How bad housing policies led to the financial crisis

by Eric Grover

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HIDDEN IN PLAIN SIGHT: WHAT REALLY CAUSED THE WORLD'S WORST FINANCIAL CRISIS AND WHY IT COULD HAPPEN AGAIN

By Peter J. Wallison

Encounter Books, $27.99, 432 pages

Peter Wallison's important, engaging and alarming "Hidden in Plain Sight" is the definitive work on the financial crisis and a must-read for policymakers, the commentariat and citizens wanting to pierce the populist anti-Wall-Street, anti-bank fog. Mr. Wallison makes a cogent case that "the 2008 financial crisis would not have occurred but for the housing policies of the U.S. government between 1992 and 2008."

Washington's "affordable-housing" mandates ratcheted up over the prior decade forced government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac to buy and backstop ever-riskier mortgages, fueling unprecedented subprime-mortgage and housing bubbles. Affordable housing was and remains a euphemism and rallying cry for government gutting mortgage credit standards. Many affordable-housing activists dislike credit standards because the less creditworthy fall below cut-offs. As the Federal Housing Finance Agency pressured the GSEs to do more high-risk mortgages, few realized the magnitude or peril of the debt bomb tied to inflated housing. Analysts and regulators wrongly assumed the GSEs' exposure to risky nontraditional mortgages was modest because the GSEs grossly underreported them.

The time-proven tripod of prudent mortgages are prime credit scores, debt-to-income ratios less than 38 percent and loan-to-value ratios not greater than 80 or 90 percent. Congress' and the Department of Housing and Urban Development's affordable housing goals undercut all three.

By June 2008, 57 percent of the mortgages in the United States — a whopping 31 million — were sketchy subprime and Alternative A-paper, 76 percent of which were owned or guaranteed by the GSEs and government. Alternative A-paper loans included those with no income verification, no or negative amortization, high loan-to-value ratios or other risky characteristics.

GSE mortgages, unless identified as subprime, were assumed prime and the only loans so identified were those originated by subprime specialists. Astonishingly, in its 2007 annual report Fannie estimated 0.3 percent of its single-family mortgage credit book of business was subprime, compared with 0.2 percent and 0.1 percent in 2006 and 2005, respectively. Fraudulent statements like that lulled investors and regulators into grossly underestimating the risk. In August 2008, Fed economists estimated there were 6.7 million subprime mortgages — one-fourth total high-risk nontraditional mortgages.

Regulators were inept, and, ironically and tragically through Dodd-Frank, were rewarded with vastly expanded powers.

Notwithstanding most nontraditional mortgages being held by government, frozen markets and the Securities and Exchange Commission's mark-to-market accounting forcing reckless and unjustified PMBS write-downs, reduced private-sector capital caused a massive common shock.

While Federal Reserve Chairman Ben Bernanke and Treasury Secretary Hank Paulson didn't create the subprime-mortgage tsunami and housing bubble, their blundering helped precipitate the crisis. Rescuing Bear Stearns created moral hazard. Once it had been rescued, not saving Lehman, which was 50 percent larger, was hard to fathom and caused panic. Mr. Bernanke and Mr. Paulson subsequently falsely asserted they didn't have the authority to rescue Lehman. Mr. Paulson's Troubled Asset Relief Program (TARP) did little good. Forced on solid banks like Wells Fargo and BB&T, which didn't need or want it, it created the impression that banks were bailed out, making it politically impossible for Congress to reform Dodd-Frank. Acting like Vito Corleone, Mr. Paulson and Mr. Bernanke threatened to declare the only AAA-rated bank Wells Fargo "capital deficient" coercing it to accept $25 billion in TARP funds, signaling markets the system must be on the brink.

In 2009, Congress established a Financial Crisis Inquiry Commission to investigate the crisis. A rigorous, open and public-spirited inquiry would have explored all plausible causes. The Democrat-led commission, however, saw its role as confirming the narrative that a greedy private sector and insufficient regulation were the culprits. Mr. Wallison rightly excoriates the commission majority for failing "in their obligation to the public by suppressing information that contradicted the predetermined conclusions of their report." Though at the time, the full extent of the GSEs' nontraditional-mortgage exposure wasn't known, the American Enterprise Institute's Edward Pinto presented exhaustively documented estimates just before the crisis that 49 percent of all mortgages were unsound nontraditional mortgages. It should have set off alarm bells. Brass-collar Democrats, however, ignored Mr. Pinto's report because it contradicted the narrative that rapacious bankers and insufficient regulation were culpable.

Not everyone kept their ideological blinders on.

No less an affordable-housing cheerleader than former House Financial Services Committee Chairman Barney Frank in 2010 said, "I hope by next year we'll have abolished Fannie and Freddie it was a great mistake to push lower-income people into housing they couldn't afford ... ."

House Financial Services Committee Chairman Jeb Hensarling is under no illusions, saying the crisis' cause "was not deregulation but dumb regulation," mandating the GSEs and other financial institutions to make improvident loans. But Mr. Hensarling's sober-minded assessment and desire for reform are not enough.

Democrats and many Republicans oppose curbing government's role in housing finance and Democrats have circled the wagons around Dodd-Frank. For genuine reform we can't rely only on good men with conviction. Paraphrasing Milton Friedman, conditions must be created where even bad men are compelled to support good policy. Mr. Wallison's work is part of creating those conditions.

Ominously, in December Fannie and Freddie relaunched 30-year fixed, 97 percent loan-to-value mortgages.

Unless the public understands government politicizing and weakening mortgage credit standards caused the crisis, it will be impossible to fix Dodd-Frank and eliminate government's outsized and dangerous role in housing finance.

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