



# AMERICANS for TAX REFORM

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## The Four Horsemen of the Financial Panic

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No matter what one thinks of the financial bailout package, we ought to at least agree how we got here. Below are the real actors behind the mortgage panic of 2008:

**Government-sponsored enterprises (GSEs).** Fannie Mae, et al, bears a large share of the responsibility. By purchasing mortgages, repackaging them into securities, and selling them on the open market, mortgage lenders were encouraged to issue riskier and larger mortgages. They could then shift the risk to the GSEs by selling the mortgage to them. As of this year, the GSEs owned or securitized half of the \$12 trillion mortgage debt market. Exacerbating the GSE risk is the Clinton-era rule which said that the GSEs only needed to retain capital equal to 2.5% of mortgages assumed (it's 10% for other financial institutions). When the GSEs had no one to whom they could shift the hot potato, the house of cards came crashing down. *According to [opensecrets.org](http://opensecrets.org), the GSEs have contributed over \$1.5 million to federal candidates this year. Nearly 60% of that money went to Democrats.*

**Easy money from the Federal Reserve.** On January 3, 2001, the Federal Reserve cut the federal funds rate by fifty basis points, to 6.00%. They continued to do so until the rate hit a bottom of 1.00% on June 25, 2003. This also had an effect on mortgages. According to Freddie Mac, the average rate for a thirty-year fixed rate mortgage fell from a peak of 8.52% in May 2000 to a nadir of 5.23% in June 2003. As a result, households with less income could afford bigger and more expensive houses.

As an example, someone paying a \$2000 per month mortgage in May 2000 would be able to afford a house worth about \$282,000. That same \$2000 payment in June 2003 would get our homeowner a house worth about \$460,000.

Many of these homebuyers, moreover, didn't get conventional 30-year mortgages. Because lending was so cheap, banks were offering adjustable-rate mortgages, "balloon" options, and no-money-down at closing. The banks shifted their risks to the GSEs. When the Federal Reserve started raising the federal funds rate, mortgage rates climbed back up (they're currently hovering around 6 percent), some of the ARMs matured, and households found themselves unable to as easily make these payments.

Did the Federal Reserve need to cut rates this low "for the economy?" Not if one believes in low inflation as a necessary precursor of economic growth. The price of gold, which is a good indicator of future inflation trends, has grown from about \$250 per oz. in 2001 to \$900 per oz. today. That's a gain of 260% in just over seven years.

**Community Reinvestment Act (CRA).** This legislation, first passed in 1977, gave federal regulators the power to encourage banks to issue loans to high-risk households and small businesses. It was ramped up in the Clinton Administration, who along with groups like ACORN, jaw-boned banks into issuing riskier and riskier loans to poor households. Efforts by the Bush Administration to rein in CRA bureaucratic zealotry met with charges of racism and elitism by Congressional Democrats and left wing activist groups.

**Mark-to-market accounting rules.** This refers to an accounting practice that forces a balance sheet to value an asset at its current market price (that is, what it could be sold for at the time). The Federal Accounting Standards Board (FASB) issued Statement 157 on November 15, 2007, which required this accounting practice for all financial firms. Some securities holding devalued mortgages still retained underlying value, but could not be sold because there were no buyers. As a result, mark-to-market required the firms to value the securities at or near \$0. If, however, the firms were allowed to value the assets at something closer to book value, their balance sheet positions would improve. Mark-to-market is an arbitrarily-restrictive accounting practice that should be scrapped for assets like securities which generate current income. Doing this alone would solve much of the problem. The SEC relies on FASB in an advisory role, but could overrule it in giving guidance to company accounting practices.

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