

# NATIONAL REVIEW

Strange Bedfellows at the Bank

Leftist activists, with lawmakers' support, worked with megabanks to lower lending standards for all.

By Charles Calomiris & Stephen Haber — February 4, 2014

According to CNN, Bruce Marks is “a crusader who has become a fierce advocate for struggling homeowners.” As executive director of the Neighborhood Assistance Corporation of America (NACA), Marks has been campaigning to protect homeowners in arrears with their mortgages from foreclosures. Marks [told](#) a CNN reporter, “These mortgages of the last ten years were structured to fail.”

You would think that, had Marks been around in the mid 1990s, he would have opposed the tidal wave of bank mergers that occurred at the time and publicly denounced the mortgage products that violated “back-to-basics” principles of prudent lending. The truth is just the opposite. Bruce Marks and NACA actively assisted some of those very institutions in amassing their power and size, and they did so with the explicit aim of getting them to issue mortgages that were “structured to fail.”

For example, when NationsBank sought approval from the Federal Reserve Board to acquire the Bank of America in 1998, creating the largest bank in the United States, Bruce Marks sent a letter to the Fed, stating that: “They [NationsBank and Bank of America] need to be applauded and supported. The regulators need to approve the application immediately . . .” George Butts, the President of ACORN Housing Corporation, a subsidiary of the Association of Community Organizations for Reform Now (yes, *that* ACORN), also sent a letter and offered testimony to the Fed in support of the merger. The irony of the situation appears not to have been lost on Butts, who noted: “It’s not the usual role for ACORN Housing Corporation to testify to the Federal Reserve Bank in favor of the merger of banks. This is a different role for us.” Six years later, when Bank of America acquired FleetBoston, Marks and Butts were there again, testifying on behalf of the merger. In that same year, when JP Morgan Chase acquired Bank One, ACORN activists again offered testimony in favor of the merger.

Why would populist groups like ACORN and NACA, whose stated goal is to help low-income Americans, actively support the creation of some of the biggest banks on the planet? You do not have to read very far into the transcripts of the Fed hearings to figure out what was going on: Activist groups were supporting megamergers because the resulting megabanks allowed the activist groups to award their constituents with billions of dollars in subsidized mortgage credit provided by the banks. The banks were, in effect, agreeing to share with the activists some of the economic benefits that they obtained from growing massively large.

The terms of the mortgages granted to ACORN and NACA constituents appeared, to use NACA’s phrase, “too good to be true.” In the case of NACA, borrowers received a one-size-fits-all mortgage with a fixed-rate, 30-year term, no down payment, no closing costs, no fees, no credit check, and no mortgage insurance premium. [Testimony](#) by Marks before the House Committee on Financial Services in 2000 indicates that NACA’s terms attracted borrowers with

very low credit ratings: 65 percent of NACA homeowners had a credit score that would categorize them as high-risk borrowers (a FICO score of less than 620), while nearly 50 percent had a score that would characterize them as very high-risk borrowers (a score of less than 580). Mortgages directed through ACORN Housing had similarly generous terms, including the right to count food stamps as income.

These arrangements with NACA and ACORN were just the tip of the iceberg. An accounting conducted by an activist umbrella group, the National Community Reinvestment Coalition, estimated that America's banks contractually committed \$858 billion in 187 agreements with activist groups between 1992 and 2007. As large as this number is, it represents a lower-bound estimate of the total amount of credit directed through activist groups. The NCRC data indicate that banks committed an additional *\$3.7 trillion* over that same period in "voluntary" lending programs to low-income or urban homeowners, and a comparison of that data and public statements by activist groups indicates that some of those funds were channeled through the activists. Banks also provided support to activist groups in the form of origination fees for administering the directed-credit programs, or philanthropic contributions, to those groups. A 2010 investigation by the Committee on Oversight and Government Reform of the U.S. House of Representatives found that between 1993 and 2008, ACORN alone received \$13.5 million from the Bank of America, \$9.5 million from JPMorgan Chase, \$8.1 million from Citibank, \$7.4 million from HSBC, and \$1.4 million from Capital One.

To understand how and why populists and financiers decided to become partners, we have to go back to the early 1970s, to trace the transformation of the U.S. banking system that began at that time, and to understand the economic and political opportunities that transformation created. Circa 1970, it was illegal for banks to branch across state lines, and the vast majority of states (38 out of 50, to be exact) limited the ability of banks to open branches even within the state. Some states, such as Texas, outlawed branches entirely: All banks were single-office "unit banks."

As the result of a variety of influences, the limits on bank branching became increasingly unsustainable in the 1980s. By the mid 1990s, subject to approval by regulators, American banks were free for the first time in their history to merge and branch wherever they liked.

There was a crucial catch to the legal changes that permitted bank consolidation: Acquisitions had to be approved by regulators. The criterion for approval of a merger that mattered the most was the acquiring bank's ability to demonstrate its good citizenship. As a practical matter, the Community Reinvestment Act (CRA) of 1977, which had established that good-citizenship requirement, had little immediate consequence for banks: From 1977 to 1991, total commitments by banks to improve their ratings under this law equaled only \$8.8 billion. Once the rapid-fire mergers of the 1990s got underway, however, this largely moribund piece of legislation became a powerful lever for activists to negotiate directed-credit deals with merging banks.

The National Community Reinvestment Coalition even put together a 101-page guide offering advice on how to negotiate agreements with banks that were in the process of merging: "Some banks are very desirous of Outstanding ratings so that they can present a clean reinvestment record to regulators when they ask for permission to merge. . . . Activists should keep in mind

that changes from Outstanding to Satisfactory ratings (and back again) is effective in leveraging reinvestment [CRA lending commitments] . . . ”

Banks contemplating mergers and activist groups seeking to grow their organizations therefore had incentives to seek one another out in order to further their mutual interests. But banks are in the business of making money, not providing loans at below-market interest rates to borrowers without collateral. They therefore looked for ways to unload the risky loans they were making through activist groups. Fannie Mae and Freddie Mac, the mortgage-purchasing giants, were, however, reluctant to purchase them, because they realized that these loans were risky. The Director of ACORN Housing, in testimony in front a U.S. Senate committee, explicitly drew a link between the ability of banks to sell their loans to Fannie and Freddie and the willingness of those banks to participate in partnerships with ACORN: “. . . many of the lenders we work with who now hold multimillion dollar CRA portfolios have told us that they may soon be unable to originate more of these loans if they remain unable to sell them to Fannie Mae or Freddie Mac.”

Activist groups soon came up with a way to solve this problem: They enlisted political allies in the House and Senate to force Fannie and Freddie to buy bank mortgages generated through CRA commitments. Senator Alan Dixon of Illinois convened a Senate Banking Committee hearing in 1991 and invited representatives from ACORN and other activist groups to testify — and they went after the underwriting standards of Fannie and Freddie with hammer and tongs. Consider the testimony of the Director of ACORN Housing: “It is ACORN’s observation that the underwriting criteria employed by Fannie Mae and Freddie Mac have been developed not for the general mortgage market, which includes low and moderate income homeowners, but for a middle income and substantially suburban mortgage market. As a result, *it is our firm belief that the underwriting standards dictated by the secondary mortgage market are, at a minimum, income discriminatory and may, by extension, be racially discriminatory* [emphasis added].”

The managers of Fannie and Freddie could see that they were being outmaneuvered, but they were not powerless, passive observers. In return for agreeing to lower their underwriting standards in order to purchase CRA commitment loans, they obtained the right to back their mortgage portfolios with paper-thin levels of capital, and to be regulated by an office within the Office of Housing and Urban Development (HUD) that had little power and no experience in financial-services regulation. In short, Fannie and Freddie agreed to go along with purchasing high-risk loans provided they could fund the expansion of their portfolios with borrowed money, and by virtue of Fannie and Freddie’s special charters as Government Sponsored Enterprises those debts were implicitly guaranteed by the U.S. treasury, which is to say by taxpayers.

The resulting deal was codified in the Federal Housing Enterprise Safety and Soundness Act (usually called the GSE Act), which was signed into law by President George H. W. Bush just prior to the 1992 election. The election of Bill Clinton in 1992 allowed activist groups to apply vastly more pressure on merging banks, as well as on Fannie and Freddie, because Clinton saw the banks and the GSEs as a way to redistribute income outside of the government’s fiscal policies. As he proudly proclaimed in a 1999 speech, the banking-reform legislation of that year “establishes the principles that, as we expand the powers of banks, we will expand the reach of the [Community Reinvestment] Act.” Activist groups jumped on the opportunities that Clinton created. Consider Bruce Marks’s testimony before the House Committee on Financial Services

in 2000 regarding Fannie Mae's underwriting standards: "The GSE's, and in particular Fannie Mae, have been a big part of both the creation and the continuation of predatory lending practices. With over a trillion dollars in assets, they set the standards in this country for access to home ownership for working people. They determine what is a conventional loan and what is considered a sub-prime loan. . . . Those who receive sub-prime loans are considered sub-prime borrowers and are excluded from the conventional 'Fannie Mae' loans. They are the ones who become the victims of what we know as predatory loans. By creating the system that excludes these borrowers from conventional affordable financing, Fannie Mae and the GSE's set them up to become victims of predatory lending."

The affordable-lending mandates to Fannie and Freddie were therefore increased throughout the Clinton administration. When George W. Bush came into office in 2001, he further increased the affordable-housing mandates that the Clinton administration had imposed on Fannie and Freddie. By 2008, something on the order of 80 percent of Fannie or Freddie mortgage purchases in the secondary market were likely in one of the mandated categories.

Meeting these ever-escalating targets became increasingly difficult. A first, crucial step in GSE relaxation of underwriting standards to meet HUD targets was a 1994 decision to purchase mortgages with loan-to-value ratios of 97 percent (a 3 percent down payment). The increasing tolerance for low down payments was not enough. Fannie and Freddie also had to buy increasing numbers of loans to borrowers with weak credit reports. They also aggressively moved into the markets for adjustable-rate mortgage loans (ARMs) and interest-only loans. Even these steps were not sufficient. In 2004, Fannie and Freddie removed the limits that they had earlier placed on their purchases of so-called no-docs loans (loans in which the applicant simply stated his or her income and employment history, with no independent verification).

When Freddie Mac decided to make this aggressive move into no-doc loans, its own risk managers pointed out that it was a grave error in a series of e-mails to Freddie's senior management. (One of us received these e-mails from the staff of the Committee on Oversight and Government Reform of the U.S. House of Representatives, and they were included in his testimony to that committee.)

These warnings fell on deaf ears because politics was driving decision-making. A July 14, 2004, e-mail from Senior Vice President Robert Tsien to Dick Syron, chair and CEO of Freddie Mac, suggests as much: "Tipping the scale in favor of no cap [on no-doc lending] at this time was the pragmatic consideration that, under the current circumstances, a cap would be interpreted by external critics as additional proof we are not really committed to affordable lending."

Representative Henry Waxman, who chaired the Committee on Oversight and Government Reform in which these e-mails came to light, summed up the situation in his opening statement to the hearings: ". . . Fannie Mae and Freddie Mac knew what they were doing. Their own risk managers raised warning after warning about the dangers of investing heavily in the subprime and alternative mortgage market, but these warnings were ignored. . . . Mr. Syron did not accept the chief risk officer's recommendation. Instead, the company fired him."

How did these arrangements give rise to the subprime crisis? Financial meltdowns of that magnitude occur only when two conditions exist simultaneously: Banks hold too many risky assets, and they back those risky assets with inadequate capital.

Let us start with the riskiness of bank-lending portfolios. Although the mandates driving the debasement of GSE underwriting were intended to be selective, in meeting those mandates Fannie and Freddie found it more politically convenient to relax standards for everyone — inner-city dwellers seeking to purchase a modest home, as well as suburbanites who aspired to trade up to a McMansion. Curiously, this is a point that has been missed by activists and academics intent on showing that the Community Reinvestment Act played no role in the Subprime Crisis because they detect no difference in default rates between loans made to satisfy the CRA and other loans made at the same time. Joseph Stiglitz, for example, claims in his book *Freefall* that “default rates on the CRA lending were actually comparable to other areas of lending — showing that such lending, if done well, does not pose greater risks.” But whether or not that is true — and it’s been hotly contested — it misses the point. Community Reinvestment Act loans by banks, as well as the mandates imposed on Fannie and Freddie that effectively forced them to purchase those loans, set in motion a process by which America arrived at debased lending standards for *everyone*.

The point is simple, but it seems to have eluded many researchers: Suburbanites would not have been able to take advantage of lax lending standards had there been no megabank-activist-GSE partnership working to undermine those standards. When Fannie and Freddie agreed to purchase loans that required only a 3 percent down payment, no documentation of income or employment, and a far-from-perfect credit score, they changed the risk calculus of millions of American families, not just the urban poor. Moreover, Fannie and Freddie, by virtue of their size and their capacity to repurchase and securitize loans made by banks, set the standards for the entire mortgage industry. Commercial banks and other mortgage lenders increasingly tolerated poor credit histories, and were willing to accept less and less documentation, because they knew that they could sell risky loans to Fannie or Freddie.

Had banks and the GSEs backed these loans with adequate prudential capital, their failure would have caused shareholders to lose money, but it would not have threatened to take down the entire financial system. But the same political forces that pushed for the explosion of high-risk mortgages also encouraged regulators to underestimate mortgage risk, and to permit banks and GSEs to maintain paper-thin capital buffers against that risk. Capital requirements for banks encouraged banks to restructure their mortgages as mortgage-backed securities, either through their own securitization operations or those of the GSEs, and regulators required very little capital against the mortgage-backed securities that were issued in those transactions. Prudential standards for the GSEs were especially weak. The deal that underpinned the GSE Act of 1992 allowed Fannie and Freddie to put up only \$2.50 in capital for every \$100 in mortgages they purchased — compared with \$4.00 for the commercial banks that originated those mortgages. Furthermore, if Fannie or Freddie bundled these mortgages together, and provided an additional 45 cents in capital per \$100 of mortgages as a buffer against default risk, they could create a mortgage-backed security, the purchaser of which had to hold only \$1.60 in capital per \$100 invested.

This structure of capital requirements created an opportunity for banks to lower the amount of capital backing their mortgage portfolios (by selling loans to Fannie and Freddie and then buying them back as mortgage-backed securities whose capital requirements were half those of the original loans), and it created an opportunity for Fannie and Freddie to make a tremendous amount of money by buying mortgages, securitizing them, and then selling those mortgage-backed securities back to banks. Not surprisingly, Fannie and Freddie's business grew rapidly; in 1990, they accounted for roughly a quarter of all single-family home mortgages; by 2003, their share had risen to half. This business turned out to be so lucrative that Fannie and Freddie went to extraordinary lengths to make sure that lawmakers did not force more stringent capital requirements or tighter underwriting standards on them. Between 1998 and 2008, Fannie spent \$79.5 million and Freddie spent \$94.9 million on lobbying Congress, making them the 20th and 13th biggest spenders on lobbying during that period.

In sum, by the early 2000s, amazingly lax lending standards were available for everyone to take advantage of, and the banks and GSEs that provided this risky credit were allowed to maintain paper-thin capital ratios. It would not take much to push millions of Americans, as well as many banks and the GSEs, into insolvency. Whether or not homeowners or bankers realized it, they had been corrupted: They had been offered a deal that was too good to be true, and they'd taken it. We are still living with the tragic consequences.

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