

Reviving the home owners' loan corporation to avoid a recession in USA

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El problema original de los créditos de alto riesgo se ha convertido en un problema de insolvencia para millones de hogares en Estados Unidos. El reciente plan de “estímulos” fiscales no aborda directamente este problema de insolvencia. Bombeando más liquidez, la Reserva Federal no acabará con el problema de insolvencia en la vivienda, si no que, por el contrario, estimulará todavía más la burbuja inmobiliaria. En su lugar, nuestra propuesta es un extenso y sólido programa para crear un importante servicio federal de refinanciación de hipotecas con dos objetivos: refinanciar los antiguos bajos tipos de interés y vencimiento ampliado, y financiación de nuevas inversiones en la vivienda del sector privado. Los fines de este nuevo servicio de préstamos son acabar con el problema de insolvencia en la vivienda, evitar una grave recesión y futuras burbujas financieras similares debido a la titulización de activos vinculados a préstamos.

Arrisku handiko maileguen hasierako arazoa kaudimen-gabeziaren arazo bihurtu da Estatu Batuetako milioika familiatan. Berriki onartutako “pizgarri” fiskalen planak ez dio zuzenean heltzen kaudimen-gabeziaren arazoari. Likidezia handiagoa izateko gaitasuna areagotuz, Erreserba Federalak ez du lortuko etxebizitzaren inguruko kaudimen-gabeziaren arazoa konpontzerik, kontrakoa baizik: are gehiago puztuko du higiezinaren burbuila. Hala egin ordez, gure proposamena programa zabal eta sendo bat da, hipotekak berriz finantzatzeko zerbitzu federal garrantzitsu bat sortzea alegia, bi helburu dituela: hipoteka zaharrak berriz finantzatzea interes-tipo apal eta itzultzeko epe luzeekin, eta etxebizitzan eta sektore pribatuan beste inbertsio batzuk egitea finantzatzea. Maileguak emateko zerbitzu berri horrek helburu hauek izango lituzke: 1) etxebizitzaren arloko kaudimen-gabeziak amaitzea, 2) atzeraldi larri bat, eta 3) etorkizuneko antzeko burbuila finantzarioak izatea saihestea, maileguei lotutako aktibo finantzarioak titularizatzeagatik.

The original subprime mess has ultimately resulted in an insolvency problem for millions of U.S. households. The government's fiscal “stimulus” plan does not directly address this insolvency problem. The Federal Reserve pumping in more liquidity will not end the housing insolvency problem. Instead, I suggest a tried and true comprehensive program to create a major federal facility to refinance mortgages at low rates and extended maturities, and to finance new investment in private sector housing. The goal of this new lending facility will be to: 1) end the insolvency housing problem; 2) avoid a serious recession, and prevent similar financial bubbles due to securitization of loan-backed financial assets from developing in the future.

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1. INTRODUCTION

For several years, the America's economy was being supported by a housing bubble that had replaced the stock market bubble of the 1990's. But no bubble can expand forever. With middle-class incomes in the United States stagnating, Americans could not afford ever more expensive homes. The word subprime has perhaps become the most often repeated word in the newspapers lately. It's there everywhere. Subprime¹ credit refers to extension of credit facilities to borrowers who have deficient credit history or

inadequate documentation. The subprime mortgage market has expanded rapidly in recent years. A decade ago, five percent of mortgage loan were subprime; by 2005 the figure had jumped to approximately 20 percent. Currently, there are about \$1.3 trillion outstanding subprime loans; over \$600 billion of which originated in 2006².

The reason for such breakneck expansion of subprime credit is not difficult to fathom. For several years, America's economy was being supported by a housing bubble that had replaced the stock market bubble of the 1990's. But no bubble can expand forever. Post 2000, in the aftermath of the dot com bust and the impending recessionary tendencies in the US economy, the Fed had

¹ Subprime mortgages are residential loans that do not conform to the criteria for "prime" mortgages and so have a lower expected probability of full repayment, as they are made to more "risky" mortgage borrowers. This assessment is made according to objective criteria such as the borrower's credit score and record and loan-to-value ratios.

² Nera Economic Consulting (2007), 'At a glance-The Chilling effects of the Subprime crisis', www.nera.com/image/AAG_Subprime_1662_final.pdf

cut interest rates to as low as 1.5 per cent in June 2003, their lowest levels since 1958³. Credit was cheaply available and it was scouting for asset markets in which to exhaust itself. It was no surprise that the outlet for deployment of credit came in form of the housing market as home prices had begun to show an uptrend after having bottomed out.

So, the great 'American' dream of owning a house found a perfect partner in low interest rates and rising home prices. In early 2003, the rate on a 30-year fixed-rate mortgage was at the lowest levels seen in nearly 40 years⁴. Home loans were being disbursed at a hurried pace as borrowers did not want to miss out on making a fortune for themselves on the back of rising real estate prices. The rationale for taking out a mortgage loan was that with home prices in a secular uptrend, in a few years itself, the market value of a mortgaged house would outstrip both the principal and interest payment liability attached to it. The house can then be sold in the open market and the excess of the market value of the mortgaged house over the liability towards the mortgage would be the potential capital gain to the borrower.

Within the last few months, the so-called "subprime mortgage crisis" has developed from a small blip on the economic radar screen to a situation that has threatened financial markets and financial institutions worldwide. This financial instability induced the Federal Reserve to announce a historically large 75 basis point decline in the federal funds rate on January 22, 2008.

³ PBS (2007), 'Federal Reserve Rate Cut', http://www.pbs.org/newshour/bb/economy/jan-june03/fed_06-25.html

⁴ Investopedia (2007), 'The Fuel That Fed the Subprime Meltdown', <http://www.investopedia.com/articles/07/subprime-overview.asp>

Financial experts and economists are suddenly talking of a U.S. recession in 2008, and the only question is how deep the depressing effects will be. There is even the possibility of a global recession. This recessionary threat has led the White House and Congress to announce a fiscal stimulus package consisting primarily of a one-time tax rebate of between \$300 to \$1,200 for families within defined income limits, plus a temporary tax reduction for business making certain investments in 2008. This stimulus plan is surely too little and too late.

Just a little over a month ago, many of the "best and the brightest" economic experts were not in favour of any fiscal stimulus package. *The Wall Street Journal* reported that former Federal Reserve Chair Alan Greenspan recommended that politicians do nothing to prevent a possible recession as a result of the subprime mortgage lending mess⁵. Greenspan preferred to let the market solve the problem by "letting housing prices (and security pegged to mortgages) fall until investors see them as bargains and start buying, stabilizing the economy." But if Congress does nothing, then a year from today we may be mired in the Greatest Recession since the Great Depression.

The proposed stimulus package will bring forth some additional household and business spending. Nevertheless, perhaps as much as 20 percent of each dollar of household tax rebate will go to buy cheap foreign imported goods, and therefore will not stimulate demand for American produced goods. Another 20 to 30 percent of household rebates may go into reducing

⁵ Wessel, David. (2007). "Don't Count On A Stimulus Plan." *The Wall Street Journal*, December 20, 2007.

household credit card or other debts, or directly into savings accounts. Accordingly, perhaps as little as fifty cents on the dollar will stimulate the economy. Not much stimulus bang for the buck!

The temporary tax cuts for businesses may not stimulate much additional investment as long as domestic market demand remains slack. Moreover, since the business tax relief is temporary, it encourages moving investments that may already be scheduled for next year into today's tax reduction period, thus creating a potential further decline in demand after the tax relief expires. In sum, any temporary fiscal stimulus package is likely to have temporary, and small if any, positive effects to offset the forthcoming recession in 2008.

As I will discuss below, the original subprime mess has ultimately resulted in an insolvency problem for millions of U.S. households. The government's fiscal "stimulus" plan does not directly address this insolvency problem. The Federal Reserve pumping in more liquidity will not end the housing insolvency problem. Instead, I suggest a tried and true comprehensive program to create a major federal facility to refinance mortgages at low rates and extended maturities, and to finance new investment in private sector housing. The goal of this new lending facility will be to: 1) end the insolvency housing problem; 2) avoid a serious recession, and; 3) prevent similar financial bubbles due to securitization of loan-backed financial assets from developing in the future.

2. BANK SOLVENCY CRISES

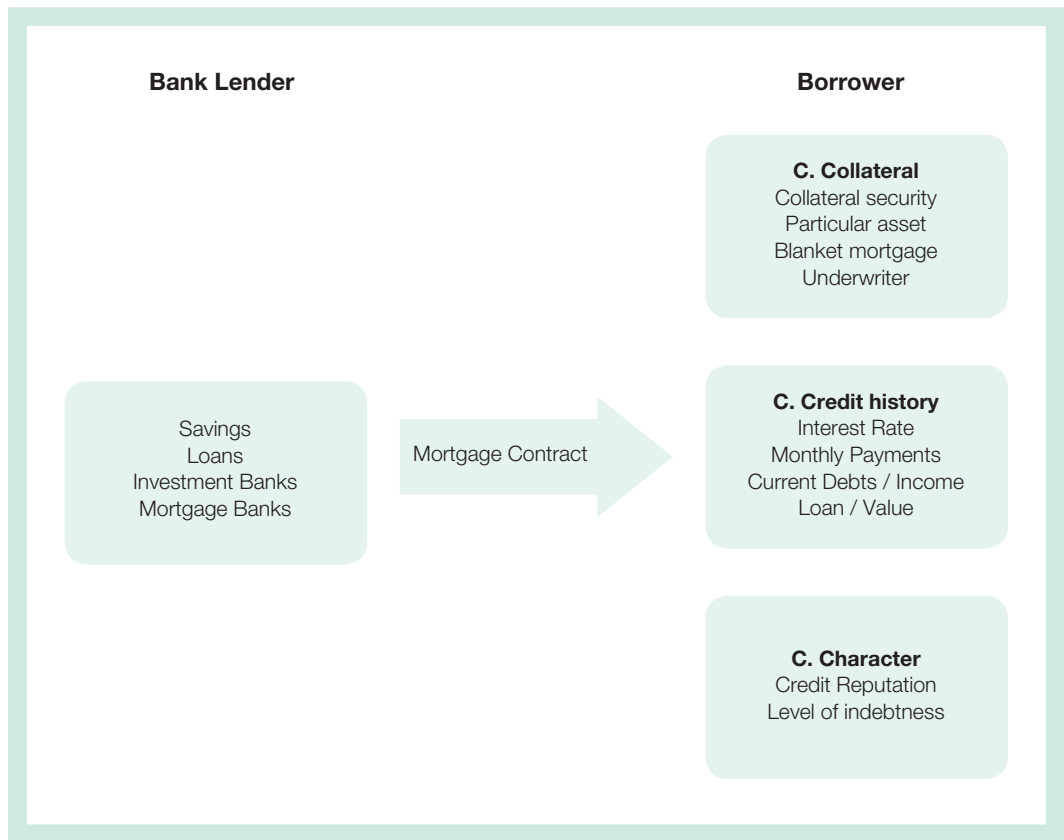
A sage once said "Those who cannot remember the past are condemned to repeat its errors." So let's look at what

history can teach us about what "caused" this housing bubble and how we can relieve the distress. After U.S. Stock Market Crash of October 1929, one out of every five banks in the U.S. failed. **Schwartz Center for Economic Policy Analysis** | 79 Fifth Ave, 11th Floor New York NY 10003 | Tel: 212 229 5901 x4911 www.newschool.edu/cepa

Several years after the Crash and the beginning of The Great Depression of the 1930s, a U.S. Senate committee held hearings on the possible causes of the Crash. These hearings indicated that in the early part of the 20th century individual investors were seriously hurt by banks whose self-interest lay in promoting sales of securities that benefited only the banks. The hearings concluded that a major cause of the Crash was that banks, in the 1920s, significantly increased their underwriting activities of securities. Consequently, in 1933, Congress passed the Glass-Steagall Act, which banned banks from underwriting securities. Financial institutions had to choose either to be a simple bank lender or an underwriter (investment banker or brokerage firm). The Act also gave the Federal Reserve more control over banking activities.

As a result, for several decades bank originated mortgage loans were not resalable. The originating bank lender knew that he or she would have to carry the mortgage loan debt security over its life. If the borrower defaulted, the lender would bear the costs of foreclosure. Thus, the originating bank lender thoroughly investigated the three C's of each borrower—Collateral, Credit History, and Character⁶—before making a mortgage loan.

⁶ Character loans are extensions of funding that are granted based on factors other than the declaration of collateral. Generally, a character loan is granted when the lender determines that the loan will be repaid in a timely manner without the need for some sort of



In the 1970s, deregulation of U.S. banking activities began when brokerage

security. Signature loans are one common form of the character loan. A lender may choose to extend a character loan based on a couple of factors. First, the lender may be very familiar with the reputation of the borrower, and have every confidence in the ability of the applicant to repay the loan according to terms. This approach was often employed with long standing clients of local banks in times past, and continues to be somewhat common in many smaller bank chains. The lender often will have dealt with the borrower in the past, and have found the business relationship to be mutually beneficial. When this is the case, there is usually not any problem in obtaining the character loan. The second factor has to do with the personal credit history of the applicant. Even if the lender has not had prior business dealings with the borrower, it may still be able to obtain a character loan based on this consideration. By checking the credit history of the individual, the lender can get a good idea of the current level of indebtedness in comparison to income and how well the applicant keeps up payments on current debts.

firms began offering money market, high interest, check writing accounts that competed with traditional banking business. In the 1980s the Federal Reserve reinterpreted the Glass-Steagall Act to allow banks to engage in securities underwriting activities to a small extent. In 1987 the Fed Board allowed banks to handle significant underwriting activities including those of mortgage-backed securities, despite objections of Fed Chairman Paul Volker. When Alan Greenspan became chair of the Fed in 1987, he favored further bank deregulation to help U.S. banks compete with foreign banks, where the latter are often universal banks which are permitted to act as investment banks, take equity stakes, and the like.

In 1996, the Federal Reserve permitted bank holding companies to own investment banking affiliates that could contribute up to 25 percent of total revenue of the holding company. In 1999, after 12 attempts in 25 years, Congress (with the support of President Clinton) repealed the Glass-Steagall Act. In a 1999 article in *The Wall Street Journal* (a few days before Congress repealed the Act), Republican Senator Phil Gramm is quoted as telling a Citigroup lobbyist to “get [Citigroup Co-Chairman] Sandy Weill on the phone right now. Tell him to call the White House and get [them] moving.” Soon after Gramm’s warning, President Clinton supported the repeal of the Glass-Steagall. Shortly after Congress repealed the Act, Secretary of Treasury Robert Rubin accepted a top job at Citigroup.

Once Glass-Steagall was repealed, there were no legal constraints between loan origination and underwriting activities. Accordingly, there is a great profit incentive for a mortgage originator to search out any potential home buyers (including sub prime ones) and provide them with a mortgage. The originator can then profitably sell these mortgages, usually within 30 days, to an underwriter, or act as an underwriter to sell to the public exotic mortgage-backed securities. The originator therefore has no fear of default if the borrower can at least make his first monthly mortgage payment.

The underwriter typically packages these mortgages into collateralized debt obligations (CDOs), Structured Investment Vehicles (SIVs), or other esoteric financial vehicles. He then sells tranches in these vehicles to unwary pension funds, local and state revenue funds, individual investors, or other banks domestically or overseas (e.g., Northern Rock in the UK) who, led on by the high ratings of these complex financial securities by rating agencies, believe these

are safe investment vehicles. Thus, since the turn of the century, this process of packaging and selling mortgage-backed securities (structured finances) has helped finance the housing bubble that pushed housing prices to historic highs by 2005. Structured finance is defined as a form of financial intermediation which is based on securitization technology: involves the pooling of assets and the subsequent sale to investors of claims on the cash flows backed by these pools. Typically, several classes (or “tranches”) of securities are issued, each with distinct risk-return profiles. This definition clearly involves the elements of a) pooling of assets (either cash-based or synthetically created by using credit default swaps) and b) the tranching of liabilities that are backed by the asset pool. In addition, c) the credit risk of the collateral asset pool is separated from the credit risk of the originator, through the involvement of a Special Purpose Vehicle (SPV) or Special Purpose Entity (SPE).

3. COLLATERALIZED DEBT OBLIGATIONS AND THE STORY FROM THE SIDE OF THE MORTGAGE PROVIDING BANKS AND INSTITUTIONS

The mortgage providing institutions cooked up enticing credit instruments like the adjustable rate mortgages to lure borrowers. An adjustable rate mortgage (ARM) is one in which the interest rates for an initial period of 2 years is very low and thereafter, every 6 months, the interest rates are jacked upwards. These mortgages were bundled with very low initial teaser rates, but after the initial period of low rates were over, the interest burden is hiked up significantly. After adjustments, the monthly

payments on such adjustable loans could go up anywhere between 20- 40 per cent, putting the borrower at risk of foreclosure.

Lenders offered subprime loans to people who could not qualify for ordinary prime loans because of poor credit or inadequate income. To help them qualify, lenders offered low teaser rates, sometimes only 3 or 4%, to produce a low monthly payment. After the first, two or three years, the monthly payments would be recalculated by adding a set number of percentages points, sometimes five or more, to an underlying measures of prevailing rates. If prevailing rates went up, the rate charged on the loan might jump over the years from 4% to 8%, perhaps even higher. Monthly payments could more than double.

The process of mortgage backed securitization provided a strong incentive to mortgage providing banks and institutions to rampantly make loans, irrespective of how ill conceived they were. Mortgage backed securitization refers to the process of issuing securities on back of loans disbursed by mortgage companies. For example, say Mortgage Bank Co. has disbursed mortgage loans of the value \$10, 000,000. This loan portfolio of ten million dollars can be broken up into 100,000 mortgage backed securities of \$ 100 face value, with interest on such securities being paid according to the different risk levels involved in the recovery of the underlying mortgage.

- (i) Tranche C (High Risk): 50,000 securities of \$ 100 each and rate of interest: 20 per cent.
- (ii) Tranche B (Medium Risk): 30,000 securities of 100 each and rate of interest: 15 per cent.
- (iii) Tranche A (Low Risk): 20,000 securities of 100 each and rate of interest: 10 per cent.

The interest rate applicable in the subprime market is higher because of the higher risk involved in lending to people who do not show adequate creditworthiness. A complex arrangement is made whereby the repayment collections of the disbursed home loans are deployed for the redemption of the mortgage backed securities. The risk of default is borne by the holders of the mortgaged backed securities, with high rates of interest being paid on tranches which will take the first hit in case of mortgage repayment defaults. Collateralized Debt Obligations (or CDOs as commonly referred to) have emerged as a very popular mortgage backed security in the run up to the crisis.

These shaky mortgage backed securities were labeled 'investment' grade by various credit rating agencies which ensured that with the higher interest payments that these securities carried, there was always sufficient demand for them in Wall Street. So all a mortgage lending company had to do was to disburse loans (no matter how ill conceived such loans were) at high subprime rates but packaged as ARMs to make the expensive loans look enticing and affordable, securitize such loans through the issue of mortgage backed securities, and pocket the profits to the tune of the difference between the interest received on the subprime loan and the interest paid on the corresponding mortgage backed security. The result: last year subprime loans were 20 per cent of the \$ 3 trillion mortgage market⁷.

In a December 14, 2007 article, New York Times op-ed writer Paul Krugman defined the resulting housing bubble as

⁷ Chris Arnold (2007), "Senate Panel Studies Subprime Loan Woes", NPR, <http://www.npr.org/templates/story/story.php?storyId=9096735>

where the price of housing exceeded a “normal ratio” relative to rents or incomes (*price earnings ratio*). Like Greenspan, Krugman does not suggest anything that politicians can do to relieve the distress caused by the deflating housing bubble. Krugman believes the market will solve the problem by deflating house prices. He estimates that housing prices will have to fall by 30 percent to restore a “normal ratio.” This implies that home values in the U.S. will decline by some six trillion dollars.

The result will be that many borrowers “will find themselves with negative equity” as their outstanding mortgage exceeds this “normal” market price of the borrower’s house—an insolvency problem. Krugman indicates that no one can provide a quick fix for this problem; he suggests that it will “take years” for the market to clean up the insolvency housing mess.

In many states mortgages are non-recourse loans (i.e., after default and foreclosure the borrower is not responsible for the difference between the outstanding mortgage balance and the lower sale price at foreclosure). If Krugman’s 30 percent house value decline is accurate, as many as 10 million households will end up with negative equity and will have a strong incentive to default. Millions of homeowners will lose their homes in foreclosure proceedings and investors in mortgage-backed securities will incur large losses.

4. THE HOME OWNERS’ LOAN CORPORATION

In the old days, when borrowers found it impossible to make their payments, mortgages would be restructured; foreclosures were bad for both the borrower

and the lender. Securitization made debt restructuring difficult, if not impossible.

It is the victims of predatory lenders who need government help. With mortgages amounting to 95% or more of the value of the house, debt restructuring will not be easy. What is required is to give individuals with excessive indebtedness an expedited way to a fresh start – for example, a special bankruptcy provision allowing them to recover, say, 75% of the equity they originally put into the house, with the lenders bearing the cost.

There are many lessons for America, and the rest of the world; but among them is the need for greater financial sector regulation, especially better protection against predatory lending, and more transparency.

But a study of history can give us clues as to how to solve the problem. The Roosevelt Administration’s handling of the housing insolvency crisis of the 1930s suggests a precedent for dealing with the U.S. housing bubble distress. In 1933, the Home Owners Refinancing Act created the Home Owners’ Loan Corporation (HOLC) to refinance homes to prevent foreclosures, and also to bail out mortgage holding banks. The HOLC was a tremendous success, making one million low-interest loans which often extended the pay-off period of the original loan, thereby significantly reducing the monthly payments to amounts that homeowners could afford. In its years of operation, the HOLC not only paid all its bills, but it also made a small profit.

Other measures might include setting up a government agency to take non-performing mortgage loans off the books of private balance sheets and therefore remove the threat of insolvency for those

who took positions in the mortgage-backed securities after being misled by rating agencies. The result will prevent further sell-offs causing financial distress in all financial markets. The Resolution Trust Corporation, set up by the government, did remove non-performing mortgage loans from Building Societies' balance sheets after the 1980s Savings and Loan bank crisis, thereby preventing further financial damage to others. Also, Congress might consider a 21st Century version of the 1930s government-sponsored Reconstruction Finance Corporation to help finance investments and operations in the private sector housing and related industries during this insolvency crisis.

Congress should act promptly to create the necessary government agencies to help clean up this mess rather than wait out the "years" that Krugman suggests it would take if we leave the solution to the market. Moreover, the Greenspan-Krugman market solution will cause collateral damage to many innocent economic casualties (e.g., homeowners in neighborhoods where foreclosures are prevalent, and workers and business firms in construction and related industries).

While we wait for Congress to act on this proposed program, it may be desirable for the Federal government to start up an infrastructure rebuilding program to help stimulate the economy out of a potential forthcoming recession and increase productivity in the longer run. There is sufficient evidence that more than 50 percent of U.S. bridges and other public structures are in a weakened or failing condition. What better way to offset a possible recession in the construction industry and at the same time contribute to improvements in our nation's transportation

productivity? Every dollar spent on rebuilding and improving infrastructure will create jobs for U.S. workers and profits for domestic enterprises.

5. RESPONSE TO POTENTIAL NAY-SAYERS

There will be those who say that this proposed solution to the housing bubble problem will be too costly. Moreover, they will question why U.S. taxpayers should bail out banks, other financial institutions, individual investors, and individual subprime borrowers who made foolish decisions. To help these institutions and individuals will merely introduce the "moral hazard" problem: protecting individuals and institutions from economic losses they would otherwise suffer due to their previous foolish decisions will only encourage them (and other fools) to make more risky decisions in the future since, if their actions result in large economic losses, they believe the government will step in to bail them out. What is the proper response to nay-sayers who raise these arguments?

First, the real cost of a serious recession in 2008 is very large if we do nothing but hope that the Federal Reserve continues to lower the interest rate that they charge banks. The above proposal assures that, at worst, a mild slow down will occur in 2008, and more likely the U.S. economy will experience substantial economic growth while rebuilding productive infrastructure. Clearly these benefits exceed the potential real costs of a recession that could last several years.

Second, this proposal avoids the significant collateral economic damage to many innocent bystanders that will occur if

we rely on the market to reduce home prices by 30 percent. These innocent bystanders include:

- 1) existing homeowners, especially in areas where there are large number of neighborhood foreclosures;
- 2) potential home buyers who have deposits on unfinished homes where builders file for bankruptcy (The New York Times recently featured a front-page article about this regarding Levitt Builders in the Carolinas);
- 3) unemployed workers and businesses in the building and home furnishing industries;
- 4) local governments that put their revenues into CDOs thinking that their money was in a safe investment, and;
- 5) some pensioners who might find their annual pension income declining as the pension fund takes a loss on its investment in mortgage-backed assets.

If this proposal is adopted, which banks will be bailed out? Probably very few banks, except the large ones who have combined normal banking affiliates with investment banking underwriting subsidiaries under the banking holding company cloak (e.g., Citigroup). There are news reports that upon occasion these big institutions provided some "liquidity puts" (i.e., promised to buy back some tranches of their asset-backed packages), which means that if financial stress occurs, these banks' off-balance sheet liabilities might have to be moved back to on-balance sheet of the bank and/or its underwriting affiliate. That partly explains the big write-offs of Morgan Stanley, Merrill Lynch, etc. But these big bank institutions are "too big to fail" anyway,

so some bailout must be arranged. Small regional banks often are not big enough to engage in significant underwriting activities. If, however, they did create mortgage-backed assets that they sold to the public, then the liability of default has probably already been passed off without any "liquidity put" guarantees.

The last refuge of those who argue against bailout is the "moral hazard" argument. But if Congress passes a 21st Century equivalent of the Glass-Steagall Act, which prohibits making bank loans resalable, then we will have legally prevented those who have been bailed out from again originating risky loans that they can push off their balance sheets within a month or so.

History also tells us that the distress to U.S. taxpayers for extensive bail-out programs is not significant. Did most taxpayers notice any significant cost of resolving the S&L crisis, despite the media's constant argument that taxpayers would suffer? Did individual and corporate income tax rates increase as a direct result of the S&L problem?

6. THE FALLACY OF THE TAXPAYER COST QUESTION

The question of taxpayer costs for bailouts of financial institutions is typically part of discussions by the mass media. The question "what is it going to cost the U.S. taxpayer?" reflects an unthinking bias against active government policies to prevent recession and depression. Asking how much an active government policy to prevent a financial market calamity is going to cost the taxpayer can only be based on an economic theory that assumes that the

macroeconomic activity in the economy will be unchanged whether or not the government takes any positive action to remove distress in financial markets. In other words, underlying this question is the micro theory *ceteris paribus* assumption—where the *ceteris paribus* is that the nation's GDP will, in the long run, follow an unchanging long-run permanent full employment trend line.

Accordingly, if there is a recession due to some financial distress, it is conceived as representing an X percent fall below this trend line for a period of time before some automatic market mechanism restores the economy to the predetermined full employment trend line. If, on the other hand, the government takes some positive policy action to resolve the housing insolvency finance problem, then, it is presumed, there must be a Y percent taxpayer cost deduction from the trend line. When the problem is framed in this rhetoric, then it appears obvious that one should compare the magnitudes of X percent vis-à-vis Y percent reduction from the trend line. If Y percent is greater than X percent, then no government action should be taken.

Since the cost of a forthcoming recession cannot be accurately predicted except after the fact, while one can always make some estimate of the cost of operating a government program, it should be obvious that the government plan can always be painted as larger than the cost of a mild recession. Consequently, the rhetoric of this cost to taxpayer question will almost always favor the “do nothing” argument, because it assumes that the economy has some automatic market mechanism that assures that the GDP will always quickly return to a full employment level of GDP.

In the real world, however, there is no predetermined, long-run GDP full employment trend line. The macroeconomic performance of the U.S. economy will be substantially improved in both the short- and long-run if the government takes direct action. If, on the other hand, the government leaves it to the market to solve the problem, the result will be an economic recession that might even collapse into a depression. Consequently, the income of American taxpayers will, on average, be significantly improved if government takes action than if we rely on the market to solve such problems. If the government does nothing, U.S. residents stand to experience a severe reduction to their income levels. Accordingly, a properly designed policy to avoid financial and economic depression provides only benefits—not costs—to the nation's economy.

Let us look at a historical example where if this type of “what will cost to the tax payer and/or the economy?” question were asked, one of the most desirable government policies would never have been undertaken. At the Bretton Woods conference it was recognized that the European nations would need significant aid to help rebuild their economies after the war. Keynes estimated that the need would be between \$12 and \$15 billion. U.S. representative Harry Dexter White indicated that Congress could not ask the taxpayers to provide more than \$3 billion. Accordingly, the Keynes Plan was defeated at Bretton Woods, and the Dexter White proposals were adopted

Suppose that in 1946 it was recommended that U.S. give a gift of \$13 billion dollars over four years to various European countries to help them rebuild their war-ravaged economies (in 1940s

current dollars, this sum would be well over \$150 billion in 2007 dollars). Obviously if Dexter White was correct, the Congress would never have approved the Marshall Plan. Since the Marshall Plan did not reveal in advance that it would provide foreign governments \$13 billion over a period of four years, Congress approved the Marshall Plan. The Marshall Plan gave foreign nations approximately two percent of the United States' GDP each year for four years. Was the Marshall Plan costly to U.S. taxpayers and the U.S. economy?

The statistics indicate that, during the Marshall Plan years, for the first time in history the U.S. did not experience a serious economic slowdown immediately after a war. And this despite the fact that federal government expenditures on goods and services declined by approximately 57 percent between 1945 and 1946. Furthermore, four years after World War II, federal government expenditure was still approximately half of what it had been in 1945.

When the U.S. emerged from World War II, the federal debt was more than 100 percent of the GDP. Accordingly, there was great political pressure to reign in federal government spending to make sure that the federal debt did not grow substantially. Clearly, then, it was not "Keynesian" deficit spending that kept the U.S. out of recession in the immediate post-World War II years.

What was the cost of the Marshall Plan to the U.S. economy and the U.S. taxpayer? In 1946, the GDP per capita was 25 percent higher than it had been in the last peace years before the War. GDP per capita continued to grow during the Marshall Plan years. Despite giving away two percent of U.S. GDP, American

residents (and taxpayers) experienced a higher standard of living each year. Clearly The Marshall Plan did not make American taxpayers feel they were bearing a great cost in terms of real income.

The Marshall Plan was good for the European nations since the Europeans used the funds to buy U.S. exports needed to feed its population and rebuild its war damaged capital stock. In the United States, unemployment was not a problem despite nine million men and women being released from the Armed Services into the civilian population and labor force. The Marshall Plan financed a significant growth in U.S. exports that help offset, in part, the fall in aggregate demand due to a reduction in government spending. U.S. export growth was not the only offset as pent up consumer demand also expanded in the post-war period. Without the Marshall Plan, however, the U.S. export industries would not have expanded, and probably would have declined, as European nations exhausted whatever foreign reserves they possessed.

In sum, were there any real costs of the Marshall Plan as compared to doing nothing? A response that Americans were forced to reduce their living standards by approximately two percent would only be correct if one assumed that the GDP would have been the same in those early post-war years without the Marshall Plan. Can anyone really believe this?

7. THE ACCOUNTING COSTS OF INSTITUTIONS SUCH AS HOLC AND RTC

It has already been indicated that the HOLC actually earned a small profit over its

life. From 1933 to 1935, the HOLC provided almost \$3 billion in bonds to banks in exchange for mortgages, thereby reducing the pressure of potential economic failure for many banks. Moreover, if it were not for the HOLC more houses would have been foreclosed. The economic misery of the depression would have been worse. More Americans would have been living in the street (or Hoovervilles), while the U.S. housing stock would have depreciated much more rapidly due to the neglect of vacant foreclosed homes.

The HOLC financed all of its operations through either earnings or borrowing. Congress never appropriated any funds for the HOLC. [Notice this made the operations of HOLC an off-balance sheet operation.] The original act called for the HOLC to issue its own bonds with the interest guaranteed by the U.S. Treasury and with a maturity not to exceed 18 years. A year later the guarantee by the Treasury was extended to the principal as well. Although HOLC initially issued its bonds to the public, eventually the HOLC received its funds by borrowing directly from the Treasury rather than from the money markets. From 1936 to 1940, HOLC borrowed \$875 million directly from the U.S. Treasury.

The RTC was a corporation formed by Congress in 1989 to replace the Federal Savings and Loan Insurance Corporation and to respond to the insolvency of about 750 savings and loan associations. As receiver, it sold assets of failed S&Ls and

paid insured depositors. In 1995 its duties, including insurance of deposit in thrift institutions, were transferred to the Savings Association Insurance Fund.

The S&L crisis in 1989 occurred under a Republican Administration that had pledged “no new taxes.” Nevertheless, the Administration recognized the difficulty of the problem involving the large number of S&L insolvencies, and it supported the formation of the RTC. The first Bush administration recognized, apparently, that the RTC would not require new taxes to burden the U.S. taxpayer with the cost of the program.

After much wrangling by Congress, the initial funding of the RTC included \$18.8 billion from the Treasury and \$31.2 billion from bonds issued by the RTC (and therefore an off budget liability). In 1995, the RTC was folded into another larger government agency, and there has been no public accounting records provided to show whether the RTC operations ultimately made a profit or not.

In sum, although there are some accounting costs of setting up any institution similar to the HOLC and the RTC, these bookkeeping entries are unlikely to hurt U.S. taxpayers. The benefits from having such institutions alleviating economic distress far outweigh the costs of allowing deflationary market forces solve the problem of our bursting housing and financial bubble.

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APPENDIX

The mortgage market securitization

Securitization can be defined as the process by which current or future loan rights of an entity, previously modifying and aggregating some of their characteristics, can be totally or partly transformed into securities that can be bought or sold in an organized market. In summary, it consists of the transformation of loan rights that, because of their own nature, are not marketable into credit rights that are marketable. The main generator of rights available to be securitized are the loan entities, because of the high quantity of different loans they issue. However, it is worth noticing that the international rules governing the market predict the securitization of other credit rights, specifically the right of the highway toll collection dealer, as well as the rights regarding the exploitation of the granting of public works. Traditionally, securitization can be defined as the pooling of financial assets, such as for example residential mortgages, and their subsequent sale (of either the assets themselves or only their credit risk) by the originator to a SPV, which then issues debt securities known as asset-backed securities (ABS) for sale to investors. The principal and the interest of the ABS issued by the SPV depend on the cash-flows produced by the pool of underlying financial assets (such as residential mortgages). In different words, securitization can also be interpreted as a financing mechanism, or a process in which assets are refinanced in the capital markets by issuing securities sold to investors by a SPV. Securitizations can be conducted basically in two ways. First, in a so-called true sale securitization, the underlying assets are indeed actually sold by the originator to the SPV and thus removed from the balance sheet of the originator (for example a bank). Second, in a so-called synthetic securitization, the underlying assets remain on the balance sheet of the originator, and only the credit risk of the underlying assets is transferred to the SPV by buying credit derivatives such as credit default swaps over this assets. In numerous cases, banks underestimated their exposures to structured finance products and to specific “off-balance sheet” vehicles which play an important role in this type of finance. Moreover, certain banks invested heavily in structured finance products, with retaining large exposures to specific structured finance instruments such as collateralized debt obligations, but without understanding sufficiently their impact on the banks’ capital and liquidity positions.

Securitization is economically justified as long as it is capable of creating value. One of the sources of this value is the refinancing of new credit rights. If we think about loans, specifically those with a mortgage guarantee, where formalization is usually made in a medium or long term although in a traditional

banking entity they are financed with short term deposits, the banking entity assumes the risk which, by itself, complicates the issuing of such loans in the best of conditions for those who need them. If such loans are used for the purchase of a house, they become more expensive. Therefore it is not strange that securitization began in the housing mortgage and loans market in the USA in 1970. Such loans are the safest and therefore the most commonly accepted by the equity market to be securitised. Through their refinancing, they offer through the market, support for the purchasing of houses. Conceptually, the securitization does not demand, by itself, that the loans "leave" the balance of the entity which has issued it, but, as we will also do here, such a term is usually used for those assumptions in which such assets are taken out of the balance sheet and their corresponding risks (default, for example) are transferred to the investors.

The main participants in a securitization process are the lender of the credit rights; the vehicle by means of which the process is carried out, or the securitization fund, negotiated by a managing company, and the investors who purchase the resulting securities. In general, the transformation demands the intervention of other specialized entities to make the result more acceptable for the equity markets, for example improving the credit quality of the portfolio incorporated in the fund. A simple way of obtaining this is to overcollateralize, which consists of making more loans available to the fund than necessary, so that they can substitute a default or early repaid loan.

The securitization, since it supplies new securities to the market, contributes to expand and develop such markets. A high percentage of the private fixed income in many developed countries consists of such funds. The securitized mortgages or funds in the USA represent the second most negotiated security in the market, after the Public Debt. They are representative securities of closed fund shares (Mortgage Backed Securities in the USA). They are composed of a portfolio of mortgage loans. The flows, with a periodical character, include interest payments and the principal of such mortgages receiving the complete repayment of the portfolio. The cause of these securities is very different from that of the bonds, as the mortgage loans that constitute the portfolio or the securitization fund may be early repaid, therefore the flows are changed as the stakeholders receive the early repayments that obviously stop interest generating.

The issue of mortgage backed securities by credit entities is situated in the framework of a wider financial figure, which has been specifically regulated: the mortgage market. It represents a way of attracting liabilities, but by means of a second phase financing that is very similar to "refinancing". The refinancing legally means the sale of financial assets. And therefore there is an assets mobilization which does not exist in the issuing of mortgage backed securities, as in this case

the assets (the mortgage loans) belong to the entity, although the new securities issued are guaranteed. What does the refinancing consist of? After a first phase of “investment-financing” (obtaining savings and investment in the shape of mortgage loans), follows the second phase in which the bank issues mortgage backed securities (that will appear in its liabilities and represent a new way of obtaining savings) guaranteed by the mortgage loans of the first phase, investing afterwards the obtained resources with new loans.

- (i) *Mortgage bonds*: The capital and interests are guaranteed by concrete mortgage loans that have to appear in the emission deeds, in other words, they are guaranteed by specific properties fixed and registered in the Public Registry of Property. Their maturity is loan backed (more than 5 years average maturity), and their main issuers are private banks, mortgage and loan companies, postal banks, banks and savings banks.
- (ii) *Mortgage certificates*: Mortgage certificates are issued with a total mortgage guarantee, that is, they are guaranteed by all the mortgages of the issuing entity, therefore they have a greater support than bonds. They do not need to be registered in the Public Registry of Property. The most issued assets in the mortgage market are these certificates. Actually, the mortgage bonds and the mortgage certificates solve the problem of long term fixed funds related to real estate financing, allowing a dynamic loan portfolio.
- (iii) *Mortgage participations*: Mortgage participations are registered securities by means of which the issuing entity enables a third party to participate in the whole or a part of one or several mortgage loans, sharing profits as well as risks. So that the issued part is not considered a risk, although the entity that issues it is the only entity capable of carrying out a foreclosure. As they are registered, they do not have a secondary market. A special characteristic is the use of the mortgage market in which the entities can take part in the repurchase of their own securities (not only in order to reach a market structural balance, but also to enable the negotiation). Such repurchases will be registered in the assets of the entity. From the economic point of view, we must emphasize that even when such securities appear in the financial accounts as assets, the account showing the repurchases has to be considered as an account which reduces the effectiveness of the financing obtained.