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Faulty Conclusions Based on Shoddy Foundations

FCIC Commissioner Peter Wallison and Other Commentators Rely on Flawed Data from Edward Pinto to Misplace the Causes of the 2008 Financial Crisis

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Introduction and summary

The congressionally appointed and bipartisan Financial Crisis Inquiry Commission last month released its final report on the causes of the U.S. financial crises in the first decade of the 21st century.[1] This carefully researched report provides a balanced and thoughtful explanation of the causes of the recent financial crisis, blaming a range of policies implemented by both the Clinton administration and the Bush administration. Like the previous staff reports issued by the FCIC, this final report is excellent and well worth reading.[2]

Alas, this final report was issued only by a majority of the FCIC members, as the minority members released a dissent that concluded a narrower set of issues, including federal affordable housing policies, were the driving cause behind the financial crisis.[3] Notably, FCIC minority member Peter Wallison, a senior fellow at the American Enterprise Institute, a conservative think tank based in Washington, D.C., issued his own separate dissent.[4] Based on work done by his AEI colleague Edward Pinto, Wallison concludes federal affordable housing policies were the driving cause behind the financial crisis, causing a decline in underwriting standards that triggered the U.S. housing bubble.[5]

Wallison's conclusion that affordable housing policies were the proximate cause of the financial crisis is integrally based on the claim that "[a]s a result of [U.S. government housing] policies, by the middle of 2007, there were approximately 27 million subprime and Alt-A mortgages in the U.S. financial system—half of all mortgages outstanding—with an aggregate value of over $4.5 trillion."[6] How does Pinto come to these conclusions? Wallison succinctly summarizes Pinto's findings in a January 3, 2011, Wall Street Journal op-ed:

> *By 2008 half of all mortgages in the U.S.—27 million—were subprime and other high-risk loans. … Because of their affordable-housing requirements, [Fannie Mae and Freddie Mac] bore the risk of default on 12 million of these mortgages. The Federal Housing Administration (FHA) and other government agencies insured or held an additional five million. And banks under the Community Reinvestment Act, and other mortgage providers under a Department of Housing and Urban*

Development program, made another 2.2 million. Thus, more than 19 million subprime loans [out of 55 million total outstanding loans] were the responsibility of taxpayers, courtesy of the federal government's housing policies.[7]

As Wallison clearly indicates in his FCIC dissent, all of the data on the number of outstanding subprime and Alt-A mortgages outstanding, and their distribution, that he relies on to form his conclusions come from Pinto's research.[8] Pinto's findings also were widely circulated among the public and key policymakers.[9] Pinto's work also is cited by prominent conservatives, including U.C. Berkeley Haas Business School Professor Dwight Jaffee, New York University Professor Lawrence J. White, Columbia Business School Professor Charles Calomiris, Cato Institute Senior Fellow Richard Rahn, and Reuters columnist James Pethokoukis.[10]

Unfortunately, Pinto's research findings relied upon so heavily by Wallison and others are false. Pinto's work is based on a series of faulty assumptions and serious methodological flaws. Pinto's controversial conclusion that federal housing policies were responsible for 19 million high-risk mortgages is based on radically revised definitions for the two main categories of high-risk mortgages, subprime loans and so-called Alt-A mortgages, which refer to loans with low documentation of income and wealth. Importantly, these revised definitions are not consistent with how the terms subprime and Alt-A are used for data collection, as this paper will demonstrate.

As a result of his dramatically expanded new definitions that are not used by other leading scholars, Pinto's findings on the extent of subprime and Alt-A exposure are extreme outliers among mortgage market analysts. Pinto's claim that there were 26.7 million subprime and Alt-A loans outstanding (out of roughly 55 million total) as of June 30, 2008, is exponentially higher than other estimates. In a 2010 report, the nonpartisan Government Accountability Office, the research arm of Congress, found there were only 4.58 million subprime and Alt-A mortgages outstanding at the end of 2009, less than one-fifth of Pinto's estimate.[11]

Similarly, Pinto's claim that 19 million, or 72 percent of all "subprime" and "Alt-A" mortgages were attributable to federal affordable housing policies is far afield of the conclusions of other analysts. The claim is also difficult to reconcile with the actual data, which indicate the entire federal government (including Fannie and Freddie) owned or guaranteed only 32 percent of seriously delinquent loans despite holding 67 percent of all mortgages.[12] Pinto's claim that Fannie and Freddie were the primary driver of high-risk mortgages does not stand when the evidence is weighed accurately.

Because of Pinto's anomalous findings, Wallison largely elides over the role of so-called "private-label" mortgage-backed securities in causing the crisis despite the large amount of attention these financial instruments received elsewhere, including in the FCIC majority's report.[13] This private mortgage financing channel, which does not involve the federal government at all and was policed only minimally, generated only 13 percent of outstanding loans but was responsible for 42 percent of serious delinquencies.[14]

Pinto makes numerous other serious errors in his analysis. Case in point: In analyzing the influence of the Community Reinvestment Act, a 1977 antidiscrimination law that simply requires regulated banks and thrifts to lend nondiscriminatorily to low- and moderate-income borrowers and communities within the immediate geographic areas surrounding branch offices of a deposit-taking institution,[15] Pinto includes a large quantity of loans that were not required by CRA or any other equivalent law or regulation.[16] This mistake, coupled with some unsupported assumptions about the riskiness of CRA loans, produces a shockingly high estimate of 2.24 million "subprime" and "high-risk" loans attributable to CRA. This compares to a finding of 378,000 CRA-eligible loans originated during the housing bubble by other leading researchers.[17]

Pinto also wrongly blames the affordable housing goals of Fannie and Freddie for the origination of Alt-A loans, which under his analysis account for 65% of the "high risk" mortgages attributable to Fannie and Freddie. In fact, these Alt-A loans (either according to the normal usage of "Alt-A" or Pinto's newly invented definition of "Alt-A") would not have qualified for the affordable housing goals.

As this paper will demonstrate, these and many other similar methodological flaws are fundamentally embedded in Pinto's research, making his conclusions fundamentally unreliable and essentially useless for the purpose of understanding either the causes of the housing bubble or the high rates of delinquencies that have occurred during the housing downturn. Yet based in large part on the inaccurate and misleading data peddled by Pinto, many policymakers are advocating inapt and often counterproductive solutions to the financial crisis.

This paper is designed to set the record straight on the following specific claims by Pinto that are either wrong or grossly distorted, and to highlight the extremely shaky foundation for the argument found in Wallison's FCIC dissent that federal affordable housing policies caused the financial crisis.

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