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On the Issues

Getting the Story Right: The True Origin of the Financial Crisis

One year ago, on September 14, Lehman Brothers declared bankruptcy. The next day the Dow fell five hundred points. Soon thereafter, the government essentially nationalized AIG, made Goldman Sachs and Morgan Stanley into bank-holding companies, and petitioned Congress for aid. In early September, Fannie Mae and Freddie Mac had been placed in government conservatorship. These events followed the bursting of the housing bubble. We present here three essays written by AEI scholars in the spring and summer of 2009 on the origins of the financial crisis whose reverberations we continue to feel today. Vincent R. Reinhart sets the stage by reminding us of the importance of getting the story of what happened right, as policy recommendations flow from our understanding of what occurred. He also tells us that "the narrative first written about the Great Depression was wrong in many important respects." John H. Makin and Peter J. Wallison focus on the misguided policies that contributed to the crisis. In a new Economic Outlook*, Makin discusses three important lessons of the financial crisis that should be understood in order to enable a faster, more effective policy response to future crises.*

The High Cost of Getting the Story Wrong

By Vincent R. Reinhart

The global financial crisis has been with us for more than a year. Despite all its twists and turns, the United States is only now entering the most expensive phase of the crisis. Given the current political climate and widespread misunderstanding of the origins of our problems, the cost is unfortunately going to be very considerable and long lasting.

The most expensive stage of a financial crisis is not the initiating economic loss—in our case, an unsustainable boom in residential construction that left too many houses and a mountain of debt. Nor are the largest losses racked up as investors withdraw from risk, markets freeze, and balance sheets implode. Policy missteps, including the continuing confusion of solvency problems for liquidity ones, no doubt add to the tab. These costs, while they may be big, pale to insignificance compared to what follows.

The most expensive stage of a financial crisis occurs when society tries to explain to itself what just happened. The resulting narrative is not the product of one person or institution. Rather, it gets written in the tell-all "tick-tocks" of major

Key points in this *On the Issues*:

- Determining the true causes of the financial crisis has significant impact on America's response to it.
- Distorted explanations of the financial crisis are pervasive and destructive.
- Government policies, not market failure, were the main causes of the financial crisis.

1150 Seventeenth Street, N.W., Washington, D.C. 20036 202.862.5800 www.aei.org

newspapers, the inside accounts in bestsellers, the speeches of leading officials, and the punch lines of late-night comedians. The narrative determines our attitudes toward the actors and events of the crisis. It also identifies the structural problems thought suitable for legislative and regulatory remedy.

Why are compensation limits on the administration's list of needed reforms? Why has a bipartisan desire for new regulatory powers and additional layers of supervision emerged? Why was it easy to invert the order of debt repayment in the bankruptcy of Chrysler? Indeed, why do, as suggested in recent polls, an increasing share of twenty-somethings view socialism with interest? As of now, the draft narrative supports those judgments. We have thus far written a morality play pointing to corporate greed, supervisory incompetence, and misplaced faith in markets. With the outline so distinct in black and white, the policy implications are similarly self-evident.

Before government officials rush to codify the current understanding, they should reflect upon the last time we were in this position. Over the past year, there have been all manner of comparisons to the experience of the Great Depression, the prior episode when global financial markets and the economy were so stricken. There is, indeed, an apt parallel to the current stage of our crisis. The narrative first written about the Great Depression was wrong in many important respects.

By the 1940s, the educated consensus was that fiscal stimulus was the only effective means to engineer revival. In particular, this followed because it was believed that the Federal Reserve ran out of effective tools once the policy interest rate fell to zero. The Great Crash was agreed to have followed in part from excessive competition among financial institutions. And restraints on the trade of goods, services, and capital helped to anchor an otherwise unstable system.

Having learned these lessons, fiscal policymakers viewed themselves as given a mandate to smooth the business cycle, as enshrined in the Employment Act of 1946, and the Federal Reserve was pushed to a supporting role. The Congress legislated and regulators promulgated numerous restraints on the baser nature of commerce. Financial institutions were split by function and policed by different agencies. Limits were placed on deposit and lending rates. And tariffs rested near century highs.

Over the next few decades, the U.S. economy expanded rapidly, and the gains from this growth were shared relatively equitably. But this owed more to the rewards of winning a world war on foreign land masses. In fact, institutions at home were calcifying around an elaborate regulatory apparatus. The nation was poorly positioned for and too rigid to cope with the energy and environmentalism shocks of the 1970s.

Meanwhile, leading academic—including Milton Friedman, Anna Schwartz, Ben Bernanke, and Christina Romer—pushed back against the prevailing worldview. As they won the field and the false lessons of the Great Depression were unlearned, deregulation followed.

So here we are, still paying the cost of writing the wrong narrative almost three-quarters of a century ago.

Incremental policy change fostered innovation in all aspects of commerce. However, deregulation did not attack the fundamental infrastructure of our post-1930s regulatory framework. As a result, financial institutions stretched into the gaps between regulators' watch, becoming more complicated and harder to govern. Self-interested lobbying groups made sure that significant subsidies to housing remained inviolate. More generally, the gains from economic progress were not broadly shared. The system as a whole was less resilient and more vulnerable than it could have been.

Greed, no doubt, was an accelerant when a spark struck. However, the critical question is not whether people are greedy. People have been, are, and always will be greedy. Rather, we should ask why restraints on the exercise of that greed did not work.

Perhaps enlightened policymaking at the time of crisis in 2007 and 2008 could have compensated for these underlying fragilities. But we will never know. In the event, the triumvirate of Henry Paulson, Bernanke, and Timothy Geithner failed to identify the solvency problem at the root, acted in an inconsistent manner when resolving institutions that set problematic precedents, and generally inflamed fears.

So here we are, still paying the cost of writing the wrong narrative almost three-quarters of a century ago. The most important lesson to draw as we write the new one is that many blows brought us low.

Under any plausible scenario, finance will get more expensive. Banks will hold more capital. Constraints will be placed on individual choice. How those changes are enacted through supervision and proscription will depend on the lessons we are learning now. And we will live with the results for a long time.

There is an opportunity to help society get the story straight. The Financial Crisis Inquiry Commission was established in a provision of recently enacted mortgage fraud legislation. This bipartisan body is to find "the causes, domestic and global, of the current financial and economic crisis." The precedent is not encouraging. But as William of Orange admonished, "One need not hope to undertake, nor succeed to persevere."

Vincent R. Reinhart is a resident scholar at AEI. A version of this article appeared on The American on June 2, 2009.

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A Government Failure, Not a Market Failure

By John H. Makin

The idea that homeownership confers special benefits on American society is deeply embedded in our culture—so much so that our national tax policy confers a special benefit of its own on it. Homeownership is granted an advantage over all other forms of ownership in the form of an enormous deduction on the interest payments most individuals incur in financing their homes. Nothing else in the tax code comes anywhere near that deduction in scope or size. We have decided, as a nation, that homeownership is not only a good thing for an individual or a family, but that it is beneficial for the public at large and the country as a whole. Otherwise, why would it be necessary for the government to give it this kind of preferential treatment? Without it, clearly, we believe that the national rate of homeownership would be lower and that a lower rate of homeownership would be deleterious to our common weal.

After 2000, the national push toward homeownership intensified in three dimensions, leading to a doubling of housing prices in just five years' time. First, the Federal Reserve Board's interest-rate policy drove down the cost of borrowing money to unprecedented lows. Second, a common conviction arose that homeownership should be available even to those who, under prevailing conditions, could not afford it. Finally, private agencies charged with determining the risk and value of securities were exceptionally generous in their assessment of the financial products known as "derivatives" whose collateral resided in the value of thousands of mortgages bundled together. The rating agencies understated the risks from these bundled mortgages by assuming that home prices were simply going to rise forever.

When the housing bubble burst in 2006, the damage to the financial system pushed the global economy into the worst contraction since the Great Depression. In the midst of the pain and suffering that have accompanied financial collapse and economic contraction—over $15 trillion in wealth has been lost by American households alone while, by July 1, more than 6 million job losses had boosted the unemployment rate to 9.4 percent—much of the blame has been placed on unregulated financial markets whose behavior is said to have revealed a terrible flaw in the foundation of capitalism itself.

This was a market failure, we are told, and the promise of capitalism has always been that the self-correcting mechanisms built into the system would preclude the possibility of a systemic market failure. But the housing bubble burst only after government subsidies pushed house prices up so fast that marginal buyers could no longer afford to chase prices even higher. A bubble created by rigged financial markets and a government-sponsored obsession with homeownership is not a result of market failure, but rather, a result of bad public policy. The belief that homeownership, per se, is such a benefit that no amount of government support could be too great and no pace at which home prices rise could be too fast, is the root of the crisis. There was no market failure.

According to *The New Palgrave Dictionary of Economics*, an invaluable collection of precise summaries of virtually every topic in the dismal science: "The best way to understand market failure is first to understand market success, the ability of a collection of idealized competitive markets to achieve an equilibrium allocation of resources which is Pareto optimal." Allow me to translate. Pareto optimality, a term named after the Italian economist Vilfredo Pareto (1848–1923), is defined as an allocation of economic resources that produces the greatest good. Thus, if one changes the allocation of resources away from Pareto optimality for the purpose of making someone better off, that change will make someone else worse off. Economists have expended a great deal of effort to demonstrate that free and competitive markets produce an outcome that is Pareto optimal.

This is not to say that there is no such thing as market failure. There are many instances of market failure. Someone may possess information that others do not, as in insider trading, and thereby gain an illegitimate leg up. There may be too few players in a given market, which allows them to manipulate, hoard, and toy with prices. Capricious government intervention in cases in which it is neither required nor appropriate constitutes another condition that may create a market failure.

There are also cases of market failure in which some people get a free ride while others bear a disproportionate burden. This is the case in national defense, for example, in which soldiers bear a burden nonsoldiers do not. Consequently, a government subsidy for national defense is necessary for the maintenance of security and power, and the overwhelming majority of citizens acknowledges it and does not complain about it. National defense is a public good, perhaps the original public good.

Owner-occupied housing is something else that has been deemed a public good. Herbert Hoover's affirmation of the need for encouragement of homeownership "at all times" came in 1932 at the fiercest stage of the Great Depression. Others have made powerful arguments that homeowners make better citizens and contribute to stable communities. Why renters do not and cannot offer the same contribution to the public good is never specified, but existing homeowners, homebuilders, mortgage lenders, and mortgage servicers have all seized on the idea that subsidizing homeownership is Pareto optimal. It isn't.

Subsidies for homeownership—in the form of full deductibility of mortgage interest, lower mortgage borrowing rates derived from government guarantees for mortgage lenders like Fannie Mae and Freddie Mac, and deductibility of local real-estate taxes—have long benefited those who own homes at the expense of those who do not. The size and severity of the burst bubble makes a mockery of the argument that the disproportionate gains to homeowners also improved the welfare of renters. By erasing, in just a few years, nearly one-third of the wealth on the national balance sheet, the collapse has created a substantial loss in national welfare, including for renters.

Homeownership should not be considered a public good deserving of government subsidies even without the bubble collapse for a simple reason: those who receive the subsidy get to capture the benefits in the form of home prices that are higher than they would otherwise be without government support. The subsidies make homeowners better off while they make renters worse off. They are, therefore, not Pareto optimal. In addition, homeownership subsidies are inherently unjust. They favor the relatively well-off at the expense of those who are poorer. Why? Because the value of an owned home and the size of the government subsidy both grow as income increases. A tax deduction tied to homeownership for a well-to-do American with a $1 million mortgage and a $60,000 annual interest payment is worth $22,000 (assuming the American is in the 35 percent tax bracket). The higher the marginal tax rate rises, the more valuable the mortgage-interest deduction is to the homeowner. For a family with a modest income that may pay little or no income tax, the mortgage-interest deduction is worth virtually nothing. And yet, for the past fifteen years, even the party in the United States most associated with preferential treatment for the poor began preaching the evangel of homeownership as a form of class salvation.

> The belief that homeownership, per se, is such a benefit that no amount of government support could be too great and no pace at which home prices rise could be too fast, is the root of the crisis.

During Bill Clinton's first term, government housing policy changed substantially. After decades in which liberal politicians and thinkers devoted themselves to arguments for expanding the number of public housing units, the disastrous condition of those units led the president, a "new Democrat," to a dramatic ideological shift in emphasis. No longer would public housing be at the top of the liberal Democratic agenda. Instead, borrowing from conservative ideas about the inestimable benefit of homeownership to the striving poor, the Clinton administration and members of his party in the House and Senate decided to use government power to achieve that aim.

In 1994, the National Homeownership Strategy of the Clinton administration advanced "financing strategies fueled by creativity to help homeowners who lacked the cash to buy a home or the income to make the down payments" to buy a home nonetheless. It became U.S. government policy to intervene in the marketplace by lowering the standards necessary to qualify for mortgages so that Americans with lower incomes could participate in the leveraged purchases of homes.

The goal of expanding homeownership led to the creation of new mortgage subsidies across the board. The loosening of standards became the policy of Fannie Mae and Freddie Mac, the pseudo-private government-sponsored enterprises that bought mortgages from originating lenders. A particular change in the tax law in 1997 encouraged many households to make buying and improving a home the primary vehicle by which they enhanced net worth. By eliminating any capital gains tax on the first $500,000 of profits from the sale of an owner-occupied residence once every two years, Washington encouraged enterprising American families to purchase homes, fix them up, resell them, and then repeat the process. Flipping became a financial pastime for millions because this special advantage created a new incentive—which did not exactly fit the model of encouraging people to remain in a stable home for many years and thereby help to stabilize the neighborhood around them.

There was, however, a rival to homeownership as a way of building wealth in the late 1990s—the run-up in the stock market, which was caused by another bubble, this one in the technology sector. Given the size of the gains in the stock market, which were running 20 percent or more per year, the relative desirability of homeownership eroded. But when, in 2000, the tech bubble burst, households were left in search of an alternative way to store and enhance wealth. Homeownership emerged as the most promising alternative. After 2000, and especially after 2002, U.S. real house prices began to surge.

Everything I have described thus far constituted a necessary but not sufficient precondition for a full-fledged housing bubble. It took the addition of a new market in derivatives to drive bankers, lenders, and credit agencies to create the conditions for an implosion by expanding mortgage financing to borrowers who could not possibly afford the homes they were purchasing.

In February 2003, Angelo Mozilo, then head of the major mortgage supplier called Countrywide, declared that the need to provide a down payment should no longer be an impediment to homeownership for any American. Was it any wonder that a home-buying frenzy occurred when Countrywide's chieftain was suggesting that there was no need for a purchaser to supply even a minimal equity stake in his purchase? During 2004 and 2005, the rise in home prices accelerated. That, in turn, caused Americans to refinance their homes to remove their equity—their accumulated wealth, in other words—and convert it into disposable income. They did so because they were confident the equity would simply be recreated by continued growth in the value of their homes.

> Homeownership should neither be penalized nor favored under government policy.

The hunger for more mortgages that could serve as backing for more new securities led to the acceleration of undocumented, no-down-payment, negative-amortization mortgage loans to individuals with virtually no prospect of servicing them. The designers of derivative securities effectively collaborated with the rating agencies, such as Standard & Poor's and Moody's, that were relied upon (often through government mandate) by pension funds and other gigantic repositories of wealth with identifying the securities safe enough to invest in.

A situation in which creators of derivatives provide the monetary compensation for the very agencies that are tasked with determining the riskiness of their securities hardly constitutes a competitive market. Indeed, it constitutes dangerous collusive behavior. But that collusion, again, was made possible by the distorting actions of government agencies, which effectively provided a subsidy for risk-taking that was, by definition, unsustainable.

It is fair to ask, in the light of past bubbles that have burst—like the entire economy of Japan in the 1990s and the tech-stock tragicomedy—why investors were prepared to take on the substantial risks tied to unfamiliar derivative securities whose value was tied to the continued rise in house prices. A substantial part of the answer lies with the Federal Reserve Board. It deliberately adopted a policy that it would not seek to identify bubbles and then to act in ways that would let the air out slowly. Instead, Fed chairman Alan Greenspan allowed bubbles to inflate and then stepped in to repair any damage afterward. This constituted a substantial subsidy to excessive risk-taking.

The policy became clear in 1998, the year in which the unwinding of the Asian currency crisis, together with Russia's defaulting on its debt, created huge volatility in the credit markets. At the time, Long Term Capital Management, a hedge fund, was on the verge of collapse, and an aggressive intervention was staged to save it. The New York Fed provided its offices and encouragement to bring financial firms together to contain it.

The salvation of Long Term Capital Management suggested a new reality for the marketplace: aggressive risk-taking in pursuit of huge profits was manageable even if bubbles were created, just so long as the Fed was around to raise the "systemic risk flag" in the event of serious trouble. There would always be a rescue; the trick was to get out before everything began to collapse. It was this fact that led Charles Prince, then-head of Citicorp, to give the game away in July 2007 about the reckless and imprudent nature of his bank's conduct. "When the music is playing," Prince said, "you've got to get up and dance."

The housing bubble was thus a fully rational response to a set of distortions in the free market—distortions created primarily by the public sector. The heads of large financial institutions, as Prince's remark suggested, recognized the risk-taking subsidy inherent in public policy, but felt they had no choice but to play along or fall behind the other institutions that were also responding rationally to the incentives created by government intervention.

The housing collapse and its painful aftermath, including that $15 trillion wealth loss for U.S. households (so far), do not, therefore, represent a market failure. Rather, they represent the dangerous confluence of three policy errors: government policy aimed at providing access to homeownership for American households irrespective of their ability to afford it; the Fed's claim that it could not identify bubbles as they were inflating but could fix the problem afterward; and a policy of granting monopoly power to rating agencies like Standard & Poor's, Moody's, and Fitch's to determine the eligibility of derivative securities for what are supposed to be low-risk portfolios, such as pension funds.

The Fed's bubble policy has evolved in a constructive direction since the bursting of the U.S. housing bubble. The trauma of dealing with the aftermath, including the fire sale of the investment bank Bear Stearns and the outright failure of Lehman Brothers, has convinced the Fed that more effort should be directed toward identifying bubbles before they grow too large.

Now the collusive relationship between rating agencies and creators of derivative securities needs to be ended by bringing more market discipline to the process. Free entry into the rating business should be permitted. The monopoly of a small number of rating agencies to determine the eligibility of new securities for investment by massive pension funds is unjustifiable. The practice whereby the creators of such derivative securities compensate the rating agencies for the ratings also needs to be ended.

Alas, the federal government's response to the collapse of the housing bubble has been deeply problematic. It has chosen to provide additional subsidies to homeowners while nationalizing the government-sponsored enterprises, Fannie Mae and Freddie Mac, that helped to subsidize lower mortgage-interest rates. While the extreme distress visited on American households by the collapse of the housing bubble certainly needs some alleviation, over the longer run we must have a serious national debate on the question of the degree to which we still want to consider homeownership a public good.

The long-term solution is for government to stop playing favorites, as it has for decades with housing. Homeownership should neither be penalized nor favored under government policy. We have seen how that distortion led inexorably to a degree of wealth destruction we have not seen in our lifetimes. The distortion of the market introduced by government intervention can and must be brought to an end. The market that would take its place after this dramatic and admittedly difficult change would allow Americans to allocate their resources more effectively. It would no longer create an unjust advantage for the wealthy homebuyer. And it would, finally, make it possible for Americans to see their homes as they should be seen—not as investment vehicles, but rather, as the places they live in, the hearthstones of their families.

John H. Makin is a visiting scholar at AEI. A version of this article appeared in *Commentary* magazine on July 1, 2009.

The True Origins of the Financial Crisis

By Peter J. Wallison

Two 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 December 21, 2008, is that President Bush excessively promoted growth in homeownership 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 (CRA) 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 government policy is to blame instead, the prescription is to terminate those government policies that distort mortgage lending.

There really is not 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 homeownership 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*, of where the push to reduce lending standards and boost homeownership 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 homeownership and the housing bubble.

There are two key examples of this misguided government policy. One is the 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 sixteen years, the act was invoked rather infrequently, but 1993 marked a decisive turn in its enforcement. What changed? Substantial media and political attention were showered upon a 1992 Boston Federal Reserve Bank study of discrimination in home mortgage lending. This study concluded that, 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.

> The fact is that neither political party, and no administration, is blameless; the honest answer is that government policy over many years caused this problem.

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 was not 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 who lacked the 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, the share of all mortgage originations that were made up of conventional mortgages (that is, the thirty-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, subprime 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 subprime 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.

In 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 LMI 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 subprime mortgages. These did not necessarily come from traditional banks, lending under the CRA, but from lenders like Countrywide Financial, the nation's largest subprime and nontraditional mortgage lender and a firm that would become infamous for consistently pushing the envelope on acceptable underwriting standards.

> The gradual decline in lending standards came to dominate mortgage lending in the United States.

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 subprime 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 subprime 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 subprime 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 showing today, the number will be staggering. The losses could make the $150 billion savings and loan bailout in the late 1980s and early 1990s look small by comparison.

The GSEs' purchases of subprime 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 subprime 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 subprime 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 subprime 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 subprime 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, conventional loans (including jumbo loans) declined from 78.8 percent to 50.1 percent of all mortgages, while subprime 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 nonprime 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 subprime 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.

> U.S. housing policies are the root cause of the current financial crisis.

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, homeowners may, without penalty, refinance a mortgage whenever interest rates fall or home prices rise to a point at which 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, nonrecourse 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 simply 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 a mortgage-backed securities (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.

Preventing 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.

Peter J. Wallison is the Arthur F. Burns Fellow in Financial Policy Studies at AEI. A version of this article appeared in the January/February 2009 issue of *The American Spectator*.