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Cause and Effect: Government Policies and the Financial Crisis

By Peter J. Wallison

Although the media are full of talk that we face a “crisis of capitalism,” the underlying cause of the financial meltdown is something much more mundane and practical—the housing, tax, and bank regulatory policies of the U.S. government. The Community Reinvestment Act (CRA), Fannie Mae and Freddie Mac, penalty-free refinancing of home loans, tax preferences granted to home equity borrowing, and reduced capital requirements for banks that hold mortgages and mortgage-backed securities (MBS) have all weakened the standards for granting mortgages and the housing finance system itself. Blaming greedy bankers, incompetent rating agencies, or other actors in this unprecedented drama misses the point—perhaps intentionally—that government policies created the incentives for both a housing bubble and a reduction in the bank capital and home equity that could have mitigated its effects. To prevent a recurrence of this disaster, it would be far better to change the destructive government housing policies that brought us to this point than to enact a new regulatory regime that will hinder a quick recovery and obstruct future economic growth.

The current financial crisis is not—as some have said—a crisis of capitalism. It is in fact the opposite, a shattering demonstration that ill-considered government intervention in the private economy can have devastating consequences. The crisis has its roots in the U.S. government’s efforts to increase homeownership, especially among minority and other underserved or low-income groups, and to do so through hidden financial subsidies rather than direct government expenditures. The story is an example, enlarged to an American scale, of the adverse results that flow from the misuse and manipulation of banking and credit by government. When this occurs in authoritarian regimes, we deride the outcome as a system of “policy loans” and note with an air of superiority that banks in these countries are weak, credit is limited, and financial crises are frequent. When the same thing happens in the United States, however, we blame “greedy” people, or poor regulation (or none), or credit default swaps, or

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anything else we can think of—except the government policies that got us into the disaster.

Expansion of homeownership could be a sound policy, especially for low-income families and members of minority groups. The social benefits of homeownership have been extensively documented; they include stable families and neighborhoods, reduced crime and delinquency, higher living standards, and less depreciation in the housing stock. Under these circumstances, the policy question is not whether homeownership should be encouraged but how the government ought to do it. In the United States, the policy has not been pursued directly—through taxpayer-supported programs and appropriated funds—but rather through manipulation of the credit system to force more lending in support of affordable housing. Instead of a direct government subsidy, say, for down-payment assistance for low-income families, the government has used regulatory and political pressure to force banks and other government-controlled or regulated private entities to make loans they would not otherwise make and

to reduce lending standards so more applicants would have access to mortgage financing.

The two key examples of this policy are the CRA, adopted in 1977, and the affordable housing “mission” of the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac. As detailed below, beginning in the late 1980s—but particularly during the Clinton administration—the CRA was used to pressure banks into making loans they would not otherwise have made and to adopt looser lending standards that would make mortgage loans possible for individuals who could not meet the down payment and other standards that had previously been applied routinely by banks and other housing lenders. The same pressures were brought to bear on the GSEs, which adapted their underwriting standards so they could accept the loans made under the CRA and other loans that did not conform to what had previously been considered sound lending practices. Loans to members of underserved groups did not come with labels, and once Fannie and Freddie began accepting loans with low down payments and other liberalized terms, the same unsound practices were extended to borrowers who could have qualified under the traditional underwriting standards. It should not be surprising that borrowers took advantage of these opportunities. It was entirely rational to negotiate for a low-down-payment loan when that permitted the purchase of a larger house in a better neighborhood.

Many culprits have been brought before the bar of public humiliation as the malefactors of the current crisis—unscrupulous mortgage brokers, greedy investment bankers, incompetent rating agencies, foolish investors, and whiz-kid inventors of complex derivatives. All of these people and institutions played their part, of course, but it seems unfair to blame them for doing what the government policies were designed to encourage. Thus, the crisis would not have become so extensive and intractable had the U.S. government not created the necessary conditions for a housing boom by directing investments into the housing sector, requiring banks to make mortgage loans they otherwise would never have made, requiring the GSEs to purchase the secondary mortgage market loans they would never otherwise have bought, encouraging underwriting standards for housing that were lower than for any other area of the economy, adopting bank regulatory capital standards that encourage bank lending for housing in preference to other lending, and adopting tax policies that favored borrowing against (and thus reducing) the equity in a home.

As a result, between 1995 (when quotas based on the CRA became effective during the Clinton administration)

and 2005, the homeownership percentage in the United States moved from 64 percent, where it had been for twenty-five years, to 69 percent; in addition, home prices doubled between 1995 and 2007. In other words, the government is responsible for the current crisis in two major respects: its efforts to loosen credit standards for mortgages created the housing bubble, and its policies on bank capital standards and the deductibility of interest on home equity loans made the current crisis inevitable when the bubble collapsed. This *Outlook* will explore the strong relationship between the intervention of the U.S. government in the housing market and the worldwide financial crisis that has resulted.

The Community Reinvestment Act

As originally enacted in 1977, the CRA was a vague mandate for regulators to “consider” whether an insured bank was serving the needs of the whole community it was supposed to serve. The “community” itself was not defined, and the act stated only that it was intended to “encourage” banks to meet community needs. It was enforced through the denial of applications for such things as mergers and acquisitions. The act also stated that serving community needs had to be done within the context of safe and sound lending practices, language that Congress probably inserted to ensure that the law would not be seen as a form of credit allocation. Although the act was adopted to prevent “redlining”—the practice of refusing loans to otherwise qualified borrowers in low-income areas—it also contained language that included small business, agriculture, and similar groups among the interests that had to be served. With the vague compliance standard that required banks only to be “encouraged” and their performance to be “considered,” the act was invoked relatively infrequently when banks applied for permission to merge or another regulatory approval, until the Clinton administration.¹

The decisive turn in the act’s enforcement occurred in 1993 and was probably induced by the substantial amount of media and political attention that had been paid to the Boston Federal Reserve Bank’s 1992 study of discrimination in home mortgage lending.² The study concluded that while there was no overt discrimination in the allocation of mortgage funds, more subtle forms of discrimination existed in which whites received better treatment by loan officers than members of minorities. The methodology of the study has since been questioned,³ but it seems to have been highly influential with regulators and members of the incoming Clinton administration at the time of its publication. In 1993, bank regulators initiated a

major effort to reform the CRA regulations. Some of the context in which this was occurring can be gleaned from the following statement by Attorney General Janet Reno in January 1994: “[W]e will tackle lending discrimination wherever and in whatever form it appears. No loan is exempt, no bank is immune. For those who thumb their nose at us, I promise vigorous enforcement.”⁴

The regulators’ effort culminated in new rules adopted in May 1995 that would be phased in fully by July 1997. The new rules attempted to establish objective criteria for determining whether a bank was meeting the standards of the CRA, taking much of the discretion out of the hands of the examiners. “The emphasis on performance-based evaluation,” A. K. M. Rezaul Hossain, an economist at Mount Saint Mary College, writes, “can be thought of as a shift of emphasis from procedural equity to equity in outcome. In that, it is not sufficient for lenders to prove elaborate community lending efforts directed towards borrowers in the community, but an evenhanded distribution of loans across LMI [low and moderate income] and non-LMI areas and borrowers.”⁵ In other words, it was now necessary for banks to show that they had actually made the requisite loans, not just that they were trying to find qualified borrowers. In this connection, one of the standards in the new regulations required the use of “innovative or flexible” lending practices to address credit needs of LMI borrowers and neighborhoods.⁶ 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—a clear requirement for the relaxation of lending standards.

There is very little data available on the performance of loans made under the CRA. The subject has become so politicized in light of the housing meltdown and its effect on the general economy that most reports—favorable or unfavorable—should probably be discounted. Before the increases in housing prices that began in 2001, reviews of the CRA were generally unfavorable. The act increased costs for banks, and there was an inverse relationship between their CRA lending and their regulatory ratings.⁷ One of the few studies of CRA lending in comparison to normal lending was done by the Federal Reserve Bank of Cleveland, which reported in 2000 that “respondents who did report differences [between regular and CRA

housing loans] most often said they had lower prices or higher costs or credit losses for CRA-related home purchase and refinance loans than for others.”⁸ Much CRA lending after 2000 occurred during a period of enormous

growth in housing values, which tended to suppress the number of defaults and reduce loss rates.

The important question, however, is not the default rates on the mortgages made under the CRA. Whatever those rates might be, they were not sufficient to cause a worldwide financial crisis. The most important fact associated with the CRA is the effort to reduce underwriting standards so that more low-income people could purchase homes. Once these standards were relaxed—particularly allowing loan-to-value ratios higher than the 20 percent that had previously been the norm—they spread rapidly to the prime market and to subprime markets where loans were made by lenders other than insured banks. The effort to reduce mortgage underwriting

standards was led by the Department of Housing and Urban Development (HUD) through the National Homeownership Strategy published in 1994 in response to a request by 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.”⁹ Many subsequent studies have documented the rise in loan-to-value ratios and other indicators of loosened lending standards.¹⁰

After 1995 and the adoption of the new CRA regulations, homeownership in the United States grew rapidly. Having remained at 64 percent for almost twenty-five years, it grew to 69 percent between 1995 and 2005.¹¹ The increased availability of credit under CRA requirements probably also spurred housing demand, which doubled home prices between 1995 and 2007.¹² The key question, however, is the effect of relaxed lending standards on lending standards in non-CRA markets. In principle, it would seem impossible—if down payment or other requirements were being relaxed for loans in minority-populated or other underserved areas—to limit the benefits only to those borrowers. Inevitably, the relaxed standards banks were enjoined to adopt under CRA would be spread to the wider market—including to prime mortgage markets and to speculative borrowers. Bank regulators, who were

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in charge of enforcing CRA standards, could hardly disapprove of similar loans made to better qualified borrowers. This is exactly what occurred. Writing in December 2007 for the Milken Institute, four scholars observed: “Over the past decade, most, if not all, the products offered to subprime borrowers have also been offered to prime borrowers. In fact, during the period from January 1999 through July 2007, prime borrowers obtained thirty-one of the thirty-two types of mortgage products—fixed-rate, adjustable rate and hybrid mortgages, including those with balloon payments—obtained by subprime borrowers.”¹³

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 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 seems highly likely that the lower lending standards banks were required to adopt under the CRA influenced what they 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. There is nothing immoral about this; if the opportunity is there, most families can think of better uses for their savings than making a large down payment for a home.

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.”¹⁴ 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 underwriting standards to the prime loan market that encouraged the huge increase in credit availability for mortgages, the speculation in housing, and ultimately the bubble in housing prices.

Fannie Mae and Freddie Mac

Before they were taken over by a federal government conservatorship in September 2008, Fannie and Freddie had become two of the largest financial corporations in the world. In an important sense, the GSEs were the successors to the failed savings and loan associations (S&Ls) of the late 1980s and early 1990s. The fact that

Fannie and Freddie were permitted—indeed encouraged—to grow after the S&Ls collapsed speaks volumes about the inability of congressional lawmakers to learn any lessons from the past. This discouraging conclusion comes into even sharper focus as we see policymakers developing solutions to the current crisis that will cause it to recur, just as the GSEs’ supporters in Congress enabled them to repeat the policy mistakes that eventually, in the S&L fiasco, cost the taxpayers \$150 billion.

By 2005, it had become clear that Fannie and Freddie were not materially assisting middle-class homebuyers by lowering interest rates.¹⁵ Given the political basis for the existence of the GSEs, this is a significant fact. Both Fannie and Freddie had suffered major accounting scandals in 2003 and 2004, and their political support in a Republican Congress was shaky. Alan Greenspan, then at the height of his reputation for financial sagacity, had begun to campaign against them—particularly against their authority to hold the portfolios of mortgages and MBS that constituted their most profitable activity.

When the history of this era is written, students will want to understand the political economy that allowed Fannie and Freddie to grow without restrictions while producing large profits for shareholders and management but no apparent value for the American people. The answer is the affordable housing mission that was added to

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their charters in 1992, which—like the CRA—permitted Congress to subsidize LMI housing without appropriating any funds. As long as Fannie and Freddie could credibly contend that they were advancing the interests of LMI homebuyers, they could avoid new regulation by Congress—especially restrictions on the accumulation of mortgage portfolios, totaling approximately \$1.5 trillion by 2008, that accounted for most of their profits. They could argue to Congress that if the mortgage portfolios were constrained by regulation, they could not afford to subsidize affordable housing.¹⁶ In addition, the political sophistication of Fannie Mae's management enabled the company to serve the interests of key lawmakers who could and did stand in the way of the tougher regulation that might have made the current crisis far less likely.¹⁷

Although they were pressed by HUD's affordable housing regulations to buy increasing numbers of LMI loans, Fannie and Freddie appear to have willingly cooperated with the implementation of this policy. In 1994, HUD required that 30 percent of GSE mortgage purchases consist of affordable-housing mortgages, and requirements became tighter over the following years. But there was still doubt as to whether Fannie and Freddie were doing as much as they could to advance the administration's goals in this area. In 1997, for example, HUD commissioned the Urban Institute to study the GSEs' underwriting guidelines. The Urban Institute's report concluded: "The GSEs' guidelines, designed to identify creditworthy applicants, are more likely to disqualify borrowers with low incomes, limited wealth, and poor credit histories; applicants with these characteristics are disproportionately minorities. Informants said that some local and regional lenders serve a greater number of creditworthy low-to-moderate income and minority borrowers than the GSEs, using loan products with more flexible underwriting guidelines than those allowed by Fannie and Freddie."¹⁸ Following this report, Fannie and Freddie modified their automated underwriting systems to accept loans with characteristics that they had previously rejected. This opened the way for the acquisition of 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.

By 1997, Fannie was offering a 97 percent loan-to-value mortgage, and 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 this goal, that 38 percent of all purchases were from underserved areas (usually inner cities) and 25 percent were purchases of loans to low-income and very-low-income borrowers.¹⁹ 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.

There is no universally accepted definition of either subprime or Alt-A loans, except that neither of them is considered a prime loan (fifteen- or thirty-year amortization, fixed interest rate, good credit history) and both thus represent enhanced risk. The Federal Reserve Bank of New York defines a subprime loan as one made to a borrower with blemished credit or who provides only limited documentation. The federal bank regulators define a loan to a borrower with less than a 660 FICO score as subprime. Alt-A loans generally have a higher balance than subprime and one or more elements of added risk, such as a high loan-to-value ratio (often as a result of a piggyback second mortgage), interest-only payments, little or no income documentation, and the borrower as an investor rather than a homeowner. The term "subprime," accordingly, generally refers to the financial capabilities of the borrower, while Alt-A loans generally refer to the quality of the loan terms. Subprime and Alt-A loans are both defaulting at unprecedented rates and should be regarded together as the toxic loans that are currently on the books of banks and other troubled financial institutions around the world.

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, amounting to about 40 percent of their mortgage purchases during that period. Freddie's data show that it acquired 6 percent of its Alt-A loans in 2004; this jumped to 17 percent in 2005, 29 percent in 2006, and 32 percent in 2007. Fannie purchased 73 percent of its Alt-A loans during these three years. Similarly, in 2004, Freddie purchased 10 percent of the loans in its portfolio that had FICO scores of less than 620; it increased these purchases to 14 percent in 2005, 17 percent in 2006, and 30 percent in 2007, while Fannie purchased 57.5 percent of the loans in this category during the same period.²⁰ For compliance with HUD's affordable-housing regulations, these loans tended to be "goal-rich." However, because they are now defaulting at unprecedented rates, the costs associated with these loans will be

borne by U.S. taxpayers and are in large part the result of the failure of Congress to adopt an effective new regulatory structure for Fannie and Freddie. In this sense, the GSEs' extraordinary and devastating commitment to affordable housing loans was a tactical success.

All told, Fannie and Freddie probably hold or have guaranteed \$1.6 trillion in subprime and Alt-A mortgages today. It is impossible to forecast the total losses they will suffer as a result, but if default rates on these loans continue at the unprecedented levels they are showing today, 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 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. This competition had already existed, but the GSEs were not major buyers until late 2004. Prior to that, private-label issuers—investment and commercial banks for the most part—specialized in subprime and Alt-A loans because the financial advantages of the GSEs, including their access to cheaper financing, enabled them to exclude private-label competition from the conventional market. When the GSEs decided to ramp up their purchases of subprime and Alt-A loans, they began to take market share from the private-label issuers but also created greater demand for subprime and Alt-A loans from the mortgage brokers, mortgage bankers, and other 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, and these loans joined the flood of junk loans that flowed to both the GSEs and the private-label issuers beginning in late 2004. During this period, conventional loans (including jumbo loans) declined from 78.8 percent of all mortgages in 2003 to 50.1 percent at the end of 2006. During this same period, subprime and Alt-A loans increased from a 10.1 percent to a 32.7 percent share.²¹ Since 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.

The GSEs' regulation-induced competition with private-label issuers almost certainly had the same effect on the quality of the mortgages the private-label issuers were securitizing. 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, then, competition from Fannie and Freddie beginning in late 2004 caused both groups to scrape the bottom of the barrel—Fannie and Freddie in order to demonstrate to Congress their ability to increase support for affordable housing, and the private-label issuers trying to maintain their market share against the GSEs' increased demand

for subprime and Alt-A products. Thus, the gradual decline in lending standards that began with the revised CRA regulations in 1993 and continued with the GSEs' attempts to show Congress that they were meeting their affordable housing mission came to dominate mortgage lending in the United States.

Homeowner Options under U.S. Law

State-based U.S. residential finance laws, accommodated by the national mortgage market system, give U.S. homeowners two free options that contributed substantially to the financial crisis we confront today. 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. The right to refinance is very rare in the commercial world because it increases the difficulty of matching assets and liabilities and thus places significant risks on financial intermediaries. Because home mortgages can be refinanced at any time, banks and others must engage in sophisticated hedging transactions to protect themselves against the disappearance of their mortgage assets if interest rates decline. More important for the purposes of this *Outlook*, the ability of homeowners to refinance their mortgages whenever they want also enabled them to extract any equity that had accumulated in the home between the original financing transaction and any subsequent refinancing. When combined with the gradual decline in lenders' demands for substantial down payments and the absence of any prepayment penalty, this option permitted homeowners to obtain in cash at the time of a refinancing a significant portion of the equity that had accumulated

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in the home up to that point. That equity, of course, could have been the result of a general increase in home prices rather than a homeowner's gradual amortization of principal under the mortgage loan.

The result was the so-called cash-out refinancing, in which homeowners treated their homes like savings accounts, drawing out funds through refinancing to buy cars, boats, or second homes, or pay for other family expenditures. By the end of 2006, 86 percent of all home mortgage refinancings were cash-out refinancings, amounting to \$327 billion that year.²² 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. This phenomenon, of course, applied to prime mortgages as well as subprime and Alt-A loans. The degree to which holders of prime mortgages might be willing to abandon their homes when the mortgage debt is greater than the home's value is one of the major unknowns of the current crisis.

The willingness of homeowners to walk away from their "underwater" mortgages is increased by the second element of the options that are routinely made available to U.S. homeowners and accommodated by the national mortgage system. In most states, either mortgages are "without recourse"—meaning 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 the process for enforcing this obligation is so burdensome and time-consuming that lenders simply do not bother to enforce it. Frequently, the mortgage note permits the lender to waive this burden in exchange for a quick foreclosure and sale. 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 that occurred throughout the bubble period.

There is a lot of discussion in Washington today about new regulations that will prevent the recurrence of today's crisis. The ideas are as far-reaching as regulating all financial intermediaries and as modest as providing better disclosure to homeowners when they take out a mortgage, but no one in Congress or elsewhere is considering or recommending that homeowners be required

to pay a penalty for the privilege of refinancing their homes when mortgage rates decline or that state laws allowing for nonrecourse mortgages be preempted. These simple changes would go far toward rationalizing our mortgage system for the future, without the harmful effects on the whole economy that will result from new and unnecessary regulation of financial intermediaries.

Tax Policies

The housing bubble, as well as the problem of homeowners extracting equity from their homes, was made considerably worse by tax laws. Two elements deserve particular mention: the deductibility of mortgage interest and the deductibility of interest on home equity loans. Of these two, the most influential by far is the general mortgage interest deduction. That provision substantially tilts the decision whether to

rent or buy a home in favor of ownership. This might be a good idea if it encouraged low-income families to buy rather than rent their homes, but it does not. In general, low-income individuals do not pay any federal income taxes and thus get no benefit from the mortgage interest deduction. Even families with moderate incomes do not get a benefit from the mortgage interest deduction unless they itemize their tax returns.

But in terms of its effect on the current financial crisis, the deductibility of interest on home equity loans is far and away the most important provision in the tax laws. 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 what the purpose of the loan or the use of the funds. 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 credit cards, auto loans, or ordinary consumer loans. Under these circumstances, 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.

The effect of the Basel bank capital standards, applicable throughout the world's developed economies, has been to encourage commercial banks to hold only a small amount of capital against the risks associated with residential mortgages.

Bank Capital Regulations

Under a 1988 international protocol known as Basel I, the bank regulators in most of the world's developed countries adopted a uniform system of assigning bank assets to different risk categories. The purpose of the system was to permit some flexibility in the allocation of capital, based on the perceived riskiness of various types of assets. Capital is viewed as a shock absorber, and thus more capital should be held against the possibility of losses from riskier assets. The general rule is that banks are required to hold 8 percent risk-weighted capital in order to be adequately capitalized and 10 percent in order to be well-capitalized, so that the riskiest assets have to be backed by no less than 8 percent capital, while the safest (sovereign debt) are assigned a risk weight of zero. In this system, commercial loans received a risk weight of 100 percent, meaning that a bank must have capital of at least 8 percent of the value of its portfolio of commercial loans. In the same system, residential mortgages are deemed to be half as risky as commercial loans and were assigned a 50 percent risk weight, so banks are required to hold only 4 percent capital against the value of a residential mortgage. In addition, asset-backed securities rated AAA were assigned a 20 percent risk weight, so only 1.6 percent capital is necessary for a bank to hold AAA-rated MBS.

Basel I is in the process of being replaced by Basel II, which generally permits banks to use more refined methods, including internal models, for determining the risk weight to be placed on their assets and the capital they will be required to hold. However, for the purposes of this *Outlook*, it is only necessary to consider the effects of Basel I, which has been in force for all relevant periods up through 2007. The risk weight for residential mortgages has not been changed in Basel II.

The 50 percent risk weight placed on mortgages under the Basel rules provides an incentive for banks to hold mortgages in preference to commercial loans. Even more important, by purchasing a portfolio of AAA-rated MBS, or converting their portfolios of whole mortgages into an MBS portfolio rated AAA, banks could reduce their capital requirement to 1.6 percent. This amount might have been sufficient if the mortgages were of high quality or if the AAA rating correctly predicted the risk of default, but the gradual decline in underwriting standards meant that the mortgages in any pool of prime mortgages—and this was certainly true of subprime and Alt-A mortgages—often had high loan-to-value ratios, low FICO scores, or other indicators of low quality. In other words, the effect of

the Basel bank capital standards, applicable throughout the world's developed economies, has been to encourage 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. Even if it is correct to believe that residential mortgages are less risky than commercial loans—an idea that can certainly be challenged in today's economy—the lack of bank capital behind mortgage assets became blazingly clear when the housing bubble deflated.

Conclusion

A review of the key housing, tax, and regulatory policies pursued by the U.S. government over many years connects these policies very directly to the rise of a housing bubble, a decline in the quality of mortgages, and a reduction in the home equity and bank capital that would have protected the economy in the event of a bubble's collapse.

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; foolish investors; imprudent 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 wanting to prevent 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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Notes

1. See the extensive discussion of the Community Reinvestment Act's development in A. K. M. Rezaul Hossain, "The Past, Present and Future of Community Reinvestment Act (CRA): A Historical Perspective" (working paper 2004-30, Department

of Economics, University of Connecticut, Storrs, CT, October 2004), available at www.econ.uconn.edu/working/2004-30.pdf (accessed November 21, 2008).

2. Alicia H. Munnell, Lynn E. Browne, James McEneaney, and Geoffrey M. B. Tootell, "Mortgage Lending in Boston: Interpreting HMDA Data" (working paper 92-7, Federal Reserve Bank of Boston, 1992), available at www.bos.frb.org/economic/wp/wp1992/wp92_7.pdf (accessed November 21, 2008).

3. See discussion in Vern McKinley, "Community Reinvestment Act: Ensuring Credit Adequacy or Enforcing Credit Allocation?" *Regulation* 17, no. 4 (1994): 32, available at www.cato.org/pubs/regulation/regv17n4/vmck4-94.pdf (accessed November 21, 2008).

4. *Ibid.*, 30.

5. A. K. M. Rezaul Hossain, "The Past, Present and Future of Community Reinvestment Act (CRA): A Historical Perspective," 54.

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