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Moral Hazard and the Meltdown

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An appropriate government response to the bursting of the housing bubble requires a full understanding of what went wrong and why. Many commercial banks, investment banks, savings and loans, mortgage originators, subprime borrowers, and insurance giant AIG obviously placed heavy bets on continued housing-price appreciation. They gambled; the losses have been huge and widespread.

Why did so many players place these large, risky bets? A simple yet significant part of the answer is that the potential gains and losses were asymmetric. If housing prices continued to climb, or at least not fall, the participants could achieve large profits. If housing prices failed to appreciate, or even fell, the losses would be largely borne by others, including taxpayers. "Heads" and the bettors would win -- "tails" and others would lose.

On the supply side, de facto -- and now de jure -- government guarantees of Fannie Mae and Freddie Mac debt lowered their financing costs and thus amplified mortgage-credit expansion and housing-price appreciation. Bank deposit insurance and implicit guarantees of bank obligations encouraged risky mortgage lending and investment, especially given strong pressure from Congress for more subprime lending. The shift to corporate ownership of investment banks, with limited liability, encouraged them to take greater risk in relation to capital, especially given expanded competition with investment-bank affiliates of bank holding companies that followed the Gramm-Leach-Bliley Act in 1999.

Moreover, the Security and Exchange Commission's adoption in 2004 of "consolidated supervision" of the largest investment banks allowed them to increase leverage substantially, in significant part by taking on more subprime-mortgage exposure.

Meanwhile, AIG facilitated investment in mortgage securitization by domestic and foreign banks and investment banks by selling cheap protection against default risk. Subprime mortgage originators were often new entrants that had little reputational capital at risk, and didn't have to hold the mortgages.

On the demand side, many subprime borrowers acquired properties with little or no money down. They faced relatively little loss if housing prices fell and they defaulted. Many people took cheap mortgages on investment property to speculate on housing-price increases. Others took cheap second mortgages to fund current consumption.

The Federal Reserve played a key role in making these bets attractive to borrowers, lenders and investors. It kept interest rates at historically low levels until it was too late to prevent the eventual implosion. This deliberate policy and public statements by then Fed Chairman Alan Greenspan fueled demand for credit and housing and encouraged lenders to relax mortgage-lending criteria.

Given what we know about the bubble's causes, the main objectives of legislative and regulatory responses should be to encourage market discipline as a means to promote prudence, safety and soundness in banking and securities. We should avoid extending explicit or implicit "too big to fail" policies beyond banking.

Unfortunately, the most conspicuous proposals on Capitol Hill -- the creation of a "systemic risk" regulator and expanded federal authority over financially distressed insurers and other nonbank institutions -- could easily undermine both objectives by protecting even more institutions, investors and consumers from the downside of their actions.

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