‘Sub-prime’ should not be the basis for increasing financial regulation

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There really is nothing new under the sun. So too with financial crises and the responses to financial crises—the subprime crisis has resulted in calls for even more regulation. In Australia the Finance Sector Union will campaign for banks to change their lending practices so as to be more ‘responsible’. In other words, not only will borrowers have to convince their bank manager to give them a loan, they will have to convince a union official as well.

Debt is the world’s oldest financial instrument. The principles of debt are very simple and very clear. Individuals borrow money for a period of time, repay the money, and also pay a charge for the use of that money. Lenders need to be sure that the borrower can repay the loan. To be sure lenders can seize assets in lieu of the loan, but would always prefer to have the loan repaid rather than foreclose.

In the 1990s banks in the United States were often accused of ‘redlining’ or mortgage discrimination—basically, racism. Now the accusation is that lenders have lent too much, often to the same category of borrower. The process of lending has become more complicated over time—there are now sales agents, loan brokers, banks, ratings agencies and the like—but the principle remains the same. The loan needs be repaid.

Lenders in the US, and elsewhere, make loans and then securitise those loans and on-sell them. In other words, investors can buy a portfolio of loans. Some borrowers will always default on their loans, but most will not. When investors hold a portfolio of loans much of the individual risk of loan default will have been diversified away. This is called securitisation and is a valuable mechanism for transferring risk to those best placed to hold it. What has happened is that high-risk loans (subprime) have also been securitised and on-sold. It is important to understand that these loans are high-risk loans—the people receiving the loans have a poor credit history or have a high risk of default—despite the fact they may have investment grade ratings. To the extent individuals with a poor credit rating are likely to struggle financially in any economic downturn, so these securitised instruments are very sensitive to the economic cycle.

The cause of the crisis seems to be that many investors undervalued the risk of these instruments. True, many investors had relied excessively on the investment-grade ratings these instruments received. The point to remember, however, is that rating agencies provide an opinion; they do not provide a guarantee against investment losses. Many investors lost money because they didn’t do their own homework, and were seduced by apparently low-risk instruments offering high rates of return. It was too good to be true. But investors making poor investment choices should not be grounds for regulatory intervention.

The real regulatory danger is for borrowers. US regulators want to stop lenders from making loans that disregard borrowers’ ability to repay them. Australian unions share this remarkable ambition. The government wants to regulate against firms making unprofitable business decisions. There may well be individual cases of abuse, but the idea of widespread ‘predatory lending’ is pure class warfare. It is also inconsistent with previous claims of redlining.

Other arguments have been that individuals do not fully understand the terms of their mortgages and greater disclosure requirements are required. In particular, some US observers have argued that variable rate mortgages and low initial teaser rates are to blame for the crisis. Paul Krugman has referred to teaser rates as ‘exotic’ loans that constitute ‘abusive lending practices’. The ‘solution’ to this crisis has been to call for greater regulation and disclosure. US home owners, apparently, should not be offered variable rate mortgages. Nor should individuals with a poor credit history be offered a loan.

Many people may well lose their homes. Many others, however, will have had a chance to buy a home they otherwise would never have had. Some, if not most, will succeed in buying their own home. Increased regulation that makes it hard to offer loans will simply crowd out individuals from the loans market and truly discriminate against the poor.

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