Anatomy of a Train Wreck

The causes of the mortgage meltdown

STAN J. LIEBOWITZ, National Review, October 20, 2008

Why did the mortgage market melt down so badly? Why were there so many defaults when the economy was not particularly weak? Why were the securities based upon these mortgages not considered anywhere near as risky as they actually turned out to be? Although there are many factors involved, the key and fundamental answer is that, in an attempt to increase homeownership — particularly among minorities and the less affluent — an attack on underwriting standards has been undertaken by virtually every branch of the government since the early 1990s. This weakening of underwriting standards had the intended impact of increasing home ownership and the unintended impact of increasing the price of housing, helping lead to a housing-price bubble that masked for many years the crucial (and predictable) problem of increased defaults.

After the government succeeded in weakening the underwriting standards, mortgages seemed to require virtually no down payment — which is the main key to the problem. There were also few restrictions on the size of monthly payments relative to income, little examination of credit scores, and little examination of employment history. This was the government’s goal and, as homeownership rates increased, there was self-congratulation all around. The community of regulators, academic specialists, and housing activists all reveled in the increase in homeownership and the increase in wealth that ensued. The decline in underwriting standards was universally praised as an “innovation” in mortgage lending.

The resulting bubble brought in a large number of speculators, in the form of individuals owning one or two houses in the hope of quickly reselling them at a profit. It is estimated that one-quarter of all home sales were speculative sales of this nature. The speculators wanted mortgages with the smallest down payment and the lowest interest rate: adjustable-rate mortgages, option ARMs, and so forth. Once housing prices stopped rising, these speculators tried to get out from under their investments made largely with other people’s money, which is why foreclosures increased mainly for adjustable-rate mortgages and not fixed-rate, regardless of whether the mortgages were prime or subprime. The rest, as they say, is history.

In good times, strict underwriting standards seem unnecessary. But like levees against a flood, they serve a useful purpose. When markets turn sour, these standards help ensure that homeowners will not bail out of homes at the first sign of price declines, that they will have the financial wherewithal to survive economic downturns, and that even if they can’t make their payments, mortgage owners will be covered by the equity remaining in the home. Removing these protections greatly increased the risk in this market when a storm did approach.

Unfortunately, it seems likely that our governing bodies have learned little or nothing from this series of events. If the proper lessons are not learned, it’s all likely to happen again.

WEAKENING THE LEVEE

Homeownership wouldn’t seem to require much help from the federal government. If you let builders build, developers develop, and lenders lend, you will soon have people living in private homes. In 1900, before the federal government became involved in the housing industry, homeownership in the U.S. stood at 47 percent (in 2000, it was 66 percent). That was before the enormous wealth increase of the 20th century and before mortgage deductibility was enacted as a form of homeownership subsidy, both factors that would be expected to increase the ownership of homes. Clearly, homeownership rates would have increased even without flexible underwriting policies.

Nevertheless, during the Great Depression, homebuilding, like many other industries, experienced a profound decline. Mortgages were generally of a short duration, often only a few years. Because banks were cash-strapped and nervous about being paid, when a mortgage came due, instead of offering to refinance it, the banks often asked for payment in full. It was difficult or impossible for homeowners, even those with the financial ability to handle a mortgage, to pay the full amount of the mortgage all at once.

To help alleviate such problems, the federal government in 1934 created the Federal Housing Administration, which guaranteed mortgages against default, thus removing the risk from the bank. This was the first major intrusion in the mortgage market. In 1938 Fannie Mae was created to purchase FHA mortgages. Its purpose was later altered somewhat, and it now purchases and repackages a large share of all private mortgages in the country.

The government became heavily involved in the mortgage market in a new way after concerns about mortgage discrimination arose in the 1970s. Congress passed the Community Reinvestment Act (CRA) in 1977, requiring banks to conduct business across the entirety of geographic areas in which they operated, thus preventing them from doing business in a suburb, say, while neglecting a downtown area. Congress had already (in 1975) passed the Home Mortgage Disclosure Act (HMDA), which required that mortgage lenders provide detailed information about mortgage applications. Every year banks receive a score on their CRA compliance, just as they received a score on their financial viability; and banks strive to do well on both parts of their examination.

In 1991, the HMDA data were expanded, allowing for comparison of rejection rates by race. Various news organizations started publicizing simple examinations of HMDA data showing that minorities were denied home mortgages at a rate far higher than that for whites. It was, and still is, common for newspapers in large cities, shortly after the yearly HMDA data are made public, to do exposés examining the differences by race in rejection rates on mortgage applications. Although such comparisons are completely unable to distinguish between race discrimination and differences in creditworthiness as explanations, and are therefore fairly meaningless, these results were trumpeted in the media.
The last defense of banks trying to rebut charges of engaging in biased mortgage lending appeared to fall when the Boston Fed conducted a seemingly careful statistical analysis in 1992, which purported to demonstrate that — even after controlling for important variables associated with creditworthiness — minorities were denied mortgages at higher rates than whites. In fact, the study was based on horribly mangled data: Every later article of which I am aware — even those written by individuals who ultimately agreed with the conclusions of the Boston Fed study — accepted this. The authors of the study, however, stuck to their guns even in the face of the overwhelming evidence of error. And most politicians jumped to support it.

My colleague Ted Day and I investigated the Boston Fed study, and we were shocked at the poor quality of its data. Its information — if it were to be believed — implied that hundreds of loans (out of 3,000) had interest rates that were much too high or much too low (about 50 loans had negative interest rates); 44 loans were supposedly rejected by the lender but then sold in the secondary market — which, of course, is impossible; two separate measures of income differed by more than 50 percent in over 50 cases; hundreds of these mortgages did not match the original data set from which they came; and so on.

When we attempted to conduct the statistical analysis removing the impact of these obvious data errors, we found that the evidence of discrimination vanished. Without discrimination, of course, there would be no reason to try to "fix" the mortgage market by changing lending standards. But the fix was in — there was no standing in the way of this train, to paraphrase a Fed economist who warned me not to waste my time.

Indeed, when an economist at the FDIC, who — unlike everyone else — actually had access to the raw loan files, suggested that the data had serious errors, the Boston Fed authors accused him in a journal article of "fudg[ing]" his data (as the New York Times put it). That the journal editor allowed the Fed authors to make this unfounded claim while refusing to allow a response was an amazing breach of academic etiquette, which only reflects the political power of this issue. When I gave a seminar on this subject at the Dallas Fed, to which the Boston Fed authors were invited as a courtesy, they originally asked for 15 minutes to make their case after my 90-minute talk. Fair enough. But 30 minutes before I was to begin my talk, I was told by an embarrassed Dallas Fed employee that I was to split my time with them, 45 minutes each. They, unlike me, refused to take questions during their talk — during which they falsely claimed that they had a new data set without data problems, and that it gave the same results. They then left, claiming they had to catch a plane, before they could be questioned. Slimy stuff.

The supporters of relaxed underwriting standards had no interest in engaging in a fair debate of the value of lower underwriting standards or the existence of mortgage discrimination. They were too busy trying to reengineer society according to their rules.

Within a few months of the appearance of the Boston Fed study, a new manual appeared from the Boston Fed. It outlined the new standards that would lead to today’s mortgage meltdown: “Management should be directed to review existing underwriting standards and practices to ensure that they are valid predictors of risk. Special care should be taken to ensure that standards are appropriate to the economic culture of urban, lower-income, and nontraditional consumers.” Now, you might have thought that financial standards that indicate a high probability of success in making mortgage payments — such as steady employment, a record of savings, and keeping the loan payment small relative to income — would have been prudent standards for borrowers of all incomes and all races. In fact, you would have been correct. But in the world of mortgage discrimination the goal is to increase mortgages for certain “non-traditional” customers, and financial standards will have to be twisted or discarded if necessary.

Banks responded just as the government wanted: They began to loosen lending standards. And loosen and loosen and loosen.

One of the banks that jumped most enthusiastically onto this bandwagon was Countrywide, which used its efforts to lower underwriting standards on behalf of minorities (and everyone else) to catapult itself into becoming the nation’s leading mortgage lender. For this behavior it received preferred treatment from Fannie Mae. Testimonials to its virtue abound: In 2000, La Opinión (the nation’s leading Spanish-language newspaper) named Countrywide “Corporation of the Year” for its outstanding work in the Latino community. The LULAC (League of United Latin American Citizens) chair of national housing said, “Through the generosity of ethical businesses like Countrywide, we can make significant strides towards bringing the pride of homeownership to our communities and enhancing the quality of life for more Latinos.”

According to a flattering report by the Fannie Mae Foundation, Countrywide was a paragon of lending virtue: “Countrywide tends to follow the most flexible underwriting criteria permitted under GSE and FHA guidelines. Because Fannie Mae and Freddie Mac tend to give their best lenders access to the most flexible underwriting criteria, Countrywide benefits from its status as one of the largest originators of mortgage loans. . . . When necessary — in cases where applicants have no established credit history, for example — Countrywide uses nontraditional credit.”

THE MAKING OF A BUBBLE

So we see how government got the ball rolling toward the eventual crisis, with the banks’ initially forced cooperation (although they became happy participants when they found they could make money selling these mortgages). But why did investors, who are supposed to be cool and rational, go along? Very specifically: Why were purchasers of mortgages (i.e., mortgage-backed securities) willing to treat them as AAA — and why were the rating agencies willing to give them AAA ratings? It’s not clear that any answer will be completely satisfactory. But if we understand how universal the idea of flexible underwriting standards had become, how dangerous it was to suggest anything else (and risk being labeled a racist), and how strong this force is even now (there are blogs referring to me as a racist based on the ideas I express in this essay) — it becomes possible to understand how investors, who, just like other human beings, are prone to mistakes (the dot-com bubble is another recent example), might be influenced by the same arguments.

To understand this, it’s useful to examine the sales pitches that were made. I was able to find a 1998 sales pitch from Bear Stearns, the first underwriter of mortgage-backed securities for loans banks undertook to fulfill their CRA obligations. This sales pitch shows us the thinking being...
used to sell these products in secondary markets, and probably also being used to persuade the security-rating organizations. The pitch generally follows the script laid out by the Boston Fed, and followed by the entire regulatory apparatus surrounding the housing industry. Faced with overwhelming acceptance of these facts by these presumably knowledgeable experts, why wouldn’t an investor believe it?

The Bear Stearns pitch claimed that LTV (loan-to-value, or the size of the loan relative to the value of the home) had once been the key consideration for predicting defaults — but suggested that it was no longer appropriate for “affordable” loans. The traditional logic, of course, remains sound: If someone puts 20 percent (the traditional down-payment level) down on a house, he will be unlikely to default. Even if the homeowner has trouble making the payments, as long as prices don’t fall by 20 percent he will prefer to sell the house and get some of the down payment back. Yet, in this sales pitch, we encounter a feeble attempt to explain why this is not true for low-income borrowers:

Traditionally rating agencies view LTV as the single most important determinant of default. . . . While we do not dispute these assumptions, LTVs have to be analyzed within the context of the affordable-loan situation. Three or 4 percent equity on a $50,000 house is significant to a family of limited financial resources. In relative terms, $1,500 to $2,000 could easily mean three to four months of advance rent payments in their previous housing situation. . . .

Obviously, there are more delinquencies with the higher LTV loans than the lower, but there is no tight linear correlation between the LTV levels. Delinquency rates increase along with the LTV levels, but not proportionately. As a result, the use of default models traditionally used for conforming loans have to be adjusted for CRA affordable loans.

Let’s examine this logic. LTV has been the most important predictor of default. But when it comes to “affordable” housing, LTV is not to be taken as seriously. Why? The real reason is that if traditional LTVs were imposed on applicants for “affordable” loans, most of these applicants would be unable to come up with anything like a 20 percent down payment, and the loan would be rejected. That is a politically unacceptable result. The logic being put forward by Bear Stearns appears to be that 3 to 4 percent of a small mortgage is more important to poor people than 3 to 4 percent of a bigger mortgage is to wealthier applicants. This is a mere assertion, unsupported by facts.

Also, the mortgages of low-income buyers have had, for the last 30 years at least, much higher default rates than traditional mortgages, a result that is too often conveniently ignored. Subprime mortgages have tended historically to be foreclosed at ten times the rate of prime mortgages, and FHA loans are foreclosed at about four times the rate of prime mortgages.

The Bear Stearns pitch also pooh-poohs credit ratings as a lending standard: “While credit scores can be an analytical tool with conforming loans, their effectiveness is limited with CRA loans. Unfortunately, CRA loans do not fit neatly into the standard credit score framework. . . . Do we automatically exclude or severely discount . . . loans [with poor credit scores]? Absolutely not.” They agree with the Boston Fed manual that traditional credit scores are not useful for poor and moderate-income households — but they don’t really provide any reason for this belief, except to say that credit scores are complicated constructs.

The ratings agencies should not have known how to rate these loans, since they had little experience with them. Nevertheless, in a show of bad judgment, they decided to rate them based on their performance during the housing bubble — as if the performance would be the same when the housing bubble burst. Big mistake.

The strongest incentive for eliminating traditional underwriting standards, as we have seen, came from attempts to help poor and minority borrowers. Nevertheless, newspapers tell us that upper-income individuals are being foreclosed on in large numbers as well. There are two points that need to be kept in mind. First, preliminary evidence (in a recent University of Chicago study) indicates that the current increase in defaults has been concentrated in those areas populated by poor and moderate-income borrowers. Further, poor and moderate-income areas had the largest share of speculative home buying, and speculative home buying appears to be the leading cause of current home foreclosures. Thus the evidence is that the foreclosures are disproportionately a problem of the poor and moderate-income areas. Second, although the original mortgage innovations were rationalized for low- and middle-income buyers, it is naive to believe that once this sloppy thinking had taken hold, the decade-long attack on underwriting standards would not also lead to more relaxed standards for higher-income borrowers.

THE (URBAN) LEGEND OF THE SUBPRIME VAMPIRE

The immediate cause of the rise in defaults is the reversal in the remarkable price appreciation of homes that occurred from 1997 to 2006. But the relaxation in lending standards was the cause of the housing-price bubble in the first place. Homeownership rates had, except for a small but temporary increase in the late 1970s, been basically flat for 25 years prior to 1995, whereupon they began a steep ascent. The relaxed lending standards, whose mechanics were put in place beginning in 1993, increased the pool of potential homeowners. This increase in demand for houses led to a rise in house prices, as Econ 101 would predict. This is not a controversial result. A study by the Federal Reserve Bank of San Francisco concluded as much in 2006: “It is likely that much of the increase [in homeownership rates] is due to innovations in the mortgage-finance industry that may have helped a large number of households buy homes more easily than they could have a decade ago” (italics added). Of course, that was written before the economic damage from the bubble’s collapse was apparent and before accountability became an issue.

Today, very few people in the area of housing regulation seem willing to point the finger at the relaxed standards in fear of where that finger will lead. Instead, almost all the blame is focused on subprime lenders (who happen to specialize in loans that use relaxed lending standards). Unscrupulous subprime lenders, we are told, are financial vampires, sucking the lifeblood from hypnotized mortgage applicants. Forgotten in this story is any explanation of why subprime lenders suddenly became so predatory. Did they wake up one morning with changed personalities? There is no reason to believe that subprime lenders became more unscrupulous in the past few years than they had been before, or that their level of unscrupulousness is much different than that of any other profession, say politicians. The fact is that the increase in subprime lending was consistent with the government’s effort to increase lending to poor and minority applicants. Countrywide, the largest subprime lender by far,
winner as we have seen of minority awards and accolades from government banking regulators before the mortgage meltdown, saw itself cast as a predatory lender by the very same people who had previously praised it, when blame began to be assigned for the mortgage meltdown.

There is a more substantial problem with the hypothesis that predatory subprime lenders caused the mortgage meltdown: the fact that subprime loans did not perform any worse than prime loans. The media often claim that prime loans started suffering from defaults only after the problems in the subprimes “seeped” into the prime market. Yet prime foreclosures began their increase at the same moment (third quarter of 2006) as subprimes. Further, the prime-foreclosure rate went into territory that was far above anywhere it had been in the prior ten years, much more so than was the case for subprimes. The increase in foreclosure starts, from the second quarter of 2006 until the end of 2007, was 39 percent for subprime loans — and 69 percent for prime loans. There is no evidence to support a claim that somehow the subprime market had an unprecedented increase in foreclosures, and that later the primes accidentally caught the contagion. Why would mortgage defaults increase so greatly in the prime market, where there were, by definition, no subprime vampires preying on the innocent?

As an aside: The prime/subprime distinction is not related to differential increases in foreclosure rates, contrary to numerous stories to that effect. The key distinction is that between adjustable and fixed-rate mortgages, with the former having much higher increases in foreclosure rates than the latter. This is consistent with a view that speculators, who would prefer adjustable mortgages (which have lower interest rates) since they do not plan to hold houses very long, are responsible for many of the current foreclosures. Since flexible underwriting standards allowed homes to be purchased with little or no cost to the purchaser, they allowed speculators to bet without using any of their own money.

THE HARD ROAD AHEAD

We are now experiencing one of the worst financial panics in the post-WWII era. Everyone knows that the increase in mortgage defaults has been the primary driver for these financial difficulties. The mortgages with outrageously lax underwriting standards that have been justifiably ridiculed in the press are not outliers, but unfortunately representative of a great many recent mortgages. The question being asked is the correct one: How did it come about that our financial system allowed such loans to be made, and even celebrated them? The answers that are being given are not yet the correct ones, however. The main answer that is being given, that unscrupulous lenders were taking advantage of poorly informed borrowers, does not fit the evidence.

No, it is the mortgage “innovations” that are to blame — and the culpability for them lies squarely on the doorstep of the federal government and the political activists working with it. Without these innovations we would not have seen prime mortgages made with zero down payments, which is what happens when individuals use a second mortgage to cover the down payment of the first. Nor would we have seen “liar loans” where the applicant was allowed to make up an income number — unless the applicant was making an enormous down payment, which is the legitimate historical use of such loans.

Nor is it a cheap shot to say these problems were predictable. A co-author and I predicted increased foreclosures in 1998. Even the New York Times, in a surprisingly prescient 2004 business-section article, blames the Clinton administration’s 1994 decision to increase homeownership for leading to a situation in which “the move to push homeownership on people that historically would not have had the finances or credit to qualify could conceivably and ultimately turn Fannie Mae’s American dream of homeownership into the American nightmare of homeownership.”

The political housing establishment remains committed to flexible underwriting standards, although it is unwilling to accept responsibility for the havoc those standards have wrought. Unless this attitude is corrected, soon, today’s bailout crisis will only be the first, with more to come.

Mr. Liebowitz is a professor of economics at the University of Texas at Dallas and a research fellow at the Independent Institute. This article is adapted from a chapter in the book Housing America: Building Out of a Crisis, edited by Benjamin Powell and Randall Holcombe (forthcoming in 2009 from Transaction and the Independent Institute). A full version of the chapter can be found at www.independent.org.