Dangers of Housing Policy ‘Hidden in Plain Sight’ No more

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Necessary reform of the U.S. housing finance system will only be possible when we understand how government policy shaped the financial crisis. We are nowhere near this achievement, as made clear by the new book *Hidden in Plain Sight: What Really Caused the World's Worst Financial Crisis and Why It Could Happen Again*, by the American Enterprise Institute's Peter Wallison.

Wallison describes how the Clinton and Bush administrations forced Fannie Mae and Freddie Mac to weaken mortgage credit standards in order to increase homeownership in the run-up to the housing crisis. Meanwhile, advocacy groups used the Community Reinvestment Act to club banks in need of regulatory approval for expansion into cutting credit standards.

From 1996 through 2008, the Department of Housing and Urban Development increased Fannie and Freddie's affordable housing goals for low- and moderate-income borrowers. Every year until 2008, the government-sponsored agencies exceeded their goals by increasing nontraditional mortgages: subprime and "Alt-A" mortgages with no or negative principal amortization, no income verification, and down payments of less than 3%. In response to the GSE's reckless Washington-driven competition, the entire mortgage market weakened credit standards.

Easy mortgage credit fueled an unprecedented housing bubble. According to the Case-Shiller index, real home prices from 1997 to 2007 increased almost 90%.

Rising housing prices masked risk. The homeownership rate rose from 64% in 1994 to 69% in 2004, according to data from the Federal Reserve Bank of St. Louis.

By June 2008, 57% of all U.S. mortgages — 31 million — were high-risk nontraditional mortgages, according to Wallison. Seventy-six percent of those were backed by the GSEs and government agencies.

Washington propelled the tsunami of sketchy mortgages, Wallison writes. The private sector followed its lead. If there had been no taxpayer-backstopped mortgages on the table, then private lenders wouldn't have supplied unsound mortgages in such quantities.

For many people on the left, greedy Wall Street is an irresistible villain. But there's always been greed on Wall Street. As House Financial Services Committee Chairman Jeb Hensarling observes, "Washington greed" was more the problem in the run-up to the crisis — and it remains so today.

The fable that deregulation was the cause of the crisis drove the passage of the Dodd-Frank Act. But under Bush, there was no financial deregulation. In fact, the Privacy and Patriot Acts and Sarbanes-Oxley imposed a battery of additional regulatory burdens on banks.

Dodd-Frank was falsely sold as a silver bullet preventing another financial crisis. Instead, as Wallison notes, it "slowed and will continue to slow economic growth" and conferred enormous new powers on Washington bureaucrats. But it didn't address the culprit in the crisis: government's role in housing finance.

Now, as Hensarling warns, "Washington appears to be rolling the dice again" on the same gamble that produced the last crisis. Fannie, Freddie and the Federal Housing Administration are playing a game of thrones to dominate subprime mortgages.

In December, Fannie and Freddie re-launched 30-year, fixed-rate, 97% loan-to-value mortgages. With FHA's reserve fund below a statutorily mandated 2%, HUD secretary Julian Castro says lowering premiums by 50 basis points makes mortgages more affordable.

Over half of government purchase mortgages now have down payments of 5% or less. With a straight face, FHFA director Mel Watt contends that GSE mortgages with a 3% down payment with "other compensating factors" are no riskier than those with 10% down payments.

Meanwhile, AEI's National Mortgage Risk Index hit a high in January. In January, 37% of Fannie/Freddie and 65% of FHA mortgages respectively had debt-to-income ratios greater than 38%. In December, over 35% of loans from the FHA's top 25 issuers had subprime FICO scores of under 660.

These changes are setting the housing industry up for another crisis.

The problem could be averted by sticking to traditionally-underwritten mortgages, which perform well. The default rate on fully-documented Freddie Mac 30-year fixed-rate home purchase loans acquired in 1999 through 2007 with FICO scores above 660, debt-to-income of 38% or lower and LTV of 90% or lower was .55%.

Clearly we have a problem.

Genuine reform is a tall order. The public buys the narrative the crisis was caused by insufficient regulation and rapacious Wall Street bankers.

Wallison warns unless that narrative is supplanted by one that highlights government housing policy as the real cause of the last crisis, another one awaits us. But a number of parties, including real estate and mortgage brokers, home builders, community activists and politicians, have a stake in government-financed mortgages. Many Democrats support politicized government lending, and many Republicans want to proclaim they've "fixed" Fannie and Freddie while keeping a government-mortgage backstop. The Corker-Warner Housing Finance Reform and Taxpayer Protection Act was a vivid example of such faux reform.

Hidden in Plain Sight, however, can educate voters that government-financed housing is inevitably politicized, leading to gutted credit standards. Society pays a steep price in the end, including the very people that affordable-housing policies are purported to help. Informed voters are a prerequisite for real reform.

To better protect the U.S. economy, Fannie and Freddie should be privatized and permitted to sink or swim. And government-agency housing finance should be terminated. These changes would allow the financial industry to provide mortgages without putting taxpayers on the hook.

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