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Subprime Crisis of Regulations

A report issued by the Federal Reserve early in August should receive far more attention than it has received to date.

According to this FRB study, neither the Community Reinvestment Act (CRA) nor the affordable housing goals of the federal government sponsored enterprises (GSEs) were significant causes of the recent problems in the subprime mortgage market.

Although this report offers "tentative" conclusions, it is remarkable nonetheless to use empirical data to look for a direct link between the applicable regulations and loan performance - and find nearly no link at all!

So, does a link exist between these programs and subsequent mortgage performance?

Superficial Association

Generally speaking, the CRA and the GSEs have been blamed for causing or at least contributing to the subprime crisis. After all, both favor lending to borrowers in lower-income census tracts which accounted for a disproportionate share of the growth in lending during the subprime buildup, as well as a disproportionate share of higher-priced, piggyback, no-income, and high-PITI lending, and elevated mortgage delinquency rates.

But the report concludes that "superficial association may be misleading." This view represents the empirical analysis caution, best stated in the probability dictum: correlation is not causation.

Let's take a closer look at the report.

"With few exceptions, the evidence is scant."

The FRB study is entitled The Subprime Crisis: Is Government Housing Policy to Blame? Written by FRB Senior Economists Robert B. Avery and Kenneth P. Brevoort, the paper, described as "tentative," notes the existence of studies with contrary findings, but says that these studies were based on "associations between aggregated national trends" rather than empirical data.

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The paper concludes that **"with few exceptions, the evidence is scant"** that the CRA or even the affordable housing initiatives of the GSEs actually caused the subprime market implosion.

Housing Policy and Regulations

The study was untaken to examine a growing body of literature suggesting that housing policy, embodied by the CRA and the affordable housing initiatives of the GSEs, may have caused the subprime crisis. But, according to the authors, the conclusions drawn in this literature, for the most part, have been based on associations between aggregated national trends.

The study found that there is:

> "...little evidence that either the CRA or the GSE goals played a significant role in the subprime crisis."

Indeed, the quantitative tests conducted actually indicate that **areas disproportionately served by lenders covered by the CRA experienced lower delinquency rates and less risky lending.**

And so-called "threshold tests" show no evidence that either program had a significantly negative effect on outcomes.

Models, Findings, and Conclusions

Two models were used:

Model # 1 - Determined whether loan outcomes across low-moderate-income (LMI) areas varied according to whether the lender was covered by CRA. (Obviously, because not all lenders are subject to the CRA, this creates a quasi-natural experiment of the CRA's effect.)

Findings: "If the CRA caused depository institutions to reduce their underwriting standards in LMI tracts, then LMI tracts that have been disproportionally served by CRA-covered lenders historically should have experienced worse outcomes than otherwise similar tracts."

Conclusion: There is little evidence of an adverse effect from CRA; in fact, tracts served by CRA-regulated lenders showed a lower rate of default in 2008.

Model # 2 - Determined the extent to which both CRA and the GSE housing goals encouraged lending in areas where the median family income was lower than an established standard.

Findings: If CRA and the GSE housing goals encouraged institutions to make loans that otherwise would not have been made, loans for homes in these areas would not have performed as well as loans made for homes elsewhere. Focusing on geographic areas that were on one side or the other of the tipping point of eligibility, and considering all of the types of lending activity that were examined, only loans purchased by CRA-regulated lenders within their assessment areas showed a meaningful difference in performance.

Conclusion: "Using a variety of indirect tests, [the authors] find little evidence to support the view that either the CRA or the GSE goals caused excessive or less prudent lending than otherwise would have taken place."

Regulatory Drift

Partially in response to the subprime crisis, many new regulations have been implemented over the last few years. The subject study indicates that such regulations were probably not too little too late, but too much too soon. In the event, many consumers are no longer served by mortgage loan originators. Rather than to be bottled up in these new regulations, many mortgage companies prefer to side-step subprime loan products altogether. In many cases, it would have been better for regulators to have enforced the existing regulations.

Credit-impaired borrowers constitute a significant part of the housing market, especially since the Great Recession began. No law says that every person should own a home, no matter how ineligible in terms of his or her assets, credit, income, or the collateral. Nobody should ever be taken advantage of in a financial transaction of any kind.

Regulations have their place, assuring a level playing field, providing consumer financial protection, and acting as the framework to a vibrant market. Suitable and strong regulations support a market economy.

Surely, however, if the CRA and the affordable housing goals of the GSEs are not at fault for the subprime crisis, perhaps instituting more regulations that may dampen loan originations for credit-impaired borrowers is simply not the correct way to prevent another subprime crisis from happening.

Commentary: Jonathan Foxx, President and Managing Director of Lenders Compliance Group.

Labels: Affordable Housing, Community Reinvestment Act, CRA, Government Sponsored Enterprises, GSE, Mortgages, Subprime Crisis, Subprime Mortgages

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