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'The Big Short' Falls Short On Explaining The Housing Collapse

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The Community Reinvestment Act of 1977. If you haven't heard of it, I wouldn't be surprised. I wasn't surprised when nobody mentioned it after the housing market collapsed in 2008, and I wasn't surprised when few noticed in 2010 when the federal banking executives proposed changes expanding the act. I was surprised, however, when *The Big Short*, a movie claiming to explain the housing collapse so as to prevent another one, left out not only the CRA but also any responsibility of the federal government, since the act–and the government–is the major cause of the 2008 housing collapse yet still remains a part of the U.S. Code of Laws.

I realize Adam McKay, a disciple of Bernie Sanders and the movie's director, would be eager to pin blame upon Wall Street (whose investment bankers are certainly not entirely innocent) but his obligation to the truth, the whole truth, should've yielded a mention of the act. The best way to prevent another housing collapse, which McKay foreshadows at the end of the movie, would be to repeal the act. But Americans must first be informed of its history and implications.

The Community Reinvestment Act of 1977

Signed by U.S. President Jimmy Carter, the act requires banks wishing to receive Federal Deposit Insurance Corporation (FDIC) insurance meet the financial needs of housing borrowers in all areas of the bank's business charter–including low-income neighborhoods with a high chance for mortgage delinquency, where the loan is most likely to be subprime and unprofitable. Since banks commonly avoided granting loans for people in low-income areas in favor of the much more financially attractive higher-income ones, money was poured into the wealthy areas, leaving the impoverished ones even more impoverished.

Carter saw an opportunity for economic growth here, so he took it. His flagship act did not *require* banks purchase subprime loans, however, only that they fill a certain percentage of their overall mortgage portfolio with loans from low-income neighborhoods–regardless of rating–which greatly improved the economy and pulled new money into new parts of the country.

The CRA allowed Lewis Raineri of Salomon Brothers to develop collateralized debt obligations, a structuring system of mortgage bonds placing the most debt obligation upon the strongest loans in the bond and the least on the weakest. Originally a sound system, which Raineri himself supported even in 2007, the CDOs' collapse caused the collapse of the housing market, and just as the CRA allowed them to exist, it caused their death.

Clinton politics to blame

What crippled the CDOs was U.S. President Bill Clinton's 1995 revamp of the CRA. Needing a way to revive the country's economy, which was suffering after the savings and loan crisis of the 1980s and '90s, and make good on his campaign promise to help the lowest classes, Clinton turned his eyes to CRA reforms within a year of entering office.

The final copy of the CRA revisions earned outcry by many economists, most notably William Niskanen of the Cato Institute, who believed the 1995 revisions would be greatly harmful to the American economy. In his testimony to the Subcommittee on Financial Institutions and Consumer Credit that year, during Congressional hearings ahead of voting on the act, Niskanen revealed several unsettling problems with the revisions, including the requirement that banks purchase subprime loans, which were expected to result in losses for the banks acquiring them, in order to continue receiving benefits.

Ultimately, he declared, "[the] new regulations would be very costly to the economy, to the banking system, and to the communities they serve." The CRA, then, became an agent of Clinton's campaign promises, causing only unsustainable short-term prosperity for the lowest class and a dangerous precedent within the mortgage bond market.

In 2003, an interagency review of the 1995 revisions discovered that the federal government reviewed less than 30% of all housing loans, leading many to blame Wall Street for growing mortgage delinquency rates and CDOs composed of mostly subprime loans leading up to and after the collapse. Of course, people were unaware that the CRA was encouraging this dangerous lending practice, for which "Clinton politics," not "Wall Street greed" was to blame.

"Toxic" coercion into subprime loans

According to an article in *City Journal* entitled "Yes, the CRA Is Toxic," American Enterprise Institute fellow Edward Pinto wrote that Bank of America reported in 2008 that its CRA portfolio, 7% of its owned mortgages, was responsible for 29% of its losses, proving strong correlation between the government and the collapse. If Bank of America had not been coerced into purchasing subprime loans, it, and all other Wall Street banks, would have been able to contain their losses.

The loans to low-income housing, which the CRA required banks acquire, were, as Pinto says, "toxic" to the American economy.

And they weren't only toxic to the wealthy. As Patrick Bayer, Fernando Ferreira and Stephen L. Ross found in a 2014 paper published under the Real Estate Department at Penn's Wharton School of Business, "those black and Hispanic homeowners drawn into the market near the peak," that is, when the CRA benefits made it financially obligatory, "were especially vulnerable to adverse economic shocks and raise serious concerns about homeownership as a mechanism for reducing racial disparities in wealth."

Essentially, their point is that using the housing market to even out the economic playing field puts at risk those who are unable to sustain themselves should the market collapse and puts a far too heavy burden on the lowest economic bracket. Clinton's idealized resuscitation of the lower class temporarily worked, but after the market collapsed, the only people left standing were those wealthy enough to survive.

Good intentions, poor intelligence

Ultimately, therefore, the responsibility for the housing collapse rests on the shoulders of the federal government, who oversaw the mutation of the CRA into the beast it is today for personal political gain. While their intentions were good, the federal government acted irresponsibly by putting too much financial burden on the shoulders of the lower classes' subprime loans. Wall Street bankers seeking profits should have realized this mistake, but the government should never have offered incentives encouraging this practice in the first place.

McKay's elimination of the government's role in the collapse in *The Big Short* is dangerous on many levels. Not only does he misinform Americans unfamiliar with the causes of the collapse but also lets the true danger–the government–go unchecked in favor of gunning down Wall Street. The CRA still has yet to be repealed, and while the federal government is already responsible for the 8 million jobs lost because of 2008's collapse, if it fails to remove this toxicity from the American economy, it will be responsible for any collapses in the future emitting from a fraudulent loan market.

In the words of Niskanen, repeal the CRA. Repeal it now.