

# The True Origins of This Financial Crisis

As opposed to a desperate liberal legend.

By Peter J. Wallison



**T**WO NARRATIVES SEEM TO BE FORMING to describe the underlying causes of the financial crisis. One, as outlined in a *New York Times* front-page story on Sunday, December 21, is that President Bush excessively promoted growth in home ownership without sufficiently regulating the banks and other mortgage lenders that made the bad loans. The result was a banking system suffused with junk mortgages, the continuing losses on which are dragging down the banks and the economy. The other narrative is that government policy over many years—particularly the use of the Community Reinvestment Act and Fannie Mae and Freddie Mac to distort the housing credit system—underlies the current crisis. The stakes in the competing narratives are high. The diagnosis determines the prescription. If the *Times* diagnosis prevails, the prescription is more regulation of the financial system; if instead government policy is to blame, the prescription is to terminate those government policies that distort mortgage lending.

There really isn't any question of which approach is factually correct: right on the front page of the *Times* edition of December 21 is a chart that shows the growth of home ownership in the United States since 1990. In 1993 it was 63 percent; by the end of the Clinton administration it was 68 percent. The growth in the Bush administration was about 1 percent. The *Times* itself reported in 1999 that Fannie Mae and Freddie Mac were under pressure from the Clinton administration to increase lending to minorities and low-income home buyers—a policy that necessarily entailed higher risks. Can there really be a question, other than in the fevered imagination of the *Times*, where the push to reduce lending standards and boost home ownership came from?

The fact is that neither political party, and no administration, is blameless; the honest answer, as outlined below, is that government policy over many years caused this problem. The regulators, in both the Clinton and Bush administrations, were the enforcers of the reduced lending standards that were essential to the growth in home ownership and the housing bubble.

**T**HERE ARE TWO KEY EXAMPLES of this misguided government policy. One is the Community Reinvestment Act (CRA). The other is the affordable housing “mission” that the government-

sponsored enterprises (GSEs) Fannie Mae and Freddie Mac were charged with fulfilling.

As originally enacted in 1977, the CRA vaguely mandated regulators to consider whether an insured bank was serving the needs of the “whole” community. For 16 years, the act was invoked rather infrequently, but 1993 marked a decisive turn in its enforcement. What changed? Substantial media and political attention was showered upon a 1992 Boston Federal Reserve Bank study of discrimination in home mortgage lending. This study concluded that,

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while there was no overt discrimination in banks' allocation of mortgage funds, loan officers gave whites preferential treatment. The methodology of the study has since been questioned, but at the time it was highly influential with regulators and members of the incoming Clinton administration; in 1993, bank regulators initiated a major effort to reform the CRA regulations.

In 1995, the regulators created new rules that sought to establish objective criteria for determining whether a bank was meeting CRA standards. Examiners no longer had the discretion they once had. For banks, simply proving that they were looking for qualified buyers wasn't enough. Banks now had to show that they had actually made a requisite number of loans to low- and moderate-income (LMI) borrowers. The new regulations also required the use of “innovative or flexible” lending practices to address credit needs of LMI borrowers and neighborhoods. Thus, a law that was originally intended to encourage banks to use safe and sound practices in lending now required them to be “innovative” and “flexible.” In other words, it called for the relaxation of lending standards, and it was the bank regulators who were expected to enforce these relaxed standards.

The effort to reduce mortgage lending standards was led by the Department of Housing and Urban



Development through the 1994 National Homeownership Strategy, published at the request of President Clinton. Among other things, it called for “financing strategies, fueled by the creativity and resources of the private and public sectors, to help homeowners that lack cash to buy a home or to make the payments.” Once the standards were relaxed for low-income borrowers, it would seem impossible to deny these benefits to the prime market. Indeed, bank regulators, who were in charge of enforcing CRA standards, could hardly disapprove of similar loans made to better-qualified borrowers.

Sure enough, according to data published by the Joint Center for Housing Studies of Harvard University, from 2001 through 2006, the share of all mortgage originations that were made up of conventional mortgages (that is, the 30-year fixed-rate mortgage that had always been the mainstay of the U.S. mortgage market) fell from 57.1 percent in 2001 to 33.1 percent in the fourth quarter of 2006. Correspondingly, sub-prime loans (those made to borrowers with blemished credit) rose from 7.2 percent to 18.8 percent, and Alt-A loans (those made to speculative buyers or without the usual underwriting standards) rose from 2.5 percent to 13.9 percent.

Although it is difficult to prove cause and effect, it is highly likely that the lower lending standards required by the CRA influenced what banks and other lenders were willing to offer to borrowers in prime markets. Needless to say, most borrowers would prefer a mortgage with a low down payment requirement, allowing them to buy a larger home for the same initial investment.

The problem is summed up succinctly by Stan Liebowitz of the University of Texas at Dallas:

*From the current handwringing, you'd think that the banks came up with the idea of looser underwriting standards on their own, with regulators just asleep on the job. In fact, it was the regulators who relaxed these standards—at the behest of community groups and “progressive” political forces....For years, rising house prices hid the default problems since quick refinances were possible. But now that house prices have stopped rising, we can clearly see the damage done by relaxed loan standards.*

The point here is not that low-income borrowers received mortgage loans that they could not afford.

That is probably true to some extent but cannot account for the large number of sub-prime and Alt-A loans that currently pollute the banking system. It was the spreading of these looser standards to the prime loan market that vastly increased the availability of credit for mortgages, the speculation in housing, and ultimately the bubble in housing prices.

**I**N 1992, AN AFFORDABLE HOUSING MISSION was added to the charters of Fannie and Freddie, which—like the CRA—permitted Congress to subsidize LMI housing without appropriating any funds. A 1997 Urban Institute report found that local and regional lenders seemed more willing than the GSEs to serve creditworthy low- to moderate-income and minority applicants. After this, Fannie and Freddie modified their automated underwriting systems to accept loans with characteristics that they had previously rejected. This opened the way for large numbers of nontraditional and sub-prime mortgages. These did not necessarily come from traditional banks, lending under the CRA, but from lenders like Countrywide Financial, the nation's largest sub-prime and nontraditional mortgage lender and a firm that would become infamous for consistently pushing the envelope on acceptable underwriting standards.

Fannie and Freddie used their affordable housing mission to avoid additional regulation by Congress, especially restrictions on the accumulation of mortgage portfolios (today totaling approximately \$1.6 trillion) that accounted for most of their profits. The GSEs argued that if Congress constrained the size of their mortgage portfolios, they could not afford to adequately subsidize affordable housing. By 1997, Fannie was offering a 97 percent loan-to-value mortgage. By 2001, it was offering mortgages with no down payment at all. By 2007, Fannie and Freddie were required to show that 55 percent of their mortgage purchases were LMI loans and, within that goal, 38 percent of all purchases were to come from underserved areas (usually inner cities) and 25 percent were to be loans to low-income and very-low-income borrowers. Meeting these goals almost certainly required Fannie and Freddie to purchase loans with low down payments and other deficiencies that would mark them as sub-prime or Alt-A.

The decline in underwriting standards is clear in the financial disclosures of Fannie and Freddie.

From 2005 to 2007, Fannie and Freddie bought approximately \$1 trillion in sub-prime and Alt-A loans. This amounted to about 40 percent of their mortgage purchases during that period. Moreover, Freddie purchased an ever-increasing percentage of Alt-A and sub-prime loans for each year between 2004 and 2007. It is impossible to forecast the total losses the GSEs will realize from a \$1.6 trillion portfolio of junk loans, but if default rates on these loans continue at the unprecedented levels they are show-

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ing today, the number will be staggering. The losses could make the \$150 billion S&L bailout in the late 1980s and early 1990s look small by comparison.

The GSEs' purchases of sub-prime and Alt-A loans affected the rest of the market for these mortgages in two ways. First, it increased the competition for these loans with private-label issuers. Before 2004, private-label issuers—generally investment and commercial banks—specialized in sub-prime and Alt-A loans because GSEs' financial advantages, especially their access to cheaper financing, enabled them to box private-label competition out of the conventional market. When the GSEs decided to ramp up their purchases of sub-prime and Alt-A loans to fulfill their affordable housing mission, they began to take market share from the private-label issuers while simultaneously creating greater demand for sub-prime and Alt-A loans among members of the originator community.

Second, the increased demand from the GSEs and the competition with private-label issuers drove up the value of sub-prime and Alt-A mortgages, reducing the risk premium that had previously suppressed originations. As a result, many more marginally qualified or unqualified applicants for mortgages were accepted. From 2003 to late 2006,

## ORIGINS OF FINANCIAL CRISIS

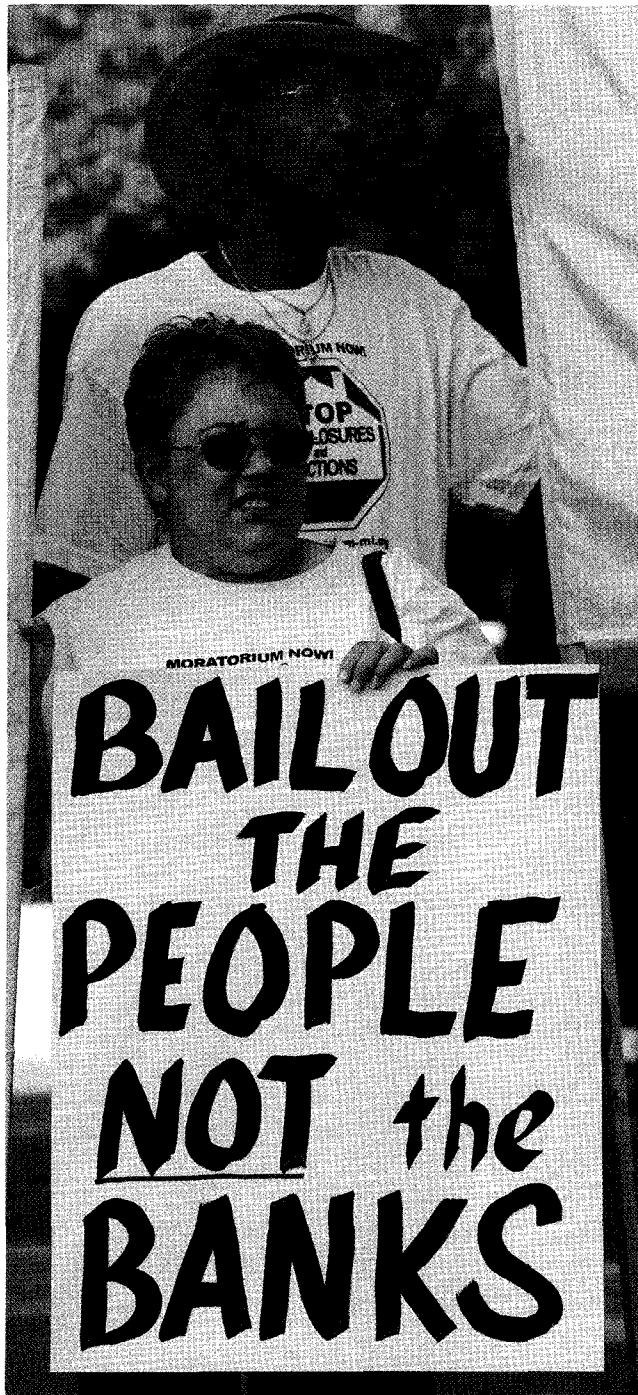
conventional loans (including jumbo loans) declined from 78.8 percent to 50.1 percent of all mortgages, while sub-prime and Alt-A loans increased from 10.1 percent to 32.7 percent. Because GSE purchases are not included in these numbers, in the years just before the collapse of home prices began, about half of all home loans being made in the United States

were non-prime loans. Since these mortgages aggregate more than \$2 trillion, this accounts for the weakness in bank assets that is the principal underlying cause of the current financial crisis.

In a very real sense, the competition from Fannie and Freddie that began in late 2004 caused both the GSEs and the private-label issuers to scrape the bottom of the mortgage barrel. Fannie and Freddie did so in order to demonstrate to Congress their ability to increase support for affordable housing. The private-label issuers did so to maintain their market share against the GSEs' increased demand for sub-prime and Alt-A products. Thus, the gradual decline in lending standards—beginning with the revised CRA regulations in 1993 and continuing with the GSEs' attempts to show Congress that they were meeting their affordable housing mission—came to dominate mortgage lending in the United States.

FEDERAL HOUSING INITIATIVES are not the only culprits in the current mortgage mess—state-based residential finance laws give homeowners two free options that contributed substantially to the financial crisis. First, any homeowner may, without penalty, refinance a mortgage whenever interest rates fall or home prices rise to a point where there is significant equity in the home, enabling them to extract any equity that had accumulated between the original financing transaction and any subsequent refinancing. The result is so-called cash-out refinancing, in which homeowners treat their homes like savings accounts, drawing out funds to buy cars, boats, or second homes. By the end of 2006, 86 percent of all home mortgage refinancings were cash-outs, amounting to \$327 billion that year. Unfortunately, this meant that when home prices fell, there was little equity in the home behind the mortgage and frequently little reason to continue making payments on the mortgage.

The willingness of homeowners to walk away from their “underwater” mortgages was increased by the designation of mortgages as “without recourse” in most states. In essence, non-recourse mortgages mean that defaulting homeowners are not personally responsible for paying any difference between the value of the home and the principal amount of the mortgage obligation, or that the process for enforcing this obligation is so burdensome and time-consuming that lenders sim-



ply do not bother. The homeowner's opportunity to walk away from a home that is no longer more valuable than the mortgage it carries exacerbates the effect of the cash-out refinancing.

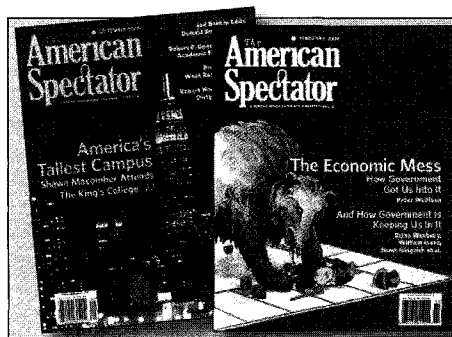
Tax laws further amplified the problems of the housing bubble and diminished levels of home equity, especially the deductibility of interest on home equity loans. Interest on consumer loans of all kinds—for cars, credit cards, or other purposes—is not deductible for federal tax purposes, but interest on home equity loans is deductible no matter how the funds are used. As a result, homeowners are encouraged to take out home equity loans to pay off their credit card or auto loans or to make the purchases that would ordinarily be made with other forms of debt. Consequently, homeowners are encouraged not only to borrow against their homes' equity in preference to other forms of borrowing, but also to extract equity from their homes for personal and even business purposes. Again, the reduction in home equity has enhanced the likelihood that defaults and foreclosures will rise precipitously as the economy continues to contract.

Bank regulatory policies should also shoulder some of the blame for the financial crisis. Basel I, a 1988 international protocol developed by bank regulators in most of the world's developed countries, devised a system for ensuring that banks are adequately capitalized. Bank assets are assigned to different risk categories, and the amount of capital that a bank holds for each asset is pegged to the asset's perceived riskiness. Under Basel I's tiered risk-weighting system, AAA asset-backed securities are less than half as risky as residential mortgages, which are themselves half as risky as commercial loans. These rules provided an incentive for banks to hold mortgages in preference to commercial loans or to convert their portfolios of whole mortgages into an MBS portfolio rated AAA, because doing so would substantially reduce their capital requirements.

Though the banks may have been adequately capitalized if the mortgages were of high quality or if the AAA rating correctly predicted the risk of default, the gradual decline in underwriting standards meant that the mortgages in any pool of prime mortgages often had high loan-to-value ratios, low FICO scores, or other indicators of low quality. In other words, the Basel bank capital standards, applicable throughout the world's developed economies, encouraged commercial banks to hold only a small amount of capital against the risks associated with residential mortgages. As these risks increased because of the decline in lending standards and the ballooning of home prices, the Basel capital requirements became increasingly inadequate for the risks banks were assuming in holding both mortgages and MBS portfolios.

**P**REVENTING A RECURRENCE OF THE financial crisis we face today does not require new regulation of the financial system. What is required instead is an appreciation of the fact—as much as lawmakers would like to avoid it—that U.S. housing policies are the root cause of the current financial crisis. Other players—greedy investment bankers; incompetent rating agencies; irresponsible housing speculators; shortsighted homeowners; and predatory mortgage brokers, lenders, and borrowers—all played a part, but they were only following the economic incentives that government policy laid out for them. If we are really serious about preventing a recurrence of this crisis, rather than increasing the power of the government over the economy, our first order of business should be to correct the destructive housing policies of the U.S. government. ❧

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# Providing Relief From the Crisis

How to spare the economy further crippling government intervention by suspending mark-to-market accounting.

*Our economics editor, Brian Wesbury, has put together this symposium in the hope that the present financial crisis can be relieved without much more pain for the taxpayer. We believe that a major cause of the ongoing credit freeze is mark-to-market accounting rules that the Securities and Exchange Commission could simply suspend. In the following contributions, some of the country's top economic thinkers argue that the government, especially through its enforcement of mark-to-market accounting rules, has deepened and broadened the crisis. In fact, we believe that the current crisis has burned out of control because of the government's obduracy in refusing to admit that its policies have made things worse.*

*In their seminal work, A Monetary History of the United States, Milton Friedman and Anna Schwartz reported that mark-to-market accounting rules caused banks to fail in the Great Depression, not from bad loans, but from writing down bond values at the behest of regulators. And as William Isaac, former head of the FDIC, tells us in his submission, FDR eventually called together a panel in 1938 that suspended those rules. By then the Depression had lasted eight years. We hope our current government leadership understands this history.*

— R. Emmett Tyrrell, Jr.