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Collective Delusion [1]

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Four years ago this month, New Century Financial, one of America?s largest sub-prime lenders, filed for bankruptcy, signalling the start of the global financial crisis. Arguments are still flying as to who or what caused the crisis with banks largely cast as the biggest villains, closely followed by inept regulators.

The most obvious explanation is that too many were borrowing too much that they couldn?t repay, whether they were governments, companies, home buyers or shopaholics. In this frenzy, the banks merrily kept the punch bowl topped up while the regulators saw no reason to spoil a good party.

Earlier this week, our own Tom Clougherty reiterated [3] how the implicit government guarantee that no bank would be allowed to fail distorted the normal risk-assessment process and misallocated investment flows.

Now comes another fascinating insight into how insidious the effects of such market interference can be. In an article [4] by Mark Brickell, a former chairman of the International Swaps and Derivatives Association, those distortions are seen as corrupting the fundamental market data that the banks and regulators need to assess risks.

According to Mr Brickell:

> Government policy inadvertently distorted the data used to measure risk, so that mortgage loans appeared to be less risky than they really were?Risk managers compile a record of historical price changes and plot the probability of large future shifts. Lenders, securities underwriters, rating agencies, and regulators all rely on some variation of this technique to help measure risk?Pre-crisis default rates were low, making mortgages look like low-risk investments to portfolio managers, their regulators and many others.
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> That historical data, though, was becoming increasingly skewed by federal policies. US regulators, like those overseas, allowed financial groups to make mortgage loans using less capital and more borrowed money than they required for other loans.. As demand for housing rose, so did home prices. And as policy pumped up home prices, the rate of mortgage defaults was artificially suppressed because distressed borrowers had no need to default. As the bubble grew, they could sell the home at a profit and pay off the mortgage, or simply refinance.
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> Every mortgage decision?relied to some extent on the skewed database. So did rating agencies. Oversight by regulators suffered from the same flaw?This should make it easier to understand why so many got it so wrong.

In other words, not only did government policies distort the market, they distorted the underlying data used to assess the market.

This is no surprise to friends of the Adam Smith Institute and is a salutary warning for other markets where government policies, however well intentioned, seek to skew behaviour.

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