Statement of Stan Liebowitz before the House Subcommittee on the Constitution, Civil Rights, and Civil Liberties Hearing on Enforcement of the Fair Housing Act of 1968, June 12, 2008

The major economic news for the last years has been the disarray in the mortgage market. The malaise in the mortgage market has been threatening to drag the rest of the economy down with it.

How did we get here? One key component is that the government in the 1990s began to base its housing policy on a false claim, or lie. The government repeated this claim over and over again. Eventually this lie began to poison the mortgage market, and now the entire economy is at risk.

The poison began with the claim that minorities were being denied mortgages because of racial discrimination. This claim was originally trumpeted in newspapers and television based on HMDA data even though it should have been obvious to those making the charges that the HMDA data were insufficient to examine the issue of discrimination. Every year when the HMDA came out charges of discrimination were made by the legions of individuals hell-bent on finding discrimination, whether it was there or not.

Because it was obvious to a more sophisticated audience that the HMDA data were inadequate to test for discrimination, an expanded HMDA data set was created by the Boston Fed to allow a more complete analysis of the question. The researchers at the Boston Fed performed a study and claimed that one forth of the higher minority mortgage rejection rate was due to discrimination.

Unfortunately, this data set was created with insufficient care. The data had apparently never been examined for transcription errors by its creators at the Boston Fed. When my coauthor and I actually looked at the numbers in the data set it was clear that the data were outrageously unreliable. There was no basis for a claim that minorities were discriminated against by mortgage lenders. Full details are available in my article published in the 1998 issue of the economics journal “Economic Inquiry.”[1]

Nevertheless, government officials and regulatory agencies showed no interest in getting to the truth of the matter. In a rush to judgment and before any outside analysis of the Boston Fed study could even take place, the Boston Fed study was claimed to be definitive and conclusive. In other words, the fix was in. The Boston Fed study was just a fig leaf that could be used to continue attacking the mortgage industry as being racist.

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[1] Available at http://www.utdallas.edu/~liebowit/mortgage/mortgages.pdf

This ‘finding’ of discrimination was then used to argue for weaker lending standards, in the guise of ensuring greater minority participation in the mortgage lending process. Traditional lending standards were attacked as a form of discrimination by regulators and housing advocates. It was claimed that mortgage applicants could handle larger obligation ratios than those imposed by traditional standards; that mortgage applicants could make their monthly payments without having been consistently at a job; that mortgage applicants didn’t need to be able to show that they could come up with a downpayment—a gift, say from a phony charity set up by the seller of the home, would do just fine. It was suggested that mortgage applicants should be deemed credit-worthy if the applicants watched some sort of educational video about the housing market and the mortgage process. This was all nonsense, one lie compounding another.

The claim that lending standards could be “relaxed” without increasing the number of defaults was false. When you build a housing market on such false claims, you are asking for trouble.

The recent unusually high defaults are due to an unusually steep decline in home prices. But there would not have had such a large number of defaults if substantial downpayments had been made on the homes. We can thank relaxed lending standards for that.

I even doubt that the recent major price bubble in housing would have occurred if relaxed lending standards were not in place. It is much easier to speculate on house prices if no money needs to be put down and if income does not need to be verified.

Nor would the secondary market have been as likely to step in and fund mortgages backed by relaxed secondary standards if they hadn’t have heard all the claims about the safety of relaxed lending standards coming from various government agencies. If you examine sales pitches that were being made for the sale of these mortgages in the secondary market, you will find them repeating the government claims about how relaxed lending standards do not lead to greater defaults.

Although there are many other contributing factors, I think we can probably lay the core of the mortgage debacle at the proliferation of relaxed lending standards, which have been and continue to be supported by many of the people likely to be in this room.[2]

[2] See Fannie Is Poised to Scrap Policy Over Down Payments By JAMES R. HAGERTY, Wall Street Journal May 16, 2008; Page A3 which reports that affordable housing advocates are among the supporters of attempts to keep Fannie Mae from slightly tightening its lending standards.

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THE REAL SCANDAL

HOW FEDS INVITED THE MORTGAGE MESS

By STAN LIEBOWITZ

February 5, 2008 -- PERHAPS the greatest scandal of the mort gage crisis is that it is a direct result of an intentional loosening of underwriting standards - done in the name of ending discrimination, despite warnings that it could lead to wide-scale defaults.

At the crisis' core are loans that were made with virtually nonexistent underwriting standards - no verification of income or assets; little consideration of the applicant's ability to make payments; no down payment.

Most people instinctively understand that such loans are likely to be unsound. But how did the heavily-regulated banking industry end up *able* to engage in such foolishness?

From the current hand-wringing, 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.

In the 1980s, groups such as the activists at ACORN began pushing charges of "redlining" - claims that banks discriminated against minorities in mortgage lending. In 1989, sympathetic members of Congress got the Home Mortgage Disclosure Act amended to force banks to collect racial data on mortgage applicants; this allowed various studies to be ginned up that seemed to validate the original accusation.

In fact, minority mortgage applications *were* rejected more frequently than other applications - but the overwhelming reason wasn't racial discrimination, but simply that minorities tend to have weaker finances.

Yet a "landmark" 1992 study from the Boston Fed concluded that mortgage-lending discrimination was systemic.

That study was tremendously flawed - a colleague and I later showed that the data it had used contained thousands of egregious typos, such as loans with negative interest rates. Our study found no evidence of discrimination.

Yet the political agenda triumphed - with the president of the Boston Fed saying no new studies were needed, and the US comptroller of the currency seconding the motion.

No sooner had the ink dried on its discrimination study than the Boston Fed, clearly speaking for the entire Fed, produced a manual for mortgage lenders stating that: "discrimination may be observed when a lender's underwriting policies contain arbitrary or outdated criteria that effectively disqualify many urban or lower-income minority applicants."

Some of these "outdated" criteria included the size of the mortgage payment relative to income, credit history, savings history and income verification. Instead, the Boston Fed ruled that *participation in a credit-counseling program* should be taken as evidence of an applicant's ability to manage debt.

Sound crazy? You bet. Those "outdated" standards existed to limit defaults. But bank regulators *required* the loosened underwriting standards, with approval by politicians and the chattering class. A 1995 strengthening of the Community Reinvestment Act required banks to find ways to provide mortgages to their poorer communities. It also let community activists intervene at yearly bank reviews, shaking the banks down for large pots of money.

Banks that got poor reviews were punished; some saw their merger plans frustrated; others faced direct legal challenges by the Justice Department.

Flexible lending programs expanded even though they had higher default rates than loans with traditional standards. On the Web, you can still find CRA loans available via ACORN with "100 percent financing . . . no credit scores . . . undocumented income . . . even if you don't report it on your tax returns." Credit counseling is required, of course.

Ironically, an enthusiastic Fannie Mae Foundation report singled out one paragon of nondiscriminatory lending, which worked with community activists and followed "the most flexible underwriting criteria permitted." That lender's $1 billion commitment to low-income loans in 1992 had grown to $80 billion by 1999 and $600 billion by early 2003.

Who was that virtuous lender? Why - Countrywide, the nation's largest mortgage lender, recently in the headlines as it hurtled toward bankruptcy.

In an earlier newspaper story extolling the virtues of relaxed underwriting standards, Countrywide's chief executive bragged that, to approve minority applications that would otherwise be rejected "lenders have had to stretch the rules a bit." He's not bragging now.

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 caused by relaxed lending standards.

This damage was quite predictable: "After the warm and fuzzy glow of 'flexible underwriting standards' has worn off, we may discover that they are nothing more than standards that lead to bad loans . . . these policies will have done a disservice to their putative beneficiaries if . . . they are dispossessed from their homes." I wrote that, with Ted Day, in a 1998 academic article.

Sadly, we were spitting into the wind.

These days, everyone claims to favor strong lending standards. What about all those self-righteous newspapers, politicians and regulators who were intent on loosening lending standards?

As you might expect, they are now self-righteously blaming those, such as Countrywide, who did what they were told.

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