The wages of greed: Credit meltdown

by James Halteman in the October 21, 2008 issue

The sources of the current economic crisis are complex and the blame for the crisis difficult to assess precisely. But it’s clear that for years leading investment firms have disregarded the common good and even their own long-term interest in their quest for profits.

A market for capital is a good and necessary feature of a market economy. Economic growth depends on the ability of firms to borrow money to generate the goods and services that create earnings. When people save money in bank accounts or retirement accounts, their savings can be put to work as capital that serves the productivity of the entire society. A market for financial capital is created wherever savers and investors meet to exchange contracts or IOUs that reward the savers for lending their money. When this saving and investment flow is successful, the economy grows. When loans become difficult to get, economic growth is constricted.

The system gets more complicated, however, when savings are channeled into assets like housing, which generate a financial return through appreciation in price rather than through increased business productivity. For many investors, housing was an attractive purchase because they assumed that housing values would always go up. When this assumption became a universal principle, investors stopped caring about whether there was a business plan to justify their loans. Mortgages were drawn up with little care on the assumption that the appreciation in the value of the housing would always cover the loan exposure.

This assumption opened the door to creative but more risky mortgage practices. Brokers—who get commissions for making loans—enticed families with no equity to take out mortgages. The banks that made the loans sold the mortgages on the secondary market to investment banks and government-sponsored enterprises like Fannie Mae and Freddie Mac, which then packaged the loans as collateral for bonds and other financial instruments. (Freddie Mac and Fannie Mae are government-sponsored, privately funded agencies designed to encourage the flow of mortgages in the secondary market and make home ownership more accessible.)

Investors looking for good returns on their money purchased the bonds thinking they had a safe investment that would bring decent returns. The whole system depended on getting a return on the initial mortgages that made up the assets of the banks holding the mortgages.

The system became even more complicated when insurance banks like AIG guaranteed other banks' mortgage-backed bonds for a premium payment. This created an interconnected network of bank relationships that, again, worked as long as the original loans were solid. When homeowners defaulted and the value of houses dropped, the banks ended up with houses that were worth less and with no payments from the borrower. When housing values fell 25 to 40 percent, banks could no longer pay a return to the holders of the bonds that the mortgages supported.

People with real estate among their investments have seen declines in the value of their portfolios. With retirement funds, college funds and other savings instruments declining in value, consumers pull back from spending—which leads to labor layoffs and the threat of a deep recession.

The culprits? Certainly some responsibility is borne by the eager brokers who sought easy commissions, enticing financially ill-prepared people to take on mortgage debt. Responsibility also falls on the people who took out the mortgages without working out a viable budget.

But the most disturbing element in the sequence of events behind the crisis is the behavior of the Wall Street investment banks. By packaging bad mortgages into bonds, by not being transparent about the status of their worst loans, and by assuming that the government would bail them out if the loans failed, these firms allowed greed to overcome prudence.

Any market has rules by which the actors play; those rules must evolve with the times. Regulation of the financial markets needs to be updated—something that has been hindered by an anti-regulatory political climate. That climate may be changing in the financial sector. In recent days I've heard from some with Wall Street experience who have been longtime believers in deregulation. They are beginning to change their minds. And both presidential candidates seem to be promoting that kind of change.