Government Housing Policy and the Financial Crisis

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It is popular around the world to blame the financial crisis on the United States. But before we identify this as the usual anti-Americanism, we should perhaps look more seriously at our country's housing policies. Unfortunately, there is a strong argument that the financial crisis is indeed the fault of the United States—an artifact of the housing policies that this country has followed since the early 1990s. These policies produced an unprecedented number of subprime and other nonprime mortgages (known as Alt-A), and when the housing bubble topped out in late 2006 and early 2007, these loans began to default at unprecedented rates. In my view, the severe losses associated with these defaults caused weakness of Bear Stearns and AIG—resulting in their rescue—the failure of Lehman Brothers, the severe recession we are experiencing in the United States today, and ultimately the financial crisis itself.

Before proceeding, I should define some terms. A subprime loan is generally one in which the borrower has blemished credit, usually measured by a FICO credit score. The traditional dividing line between a subprime and a prime loan is a 660 FICO. An Alt-A loan is not a prime loan, even if the FICO score is above 660, because there is some deficiency in the loan itself. Alt-A loans, for example, have low downpayments (i.e., high loan-to-value ratios), low or no documentation concerning income or employment, negative amortization features, and other deficiencies that make them more likely to

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Cato Journal, Vol. 30, No. 2 (Spring/Summer 2010).

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default than prime loans. In the current crisis, indeed, Alt-A loans are defaulting at rates roughly equivalent to subprime loans.

The Obama Administration's Narrative

The idea that weak or junk mortgages might be the source of the financial crisis is not widely understood. The Obama administration and most of the media have blamed the crisis on the usual suspects—lack of regulation or inadequate regulation, particularly at the mortgage origination level, but also the result of greed on Wall Street. In this narrative, unregulated mortgage brokers produced some undefined number of subprime loans through predatory lending to unwitting homebuyers. The president himself has said that this kind of lending was in part the cause of the financial crisis. This focus on the lack or insufficiency of regulation has produced the predictable response: the administration has recommended, and the Democrats in Congress have largely endorsed, a regulatory "reform" program that would extend bank-like regulation to the entire financial market. Large nonbank financial institutions—securities firms, insurance companies, holding companies of various kinds, hedge funds, finance companies and others—designated as "systemically significant"—would in the administration's plan be subjected to special regulation by the Federal Reserve and, if they fail, to a special government resolution regime, outside the bankruptcy system.

The consequences of this for our economy will be dire. Designating firms in advance and regulating them in special ways will be a signal to the market that they are too big to fail. This will give these firms advantages in raising capital and borrowing in the credit markets. Like Fannie Mae and Freddie Mac, they will be seen as government-backed. This will not only create moral hazard, but will also have serious anti-competitive effects in any of the markets in which these systemically significant firms compete. Like Fannie and Freddie, with their perceived government backing, these firms will be able to drive their smaller rivals out of any market they enter, or force consolidations so that the large companies that result will also be seen as too big to fail.

The special resolution system that the administration has proposed will also have severe adverse consequences. Since there is no way to know whether the failure of a particular firm will bring about the systemic breakdown that is implied by the term "systemically significant," giving the government the authority to take over and unwind or stabilize any firm that might cause a systemic breakdown will be a license to interfere in the creative destruction by which our economy progresses. Good business models succeed and bad ones fail, but when the government is in a position to pick the winners and losers large and politically powerful companies will always get government support, while small and politically unconnected firms will go to bankruptcy. Even apart from the inevitable politics, a system in which the government is in a position to treat the creditors of large companies differently from the creditors of small ones will inevitably give the large companies an advantage over small ones in raising capital. Fannie Mae and Freddie Mac are the poster children for this phenomenon; their implicit government backing enabled them to drive all competition out of the secondary market for middle-class mortgages. Over time, our financial system will become dominated by large firms that are wards of the government and respond to political rather than economic stimuli. This is where the Obama administration's narrative about the causes of the financial crisis ultimately leads.

What Really Happened: CRA and the Affordable Housing Mission for Fannie Mae and Freddie Mac

But there is an alternative explanation for the financial crisis, and it focuses on the U.S. government's housing policies under both the Clinton and second Bush administrations. Beginning in the early 1990s—in order to enable more Americans to buy homes—the government began to press housing lenders such as banks and the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac to reduce the requirements for a mortgage so that more Americans would be able to buy homes. The first step in this direction was Congress's enactment in 1992, near the end of the first Bush administration, of an affordable housing "mission" for Fannie Mae and Freddie Mac. These two firms were originally established to purchase loans from originators—banks, mortgage banks, and mortgage brokers—and in that way help to create a secondary market in mortgages. Eventually, Fannie and Freddie would either hold these mortgages in their portfolios or sell them off to investors as mortgage-backed securities (MBSs). Affordable housing loans were defined as mortgages for buyers who were at or below the median income, and the Department of Housing and Urban Development (HUD) was given authority to administer the affordable housing regulations that implemented the congressional mandate.

Initially, the regulations required that at least 30 percent of the mortgages that the GSEs would buy had to be affordable housing loans, but over time this requirement was ratcheted up so that by 2007 the requirement was that 55 percent of all mortgages purchased by the GSEs had to be "affordable," with a sublimit of 25 percent that were required to be mortgages made to low or very low income homebuyers. In order to meet these goals, Fannie and Freddie were expected to "lead the industry in making mortgage credit available to low and very low income families." Over time, pressure from ever increasing affordable housing goals forced a profound weakening of the GSEs' credit culture.

At around the same time in the early 1990s, the regulations under the Community Reinvestment Act (CRA) were amended to increase their influence on bank mortgage lending. The CRA had been adopted in 1977, and initially required that banks make efforts to increase mortgage lending in all the communities they serve, not just the communities where middle income or well-to-do families lived. The enforcement mechanism was the withholding of regulatory approval for mergers, expansions, or other matters if a bank had not shown that it was working to achieve the CRA's goals. In 1995, however, the rules were tightened, so that banks had to show that they had actually made the required loans, not that they were simply trying to do so. The change had a profound effect. Under the initial rule, banks could turn down applicants who did not have the necessary credit resources—such as a significant downpayment or a job—but under the new regulations the onus was put on the banks to find a way to make the loan, even if it did not meet their lending standards. The phrase in the CRA regulations was that banks had to be "flexible or innovative" in their underwriting. From the point of view of the banks, their lending standards had to be loosened. They had to show that the mortgages were being made.

CRA's overall effect on the banking industry was hugely magnified by the incentives inherent in the enforcement mechanism. The fact that banks had to have strong CRA records in order to gain regulatory approvals created a point of leverage for community groups, of which ACORN was one of the most vocal and successful. When a big bank wanted to merge with another bank, or expand its activities in some other way that required regulatory approval, it could ensure that the regulators would have no objections on CRA grounds by committing to make a specified amount of CRA loans in an agreement with community groups. The numbers here were very large, dwarfing the amounts of CRA loans that were produced by community banks in their local service areas. According to the National Community Reinvestment Coalition's 2007 annual report, the group succeeded in getting commitments for CRA-type mortgages and other lending that exceeded $4.5 *trillion* between 1997 and 2007. Another $1trillion was committed by Countrywide, the first national lender to sign HUD's CRA-like Declaration of Fair Lending Principles and Best Practices in 1994. Ninety-four percent of all announced CRA/HUD commitments can be traced to Countrywide and the four largest U.S. banks—Bank of America, Citigroup, JPMorgan Chase, and Wells Fargo, including the banks they later acquired. In order to deliver on these massive commitments, these banks changed their credit culture and underwriting standards so that they could approve CRA-compliant loans with the "flexible or innovative" underwriting standards that the bank regulators requested.

Recent research by Edward Pinto (2008a, 2008b)—an expert in this field—has shown that, largely due to the banks' commitments, over $3.5 trillion in single-family CRA loans were originated from 1993 to 2007. About half of these loans went to Fannie and Freddie, to meet their affordable housing requirements; about 10 percent were insured by the Federal Housing Administration; about 10 percent were sold as private mortgage-backed securities (PMBSs), and most of the rest remained on the balance sheets of the four largest U.S. banks. While it's difficult to find data on how these CRA loans have performed, the few bank reports that break out these loans show much higher default rates than prime loans. Pinto's research indicates that Fannie and Freddie's affordable housing loans are a good proxy for CRA loans performance. For example, Fannie's delinquency rate on its $900 billion in high-risk loans, 85 percent of which are affordable housing loans, was 11.36 percent at September 30, 2009—about 6.5 times the 1.8 percent delinquency rate on the GSEs' traditionally underwritten loans. While the vast majority of

CRA loans were fixed rate and did not have higher interest rates like other subprime loans, Pinto's research has found that most had high-risk characteristics such as small downpayments and impaired credit, signaled by a low borrower FICO score. As a result, loans with these high-risk characteristics have performed similarly to fixed rate subprime loans.

Perhaps more important in its implications for the financial crisis, Fannie and Freddie did not report that their mortgages were subprime and Alt-A. So instead of the 12 million prime loans market participants expected, Fannie and Freddie had added 12 million subprime and Alt-A loans to the market. When these loans began to fail at higher rates than expected, investors and other participants lost confidence in the data and the rating agencies, causing the collapse of the market for PMBSs and other asset-backed securities. This was an unprecedented event that precipitated the financial crisis.

So, by the middle of 2008, there were almost 27 million subprime and Alt-A loans in the U.S. financial system. This amounted to almost 50 percent of all mortgages. More than two-thirds of these mortgages were held or guaranteed by government agencies like FHA (about 4.8 million), and the GSEs Fannie and Freddie (12 million loans), and by U.S. banks (a residual of about 2.2 million) that were required to make them under the CRA. This is a vitally important fact, because it shows that the underlying cause of the large number of subprime and Alt-A mortgages in our economy was not the lack of regulation at the origination level but the government's own demand for these loans.

The Recession and Financial Crisis

The connection between the current recession and the government's housing policies is clear. Because the U.S. government has made good on what had previously been only an implicit guarantee of the GSEs' obligations, the loans bought and securitized by Fannie and Freddie did not cause losses to investors or to the financial institutions that held them. The same is true of the mortgages guaranteed by FHA and securitized by Ginnie Mae. Again, although these are defaulting at high rates, the losses will be for the account of the taxpayers. This does not mean, however, that the defaulting mortgages had no effect on the U.S. economy. Although investors were protected if they held Fannie or Freddie MBSs, the homeowners who couldn't meet their mortgage obligations were not. These defaults had major effects on housing prices, consumer confidence, consumer purchasing power, and neighborhoods. The huge default rates at the consumer level added substantially to and may have been the principal cause of the current recession.

The connection between these subprime and Alt-A loans and the financial crisis is somewhat more complex than their relationship to the recession. Obviously, the decline in housing values and consumer purchasing power had an adverse feedback effect on the health of commercial banks of all sizes that had made loans to the small and large businesses now beset with losses, and to the real estate developers and other businesses that relied on a growing housing market. Commercial and residential real estate loans are by far the largest component of bank assets, exceeding 55 percent of all bank loans in 2008, and as the values of commercial and residential real estate declined so did the health of the banks, large and small, that were heavily invested in these loans.

But there were other and more direct relationships between the growth of subprime and Alt-A loans and the financial crisis. First, the sharp increase in the number of potential home buyers made possible by the growth of subprime and Alt-A lending drove up the U.S. housing bubble to unprecedented size. Real home prices in the U.S. increased 80 percent between 1997 and 2006, far higher than in any other previous housing bubble. Thus, when the collapse came, it was far steeper and more destructive than any previous bubble collapse.

In addition, and perhaps more important, Fannie and Freddie's failure to accurately report their loans may have overturned market expectations about the delinquency and default rates that could be expected when the inevitable collapse of the bubble occurred. About seven and a half million subprime and Alt-A mortgages were securitized by Wall Street investment banks and were outstanding when concern about the deflating housing bubble in the U.S. reached a high level in mid-2007. Securitizing subprime loans had always been a Wall Street specialty because Fannie and Freddie dominated the market for prime loans and drove Wall Street investment banks into the more risky sectors of the market in order to maintain a foothold in the secondary mortgage market. Unlike investors in Fannie and Freddie MBSs, investors in these securitized mortgage loans were not assuming that the MBSs would ultimately be backed by the U.S. government. PMBSs were issued in structured transactions, in which the top tiers were rated AAA by rating agencies because it was not expected—given the composition of the mortgages in the pool—that losses would ever be so great that they would invade the AAA tranches. When investors around the world—banks and other financial intermediaries—bought these AAA-rated MBSs they were assuming that the high-yielding subprime loans in the pools were a small portion of the total number of U.S. mortgages, and that when they failed it would be at rates that would not exceed historical levels. This was a reasonable assumption, because no one knew at the time that Fannie and Freddie had made over a trillion dollars in subprime and Alt-A loans that were reported as prime loans.

This fact may have had a profound effect on the financial markets. Housing market observers, investors, and the rating agencies had assumed that subprime and Alt-A loans would become delinquent and default at higher rates than prime loans, but at roughly the rates that had occurred in the past. They also assumed that, given default, the severity of loss would be within the historical range for the number of high-risk loans thought to be outstanding. These assumptions were completely overturned by the fact that there were many more subprime and Alt-A loans outstanding than had been reported. These loans were probably defaulting at the expected rates, but because there were so many more of them than anticipated their defaults drove down housing prices further and faster than in the past—not only increasing the number of additional delinquencies and defaults but also the severity of the losses that were associated with the defaults that occurred. Data on delinquencies and defaults are published quarterly for all mortgages in the U.S. by the Mortgage Bankers Association, and in late 2006 and early 2007 began to show rapidly increasing rates of delinquency and default, both in the high-risk categories and among the loans that had been reported as "prime" by Fannie and Freddie. These were much higher rates than would have been expected in a mortgage market that was thought to contain only a relatively small percentage of subprime or Alt-A loans, and they implied that losses might extend into the AAA tranches of the outstanding PMBSs, causing sharp downgrades in the ratings for these securities. The result, beginning in 2007, was a collapse of confidence in outstanding PMBSs and other asset-backed securities. By the end of 2007, the PMBSs and the asset-backed securities market generally had stopped functioning.

This was an unprecedented event. It meant that PMBSs could not be sold except at distress prices. The asset writedowns that were then required raised questions about the financial condition of the banks and other financial institutions that held these securities. Many were believed to be insolvent. This provoked a market panic in which investors and counterparties began to withdraw financial support from the institutions thought to be in the most trouble. The first of these was Bear Stearns, the smallest of the five large Wall Street investment banks. It had invested heavily in PMBSs and put clients into funds that were quickly losing value. In order to prevent its collapse, Bear Stearns was rescued by the government in March of 2008. During the next six months, the market watched growing losses in housing, while the market for PMBSs and other asset-backed securities remained closed. Uncertainty about the financial condition of the next largest investment bank, Lehman Brothers, provoked a run on its securities. When Lehman was not rescued, even though it was larger than Bear Stearns, shocked market participants realized that they now had to know the true financial condition of all their counterparties. The freeze-up in financial markets that resulted is what is known as the financial crisis.

Conclusion

Accordingly, a strong argument can be made that the financial crisis was not caused by unregulated mortgage brokers, or by the rating agencies, the Wall Street investment banks, or the commercial banks that eventually had to be rescued with taxpayer funds. The responsible parties were those who made and sustained government policies that distorted the housing finance market—resulting in the creation of an unprecedented number of high-risk mortgages. Fault also rests with the management of Fannie Mae and Freddie Mac, who failed to disclose that they were complying with government requirements by acquiring and securitizing vast numbers of high-risk mortgages.

References

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