John Hood's Daily Journal

How the Mighty Have Fallen

By John Hood

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RALEIGH – Just a few years ago, Charlotte was home to two of the nation's largest banks, Bank of America and Wachovia. By some accounts, the Queen City was a financial capital second only to New York in the United States. But then came the financial crisis. Both banks went wobbly. Wachovia got swallowed by Wells Fargo, and its storied name will soon disappear from retail banking.

And Bank of America? Its directors and executives continue to be under significant pressure. Its mortgage business remains a mess. Officials in North Carolina and other states are demanding changes in loan servicing and other policies.

If you want to learn more about why these the two banks got hit disproportionately by the financial storm – to find out, quite literally, how the mighty have fallen – I have some recommended readings for you.

To begin with, recall that Bank of America's mortgage problems stem primarily from its 2008 purchase of Countrywide Financial. In a March paper for the Cato Institute on Fannie Mae, Freddie Mac, and their relationship to the subprime mortgage market, Mark Calabria writes: "In 2005, one out of every four loans purchased by Fannie Mae was from Countrywide. One out of every 10 for Freddie Mac was also from Countrywide."

Calabria rebuts the claim, common in the liberal blogosphere, that government guarantees had little to do with the excesses of the subprime mortgage market. Part of the problem is definition. Understood properly, he writes, subprime lending accounted for about 30 percent of the direct mortgage purchases of both Fannie Mae and Freddie Mac. The two institutions bought about 40 percent of newly issued private-label subprime mortgage securities. They were major players in the subprime market, in other words.

In a subsequent Cato paper, Brooklyn Law School professor David Reiss argues that Fannie Mae and Freddie Mac employed "regulatory privilege" to obtain benefits during boom years – exposing taxpayers to the downside risk that materialized during the subsequent bust years. Reiss proposes that the two institutions be privatized, with any truly public functions to be assumed by government agencies.

While there is some support in Congress for the privatization option, some Democrats and Republicans are reportedly working on a compromise bill to replace Fannie and Freddie with a new set of government-sponsored enterprises, perhaps organized on a regional basis. Such a failure of nerve would perpetuate the market distortions and regulatory privilege that helped set the stage for the past crisis.

Bank of America, Wachovia, and other institutions saw a financial wave in the mid-2000s – an unsustainable wave based on government subsidies and easy money – and decided that they couldn't afford to let it pass them by. They hopped on. Then the wave hit a rocky shore.

As former BB&T head John Allison explained in 2009*, those firmly committed to sound market principles knew that something was going horribly wrong in the financial markets. Check out this excerpt of a *National Review* piece on Allison and BB&T:

The fact that BB&T didn't dive headfirst into the shallow pool of subprime mortgages certainly goes a long way toward explaining the relative health of BB&T as an institution. But how was BB&T able to resist chasing after all that new mortgage money?

The answer is simple: Subprime mortgages were bad for the people who took them out. That went against BB&T's philosophy — not for reasons of altruism but because it would have been poor strategy. "We're obviously a for-profit company, but we *don't think that it's good business in the long term to do bad things to your clients, even if you make a profit doing it," Allison said. "So we chose not to do negative-amortization mortgages because we knew it was going to get a lot of people in financial trouble."*

But those bankers more comfortable engaging in crony capitalism than in free enterprise fooled themselves into thinking that the mortgage market was a perpetual motion machine. They paid for it, but it wasn't just them.

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