

Securitization and the State

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Abstract

This paper considers the relationship between the state and the market in view of the rise of modern securitization instruments. First, the importance of policy feedback is discussed through a set of converging policies that unwittingly resulted in disaster for Savings & Loans, but gave new life to the otherwise anemic market for mortgage bonds. Second, the extent to which the U.S. government can be considered a developmental or entrepreneurial state is considered in view of its long-standing effort to manage the housing market, the reorganization of the governmental housing agencies, and the issuance of the first mortgage-backed security in 1970. Third, the role of the state and the autonomy of the pricing mechanism are considered in view of Ginnie Mae's role in setting the prepayment assumptions that made it possible for brokers to price multi-tranched mortgage-backed securities. These examples reveal that the U.S. government acted in multiple capacities in the market; moreover, the second and third examples suggest that the U.S. government further took on characteristics of an entrepreneurial, developmental state.

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In 1967 a group of governmental housing experts convened as the Mortgage Finance Task Force in order to devise a better housing market in the U.S. (Maisel Interview, Private Papers). Intending to improve the efficiency of the housing market and so help struggling and working class families become homeowners (Ibid) – while avoiding adding costs to a budget already strained by the Vietnam war – these men devised a plan to auction off mortgages owned by the government. The system they developed for this would eventually turn mortgages from idiosyncratic long-term commitments that only financial giants like governments, banks and insurance companies were willing to own, into a homogenous product that virtually any investor could buy and sell with ease. By bundling mortgages into a pool that served as collateral for bonds (and pairing it with special guarantees from the government assuring timely payments), they spun mortgages into exchangeable securities, a process later named “securitization.”

After decades of technological, legal, and cultural innovation by businessmen who worked closely with government officials to establish a market for the bonds generated by these financial instruments, securitization has ballooned into a multi-trillion dollar industry and transformed American finance. According to the *Wall Street Journal* over two-thirds of new home loans issued in 2005 were pooled and repackaged into bonds that were sold off in the securitization market (Simon and Hudson 2006). The Securities Industry and Financial Market Association (SIFMA) reports that in 2006 the total amount of outstanding securitized mortgage debt was approaching \$4 trillion, while another \$2.1 trillion of other kinds of outstanding securitized bonds were backed by assets derived from other kinds of debt, like credit cards, school loans, auto loans, corporate debt, and even music royalties. By 2005 Asset-Backed Securities had surpassed

U.S. Treasuries as the largest fixed income sector of the U.S. economy; Security Exchange Commission Chairman Christopher Cox noted that this was an especially impressive feat, considering the concurrent war time debt (Cox 2006).

This new market constitutes a dramatic transformation in the ways Americans lend and borrow money. Banks increasingly act like brokers, and funnel debts into financial instruments that are then telegraphed out into the capital markets (Davis *forthcoming*). As a result, obligations are spread out between hundreds or thousands of investors, each of whom own a fraction of many different loans and obligations. The subsequent increase in lending this has encouraged has reverberated throughout markets. Defenders of securitization have argued that it increases market efficiency and has led to the “democratization of credit.” Yet it has also been associated with an array of scandals and crises, including the culmination of the S&L crisis in the 1980s (Lewis 1990), Andrew Fastow’s fraudulent deals that finally brought down Enron (McClean & Elkin 1993), and accounting scandals at Freddie Mac and Fannie Mae (Barta, McKinnon, and Zuckerman 2003). It also fueled an increase in mortgage lending to families with low credit ratings that preceded the current “mortgage market meltdown” and the hedge-fund collapses and investment bank write-offs and shake-ups that followed in its wake.

Resulting stock market volatility now threatens to escalate into a full-blown recession.¹

This paper draws from my dissertation, which uses interviews, archival research, and historical market data to investigate the rise of securitization in America between

¹ An example of a particularly damning evaluation of the industry, as reported in the *Wall Street Journal*: “In the credit world I think we've been in a bubble every bit as big as the one in technology in 2000 and in Japan in the 1980s,” he says. The chief culprit, Mr. Wood believes, is securitization, which he thinks “has been basically running amok” in the U.S. in recent years. Securitization in the housing market, he says, has led investors to ignore legitimate financial risk by pretending that it is too spread-out to matter.” (Dean & Stein, 2007).

1970 and 2005.² For this discussion I draw mainly from written accounts of the market's history by key traders, articles by experts in housing finance, reports from the *Wall Street Journal*, and from the papers of Sherman Maisel, a Governor of the Federal Reserve who was at the center of changes in U.S. housing finance in the late 1960s. These are tentative findings from an ongoing project, and much remains unknown about the history of this market. Nevertheless, they raise interesting questions and speak to sociological debates about the relationship between markets and the state. In this paper I argue that at different points in the development of the market for securitized bonds, the government acted in distinct and sometimes contradictory capacities. In addition to somewhat inconsistent regulatory efforts, governmental housing agencies directly intervened in the market in ways that are more commonly associated with developmental states or private entrepreneurs than with the U.S. government's more ostensibly hands-off approach to markets. I therefore consider the government's participation in the early securitization market in light of Yu's theory of the entrepreneurial state.

Theories of States and Markets

Economic sociologists contend that that no market is formed without assistance from the state. Building off Polanyi's (1944) assertion that market society is not actually self-regulating, economic sociologists have seen markets and states as working in close accord. They have noted that markets and states have grown up together, and even in the modern era states benefit from the revenues generated by markets, while markets benefit

² I follow Kendall (1996) and Sellon and VanNahmen (1988) in arguing that the earliest modern securitization deals were invented in the 1970 with the GNMA pass-throughs. See Jaffee (2006) for a discussion of how an early mortgage securitization market existed in the U.S. briefly in the early 20th century alongside a private market for mortgage insurance, but both failed amidst conflicts of interest and the Great Depression.

from the stability protection offered by states (Tilly 1990, c.f. Evans and Block 2003; Fligstein 2001). Institutional economist Douglass North ([1990] 2005) has posited that laws are formal rules which can increase predictability and improve information flows, and so help market participants act rationally. Fligstein (2001a) puts the state in the center of his theory of markets, arguing governments and firms work together to create enough stability for markets to survive. Here the state is viewed as an overlapping network of policy domains that can be captured or dominated by different groups in society (2001b: 39-43). States wield a great deal of power over formal laws determining property rights, governance structures, and rules of exchange; groups in a society can vie to capture the state and influence such laws.

When talking about the state influencing the market, it is important to stress that as an overlapping set of domains, the state does not necessarily act in a uniform or consistent way. Studies detailing ‘varieties of capitalism’ have identified a complex array of relations between states and markets (Block and Evans 2005: 506, Hamilton and Woolsey-Biggart 1988). Moreover, institutional theories of the state assert that even *within nations* the relationship between the government and the market can vary. Advocating for a multifaceted model of the state, Clemens and Cook (1999) write, “the analysis of institutional change rests on an appreciation of the heterogeneity of institutional arrangements and the resulting patterns of conflict or prospects for agency and innovation” (461). That is, the complexity of governmental structures creates disjuncture, unintended consequences, and policy feedbacks (Pierson 1993) that can generate opportunities for innovation and change – a dynamic that certainly is evident in the emergent securitization market (as I will explore in my first example below).

Moreover, Campbell and Lindberg, building off pioneering work like Skocpol's *Protecting Soldier and Mothers*, argue that the state is both an institutional structure and a mix of agents, and so states affect markets through many different pathways. They use this insight to challenge the assumption that the U.S. has a weak state, and argue instead that the U.S. government exerts influence on the market through the often overlooked but always crucial capacity to set *property rights*. They further remind that even this is not necessarily uniform, since such rules can vary over domains and time.

Looking at the rise of securitization, one can certainly identify moments in which the government influences property rights. But I break from Campbell and Lindberg insofar as this case shows the U.S. government exerting influence in more direct ways. That is, in the case of the emergent market for securitization, the U.S. government also acts in ways more commonly associated with developmental states and private entrepreneurs. Economist Tony Yu (1997) argues that a state can be considered entrepreneurial when it acts in ways that entrepreneurs do – that is, when it takes on the innovative role of someone who identifies and exploits new business opportunities through a process of planning, reflection, trial and learning (50). Borrowing a typology from Luedde-Neurath, Yu makes the distinction between “directive” entrepreneurship, such as the developmental and interventionist policies of Singapore, Taiwan and South Korea, and the “facilitative” entrepreneurship seen in the laissez-faire policies of Hong Kong. He argues that the directive state “aims to restore markets to their proper function” and “seeks to provide public goods . . . which cannot be supplied adequately in private markets” (51). In contrast, the facilitative state “aims to achieve predetermined results by means of conscious interference with market forces and the selective application of

incentives and/or controls” (51). A directive state intervenes in markets through activities like ownership and investment in new technologies, while facilitative action is aimed towards providing friendly environment for businesses through taxes and regulation.

By Yu’s system of classification, the U.S. would be considered a facilitative entrepreneurial state. There are many examples of this kind of relationship in the history of securitization. The Secondary Mortgage Market Enhancement Act (SMMEA) of 1984 made it legal for investors to purchase these bonds, and it did so by overriding many state’s more restrictive laws (Ranieri 1996). Another piece of legislation called the Trust for Investments in Mortgages (TIMS) was drafted by Salomon Brothers; when an analyst at the Treasury named Andy Furer objected to the legislation, Salomon Brothers hired him to rewrite it. It passed as part of the Tax Reform Act of 1986. This created a structure called a REMIC (Real Estate Mortgage Investment Conduit) that could issue Mortgage-Backed Securities (MBS) without having many of the old tax and accounting problems of earlier efforts. One trader later noted that securitization traders had “won total flexibility” (Ranieri 1996: 37-38) with this legislation; this is surely a textbook example of facilitative entrepreneurship.

But a look at the housing policy that gave rise to securitization – and the government’s extensive campaign to coax a market for securitized bonds into existence – suggests that the difference between being directive or facilitative, between being interventionist or merely supportive, is better imagined as a spectrum than as a binary category. For in its decades-long efforts to promote a healthy housing market, the U.S. government used a variety of strategies, and some of these strategies veered towards direct intervention into the market. That is, the U.S. acted as a directive entrepreneurial

state in its own quiet way through a set of public and semi-private housing agencies that served as owners, inventors, and even as part of the pricing mechanism. In taking initial steps towards mapping the different roles the state played in this market in its early days, this paper suggests that a significant interventionist impulse may hide behind the facilitative, hands-off stance often associated with the U.S. government.

Below I present three examples that speak to the theories presented above. The first example addresses how the various branches of the government can interact in surprising and unintended ways, as predicted by political-institutional theories. Here a series of policy decisions combined to create a disaster for the Savings and Loans (also called “thrifts”) and an accidental lifeline for the struggling market for mortgage bonds. In the second case, I discuss the federal government’s key role in the origination of the modern securitization industry. In the third, I discuss how the government later stepped in to bolster the market by fabricating a set of assumptions that made it possible to price complex securitized bonds.

The Fed, Regulation Q and the Unintended Consequences of Policy Feedback

Michael Lewis gives a revealing account of the early days of the securitization market from the point of view of the mortgage desk at Solomon Brothers in his book *Liar’s Poker*. In 1978 Solomon Brothers had created the first mortgage security department on Wall Street. This desk was the brainchild of Bob Dall, a trader at Salomon who had worked on the early private securitization deals with Ginnie Mae and Bank of America, and who subsequently grew interested in trading mortgage securities. Dall thought that geographical inefficiencies in housing finance created an opportunity for

arbitrage. Lewis Ranieri,³ then a rising star on the trading floor, was quickly drafted into the effort. The mortgage bond desk was not profitable in its early years, and by 1980 Salomon Brothers was considering shutting it down. By this time Merrill Lynch, First Boston and Goldman had all abandoned the effort. Lewis suggests that the only reason the department at Salomon survived was because Ranieri had the protection of CEO John Gutfreund. In other words, by the close of the 1970s only one company was still trading mortgage bonds, and the department doing it seemed to be holding on by a thread.

Yet Lewis recounts a string of events that led to massive unexpected windfalls for Salomon's mortgage department in the early eighties. The Federal Reserve lifted short term rates in October 1979, a change that brought problems with the Savings and Loans, the primary mortgage lender in the country at the time, to a head. Things had started going south for the thrifts in 1966, when yields on U.S. Treasury bills rose above 4 percent for the first time in over 20 years, and so began to lure away depositors (who provided the funds they invested into mortgages) (Green and Wachter 2005). The subsequent shortage of funds caused heavy financial losses. The situation got progressively worse as nominal interest rates rose in the 1970s, and government caps on the rates the thrifts could pay on deposits set by Regulation Q made it difficult for them to compete with U.S. Treasury securities and new mutual, pension, and money market funds (Green and Wachter 2005: 98). Laws that restricted thrifts to investing only in mortgages throughout the seventies further exacerbated these funding problems (Ibid). When the Fed lifted short term rates in October 1979 the thrifts faced disaster, and the government quickly acted to prevent a wave of bankruptcies, passing a tax break in

³ Michael Lewis would later write of Ranieri: "Lewie Ranieri was the wild and wooly genius, the Salomon legend who began in the mailroom, worked his way onto the trading floor, and created a market in America (and was starting a similar one in Britain) for mortgage bonds." (Lewis 1989: 77)

September 1981 with an unusual stipulation: if the thrifts sold their loans at a loss, they could report this loss against their taxes from the last decade and subsequently receive a refund from the IRS (Lewis 1989: 103-4).

Thrifts started selling their mortgages *en masse*, and as the sole remaining mortgage desk on Wall Street Salomon had an accidental monopoly and an incredible windfall. Lewis writes, “One trillion dollars came barreling through the phone lines, and all the traders had to do was open their mouths and swallow as much as they could” (1989: 103). The thrift managers, out of their league and backed into a corner, got fleeced: “Even knowledgeable thrift presidents felt that they faced a choice between rape and slow suicide. To do nothing spelled bankruptcy for many.” (Ibid: 106) Over the next years Ranieri’s team bought whole loans, many of which were resold to thrifts who “were attempting to grow their way out of catastrophe.” (Ibid) Salomon’s mortgage department made \$150 million in 1982 (108), and by 1984, Lewis writes, “Ranieri would argue, plausibly, that his mortgage trading department made more money that year than the rest of Wall Street combined *in all their businesses.*” (Ibid: 90)

Salomon received a windfall by being in the right place at the right time; but now they had to find a way to sell the mortgages. Its traders and lawyers then took the lead in setting up the new market, which other companies soon rushed to join. These private entrepreneurs worked on a variety of fronts to address problems, sometimes securing Ginnie Mae guarantees, other times advancing changes in the technology of securitization, to make it easier to securitize without government support. But they may never have had a chance to do this if not for that specific convergence of regulatory and Fed policy that triggered the thrifts to sell their assets at a loss. This is not to say that a

market for securitized bonds would have never been successful without this particular chain of events; but it is nevertheless through this strange convergence of policies that the market for securitized bonds first took off in America. In this instance the unintended consequence of policy feedback was of utmost importance.

This is an important facet of how the state affected the emergent securitization market, but only one aspect. I will show in the next section that it was the State's efforts to promote the housing market years earlier which had given rise to the very mortgage bonds off of which Solomon later made a killing.

The State and Housing Finance

The modern securitization market grew out of the federal government's very directive entrepreneurial effort to increase homeownership among its citizens by solving longstanding problems in the housing finance (Sellon and VanNahmen 1988, Maisel Papers).⁴ The importance of this effort, and the significant resources it would require, is reflected in a speech that Robert Weaver, then Secretary of the U.S. Department of Housing and Urban Development, gave in November of 1966:

A balanced housing supply is not a solution in itself. . . It is a framework for our society. It is the bricks and mortar base for a broad variety of services necessary for our people in this day and this century. Nevertheless, decent housing conditions are fundamental to a prosperous, educated, healthy citizenry. Housing is a beginning, it is a foundation upon which the nation can continue to upgrade itself and satisfy the promise of America.

In order to accomplish this goal over the next decade, we will need to erect some 21.4 million units . . .

⁴ Indeed, the history of housing finance in the U.S. may alone stand as a testimony to U.S. government's capacity for intervening in its markets. For the purposes of this study, however, I will focus on securitization.

Reaching this goal would not be easy, for by the late 1960s policy makers and academics had identified a host of problems with housing finance. Some noticed that the thrift system resulted in an inefficient patchwork of local markets. Others worried that the thrifts were not large enough to meet the needs of the growing market; demand for new mortgages was high, and was expected to rise as the baby boomers settled down and had children (Ranieri 1996). These problems loomed even before rising interest rates triggered a full-fledged crisis for the thrifts. Still, by 1966 these main housing lenders in the U.S. were weathering a set of escalating troubles. If the government agency Fannie Mae was to fulfill its function of purchasing mortgages during market down-turns, it would mean that the government would absorb millions and even billions of debt into a budget already strained by the Vietnam War.⁵

Thus in the late 1960s, before the full extent of the problems with the thrifts had been realized, the federal government sought to increase the pool of money available to potential home owners without taking on additional debt itself, a key concern as wartime debts continued to balloon. To deal with this, the Interagency Committee on Housing Finance was convened in 1966, and it was followed by the Mortgage Finance Task Force in 1967. The latter, led by the Federal Reserve Governor Sherman Maisel and James Dusenberry of the Council of Economic Advisors, decided that the preferred solution would be to bolster the troubled secondary market for mortgages. This would allow the

⁵ Memos between government officials working on this at the time continually reference concerns about the budget and the need to find a solution that would not add to it, that would curtail the expected expenditures by 1969, and that could even reduce the budget deficit. For example, take the Memorandum for Honorable Joseph A. Califorano, Jr. from Charles Zwick, James Dusenberry, Fred Bohn, December 2, 1967: "This is in response to your request that we look intensively at the proposed multi-fold expansion of federally assisted low-income housing, with special attention all possible ways of reducing the minimum, or eliminating its immediate impact on the federal budget. " From the private papers of Sherman Maisel, Member of the Board of Governors of the Federal Reserve System. As part of my ongoing research I am investigating the extent and ways in which pressures created by the Vietnam war influenced the changes in housing finance that I outline below.

federal government to sell off the mortgages on its own books, and help other lenders do the same (Sellon and VanNahmen 1988, Green and Wachter 2005). The goal was to free up capital held in reserves by private companies, generate new capital from sales to increasingly important investors like mutual and pension funds, and thereby create efficiencies, savings, and new sources of capital that could be passed on to homebuyers (Sellon and VanNahmen 1988).

Thus the federal government undertook sweeping housing regulation reform from 1968 to 1970, which began with the privatization of Fannie Mae and two-years later resulted in the creation of the first modern securitization instruments. In a move that may be indicative of a shift away from more directive or developmental action and towards a more hands-off facilitative state entrepreneurship, in 1968 Fannie Mae was privatized but given special privileges in exchange for following a governmental charter to support the housing market. Fannie Mae had long been in the business of providing stability for the housing market by way of promoting the secondary one – specifically, it purchased mortgages during market downturns, which the U.S. was then facing for the foreseeable future. However, going forward it would do so as a private entity. To make sure that the newly-private agency was successful, Ginnie Mae was created in 1968 as a new governmental agency that would officially support the market on behalf of the federal government, mostly by providing guarantees for governmental debt held by and sold through Fannie Mae. Even as the government took steps away from direct ownership of mortgages, it found it needed to maintain a directive presence in order to secure investor confidence, and the step towards privatization of this governmental agency was offset by a complex set of governmental protections. Two years later (in 1970) Freddie Mac was

created as a private entity modeled after Fannie Mae. Given a similar charter and privileges, it was to compete with Fannie Mae and help create a secondary market for commercial mortgages.

Of course, the extent to which either Fannie Mae or Freddie Mac is truly private is debatable. As Government Sponsored Entities (GSEs) both follow a congressional charter that requires them to support the secondary market for housing by promoting liquidity and stability. Their debt and obligations are not backed by the U.S. government, but they have special privileges and tax exemptions, “conditional access” to a \$2.5 billion line of credit from the government, and are directly regulated by a special office in HUD (the SEC only received authority over them in 2003 after a set of scandals). Moreover, that their debt commonly trades at the level of government bonds suggests that investors believe that they are simply too big and important for the U.S. government to ever let fail. In this way they may carry an implicit, though not legal, guarantee by the U.S. government. The hybrid public-private nature of the GSEs are perhaps, then, best thought of the place where directive and facilitative action meet for the U.S. government.

It was within this configuration of public and semi-private agencies that the securitization market was first established. The idea for the first modern securitization deals had been hatched by the government’s experts in the Mortgage Finance Task Force in 1967 (Maisel Papers). They started with the idea of auctioning off Fannie Mae’s mortgages and spent a good year figuring out how to make such a plan work, and decided in the process that some sort of government guarantee was crucial in order to secure investor confidence. Their efforts came to fruition when the first mortgage-backed security was issued in 1970; a group of mortgages backed by the FHA and VA were

given a government guarantee of timely payment by Ginnie Mae and sold off on the capital markets (Sellon and VanNahmen 1988). These deals were called *pass-throughs*, as the ownership of the mortgages was literally transferred to the investors along with their payments. Investors were mainly the thrifts, private banks, and insurance companies. They had been enticed with a chance to take a position in the housing market without taking any credit risk.

There were, however, significant limitations to the use of pass-throughs,⁶ and throughout the seventies officials at Ginnie Mae and executives at Fannie Mae and Freddie Mac worked closely with investment bankers to develop new financial instruments that solved these problems. As a result, Mortgage-Backed Bonds (MBS) emerged in 1977 with new forms of collateral and credit enhancements, and in 1983 entrepreneurs created the first securitization structures with tranches, called Collateralized Mortgage Obligations (CMO).⁷ These multi-class issues were incredibly flexible and incredibly successful. Michael Lewis writes, “The CMO burst the dam between several billion investable dollars looking for a home and nearly two trillion

⁶ One concern was that most outstanding mortgages at the time had been issued by the thrifts. However, the thrifts couldn't afford to do pass-throughs themselves. They faced significant tax and regulatory hurdles (Ranieri 1996). More importantly, in order to legally create a pass-through a company had to sell these assets to investors, but the thrifts' assets were mostly made up of long term mortgages held at fixed rates that were lower than the high nominal interest rates of the inflation-plagued decade. To sell them meant taking massive losses (Sellon and VanNahmen 1988). Potential investors at mutual and pension funds also didn't like the timing of the payments, which clashed with their own bookkeeping and reporting schedules. The legal terms of the sale, however, required that the payments flow directly through to the investors, so this could not legally be changed without invalidating the entire deal structure. And often they would solve one set of problems only to run into a new set of hurdles.

⁷ Of these, Ranieri (1996) notes: “The CMO concept is very simple. Rather than look at a mortgage pool as a single group of thirty-year mortgages, the CMO concept approaches it as a series of unique annual cash flows each year for the next thirty years. It recognizes that cash flows are higher in the early years of the pool, and they can be carved up into separate tranches with a whole range of securities from one to thirty years. Each tranche can then carry a separate coupon priced at a spread off treasuries with the same maturity.” (37) Ranieri also notes that after developing these structures the deal makers realized that this technology had already existed in the form of serial bonds in the municipal bond industry (36). Thus although this technique had already existed it had been overlooked for these purposes.

dollars of home mortgages looking for an investor.” (1989: 136) Over the following decades, deals would be parsed in increasingly complicated ways; many would have over 40 different classes of debt, and at least one contained more than 90 tranches (Kendall 1996; Kochen 1996: 109). Soon new kinds of investors were entering the market (Sellon and VanNahmen 1988), reportedly attracted by instruments designed with their preferences in mind (Ranieri 1996; Fink 1996). Within 25 years, the financial structures proposed by the government officials in the Mortgage Finance Task Force – and initially bolstered with government guarantees through Ginnie Mae – grew into a multi-trillion dollar trade of sometimes staggeringly complex instruments.

The State and the Pricing Mechanism

Throughout the 1970s entrepreneurs took a progressively larger role in directing the market for securitized bonds. However, the governmental housing agencies remained an important ally and protector of the market who would step in when the market threatened to stumble. Lewis Ranieri (1996) offers what I think is a particularly revealing account of the government’s role throughout the market’s adolescence. He reports that figuring how to price securitized these bonds had been a problem throughout the 1970s because no one had a reliable estimate on the prepayment rates for the underlying mortgages.⁸ A solution for this was eventually cobbled together with contributions from

⁸ Prepayment risk is the likelihood that a debtor will repay an outstanding obligation earlier than expected. This introduces uncertainty into when the investment will actually pan out. To make matters worse, debtors are more likely to refinance mortgages when rates are low, which means that the lenders are stuck needing to reinvest precisely when there are lower interest rates. In fact, we can trace the reason why prepayment risk is such a large problem in mortgage markets back to the depression (Sellon and VanNahmen 1988). Before the 1930s most mortgages were under 10 years in length, negotiated yearly and had variable rates (Green and Wachter 2005). This became a significant problem during the depression because the Savings and Loans (also called “thrifts”) opted not to renew most of these mortgages (Sellon and VanNahmen 1988), leading to widespread foreclosures: up to 10% at the height of the depression (Ibid. 94). As part of

experts working in a variety sectors, but it was government agency Ginnie Mae who took the lead in the beginning, devising a formula that was used for a decade. It offered a pricing assumption that somewhat fantastically assumed that all loans in a pool would be paid in full on the first day of their 13th year. While no one in the market thought it was accurate, it was considered good enough to allow these deals to be traded (Ranieri 1996: 35). Later pricing innovations came from within the investment banks and academia; notably, Helen Peters wrote a dissertation in 1979 that offered a more realistic estimate of pre-prepayment rates (Ibid: 33). But the crucial lesson here is that when a core market mechanisms threatened to fail, the government was able to step in and allow it to work almost solely based on the power of its legitimacy. Here the government stepped into what is traditionally considered an entrepreneurial function in order to nurse the market when it threatened to fail.

Fourcade argues that sociologists should study prices not as indicators of demand and utility but as “technological artifacts.” That is, we should see prices as human inventions that don’t simply reflect latent utility values, but are the very means by which value is socially constructed as calculable: this, she points out, is the most fundamental condition of possibility for markets to flourish. The discipline of economics plays a crucial role here, she argues. It creates tools of calculability for people to use, and so creates a world that is rife with calculability; however, market participants often misrecognize these systems of calculability and commensuration as a natural and preexisting thing, as opposed to something they created. Ginnie Mae’s involvement with setting the prepayment assumptions necessary for pricing MBS not only underscores the

its response to this crisis, the federal government supported a 30 year standard mortgage contract. These longer contracts promoted stability and made mortgages more affordable to home buyers, but the long tenure of the mortgages also increased the prepayment risks associated with them (Ibid).

central importance of the pricing mechanism for the existence of markets, but also suggests that the government may play a larger role here than is often imagined.

Conclusion

There are many ways that the U.S. government contributed to the rise of the modern market for securitization, and not all of them were intentional. Regulation Q, the Fed's 1979 short term interest rate hike, and a bungled set of tax reforms in 1981 converged in a way that was catastrophic for the thrifts but provided a much needed shot in the arm for a struggling mortgage bonds market. But the government's influence here goes far beyond the effects of policy feedback. The U.S. government participated in the burgeoning market for securitization not only in fragmented ways, but in specifically entrepreneurial ones. The government crafted and then backed the first securitization deals, which were invented in order to protect and promote home-ownership by creating a robust secondary market for mortgages. In this way, the current U.S. secondary market for mortgages was deliberately planned for and set up by the state. And even as the state receded from the market and left it to private entrepreneurs to develop, three agencies – one public (Ginnie Mae) and two semi-private (Fannie Mae and Freddie Mac) – were left to watch over the secondary market and assure its success. Thus when traders struggled to price their deals, Ginnie Mae stepped in and provided prepayment assumptions that would underscore MBS prices for over a decade.

These findings are preliminary, but I believe they are nevertheless useful for thinking through key questions in institutional theory; questions about the complexity of government and contingency of outcomes, and about the nature of the relationship

between the state and the market. In housing finance in general, and securitization in particular, the U.S. government has not only been a multifaceted state – it has also taken on characteristics of an entrepreneurial and developmental one. This suggests that when we think of the entrepreneurial capacity of the state we should not think of this as something done by some states and not others, but rather consider this in terms of a spectrum of activities. It follows that we should take seriously the capacity for direct forms of economic intervention and state entrepreneurship in the U.S.

Finally, I believe this discussion has implications for how we study not just states and markets, but how we think about securitization. In the aftermath of the mortgage market meltdown securitization has received a great deal of attention in the press, but often in the absence of an understanding of its political and financial roots in the late 1960s and early 1970s. This study suggests that as we consider how the government and business community should respond to the ever-worsening subprime housing crisis, we also should reflect on how they helped create it.

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