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"The Subprime Crisis: Why One Bad Turn Leads to Another" at Pepperdine University School of Law

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TRANSCRIPT

“THE SUBPRIME CRISIS: WHY ONE BAD TURN LEADS TO ANOTHER” AT PEPPERDINE UNIVERSITY SCHOOL OF LAW

RICHARD A. EPSTEIN*

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I. PRELIMINARY OBSERVATIONS

I delivered the Foley Lecture in March, 2008, at a time when the dominant issues were the defaults in the subprime market and the recent failure and partial bailout of Bear Stearns. I thought it was appropriate to warn about the various pitfalls in the proposed remedies for the mortgage markets, and to discuss the larger implications of these developments, including what turned out to be an ill-conceived stimulus package that was shortly thereafter passed into law. At that time, it was clear that no one believed that we had gotten close to the bottom, and we braced ourselves for more. Still, no one, myself included, had any conception of how deep that bottom would turn out to be. If anyone had suggested that, seven months later, none of the Wall Street investment banks would have survived in their current form, that Fannie Mae and Freddie Mac would have gone bankrupt, and that a \$700 billion bailout would have been thought the *smallest* amount necessary to stop the bleeding in the stock market, he or she would have been dismissed as a reckless pessimist. All of those events, and more, have come to pass. The crisis engulfed a Presidential campaign and the inarticulate responses on all sides have intensified the risks at home and abroad. I have not sought to redo this lecture to indicate at various places why its gloomy predictions turned out to be all-too correct in anticipating the decline, even if they underestimated its extent.

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But it is worth noting that none of this will be reversed unless and until we take seriously the “iron laws” to which I referred. No government can redistribute the wealth that it systematically destroys. No person or firm can continue to take high-risk bets on the foolish hope that long shots will win enough of the races to make the game worth playing. And, last of all, no one can think that “the government” can socialize the losses which it has helped to bring about. Lord knows what desperate measures will stabilize the current crisis. But, for the long term, only the following prescription has a chance of success: Fundamentals matter. Keeping the government focused on the security of transactions and minimizing the use of government subsidies and government penalties offers the last slim hope of righting a sinking ship. Our basic collective attitude is that we can stabilize markets through collective intervention. It works, sort of, on a lot of occasions. It generates catastrophic consequences on a few indelible occasions. The first round of revisions of this paper was completed on October 6, 2008, with the stock market down 779 points at its low, and 376 points at its closing. The last round was done on January 15, 2009, where the Dow Jones was up 13 points, after being down 200 points at midday. Progress of a sort, surely. Please forgive the air of unreality that hovers over a lecture that sought to give a pointed warning, but turns out not to have been alarmist enough.

II. LECTURE

I would like to thank Grant Nelson for his kind introduction. We have both worked for years on the real estate finance issues that have come to a head in the recent subprime crisis, and we had the pleasure of disputing a complex point of mortgage law in the recent Conference held in honor of his close friend and long time collaborator, Professor Dale Whitman of the University of Missouri.¹ The subprime crisis has migrated from the inside pages of the business section to the front page. Indeed, it is precisely because the topic has received such nonstop publicity that it is necessary to return to fundamentals to understand the origins of the crisis and some possible ways to mitigate its harsh effects, many of which are regrettably beyond recall. In this connection, I often think back to *Casablanca*. It is fun to talk about kisses and sighs, but if you recall Sam’s famous song, the fundamental things still apply as time goes by. And so it is. Modern finance law has affixed many bells and whistles to the simple home mortgage. But the only way to unpack the current situation is to begin with the critical relationship of debt to equity. The more adventurous financing devices all share one characteristic: they are more vulnerable in bad times than the more modest arrangements in more modest times. So let us begin with a primer on the iron laws of debt.

A. *The Iron Laws of Debt*

The first principle to keep firmly in mind is that whenever you have debt,

¹ See, Grant Nelson, *The Foreclosure Purchase by the Equity Redemption Holder or Other Junior Interests: When Should Principles of Fairness and Morality Trump Normal Priority Rules?*, 72 MO. L. REV. 1259 (2007).

you have leverage. Leverage makes the good times better and the bad times worse. If you think back to the fairy tale, leverage is like the little girl, who when she was good, she was very, very good, but when she was bad, she was horrid. Quite simply, with leveraged transactions, you either do very well or very badly. And it is a tribute to the frailties of human nature to think that the good times will continue to roll, until they don't—when you are done in by your earlier optimism, which you have since come to regret.

So how does leverage work? It is not rocket science. To give a simple numerical example, suppose you want to buy a building for \$100. You can put down \$10 of your own cash and borrow \$90 from somebody else. In so doing you have paid for the full price, but only by placing a lien on the property. This simple transaction could be perfectly sensible. Just think of the risk characteristics of two types of investments. Some people like to hold the debt position which promises a relatively secure return at lower risk. Other persons, who have greater control of the project, may be prepared to take a greater risk in the hope of realizing a higher rate of return. The division of assets could leave both parties better off. So with property values stable or rising, the arrangement is stable. What does that mean? It means that if your property increases in value by 10%, you, as the holder of the equity—the sum equal to the value of the property less the liens on it—will see the value of your equity double from 10 to 20—a very impressive rate of return.

What happens to the creditor? In this scenario, he turns out to be the tortoise. He will enjoy a fixed rate of return before the increase in price. And he will enjoy the identical return after the increase in price. He has a larger cushion against the downturn, which makes his position less risky. But in the short term he cannot capture any of the appreciation. So he is better off than before, but his fraction of the gain is small relative to that of the equity holder whose value has doubled. Do not rejoice, however, for we must never lose sight of the second part of the fairy tale: when she was bad, she was horrid. How horrid? Just assume that the value of the underlying property does not go up by \$10. Instead, it goes down by \$10. At this point, we must note one of the fixtures of mortgage law, which is the principle of absolute priority. Put otherwise, that slow moving tortoise that gets first dibs on the property, so when its value goes down \$10, the creditor is still whole. But as a first approximation, the equity goes from 10 to zero, wiping out the high flier.

These ratios and the rules of leverage constitute the iron law of finance: if you want to reduce your risk on the downside, you have to accept a reduced return on the upside. So if you had put down \$20 and borrowed \$80, that \$10 property loss still leaves you in the game with \$10. By the same token, now the \$10 increase doesn't yield a 100% increase in profit, but only the 50% increase from \$20 to \$30.

Beware: nothing anyone can say or do, by way of politics, invocation, or prayer will change how leverage operates. It also tells you why the volatility of the real estate market matters. Let the market be relatively stable and pokey and the smaller, more predictable, swings reduce the possibilities of both bonanzas and wipeouts. All this is good, not only because of finance but because it allows us to sidestep the ticklish question of what happens institutionally once the equity is wiped out. In that unwelcome event, the incentives switch. The party who is in

possession of the real estate has no permanent interest in the property. But the party with the sole economic interest is not in possession of the property. That situation is unstable, so it is now imperative to get the defaulting debtor off the property or to restructure the deal so that he regains an interest in it, as by forgiving some portion of the loan.

The situation is still more difficult for banks that do not hold single liens but rather possess many loans, all of which are subject to common economic pressures in bad times. For example, some local factor might prove highly advantageous or highly disadvantageous to the bank, so that the higher variation increases the risk of wholesale defaults, which could impair its position. To counter that risk most finance people follow the principle of diversification, which says if you can take a portfolio of assets, including loans, and mix its components up, so that their characteristics are not positively correlated with one another, you will gain stability for the portfolio much like you can reduce riskiness by taking less leverage. And what does this mean? You have somebody who's a local originator of the loan. If that lender can ship the mortgage off into a national market, where it can be pooled with loans from other sources, an investor in that portfolio will in fact get, as it were, the good loans in Chicago and the bad loans in Los Angeles or vice versa. The riskiness in one loan from one location will tend to balance off those from another, leading to a more stable portfolio, or so the theory goes.

In addition, this process of collection paves the way for a further process of securitization which offers additional advantages, at least if the portfolio manager knows how to run the game. That manager takes these pooled mortgages to create separate tranches, such that some people get higher priorities and hence greater levels of protection than others. After putting all loan instruments into a single pot, the agreements specify that the spigot first opens to A, then B and so on down the line. Parties can then match their sliver of the pie to their taste for risk, or the time that they need the money. By creating tiers of mortgages within mortgages, some people receive triple A rating on the desirable faction of risky portfolios, while others pay less to take on far greater risk. Looking at this process from the ex-ante perspective, it is another way to assign risk to those who are in the best position to bear it.

There is one large caveat. No matter how these techniques are combined, they cannot eliminate the Achilles heel of all financial transactions. If the underlying securities lose value, then the value of the divided interests lose value as well. Diversification and securitization offer no immunity from losses, but only a way to manage risk. This proposition is another iron law, like the law of leverage. So beware of political solons who in running for public office at the national, state or local level announce that they can open the spigot wide to solve the problem of credit for high risk customers. Better to think first that they have committed a genteel form of securities fraud. Don't listen to the details because the iron law remains that every financial arrangement that creates some advantage has an offsetting disadvantage.

What then are the disadvantages for this diversification strategy, no matter how sophisticated? Well the first point is that the prospect of resale influences the incentives of the original lender. The lender who holds the loans it originates from has every reason to worry about their quality, which covers both the value of the

property and the credit worthiness of the borrower. That last proposition is evident for loans that are “recourse,” that is, which allow the lender to pursue any and all assets of the borrower if the loan goes sour. But it is also important even in the context of nonrecourse loans, which allow the lender to only look at the secured property. The debtor with fewer assets is more likely to default than one who has sufficient wealth to ride out some short term misfortune. Looked at in any way, however, the original lender’s concern with these risk factors is diminished if it knows that it is going to ship these loans off to a third person the moment the ink is dry on the mortgage papers. After all, now the consequences will be borne by the multiple institutions that receive some slice of these papers after the usual drill of diversification and securitization. It is hard to get the original lender to go overboard about quality when the losses are borne by the buyers and not by yourself. So resale can easily lead to sloppier underwriting. The same is true when some third person, like Fannie Mae or Freddie Mac, steps up to guarantee the repayment of the loan, even if it does not purchase it. The loan originator is more concerned with the solidity of the guarantee than the value of the collateral or the solvency of the borrower. Government guarantors offer the greatest assurance and thus create the largest systematic risk.

Now, there is a way to counter this: with oversight. Ideally, the managers of the security pools need to rate the mortgages that they receive. They have to insist that they can turn back mortgages from the pools if they don’t meet certain parameters. The monitoring should therefore make it clear to the loan originator that it will have to keep that paper which should never have been issue at all. But here is yet another of my iron laws: every time there’s a monitor, there’s a potential evasion. The originators now have an incentive to game the system by making loans that look good under the stated parameters for repurchase, but which in fact are riskier than the purchasers know. And if the criteria for repurchase are stated in advance, it is often easy for the astute lender to make loans that meet the tests even if they are of inferior quality. There may be a way to beat some four point scale used by repurchasers by looking at some fifth variable, which the regulators miss, or misunderstand. After all, the originator can say rightly that it is not its business to volunteer information that potential purchasers don’t care to know. So the mortgage paper is not quite as good as the purchasers would hope. There is no magic bullet to avoid that particular problem. Indeed, the higher the volume, the deeper that the lender goes into the pool, and the weaker the securities. So we have identified the first problem with diversification.

The second problem with diversification is that it is more difficult to achieve than might appear at first sight. It is easy to think that risks are diversified when they are not. What do I mean by that? Well, think back to the earlier example where mortgages from one state are pooled with those from another to take advantage of these regional variations across locations. But even if these risks are randomly associated by some measures, they could easily be correlated by others. We can be certain that certain shocks to the system will be positively correlated across large regions or, indeed, over the entire nation so that diversification will never be complete. Thus a change in the federal rates of interest, or in the policies of Fannie and Freddie (both in serious disrepair) are risks that are system-wide. Congress is capable of nationwide blunders that hit California as hard as Illinois

and Texas. Here is another iron law: There's no way that any loan pool can diversify that system-wide risk. Take the dangers of high leverage, serious agency costs (between originators and buyers), incomplete diversification, and in combination they spell trouble. The initial models begin with a jaunty optimism borne of the high level of confidence in the new mathematical modeling techniques. When they work with the initial round of loans, the political pressures combine to say, "Let's do more." What the political forces forget is that the more that is done, the weaker the average quality of the loans within the portfolio. Loan quality goes down, leverage goes up, and lo and behold, without anyone knowing where or why, the portfolio succumbs to the law of averages. The rates of default increase; the difficulties of foreclosure multiply. The ability of securitized firms to renegotiate loans is limited because it is hard for one party to speak to so many. So now when the subprime loans fail, what should be done?

B. Tackling the Subprime Mess

One reason why the subprime crisis reached such major proportions is that the financial network is so highly articulated that everything is dependent on everything else. Therefore, when confidence breaks property moves down sharply in value. So the market has all the symptoms of the absolutely standard bubble—after it has burst. But some clue to the right response starts with this simple question: what were the terms of the subprime mortgages that failed? Well, frequently, the lender advanced the borrower the entire amount of the purchase price. The common justification for this heroic position is the cushion for the creditor that comes in the anticipated appreciation in the underlying property. Oh, yes, and remember the Brooklyn Bridge is now up for sale. Of course, in some cases this proposition will pan out, so that the lender becomes the genius de jour. Play the leverage game at 99 to 1, and an increase 10%, translates into a thousand fold gain on the original investment—nice work if you can get it. On the other hand, if the property goes down even an eyelash, the loan will crash.

And crash it will, for all sorts of reasons. The job market doesn't always remain good, for example, or a foreign relations crisis appears. Yet once a property goes "under water," no one can breathe because that equity value was the financial oxygen that keeps the lending market alive. So what now? It is not an easy set of choices. Starting first with an individual underwater borrower. That property could be worth \$90 on the market, but \$110 to the borrower who has customized it in some way. He might keep the mortgage alive. But the more common situation is one where the property may be worth \$90 on the market, but only worth \$85 to the stretched borrower. The former is a better bet for renegotiation but, given diversification, who can take the lead in negotiation when tiny fractional interests are spread across the globe? Who's going to be the leader of the syndicate? What sort of fiduciary duties does that syndicate leader have with respect to everybody else? These are non-trivial problems that don't frequently arise in good times. But they start to dog lenders, loan purchasers, and guarantors in bad times.

Yet even if that control problem is solved, we still have Lenin's question: "What is to be done?" Unfortunately, there is no obvious answer on the individual

case once the situation unravels. If the borrower has equity in his house of, say, \$50, and the house is worth \$100, then the mortgage covers only half the value. The only way the borrower can trash the mortgagee's interest is to trash his own. He has to reduce the value of the property below \$50 so the first \$50 of loss from destruction or neglect comes out of the borrower's own pocket. It's only after the value of the property dips below the amount of the lien that the acts of the borrower damage the lender. A robust cushion thus protects the mortgagee from the self-interest of the borrower far more effectively than any legal rule. The borrower gets all of the upside and all of the downside of any small move, so he's going to behave very well. Once the property is underwater, however, all too many borrowers are willing to neglect the property because they are playing with somebody else's money, not their own. The debtor in possession after default creates an acute conflict of interest because now the party who controls potential expenditures is not the party who bears the loss. In the language of economics, this position creates a huge externality that never quits no matter how sophisticated the arrangement. So, back to Lenin. What is to be done?

It is critical to think long and hard about the possible alternatives. Two courses of action are most likely when the lender holds all the cards. The first of them is to continue the dance; the second is to call the dance to an end. How do you start to continue a dance and why might you want to do it? Well, one of the reasons why you'd want to continue to let the debtor remain in possession is that foreclosures are a real drag. The lender has to go through all sorts of procedures to remove the borrower from the premises. That turns more difficult than it seems, especially if there are more than two players in the mix, which often happened with home equity loans. Thus property that was purchased for a \$100 with \$2 down could go up to \$125 only for a second lender to make a second loan for another \$25. So now the first lender need not just get rid of the original tenant, it also has to contend with the position of the second mortgagee. And of course some original owners had to leave town, so they let the property to a tenant who is not liable on either mortgage. So what should be done with the tenant who, for good measure, may not know about either or both mortgages? The large number of moving parts sows confusion that slows down the process of repossession or renegotiation, for neither the second mortgagee nor the tenant can just be ignored.

It is now time for another iron law of real estate finance. The greater the number of parties who are necessarily locked in a deadly embrace, the higher the transaction costs to unravel the mess. So it's not at all clear that the original lender wants to keep the loan alive. And no first mortgagee will write down the value of his lien by \$25 so as to make it possible for the second mortgagee to collect on his loan. The process can easily get frozen, as banks decide whether to foreclose, to refinance over a longer period of time, to take new collateral, and the like. But in many cases a responsible lender who knows of the fragmented condition of the title will say in light of its fiduciary duty to its shareholders that foreclosure is the preferred alternative even if the borrower is thrown out into the street. The only way to minimize loss is to get the underwater debtor off the property.

We thus come to yet another iron law of economics. Once the value of the property has gone down, its value cannot be revived by altering the arrangements between the borrower and his multiple mortgagees. Supply and demand determine

property values. All the lender can do is use foreclosure to get, if allowed, a clean title to allow the property to reenter the market. Government intervention may make this person richer and that person poorer, but the value of the asset is determined by external constraints. Often the proper solution requires the first mortgagee to take over the property in order to create clean title so that it can be sold to a willing buyer at a price that might not equal the amount of the outstanding debt.

Indeed, in some cases banks are prohibited from entering into non-lending businesses so they cannot even put in short-term tenants (at some risk, of course) to generate revenue while the property is being prepared for resale. Yet to let the property lie vacant is to run the risk of creating a public nuisance that reduces nearby property values, and thus invites a possible seizure by the public authorities in response to complaints by neighbors. One problem just leads to another. And so, for the mortgagee, speed is of the essence, marked by quick foreclosure and quick resale, perhaps to individuals who are not as leveraged as their predecessors in title. How nice would it be to see a debt-equity ratio of 90 to 10, or better, 80 to 20? The lower prices allow the land to return to productive use. We should not think, therefore, of the mortgagee turned owner as a sadist or despoiler. Rather, we should allow first-home buyers to benefit from the crisis by getting into the market on advantageous terms.

So what about the precarious position of the debtor? Well, it's one of the interesting features of these cases that by pushing the mortgage to its limits, it is not all that clear whether the "debtor" should be thought of as an "owner" or a "tenant". The terminology can matter. A tenant who is in default on his rent payments is subject to eviction. With no money down, those few monthly mortgage payments could be thought of rent. The removal for nonpayment could be regarded as an eviction under a lease, not as foreclosure. And there is no widespread public sympathy for tenants who have not paid their rent.

But in some cases, the party in possession has made a small down payment. Just how does that change the analysis? Let's assume this person has put very little, say \$3,000, down on a \$100,000 house, which is now worth only \$80,000. Assume further that the party has lived in the house for a year and made mortgage payments of \$1,000 a month. It is instructive to marry the down payment to the monthly payments. The former is only 25 percent of the latter. How, therefore, does this transaction differ from one in which the party in possession pays \$1,250 in rent before defaulting? In fact the situation could be more dramatic if the foreclosure (or eviction) remedy is stalled for a few months while the party in possession pays nothing at all. Thus if that lasts for 3 months on the numbers given, the situation is no different from a lease for 15 months at \$1,000, followed by eviction. The borrower has come out of this far better than the lender who has lost \$20,000 over the same period, without any prospects of relief. So put the matter in perspective. If there is no special solicitude for the tenant who cannot continue to pay rent, why is it different for the borrower? Note that this argument could apply in form to any case no matter what the size of the down payment. But, in practice, those persons who have extensive equities and long standing mortgages don't get themselves into the ticklish situations of highly leveraged borrowers. Their removal does not wipe out life savings. It only sends them, in all likelihood,

back to an explicit rental market, where the large down payment gives way to a smaller security deposit.

If there is one thing that should be clear, therefore, there is no great social premium in seeking to encourage homeownership that rests on rickety foundations, and once that is understood it is hard to take sides in the constant battle between borrowers and lenders. It is yet another one of my iron laws that in most settings it is hard to pin the label of scoundrel on either landlords or tenants as a class. There are likely to be some scoundrels in both groups in any large population. Perhaps some of these ill-fated mortgages resulted from fraud in the inducement, for which the borrower should have some relief. But shady lending practices look to be only a small fraction of the overall situation relative to cheap money and foolish guarantees. In most cases, the real issue is getting out of the situation, and there are now kits available that allow the borrower/tenant to surrender the property by issuing a deed in lieu of foreclosure, which removes his claim from the property while releasing him from his obligations to pay back debt. A quick deal and a clean solution, which works for the best of both sides, as the lender can now resell the property free and clear of all claims. In some cases, a tenant from the borrower remains on the premises, and here resourceful banks can easily find that it is easier to offer “cash for keys” than to fight out an eviction proceeding, which again conforms to our view that quick solutions are best.

Given the range of alternatives to this difficult conflict of interest, is there anything that the state can do which is better than a voluntary sorting out of these knotty problems under the law of foreclosure? I think not. This is a situation in which the maxim *laissez-faire* should be taken to heart, which is that government intervention in knotty situations should be regarded as an evil, unless and until it is proven to be a good. In the absence of any dominant solution to the genuine conflicts between debtors and creditors, or landlords and tenants, it should be quickly apparent that injecting public moneys into the mortgage relationship is fraught with risk. Any such intervention has heavy administrative costs. Any such program is prone to errors, in consequence of which more people may engage in similar reckless behavior down the road, leading to yet a second foreclosure when the property is worth less than before. State intervention does not have an impressive track record. It is worth examining the pitfalls in a few of the common proposals.

C. Credit Crisis Cures

One of the proposals to ease the credit crunch is to take advantage of the interest rate differentials that are found in some mortgages, just as they are found in various credit card agreements. The basic pattern runs as follows. In the days when the Federal Reserve kept interest rates too low, one common arrangement allowed for borrowers to get the benefit of a low, or teaser, rate of interest at, say, 5% a year. In subsequent years that interest rate would go up substantially, say, to 8% for the next several years. The borrower was in a position to make the first year's payment without difficulty, and planned to refinance the loan thereafter by taking advantage of another teaser rate from another lender. I have no objection to borrowers accepting these arrangements. But it was a fatal miscalculation for them

to assume that this same deal would be available next year as well. But this scheme like all others cannot go on forever. Once the value of the underlying property goes down, it is no longer possible to refinance the entire loan. And once the interest rates climb back up, the borrower is hit with a double whammy.

The proposal therefore is to eliminate the need to refinance by allowing the borrower to keep the teaser rates for an additional number of years. Any bank, or syndicate, that chooses to make that decision in lieu of foreclosure is acting, of course, within its rights. Although an external requirement that they extend the favorable interest rates may ease the problem of the borrower in the short run, it places a severe crimp on the ability of the banks to protect their reserves and remain solvent over the long run. It also creates a huge valuation problem for securitized portfolios that can only hamper liquidity in the secondary market, making the liquidity crunch more severe. It also seems like an important detail that moving in this direction will spell the end of teaser rates in all future transactions, so that those borrowers who can survive the higher payments down the road will receive less favorable offers than they get today.

The situation is, in reality, worse than this. Most people today tend to forget the financial dislocations in the 1980s when the courts in California invalidated the so-called due-on-sales clause which allowed the mortgagee to demand repayment of the loan on the sale of the property. By calling these restraints on alienation, the courts allowed the buyer of the property to take over the old mortgage at highly advantageous interest rates. The banks were denied the opportunity to renegotiate the loans at something between the old low rate and the high current one. Without the fresh infusion of cash many of these banks teetered and others sought, and obtained, federal charters to escape the financial dislocations that resulted from the systematic devaluation of their entire loan portfolio. The decision to suspend rate increases is a zero sum game. What helps the individual hurts the holder of the paper. It is hard to see any social gain that follows from these dislocations. It is easy to see how the injection of a new level of political uncertainty will lead to additional social losses.

The adoption of these partial loan forgiveness schemes is often promoted on the premise that “nobody” pays when the bank is forced to forego interest payments. That position, however, forgets yet another one of Epstein’s iron laws: no institution has ever got its penny of gain or a penny of losses in the history of all of western civilization. Every single penny of profit and loss has to land ultimately on the shoulders of one or another individual. Therefore, anyone who wants to figure out how institutions work must always follow the creed of methodological individualism, which means you trace cash flows down through institutions and entities to the balance sheets of the individuals who have stakes in their operation. Often it is difficult to run these calculations through Byzantine institutional layers. But only by making that effort can you correct the populist mantra that it is all right if banks (who suddenly have no shareholders and employees) lose so long as the people win. This philosophical outlook is, in reality, a gross intellectual error tantamount to a form of securities fraud because it allows legislators to enact relief statutes without taking into account the inevitable tradeoffs that they require.

Much the same can be said about public decisions to force a moratorium on mortgage foreclosures, which was one of the preferred remedies for the major

credit dislocations of the 1930s. That approach would be correct if foreclosures were always the wrong solution, which they're not. It is important to remember what a moratorium does. It leads to a precarious situation where property can deteriorate still further while in the hands of someone who is still underwater. Worse still, even after the delays, the foreclosure may still be necessary, at which time the property is likely to have deteriorated still further, so that the foreclosure is less effective than it otherwise would have been. There's absolutely no reason to believe that the systematic waste of property works in the social interest, no matter how great its political appeal. If, in fact, the dominant solution is to liquidate the losses and to start over again, any moratorium is far likely to do more systematic harm than good.

The third solution is one that regrettably has become a constant of bailout practices more generally. It starts with the assumption that the private lenders do not know how to manage their portfolios, which would be better handled by people who work in or under the supervision of the Fed. So the government takes over the portfolio from the private banks that have strayed from the straight and narrow. Often, however, the Fed will pay either face value for the paper, or some amount which is greater than its market value. But the implications here are stark as well. It is an open invitation to follow the policies of Fannie Mae and Freddie Mac to urge banks to make unsound loans by offering to buy or guarantee their repayment, even though the government has little or no skill in managing distressed properties, which it may have to farm out to private parties who do. The officials who run private banks are human, and if they are told that they can be sure to come out whole no matter how reckless their behavior, they will make risky loans which will be paid back by the government which is—remember methodological individualism—of course the taxpayers who are forced to pick up the tab. In this world, you always get what you pay for. And if you want to pay for improvident loans, those are what you will get, without having any clear sense of the size of the implicit subsidy created by the state action. Private entrepreneurs do not have lofty social motives that will lead them to disregard temptation that government program cast in their paths. The Fed can do as much damage with unwise subsidies as it can with unwise regulations. It is therefore time to remember yet another one of Epstein's iron laws: No government can function well when it acts simultaneously as a market regulator and a market participant. The confusion of roles will often lead it to favor its own business operations, at which point the private rivals are either driven from the marketplace or induced to follow socially undesirable policies. There is no easy way out of the current predicament. It is not as though clouds will lift, doors will be opened, and shutters will be painted. Further government intervention is likely to make matters only worse.

D. A Global Solution?

There is a larger lesson that follows from this analysis. Once government intervention starts on the wrong foot, it is likely that one bad decision will lead to yet another, which could impact not only real estate transactions, but the fabric of American economic life. Since there are no real solutions to the lost value of real estate, the temptation will be to make the problem disappear by taking more global

steps. During the Great Depression, the great deflation made it impossible for borrowers to repay their loans with more expensive dollars. The only painful solution was to reflate the currency, with the consequent short term costs. But that avenue was not pursued, which led to the rounds of mortgage moratoria, which helped the position of borrowers in the short term but created the intolerable pressures on the lending banks who could not meet the demands of their depositors who had the right to withdraw their funds at any time.

In our present situation, the newer variation on macroeconomic responses is the stimulus packages that promises rebates to virtually all Americans in varying amounts. The hope was, of course, that these funds would be used to make new purchases that would stimulate the economy. The thought is that more of this money will go to the hands of lower income individuals who are on balance more likely to spend it on current consumption than rich people, if only because poorer people have a higher marginal propensity to consume.

There are two objections here. The first is that we cannot be confident that this prediction will be born out. In practice many lower income people will use the money to pay off past debts or to replenish savings. The second point is that it would not matter even if the prediction were true. Even if every dollar were spent as advertised, these programs cannot—and in fact, did not—do anything to change the fundamental structural weaknesses in the mortgage sector. The distribution of cash to many, or even all, American citizens does not create new wealth. At best, it only creates additional paper claims against the fixed body wealth that is already there. In practice, it is likely to do even worse. Start with the administrative costs of redistribution that are a dead weight loss. These costs are very heavy if the Treasury and other government departments are to discharge their mission to find all eligible recipients of the funds, including those who are not on the tax rolls. The population is always in flux. People become of age, die, or move without leaving a forwarding address.

Next consider the question of who pays for the stimulus package. In many cases it will be the persons who receive the money in question. If there is new money printed it becomes the source of inflationary pressures. If it is old money taxed from productive society members, their payments reduce the capital they have to invest in their own businesses. The ephemeral gains on the buy side are matched by similar losses on the sell side. Taken as a whole, the systematic uncertainty makes it hard to identify any probable winners from the program.

There is a large lesson to learn from these episodes, which can be cast in the form of yet another one of my iron laws: Governments can never use macroeconomic tools to solve microeconomic problems, just as they cannot use microeconomic tools to solve macroeconomic problems. On the first point, the larger social programs cannot fix up the uncertainties in the mortgage market. On the second point, no alteration in the rules governing mortgage foreclosures can deal with matters of inflation and price stability. The constant effort to propose fixes in one area, to problems in another, will only make matters worse in both sectors. The root difficulty with the subprime crisis remains that the collateral cannot support the loans. The quicker one realizes the losses, the quicker the mortgage markets will regain their feet. The sooner the government gets out of the loan stimulation business, the less likely this whole problem will recur. What is

needed in these cases is a systematic reform of the tax code which rationalizes the treatment for investments. The short term gimmicks only divert energies from the proper reforms.

So the question then arises, is there any way to save an industry from itself? On this score it seems evident that the subprime crisis cannot be confined to the banks, but covers all the institutions that do business with them, including the investment houses. In these cases, it becomes exceedingly difficult to understand, let alone disentangle, all the obligations that any given firm has. To allow the firm to utterly fail is to invite situations where other businesses suffer in their wake because they are counterparties to these failed institutions who cannot go through bankruptcy in six months to clear transactions that have to be closed today. The task in these cases is to find ways to preserve the business in some fashion even if it is necessary to wipe out in large measure the existing shareholders. The phrase "in large measure" does not mean "entirely". It means "largely." And the reason is technical but real.

The entire system of prioritization means that the shareholders of these firms hold subordinate positions, but these are positions that could benefit from a sharp upturn, so they are not worthless, even if they have to be assigned a specific value. Letting them be included in a reorganization in some small subordinate way is consistent with the underlying realities of the situation. Allowing them anything close to full compensation is not. The Bear Stearns plan was commendable, if it was commendable at all, solely because of the minimal compensation that it offered the shareholders whose position had deteriorated substantially within the previous year. But the situation is perilous because of the fear that it will have to be duplicated by other transactions on a far larger scale. It is very difficult for any responsible outsider to know what to do to fix the current problems.

The blunt truth in all these cases is that it is easier to come up with a diagnosis of an ailment than it is to supply a cure. The only point on which we can be confident is this: Right now, there is a deep division of opinion on the proper relationship of markets to regulation. There are many individuals who see the current crisis as of March 2008 as the result of private greed. There are fewer who see it as a complex interaction between mistaken public subsidies, unwise regulation, and private overconfidence in the various models that have been used to propel the investment houses. The issues are hard enough to deal with even if the political dimensions are put to one side, but the conflicting viewpoints will lead, I fear, to a situation which will first reflect and then magnify those differences, so that much of what the government will do will aggravate matters rather than solve them.

Our only hope is to return to the principles of people like Adam Smith, David Hume and Herbert Spencer. For all their differences, they thought that government intervention was an evil until shown to be a good. But we have long since exceeded the optimal size of government under this theory. The question of whether we can understand that the risk of bailouts today leads to more serious risks of bailouts tomorrow is something that only the future can tell. I am not confident, though, that the public psyche would support government agencies if they were to take the steps needed to limit the scope of the subprime crisis.