led to record-setting homeownership in the decades that followed World War II. But it was built on a business model of short-term borrowing and long-term re-lending that could not survive the inflation and resulting high interest rates of the 1970s. After some failed experimentation with patchwork solutions during the 1980s, the whole home financing system was bailed out and redone by the politicians of the day. In the process they made sure "it would never happen again." Part of that process was to make credit terms quite restrictive and direct the bank regulatory agencies to force banks to purge their books of potentially bad credits. Regional real estate collapses resulted in Texas, New England, and California as banks stopped rolling over existing credits and gave new credit only under very stringent terms. In 1991, spending on residential construction amounted to just 3.4 percent of GDP, down from a peak of 5 percent in 1987.

Some of the very politicians who brought the new regulatory environment into play are complaining the loudest about the results.

What bankers at the time called "this regulatory reign of terror" abated as the mortgage market stabilized and more normal credit conditions emerged. Financial markets are fabulous innovators at times like these. There were three problems with the S&Ls that both the regulators and the financial markets knew had to be fixed. First, they borrowed short-term and lent long-term so when short-term rates went up, they lost money. The solution to this was to increase the number and attractiveness of variable rate mortgages and to find a way to hedge the risks on long-term mortgages. Second, the S&Ls were created to make and hold mortgages on their own books, leaving them particularly vulnerable to swings in the housing industry. The solution was to shift mortgage market risk onto institutions that were more diversified. Third, the S&Ls tended to operate on a very regional basis, leaving them vulnerable not just to national housing market and interest rate swings, but to local conditions as well. The solution was to create a national market that could diversify away from regional risks.

The overall solution was to more fully develop a national securities market for mortgages. New institutions emerged that specialized in originating loans by interacting with borrowers. These institutions then sold the mortgages they made to others who specialized in packaging the loans into loan pools. These pools of loans were often national in scope and therefore diversified. Large investors such as pension funds and insurance companies could buy a whole package of loans and spread their risks widely. This process was augmented by actions of Fannie Mae and Freddie Mac, two government-created institutions that markets assumed were backed by the federal government. An implicit government guarantee was thus attached to these bundles of mortgages, further increasing the market for them. The process worked well to vastly increase the money available for making mortgages.

The credit cycle had gone from extremely restrictive to extremely accommodative, completing half of what is and always has been a roundtrip.

One further problem needed to be addressed. A major underserved market remained in low- and moderate-income areas. "Normal" lending standards required a 20 percent down payment on a home, something that often required an insurmountable sacrifice for low- and moderate-income families to accumulate. In addition, the condition of many of these neighborhoods made it unattractive for individual lenders to underwrite specific mortgages, a challenge that could only be solved by viewing lending in these areas as a "public good" that required participation by all lenders.

The response to this in 1995 was a new set of regulations under the Community Reinvestment Act (CRA) that effectively amounted to a soft quota on lending in these areas. Regulators also substantially eased a variety of mortgage lending standards, including loan-to-value requirements, in order to increase the size of the potential market. (In the interest of full disclosure, and perhaps a bit of a *mea culpa,* I was one of those instrumental in drafting these regulations.) At first, the process worked reasonably well. A new pool of potential homebuyers was empowered with access to credit. Housing demand rose. The families who sold homes to new buyers were able to upgrade. With a generalized rise in home prices and significantly eased mortgage availability, default rates and resulting losses to lenders dropped substantially.

Lenders, buoyed by the success of these loans and the low default rates, reduced lending standards still further. They reasoned that if easier lending standards worked well for a population that had historically been higher risk, surely they must work well for the general population. Of course, to adhere to the CRA's "soft quota," that also meant that lending standards had to be further eased for the underserved population. A hard-wired cycle of ever-easier credit was created. By 2006 the median down payment for first time homebuyers was only 2 percent, down from a 20 percent standard down payment fifteen years before. Forty percent of all first time homebuyers in 2005 put zero down, or actually took out mortgages that were more than the cost of their homes. The credit cycle had gone from extremely restrictive to extremely accommodative, completing half of what is and always has been a roundtrip.

When credit standards ease, demand for the assets behind the loans increases, driving up the prices of those assets. In the case of housing, home prices rise faster than incomes and faster than rents on equivalent properties. Buyers, seeing these rising prices, jump on what they perceive to be an ever-upwardly spiraling market.

But when prices rise faster than incomes, borrowers run up against basic underwriting rules on

Alan Greenspan

Variable Rate Champion

In the current credit cycle, ways were found to save on both principal and interest in order to qualify for a mortgage. First was the development of the "interest only" loan, in which the entire principal repayment was delayed. Second, the use of variable-rate mortgages that adjusted with market conditions also became widespread. To some extent these variable rate mortgages are quite prudent. Long-term interest rates on which fixed-rate mortgages are based are typically higher than short-term rates because the lender takes a risk that rates might go up. With a fixed-rate mortgage the lender carries this risk, with a variable rate mortgage, the borrower carries the risk. Indeed, no less an authority than Federal Reserve Chairman Alan Greenspan recommended that borrowers take out variable-rate mortgages in order to take advantage of this situation.

—L. Lindsey

the income they need to service the loan. For example, a standard rule is that the mortgage payment—which combines principal, interest, taxes, and insurance—be no more than 28 percent of the borrower's monthly income. These rules are designed to ensure that borrowers are able to make the monthly payment. To make loans and buy houses at ever-rising prices, both borrowers and lenders must look for ways to lower monthly payments. There are only two items under their negotiable control: principal and interest.

In the current credit cycle, ways were found to save on both principal and interest in order to qualify for a mortgage. First was the development of the "interest only" loan, in which the entire principal repayment was delayed. Second, the use of variable-rate mortgages that adjusted with market conditions also became widespread. To some extent these variable rate mortgages are quite prudent. Long-term interest rates on which fixed-rate mortgages are based are typically higher than short-term rates because the lender takes a risk that rates might go up. With a fixed-rate mortgage the lender carries this risk, with a variable rate mortgage, the borrower carries the risk. Indeed, no less an authority than Federal Reserve Chairman Alan Greenspan recommended that borrowers take out variable-rate mortgages in order to take advantage of this situation.

None of these loan product innovations are malicious in their intent.

As the credit cycle got into its very late stages, even more exotic products were created. One was a negative amortization product where the interest rate was deliberately set below the market rate with the extra interest being rolled into the loan's principal. In a rising house price market this involved little risk to either borrower or lender. Another version of this was a very low qualifying rate with a drastically higher reset rate and a prepayment penalty attached. The lender essentially recouped the lost interest in the early stages of the loan either through payments made at the higher rate or through the prepayment penalty.

The most important point to make is that none of these loan product innovations are malicious in their intent. Their purpose was to help the borrower qualify for the mortgage. Increasing access to homeownership had the bipartisan support of the Congress and regulatory blessing and was coupled with both political and regulatory pressure. Families who never before had access to homeownership

Continued, page 68

Continued from page 25

because their income, credit history, or neighborhood made them too risky to meet conventional standards now could attain that portion of the American dream. Of course, financial market participants were not doing this out of the goodness of their hearts, but to make money. So the currently fashionable term "predatory" should be used with care when considering the actual nature of this market. "High risk" is a better phrase. In moderation, these added risks were well worth it. But the self-reinforcing nature of this up cycle camouflaged the actual risks that were being undertaken. Inevitably, the dynamics created by the upward spiral create the conditions for a downcycle.

HOW DOWNCYCLES BECOME SELF-REINFORCING

While credit market up cycles have their self-reinforcing trends, so do down cycles. We are beginning to see this already in both the real estate market and the mortgage market. With credit availability made as easy as possible in order to make as many mortgages available as possible, there does come a point when there literally is no one else who conceivably could be a homebuyer. With houses bid up to historically high prices, sellers often decide that now is the time to take profits. As in any market, whenever there is an excess of supply over demand, the only way the market can clear is for prices to fall.

But the high level of credit in housing makes the price cutting process more painful. For example, consider what would happen if you borrow money to buy a stock in the stock market using the maximum amount of borrowing allowed—50 percent. On a $100 stock, you put down $50 and borrow $50. If the price drops by 10 percent to $90, then you are forced to sell (it's termed a margin call) and pay back what you have borrowed. You end up seeing your initial investment drop by 20 percent, from $50 to the $40 you have left after you sell the stock for $90 and pay back the $50 you borrowed.

Now consider what happens when you buy a house putting only 2 percent down like the median first-time homebuyer in 2006. Let's say it is a $200,000 house and you put down $4,000. If the house goes down in price by 10 percent and you sell it for $180,000, you lose all of your $4,000 down payment, plus you still owe the bank $16,000 at the closing. You have no down payment left to buy another house and your credit rating is ruined by your $16,000 debt. Essentially you cannot get a mortgage to buy another house. Your response: don't sell.

With credit availability made as easy as possible in order to make as many mortgages available as possible, there does come a point when there literally is no one else who conceivably could be a homebuyer.

So the first thing that happens when the real estate market softens is that volume drops sharply. In 2006, for example, 9 percent fewer homes were sold than in 2005. By contrast, prices have only softened a little, with the price of the median home that was sold in January 2007 just 3 percent lower than a year earlier.

Now consider the attitude of the lenders. When house prices were going up it was easy to give someone a loan with a 2 percent down payment. After all, if home prices rose 10 percent, that 2 percent down payment became as good as a 12 percent down payment in just one year. The chances of the homeowner not being able to repay with that much of a cushion in the house was very small. But when prices begin dropping by 3 percent a year, a 2 percent down payment gets wiped out. Your loan is in the classic position of being "under water" just a year later.

Then the role of the appraiser becomes very important. Appraisers give their assessment of what the house is "really" worth by comparing it to similar houses that were sold in the area. It is a reality check by the bank on what the buyer is paying, most of which is, after all, the bank's money. When the market was going up and there were plenty of houses sold this was easy. Not only were there lots of comparable houses, but the likelihood that the appraiser would err a little on the high side would be offset by the overall rise in prices. This goes into reverse on the downside. First, there is a big decline in sales, and so fewer houses to compare to. Second, the consequences of erring a little on the high side are large because they will be magnified by the price decline. The result is that appraisers tend to be extra cautious in their appraisal of the "fair market value" of the house.

This reaction of the appraisers causes a tightening of credit conditions. Say the buyer and seller decide on a price of $200,000 and the buyer puts down $20,000 and seeks a $180,000 mortgage. The buyer may think that he is asking for a fairly conventional 90 percent loan. But if the appraiser cautiously puts the "fair market value" of the house at just $185,000, the $180,000 mortgage the buyer is applying for actually looks like one of those high risk 97 percent loans with the buyer putting down just $5,000 more than the house is worth. With the banks already in the process of lowering the maximum loan-to-value ratios on which they are lending, the net effect of this is to make fewer mortgages available. With fewer mortgages, there are fewer sales. With fewer sales, the appraisers have even fewer comparable sales on which to base their appraisals, making them even more cautious.

In a sign that we have entered the silly season, there is now a new product called a CDO-squared which is actually a bundled pool of CDOs, which of course themselves are simply bundled pools of bundled pools.

Now that house prices are going down, the statistical criteria on which the bundle of mortgages was sold no longer matches reality.

Over time this effective tightening of credit has a big effect on prices. People who have moved to a new house before selling their original house face the burden of carrying two mortgages. At some point they get desperate and decide to cut their asking price for the house. This gives appraisers a "comparable price" for other houses in the neighborhood, but the comparable price is very low relative to the recent past. With prices obviously on a downtrend, further caution sets in. Everyone in the same neighborhood now is faced with the need to make huge price concessions in order to move their property. Prices begin a downward spiral. With relatively few sales—and those sales that occur happening at very deflated prices—a sort of contagion begins to effect the values of all houses in the area.

In the current credit cycle, this process is going to be exacerbated by the development of the mortgage-backed securities market. As discussed earlier, this financial development obviated the problems that caused the old S&L industry to fail. But it set in place a whole new set of pitfalls. Since the new system relied on a separation of mortgage originators who had some knowledge of both the borrowers and the collateral from the securitizers who packaged the mortgages and the actual lenders who bought the securities, there was a complete disconnect between the lender and the borrower. Investors who buy mortgages have no idea who the actual buyer of the home was and have never seen the houses that comprise the collateral behind the mortgages they are buying. They are relying on the statistical characteristics provided by those who did make the mortgage: a given loan-to-value ratio, a given set of homeowner characteristics with regard to creditworthiness, and a given maximum percentage of mortgage payment to monthly income.

When those mortgages were made, by and large the lenders met the statistical criteria. Some may have stretched the truth just a little in order to meet the criteria, claiming perhaps some additional income for the borrower that he really didn't have, or a more generous appraisal. The originators didn't care because they would still collect their fee for making the mortgage and the actual risks involved were small as long as house prices were going up. Now that house prices are going down, the statistical criteria on which the bundle of mortgages was sold no longer matches reality. So, if one of the borrowers just happens to default on his mortgage, the holder of the mortgage bundle finds that his actual losses are much higher than anything that his statistical model said they would be.

Credit cycles like the one that we now confront in housing are fundamentally about fear and greed.

As word gets around that actual default rates in the bundled pools of mortgages are higher than what the statistical models said they were, buyers of the mortgage pools begin to pull back from the market. One of the reactions to this has been to create ever-new financial products that supposedly parse out the risk of holding mortgages more carefully, giving higher yields to those who assume more risk and more normal yields in supposedly lower-risk products. One of these products is called a Collateralized Debt Obligation (CDO) that is really nothing more than a leveraged bet on a bundled pool of bundled pools of underlying mortgages. In a sign that we have entered the silly season, there is now a new product called a CDO-squared which is actually a bundled pool of CDOs, which of course themselves are simply bundled pools of bundled pools. This has caused words to take on new, and perhaps perverse, meanings. For example, there is a so-called "equity tranche" in these CDOs that has a very high yield—40 percent or more—due to the high leverage involved. Buyers of these products actually probably expected to lose their entire equity position. But if the product just stays around for a few years, they will have made a huge return nonetheless.

The details of this process are relatively unimportant. The important points are two-fold. First, the ultimate lenders or people who have money at risk in the home mortgage market have virtually no direct knowledge of the actual collateral that lies behind their financial product. Second, the leverage on that collateral that is always inherent in a mortgage has, in turn, been leveraged several times over in the process of creating financial products with very large returns that the market would buy.

This leaves the mortgage market somewhat vulnerable. Originators are now largely detached from institutions that can actually keep mortgages on their own books. So a breakdown in this process of creating mortgage-backed securities could have profound ripple effects on the availability of mortgages generally. The leverage in the system coupled with the widespread diffusion of the underlying assets increases the likelihood that if something goes wrong, even in a fairly limited market, the effects could be nationwide.

HOW WE ALL COULD LIVE HAPPILY EVER AFTER, SORT OF

Since long before Walter Bagehot wrote his ideas in *The Economist,* credit cycles like the one that we now confront in housing have been part of the economic picture. They are fundamentally about fear and greed, and we won't repeal credit cycles until we change these very human emotions. The totalitarian ideologies that developed in the twentieth century thought they could do this, but all they did was substitute the mood swings of the megalomaniac in charge or the internal machinations of the Politburo for the functioning of markets. Today few would argue that imperfect as they are, markets are less dangerous.

Bagehot's insight was that fear and greed could also be harnessed to force market participants to clean up the excesses of the credit cycle themselves. Credit cycles become truly dangerous when fear gets so excessive that markets break down completely. When no loans are being made, the price of the underlying assets being bought and sold drops precipitously and even relatively good credits with low risks become insolvent. The solution is to let the market function but nudge it to gradually reduce the risks in the system. The best way to make market participants do this is to make the cost of the credit that is underpinning the system slightly more expensive while still making it available so that buyers and sellers can still make their transactions.

The Federal Reserve is currently doing just that. The short-term interest rate that it sets, known as the

Fed Funds rate, is 5.25 percent. But a ten-year government bond is yielding only 4.5 percent, so it certainly does not make sense to take a risk by borrowing short-term and lending long-term. Moreover, fixed long-term mortgages are only yielding about 6 percent. So, markets participants that choose to borrow short-term to finance those longer-term mortgages can only make 0.75 percent to cover both their administrative costs and the risk that is associated with a mortgage. This is not a very attractive spread even for relatively safe mortgages. It makes writing high-risk mortgages decidedly unattractive.

Markets have been responding to this higher cost of funds. The so-called "sub-prime" mortgage, which was made with generous loan-to-value ratios to people with far-from-perfect credit histories, is now a thing of the past. Even loans in the so-called "Alt-A" market, which made loans to people at more reasonable loan-to-value ratios but with little proof of income, are becoming quite hard to get. So the market is moving back to what at most times would be considered sensible: lending only to people with well-documented finances and good credit ratings with adequate collateral.

This return to common-sense lending may be a good thing long term, but it is definitely not going to be painless in the short run. Even if lending terms are what might be called historically normal, they will still be tighter than they have been in the recent past. Like it or not, this is still a contraction of credit. And a contraction of credit means a reduction in demand for housing, which in turn means falling prices and some people actually losing money on their houses. Some of these people will be unable to pay their loan and unable to sell their property. They will face foreclosure and eviction.

The credit markets have evolved ways of minimizing this. There are now "work-out" procedures that change the terms of the original mortgage in ways that often allow the homeowner to remain in the property. Credit markets may be heartless, but they are not dumb. Foreclosure is a long and expensive process in which the condition of the home—the collateral to the loan—usually declines sharply in value. Despite populist sentiment to the contrary, the bank is not repossessing the home because it expects to make money on it. This is a tough thing to say, but if no one who fails to pay their mortgage is foreclosed on, the idea of there being "collateral" behind a home loan disappears completely. With no collateral, lenders have less assurance of being paid back.

The mortgages that are out there, with their higher risk characteristics, still have to be held by someone. Existing holders of mortgage-backed securities may find the risks intolerable and sell them to those with more of an appetite for risk. As long as credit remains available and credit markets work smoothly, the paper will be sold, albeit at a somewhat lower price. Financial institutions that bought the paper will face a haircut, but the aggregate size of the losses at this point are probably able to be absorbed by the financial services industry. It will be a bad year for profits, but as long as markets work smoothly, there will be no risk to the financial system.

Moreover, new home buyers will still be able to access the mortgage market even if they have to pay a little more for the privilege. Houses can still be bought and sold, people will still be able to move if they get a job transfer to a new city, and the normal role of housing in our economy will continue. Housing may not be the great get-rich-quick scheme that some thought a couple of years ago, but it will still be a sensible asset for the great majority of American families to own and trade as their personal circumstances change.

Let's not kid ourselves that a turn in the credit cycle can happen painlessly.

Unfortunately, the real estate market up cycle was so dramatic that even under the most favorable assumptions, there are still going to be a lot of foreclosures. Consider some back-of-the-envelope math. Roughly eight million mortgages were issued in 2006 of which 25 percent, or two million, were sub-prime. Remember, these subprime borrowers were people who were completely frozen out of homeownership before all of the financial innovations of the up cycle were put in place. Some estimate that 15 percent or more of these subprime borrowers will default. That is 300,000 families. Imagine that half of these get some kind of workout that allows them to keep their homes, despite the default. That still leaves 150,000 families that would be evicted.

Now if one were going to be positive about all of this, one would note that despite all the anguish, 1.85 million families who previously were not able to get a mortgage to own their own homes now could and will be able to keep those homes. But that is not the kind of story you are likely to see on the nightly news. A family being forcibly evicted as the three-year-old crying daughter clutches her doll is a much more compelling story. Moreover, it is of little solace to that little girl that six other little girls just like her will be sleeping comfortably in their own homes. Let's not kid ourselves that a turn in the credit cycle can happen painlessly. That is why the next step is to consider this "best-case" picture in more realistic political terms. Those 150,000 foreclosures amount to about 350 per Congressional district.

> *Suing and maybe even jailing rich people in financial markets is a great way for an attorney general to move on to higher office. It is an even more sure-fire way for an entrepreneurial attorney to get rich by filing a class action suit.*

ENTER THE POLITICIANS, STAGE LEFT

Never mind that politicians in both parties have claimed credit for rising homeownership during the up part of the credit cycle. Never mind that politicians in both parties passed laws and promoted regulations that helped hard-wire the credit cycle. Never mind that the excesses of the up cycle inevitably created the conditions that will cause the down cycle. The fact is that 350 little girls clutching their dolls as they are evicted from their homes is going to be unacceptable to the Representative from that district.

In January I was invited by the Congressional Research Service to participate in their biennial briefing of the incoming freshmen members of Congress. Somewhat to my surprise, the biggest concern they expressed was not about immigration or taxes or the budget but about what they termed the "wave" of foreclosures hitting their districts. This was back in January when any such wave was almost certainly a ripple on a placid sea by historical standards, or in comparison with what is likely to happen in the next couple of years.

What were their ideas? How about a moratorium on foreclosures? Well, when it was explained to them, they quickly understood that such a moratorium would undermine collateral and wreck the mortgage market more clearly. What about using the "suitability" concept in law to go after lenders who made "inappropriate" loans? Of course an "inappropriate" loan is by definition one that used unconventional terms to help the borrower qualify and subsequently went bad. That means that lenders in the future will do their utmost to make sure that they don't make any "bad" loans since they don't want to face the liability for their actions. Trouble is, the only sure way to avoid making "bad" loans is to make no loans at all. At a minimum, the creative financing that has allowed millions of families to qualify for previously unattainable mortgages will disappear. The very people who politicians of both parties claim they want to help achieve the American dream will suffer the most.

Even if Congress rises to the challenge and avoids making things worse, the nation's mortgage market may still come under assault from state attorneys general and the trial bar. The model is well established that suing and maybe even jailing rich people in financial markets is a great way for an attorney general to move on to higher office. It is an even more sure-fire way for an entrepreneurial attorney to get rich by filing a class action suit.

When the financial risks are already so high in the mortgage market that lenders are pulling back to a more cautious stance, the worst thing that could happen would be for the risks to go even higher. The legal risks posed by future actions by either the Congress or the courts are the worst kind of risk since they are, by definition, unknowable. Even the threat that some greedy trial lawyer or state attorney general seeking higher office might soon be filing suit to get punitive damages for those "innocent" victims who were gambling on their teaser rate mortgages could send a chill on the mortgage market. It doesn't take much guesswork to figure out that both juries and the media are going to side with the little girl and her doll and not with the centi-millionaire Wall Street tycoon.

Moreover, given the widespread standard of joint and several liability, the one who will pay the punitive damages will not be the original issuer (who may be bankrupt by that time) but the buyer of that paper. The courts will not care that the individual or institution that bought the mortgage-backed security or CDO didn't make the supposedly "inappropriate" loan and had no idea to whom the loan was actually made. In effect, the arms-length system that Congress and the financial markets created after the S&L clean-up fifteen years ago would be rendered inoperative.

Money would not flow into new mortgages and the real estate market would deteriorate further. Existing holders of mortgage-backed securities who chose not to hold the risk inherent in the asset would find no buyers, thus making large portions of their portfolios effectively illiquid. Bear in mind that many of these holders are institutions such as insurance companies and pension funds who perform other vital economic functions. Of course, it goes without saying that the effect of this potential development on every American homeowner will be profound. Instead of 150,000 little girls clutching their dolls, we could easily have 1.5 million.

Short of war or terrorism, this is by far the greatest risk posed to the American economy and to our way of life. Unfortunately, neither the Administration nor the Congress nor the regulators are prepared to act to stop this eventuality. The Administration has not set up the kind of proactive interagency working group that could monitor the mortgage market and put out the proverbial fires that are bound to erupt. Congress is about to hold the very hearings that will help to remind the markets about the political risks they face. And the regulators are decidedly behind the curve.

While the Federal Reserve has done a fine job of following Bagehot's advice regarding monetary policy, it has not been timely in its actions on the mortgage market. It was not until early March 2007 that the Fed and other banking regulators issued a rule regarding sub-prime lending with teaser rates with large interest rate hikes built in. No one could argue that subprime mortgages that reset at rates many hundreds of basis points higher than the initial qualifying rate are prudent things to issue in the first place. But they didn't suddenly become imprudent in the last few months. They were imprudent loans to make two years ago when they were all the rage and the Fed was saying nothing. This might have been a clear case of closing the barn door after the cows had already left. But it gets worse, because now it is essential to get the cows back in the barn. To do that, the Fed and the other regulators must make it possible for the mortgage market to operate as freely as possible—in particular to allow and even encourage others to buy the paper that has already been issued or to encourage others to lend on a more affordable "reset" basis to the homeowners who otherwise face foreclosure.

Short of war or terrorism,
this is by far the greatest
risk posed to the
American economy
and to our way of life.

It is vital that the Fed and other political actors recognize that this is a credit market cycle and not yet an economic or monetary policy cycle. Should the mortgage market actually break down due to the enhanced legal risks now looming, there probably is no reasonable change in monetary policy that could offset the downward spiral. The Fed, the Congress and the Administration would be well advised to make every possible legal assurance to market participants that they will not be subjected to massive and unquantifiable legal risk by "doing the right thing" and participating in the mortgage market.

Sad to say, but this is the exact opposite of the political instincts of Washington. In the coming months the odds are high that we will hear pressure to "regulate and cut interest rates." This would be a policy of "restrict lending at a concessionary rate," exactly the opposite of Bagehot's suggestion of "lend freely at a punitive rate." The history of credit cycles is full of examples of countries that have ignored Bagehot's advice, and we may be about to add another chapter to that history. Homeowners, watch out. ◆