

# SUPPLEMENT TO M<sub>S</sub>ASI - HF LLC

## FALL 2008 NEWSLETTER

### Developing Policy for Dealing with the Subprime Crisis: A Matter of Justice\*

By Maury Seldin<sup>†</sup>

Developing policy for dealing with the subprime crisis may be viewed as a matter of justice. There are different views of justice with differences in underlying values. And, the concept of justice is complex. Yet, considering the issues as a matter of justice provides an opportunity for a comprehensive analysis that considers the conflicts of incommensurability.<sup>1</sup>

Dealing with incommensurability is critical because politically based pronouncements may focus on one value and scuttle a policy that would override a lesser value with one that is rated higher for the current situation. There are no simple answers that do justice to the situation. So, let us explore the complexity on the basis of a philosophical foundation built through the ages utilizing the basic principles of our American heritage.<sup>2</sup>

#### The Borrowers

The borrowers include some who were defrauded, some who were misled, some who were uninformed, and some who were greedy. Many were refinancing to take out cash for consumption expenditures. Others were buying beyond their means. And others were speculators who hoped to be bailed out with a profit from rising prices, either as a homeowner or investor.

All of these borrowers participated in absorbing a supply of mortgage money that was abundant because of a combination of easy monetary policy and a boom in derivative financing that created debt far greater than the value of underlying assets. That was possible because the asset behind the last of the debt was based on an earlier round of debt based on an asset based on the mortgage based on the presumed value of the housing. Translated that means that a pool of mortgages was created and sold off in tranches (slices) with tiered claims on payments; the tranches of different pools were pooled and sold off in another set of tranches. Some of these were heavily financed. Final investors could be leveraged as high as 33:1 meaning that a 3% decline wipes out equity.<sup>3</sup>

- Cont. -

\*This essay is the personal view of its author and is part of the series of newsletter inserts dealing with the subprime crisis.

†Dr. Seldin is Chairman of the Board of Homer Hoyt Institute, the lead sponsor of the Subprime Crisis Research Council.

Among the results of this process are the following: a rise in house prices averaging about 50% in about eight years followed by a decline in prices of varying magnitudes (some great and generally not yet abated), more housing built than will be needed for some time (varying greatly by location), borrowers with debt beyond the value of the housing they own, and more mortgage based debt (including derivatives) that cannot possibly be paid out of proceeds from sales of the financed real estate.

It would be unrealistic to assume that the borrowers as a group had any idea of the scale and complexity of the debacle in which they participated. Yet, prudent decisions on the part of the borrowers would have mitigated the extent of the fiasco.

There are numerous policy prescriptions and programs aimed at borrower education and lender disclosure, as well as regulation designed to counter the incentive payment to mortgage brokers that caused them to steer borrowers to mortgages less favorable to the borrowers but more favorable to the mortgage bankers. Some of these are discussed in the Subprime Crisis Research Council White Paper being written that was funded by the Homer Hoyt Institute and its co-funders (Freddie Mac, Mortgage Bankers Association, and National Association of Realtors). An appendix containing a National Governors Association Best Practices report, to also be funded as funds become available, will also discuss specific options relating to improved borrower decisions.

The difficulty of these programs should not be underestimated. A large proportion of defaulting borrowers do not even contact lenders' servicing representatives; this behavior indicates that many defaulting borrowers have a paucity of financial skills. It is a noble effort to improve the situation, and it will require great resources and time; all worthwhile. But, it will be overshadowed by the institutional changes necessary to avert a recurrence of such debacles.

In the meantime, there is the matter of justice for the borrowers that are engulfed in the debacle. There are some who argue for a bailout of borrowers since they say that there was a bailout of lenders. Actually, the Federal Reserve's action of providing liquidity to the capital market was to abate the chaos that was emerging, not to save the derivative investors. More on that later. But, the issue here is, what is justice for the borrowers?

At one end of the spectrum are borrowers who were defrauded. The courts are an appropriate vehicle for remedial action. However, there is a serious problem in getting corrective action when the mortgage has been securitized and is held in pieces as part of a pool by third parties who are "holders in due course." Holders in due course are generally exempt from claims against the originators. Furthermore, many of the originators are no longer in business. It is a conundrum. If the protection to the investor is overridden, what will happen when one looks for more investors? If it not overridden, how is the injured party going to get justice? The conflict is because there is incommensurability, justice and justice or justice and equity.<sup>4</sup>

The lender obeyed the law and expects the borrower to, so his cause is just. The borrower deserves to have the situation corrected because she or he was defrauded, but that justice is estopped by the law. If you move toward the middle ground the borrower is entitled to relief, but you don't want to choke off future flow of funds. But, the middle ground might be reached by overriding the highest risk tranches claim to payment under the theory that they accepted the greatest risk. True, that the fraud was not among the risks engendered, but that is the closest place at which to place the override, and the least damage to the future flow of funds.  
(Cont.)

If you don't like that solution, come up with another. The other may help future borrowers, but it may just leave the current defrauded borrower out in the cold. That may be a reasonable alternative and the legislatures and courts may be "the deciders."

At the other end of the spectrum is the set of borrowers who were speculators that knew the risks, but counted on rising prices. If anyone has sympathy for them, we just haven't heard about it. So justice would have it that they made their bet and lost; so no relief! However, there may be an exception in the case of the houses being located in a local economic disaster area of the housing debacle. Such areas, if designated by governmental authority, may have intervention programs designed to stop price cascading leading to additional foreclosures that destroy the neighborhood. In that case, then maybe speculators will get a windfall, much as derivative investors did with the Fed intervention to avoid chaos.

The spectrum in the middle requires a more detailed classification by borrower situation and location. The borrower situation relates not only to mortgage terms and property valuation, but also to buyer characteristics including ability to continue to own or possibly rent. Displacement from one's home can be a traumatic experience, and that is worthy of consideration as well as impact on the neighborhood. Lender/investor cooperation is another consideration in that there may be countervailing pressures in which some hard choices; justice to whom becomes the issue. It is the old cost/benefit situation where those that bear the costs may not be the people as those that bear the benefit.

### The Lenders

You have heard it said, "Be careful what you wish for, you might get it." Well, the lenders wanted little regulation, and they got it. The investors wanted outlets for their funds, and they got it. The problem is that what may have made sense for individual firms did not make sense for the industry.

The story goes that the head of one firm did not approve of what was going on with subprime lending, but succumbed to pressure from staff and the sales force because everyone else was doing it. He went along with it, to his regret.

There was no justice in the compensation programs that induced mortgage brokers to steer borrowers to less desirable (but more profitable for the firm and salesman) options. There was no justice in the lack of disclosure that was rampant. But, industry did not regulate itself and governmental regulation was too weak to be of significance in averting the shady practices. Justice requires consumer protection, and the American system fell short.

The American system, in contradistinction to the European system, views the market as free to operate unless regulation is indicated. By way of contrast, the European system, based on Napoleonic premises, views regulation as the starting point with markets granted permission. This is not advocating changing the American view to European; rather only to improve on the operation of the American system. (*Cont.*)

The American view of "liberty and justice for all" is rooted in "the inalienable right to life, liberty, and the pursuit of happiness," which was derived from John Locke's "life, liberty, and property." The property meant person as well as real and personal property. The philosophical base is on the individual rights.<sup>5</sup>

Freedom, or liberty, is an element in justice and is manifested in individual decisions in partaking in market activity. But, there is a wide misunderstanding about markets. Markets are tools, not idols for worshipping. As tools, they are best used to achieve objectives, but sometimes need to be regulated in order to avoid, or minimize, or mitigate, misuse.

We now turn to looking at justice as it relates to those performing the functions of the market on the supply side of the flow of funds to the mortgage sector of the capital market. There are originators, lenders, servicers, packagers, and investors.

In an earlier era much of the home mortgage finance was provided by savings and loan associations that originated, serviced and held the mortgages as investors. When the strong demand of the growing western states required more funds that were locally generated and the savings banks in the northeast were getting more local savings that were needed by local borrowers the savings and loan associations worked out an arrangement to sell 90% of some of their loans to savings banks, retaining the 10% and servicing rights. This worked well because the alignment of interests, while not the same, was close enough to provide prudence in mortgage lending.

But the industry wanted access to the larger capital market, and it got it. Fannie Mae, Ginnie Mae, and Freddie Mac led the securitization. The problem emerged as the alignment of interests was destroyed. If the originator does not have an alignment of interests with the investor, some system of justice needs to be provided.

The Subprime Crisis Research Council White Paper, and its appendix of best practices as summarized by the Best Practices unit of the National Governors Association deals with, or will when published, specific options. The concern here is with the underlying principles.

The incentive structure of the originators was counter productive for justice, and thus is a candidate for regulation. Some people may simply hope that individuals do the right thing because it is just. Maybe that would work in a perfect world, and maybe we ought to at least move closer in instilling the values in the formative years. In the meantime, the options are based upon the carrot and the stick, incentives and regulation, and probably a combination. The lender, frequently a mortgage banker, may make the loan to be sold, probably in a package, and maybe sliced (cut into tranches), or the purchaser will slice it up and sell off tranches, probably diversified by location.

Markets work best for society when they operate with a level playing field. Asymmetric information tilts the field in favor of those with superior information. Thus disclosure requirements are reasonable regulations, frequently considered as part of transparency. But the disclosure in origination is one thing, and transparency in the chain of securitization goes well beyond it. That transparency becomes critical in investors knowing what they get and borrowers knowing to whom the debt is owed, even though the servicer is the one with whom the borrow deals. (*Cont.*)

There are two sides with different problems. On the investor side there is the disclosure that includes the rating system, another mess. On the borrower side there is the renegotiation problem because the tranche system leaves investors with diverse interests. The issues may be viewed as institutional arrangements.

### Markets as Institutional Arrangements

Markets are institutional arrangements so common that each of us probably feels that we understand them well. Maybe most of us do, but maybe some of us don't really get it right. And, as the old saying goes, it is not what you don't know that gets you in big trouble, it is what you believe you know that turns out not to be so.

Well at the risk of being the victim of knowing what is not really so, here is a view of markets built on the concepts of justice.

A lone individual on earth could simply deal with the relationship between himself and nature. But, when others are involved, some organizational structure emerges. The nature of that structure varies widely by culture. As an exercise in polemics we could take the Islamic view of all governmental authority is from God, and it is written in the Koran, and justice is based on that authority. At the other extreme we could take the American view that all governmental authority arises from the individual and that the governmental authority derives from the people through a democratic process.

Both those views are rooted in Abrahamic religious heritage. The American view is rooted in the Judaic view of the value of the individual. If you want a polemic not religiously based, then one is present in communism as compared to democracy. The source of authority in communism is the state as compared with the source of authority in democracy being the individuals as politically represented.

The American view of markets may be seen as potential and actual transactions resulting from individual actions or potential actions. The key is in the concept of a commercial transaction based on individual choices of buyers and sellers. If there is only one seller, it is a monopoly. If there is only one buyer it is a monopsony. If there are a few sellers it is an oligopoly. If there are only a few buyers it it's a oligopsony.

Monopolies are illegal in the United States unless regulated. That is done because of the unequal power in the market. Similarly, oligopolies may be regulated in order to level the playing field. Interestingly enough, cartels are international arrangements for exploiting the market with a heavily tilted playing field, and are not regulated by a single government, but rather dependent on the conspirators' unified action and minimal impact of non-participating competitive suppliers.

We will leave dealing with cartels aside. Rather, our focus is on justice as sought domestically in the regulation of markets. That justice is social justice and it includes distributive justice and commutative justice.<sup>6</sup> Distributive justice relates to allocational systems while commutative justice refers to individual participation. (*Cont.*)

We see our society as just in an allocational system when we resolve the incommensurability of equality and liberty. Liberty may be positive or negative.<sup>7</sup> Negative freedom is the absence of limitation as with regulation. Positive freedom is the presence of ability. Thus, one may not be restricted from an activity by regulation, but may not have the resources.

Equality may be in opportunity or in resources. The quote from the Declaration of Independence (in footnotes) refers to equality of rights, not resources. Yet, social justice calls for some equity. The resolution then is some balance between the freedom to capitalize on market opportunity and the distributive justice. That freedom to capitalize on market opportunity is a strong incentive to productive efforts, especially innovation. The benefits must be attractive enough to call forth the efforts and talents. Yet, equity calls for some semblance of equality, not only in opportunity but in assurance of some minimal standard of living and fair share of society's production.

What is an equitable balance in society's production is the subject of substantially different views. The last few decades have been heavily skewed toward the concentration of wealth, in some measure as a result of the political economy. While that trend may reverse next year, the historic pattern of regulation has had a pendulum swing that overshoots the mark.

My personal judgment is that justice calls for a movement towards the center, but that there is a risk that the policies will overshoot the mark. The key funded proposal of SCRC through HHI and its co-funders contains the following statement: "In evaluating each of the proposals, we will be guided by the following criteria: i) *Fairness*: the issue arises of who will be helped and who *should* be helped. While few would dispute that help would be appropriate to subprime borrowers who were misled by lenders and put into loans they could not afford (especially for borrowers who were refinancing a home in which they previously held equity), there is much less sympathy for speculators who took out loans hoping to flip the home for a profit a few months later. At the other end is the question of whether the misled homebuyer is any more worthy of assistance than the misled investor who bought a security purported to be of AAA quality as a way of improving their return. ii) *The Net Impact or Bang for the Buck*: Any analysis of these programs needs to look at the total macroeconomic effects (the benefits to the economy of stemming the decline of home prices and bolstering credit markets), relative to the amounts involved, and iii) *The Distributional Impact*, i.e. the disaggregated effects on different players in the housing market and different geographic areas. We will also approach the proposals from the point of view of iv) *The Source of Financing*, and the implications thereof, as well as the v) *Future Mitigation of Moral Hazard and Return to Business as Usual*, i.e. the sunset clause in each proposal and the potential for speedy recovery."

That statement is in accord with the concept of justice espoused here in "Developing Policy for Dealing with the Subprime Crisis: A Matter of Justice." The White Paper which encompasses that project and the best analyses we can muster in the time frame is in process and is the focus of the forthcoming September 15 Subprime Crisis Research Council conference to be held in Washington.

Additional support for carrying the work forward in 2009 is hereby being sought. Potential funders will be invited to the conference.

<sup>1</sup>Incommensurability refers to conflicts in values as discussed by Isaiah Berlin. His idea of incommensurability relates to differences in concepts such that can not be integrated into a consistent view. While they may not contradict each other, they do exclude each other. Many values may conflict. Berlin writes of this conflict in his book, *Crooked Timber of Humanity*, particularly noting liberty and equality. Also noted is justice and mercy. "What is clear is that values can clash - that is why civilisations are incompatible. They can be incompatible between cultures, or groups in the same culture, or between you and me...Justice, rigorous justice, is for some people an absolute value, but it is not compatible with what may be no less ultimate values for them - mercy, compassion - as arises in concrete cases....An artist, in order to create a masterpiece, may lead a life which plunges his family into misery and squalor to which he is indifferent. We may condemn him and declare that the masterpiece should be sacrificed to human needs, or we may take his side - but both attitudes embody values which for some men or women are ultimate, and which are intelligible to us all if we have any sympathy or imagination or understanding of human beings. Equality may demand the restraint of liberty of those who wish to dominate; liberty...may have to be curtailed in order to make room for social welfare, to feed the hungry, to clothe the naked, to shelter the homeless, to leave room for the liberty of others, to allow justice or fairness to be exercised....We are doomed to choose, and every choice may entail an irreparable loss. Happy are those who live under a discipline which they accept without question, who freely obey the orders of leaders, spiritual and temporal, whose word is fully accepted as unbreakable law; or who have by their own methods arrived at clear and unbreakable convictions about what to do and what to be that brook no possible doubt. I can only say that those who rest on such comfortable beds of dogmas are victims of self-induced myopia, blinkers that may make for contentment, but not for understanding of what it is to be human." [Pages 12-14.]

<sup>2</sup> Justice may be seen as an ethical notion rooted in what ought to be, at least in a political context from a traditional Muslim perspective. Consider the following quote from Bernard Lewis, "For traditional Muslims, the converse of tyranny was not liberty, but justice. Justice in this context meant essentially two things, that the ruler was there by just right and not by usurpation, and that he governed according to God's law, or at least according to recognizable moral and legal principles."

The transcendent view of justice is also reflected in Jewish life with specific biblical reference to a biblical passage "Justice, justice shall ye pursue." The commentary in the text (*Pentateuch & Haftorahs*, edited by J. H. Hertz), is as follows: "...The duplication of the word "justice," brings out with the greatest possible emphasis the supreme duty of even-handed justice to all." [Page 821.] On the next page [822], the commentary continues, "It must be noted that the idea of justice in Hebrew thought stands for something quite other than in Greek. In Plato's *Republic*, for example it implies a harmonious arrangement of society, by which every human peg is put into its appropriate hole, so that those who perform humble functions shall be content to perform them in due subservience to their superiors. It stresses the inequalities of human nature; whereas in the Hebrew conception of justice, the equality is stressed...."

For our discussion we are focusing on justice as it relates to structuring society for justice in achieving are other goals, using our "natural" rights to "life, liberty, and the pursuit of happiness." The key is in the roots of our American heritage, as articulated in the Declaration of Independence denoted in the following quote, "We hold these Truths to be self-evident, that all Men are created equal, that they are endowed by their Creator with certain inalienable Rights, that among these are Life, Liberty, and the Pursuit of Happiness."

<sup>3</sup>The detail of securitization is well described by Charles R. Morris in his *The Trillion Dollar Meltdown: Easy Money, High Rollers, and the Great Credit Crash* (New York: PublicAffairs, 2008). The chapter to the point is Chapter 4, "A Wall of Money." The preceding chapter, "Bubble land: Practice Runs," sets the stage and provides a fine context.

<sup>4</sup>One approach is to use the classifications by Aristotle in his *Nicomachean Ethics*. The idea of universal or lawful justice as compared to particular or fair and equal justice. The former refers to obeying the law as being just. The latter is divided into distributive and rectificatory justice. [*The Nicomachean Ethics*, Aristotle as translated by David Ross with revision by J.L. Ackrill and J.O. Ursmon, pages 106-122.] The fair and equal justice sub-classification of rectificatory refers to correcting a situation. This is a move toward a balance by going to the middle ground. Note that "Justice is a kind of mean..." [Page 123.] and it is part of the doctrine of the mean in which Aristotle saw moderation as an ideal virtue. This is a view of balance, one of the fundamental principles necessary for a suitable strategy.

<sup>5</sup>Individual freedom is the key in the quotation "We hold these Truths to be self-evident, that all Men are created equal, that they are endowed by their Creator with certain inalienable Rights, that among these are Life, Liberty, and the Pursuit of Happiness." The "Life, Liberty, and Pursuit of Happiness" phrase is a takeoff on a statement in John Locke's *The Second Treatise of Civil Government*, published in 1690. The quote from Locke's Chapter VII titled "Of Political or Civil Society" is as follows:

"Sec. 87. Man being born, as has been proved, with a title to perfect freedom, and an uncontrouled enjoyment of all the rights and privileges of the law of nature, equally with any other man, or number of men in the world, hath by nature a power, not only to preserve his property, that is, his life, liberty and estate, against the injuries and attempts of other men; but to judge of, and punish the breaches of that law in others, as he is persuaded the offence deserves, even with death itself, in crimes where the heinousness of the fact, in his opinion, requires it. [Source: Original URL: <http://www.constitution.org/jl/2ndtreat.htm> Text Version Maintained: Jon Roland of the Constitution Society.]

All of this is to the point that our values start with the individual and build to society. The Declaration of Independence quotation continues with an added phrase as follows: "We hold these truths to be self-evident, that all men are created equal, that they are endowed by their Creator with certain unalienable Rights, that among these are Life, Liberty and the pursuit of Happiness. - That to secure these rights, Governments are instituted among Men, deriving their just powers from the consent of the governed." The equality is a matter of justice. But, as will be discussed, there is the interpretation of "equality."

<sup>6</sup>See Kaplan, Abraham, *In Pursuit of Wisdom: The Scope of Philosophy*. Lanham, MD: University Press of America, 1977, page 418. Here are the quotes (1) "*Distributive justice* is the adherence to moral norms of both form and content in the allocation of resources and products [Page 418.]...(2) *Commutative justice* is the allocation to each person of neither more nor less than he deserves. [Page 418.]...(3) Social justice is a comprehensive category comprising a certain degree of equality and security, as well as distributive and commutative justice." [Page 418.]

<sup>7</sup>See John Gray in his book, *Isaiah Berlin*, which is especially enlightening on the comparison and contrast. It is as follows:

"It will readily be seen that, if negative freedom as Berlin understands it presupposes the capacity for choice among alternatives, it shares a common root with positive freedom. Unlike negative freedom, which is freedom from interference by others, positive freedom is the freedom of self-mastery, of rational control of one's life. It is plain that, as with negative freedom, positive freedom is impaired or diminished as the capacity or power of choice is impaired or diminished, but in different ways. An agent may be unobstructed in the choice of alternatives by other agents, and yet lack the ability or power to act. This may be because of negative factors, lacks or absences - of knowledge, money or other resources - or may be because there are internal constraints, within the agent himself, preventing him from conceiving or perceiving alternatives as such, or else, even if they are so perceived, from acting on them. Such conditions as phobias or neurotic inhibitions may close off an agent's options, even to the point that they remain unknown to him, or else he may be constrained by irrational and invincible anxiety from acting so as to take advantage of them. In this case the power of choice has been sabotaged or compromised from within. An agent may possess very considerable negative freedom and yet, because he is incapacitated for choice among alternatives that other have not closed off from him, be positively unfree to an extreme degree. What both forms of unfreedom have in common is the restriction or incapacitation of the powers of choice." [Page 16.]

An additional explanation, according to Michael Ignatieff in his book, *Isaiah Berlin*, is as follows:

"Until Rousseau, liberty had always been understood negatively, as the absence of obstacles to courses of thought and action. With Rousseau, and then with the Romantics, came the idea of liberty being achieved only when men are able to realise their innermost natures. Liberty became synonymous with self-creation and self-expression. A person who enjoyed negative liberty - freedom of action or thought - might none the less lack positive liberty, the capacity to develop his or her innermost nature to the full." [Page 202.]