Cra and financial crisis

[Literature](), [Russian Literature]()

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W. Bush-, Clinton- and George W. Bush-administration, changed the original act, adapting to new challenges in the housing market (Braunstein, 2008). However, as time passed, the act became less important for banks, as the products, mortgages, became more profitable. As a result, more and more financial institutions started offering mortgages to low-income classes. These so called subprime mortgages are often associated with high risks (Aalbers, 2009). This point of view can be concluded with the hypothesis that the CRA will be seen as a cause of the financial crisis.

Firstly, the different opinions and their respective arguments with regard to the hypothesis are illustrated. Secondly, an explanation is given on how these examples fit in the empirical cycle. Thirdly, three other concepts of Babbie, Gravetter and Forzano are applied to the examples. Finally, a conclusion is drawn withrespectto the examples. Real-life examples As a result of the CRA, banks were rated, based on the number of loans given out to low-income households. A bad rating could have had severe consequences for a bank.

The fact that the FED did not allow a Hartford, Connecticut bank to acquire a New Hampshire bank on CRA grounds demonstrates this. In order to keep their CRA ratings high, banks had to provide low-income classes with loans. In essence it can be said that the CRA ratings raised the banks' incentives to provide low-income households with loans (Carney, 2009a). It can clearly be seen that the enforcement of the CRA over time led to a relaxation of lending standards and consequentially to more risk-taking in the banking sector in the form of mortgages. These high-risk mortgages are now seen as part of the problem.

Thus, Carney (2009b) concludes, the CRA is part of the cause of the financial crisis. Carney agrees with the hypothesis. Defendants of the CRA simply claim that an act passed in 1977 cannot lead to the creation of a housing bubble in the early 21st century. Nevertheless, the CRA was not a static piece of legislation. The act evolved over the years, as it was mentioned earlier in the introduction. To be more specific, it was more and more enforced over the years. As a conclusion it can be said that the enforcement of the CRA might have been crucial in creating the housing bubble.

Therefore the act could have created a housing bubble in the early 21st century (Carney, 2009a). However, Aalbers (2009) also argues in favor of the CRA and tries to falsify the hypothesis. He states that the majority of subprime loans in 2006 were provided by non-bank lenders. These non-bank lenders, however, were not subject to CRA regulations and thus were not obliged to provide affordable loans to low-income classes. The only logical conclusion that can be drawn from this information is that these loans to low-income classes were an attractive investment.

Thus, Aalbers says, the CRA was not the cause of the high-risk mortgages providence to low-income households by banks. By clearly, Aalbers would reject the hypothesis that the CRA was a cause of the financial bubble. Nonetheless, his argumentation has to be questioned. In 1977 most of the loans and mortgages were provided by banks as well as savings and loan associations. The extra mortgages that were provided as a result of the CRA probably increased the demand for houses, which in turn resulted in an inflation of housing prices.

Several years later, due to rising housing prices, subprime mortgages became a more attractive investment for financial institutions. Consequently, the majority of loans issued since the inception of the CRA came from nonbanks that deemed mortgages a good investment. In other words, the CRA created major lending opportunities for financial institutions (Kroszner, 2009). Since the CRA initiated the inflation of housing prices to some extent, it can be argued that the CRA can be hold partly responsible for the creation of the housing bubble. This theory should verify the hypothesis. This argumentation has to be investigated further.

As Foote et al. ’s (2008) research concludes, housing price data in Massachusetts reveals that around 70% of all homes lost to foreclosure were actually purchased with prime mortgages. From that information Aalbers (2009) derives that most loans were not used for directly financing new homes, but rather refinancing existing loans. Hence, Aalbers insinuates that the extra mortgage lending as a result of the CRA did not cause a rise in housing prices. That information implies that the CRA was not a cause of the creation or inflation of the United States housing bubble. Clearly, this would reject the hypothesis.

Nonetheless, Aalbers' argumentation contains two pitfalls. First, his argumentation solely rests on inductive reasoning. Massachusetts is just one small part of the United States of America. Without any supportive data to back up the thesis that the Massachusetts housing market is representative of the whole nation's housing market, it has to be concluded that Aalbers overgeneralizes the statistical data provided by Foote et al. As Babbie (2005) mentions, overgeneralization can lead to misdirection or rendering of inquiry. Due to this fact Aalbers' argumentation is questionable. Second, even if the study of Foote et al. 2008) were representative, Aalbers failed to acknowledge the other side of the medal: The supply side, as it is not in favor of his opinion. If the CRA-related loans were used to refinance homes only, it would strongly affect the supply side of the housing market in the way that supply was artificially lowered. Homes were occupied that otherwise would not have been, driving up the prices of real estate. Aalbers falls victim to the fallacy of selectiveobservation. He only looks at the effects of the CRA on the demand-side. Looking at the supply-side would not support his theory and point of view on the topic.

That makes this observation a selective one. Empirical cycle This debate fits in the empirical cycle in the way that it started with an observation: The burst of the housing bubble. Consequentially different hypotheses and theories where formulated and tested by reasoning and correlation. As markets nowadays are very complex phenomena, it is difficult to establish a causal relationship between several factors of this system. In spite of that it is possible to use logical reasoning and correlation between these factors to hint at the correctness of a thesis. For example, it can be investigated how many subprime loans were CRA-related.

A different question that can be posed is how these CRA-related subprime loans performed against other loans (Kroszner, 2009). The answers to these questions could give an idea of the causal relation between the CRA and the financial crisis. After testing the hypothesis, a new hypothesis and theory might be formulated until a conclusive theory is found. Nevertheless, Kroszner himself admitted the existence of a lack of data to get conclusive answers to the previously mentioned questions. For the empirical cycle, this lack of data means it is very hard to reject or not reject theses, obstructing the formulation of new theses and theories.

Other concepts of Babbie, Gravetter and Forzano applied The empirical cycle is not the only concept of Babbie (2005), Gravetter and Forzano (2009) which can be applied to the examples. Another concept that can be applied apart from the empirical cycle is the concept of authority. Carney (2009a), who was mentioned earlier in this paper, started out as a strong defendant of the CRA. He did change his mind though, relying on, among others, the FED Governor Meyer. Since Carney used a quotation of Meyer, it can be concluded that Meyer is a person with authority and strong references in the field of economics.

Babbie, Gravetter and Forzano define authority as a person with strong references in certain fields. Authority is used as a source for knowledge and can be referred to. Gravetter and Forzano (2009, p. 11) define rationalism as the search for “ answers by the use of logical reasoning”. This is exactly what Carney (2009b) does to come to the conclusion that the CRA was a cause of the financial crisis. He reasons that the CRA raised the banks' incentives to provide low-income households with mortgages. These financial products are now seen as a cause of the housing bubble, which caused the financial crisis.

Therefore, Carney concludes, the CRA is a cause of the financial crisis. Theory is described by Babbie (2005, p. 12) " as a systematic explanation for the observations that relates to a particular aspect of life". This implies that the argumentations used by Carney (2009a, b), Aalbers (2009) and Kroszner (2009) are parts of different theories as they explain how the CRA caused or did not cause a housing bubble. Conclusion As shown in this paper, there is a huge debate about whether the CRA was a cause of the financial crisis. As Carney (2009b) pointed out, the CRA raised the banks' incentives to issue risky loans.

Critics, however, state that an act passed in 1977 cannot create a housing bubble in the early 21st century. Nevertheless, the act was enforced several times, which implies that an enforcement of the CRA might have a causal relation with the financial crisis. Aalbers (2009) argues also in favor of the CRA: he points out that most subprime mortgages were provided by non-CRA-related institutions. Despite that fact, Kroszner (2009) says there is no reason to believe CRA is not to be blamed. He mentions that the inception of the act increased the demand for mortgages and consequentially, houses.

According to Kroszner, this was the start of the housing bubbles. Aalbers on his turn argues that the vast majority of houses bought in Massachusetts was financed with prime mortgages. He concludes that this provides evidence in order for the CRA not be labeled a cause of the crisis. Nonetheless, Aalbers argumentation contains two fallacies. First, he uses inductive reasoning which results in overgeneralization without supportive data. Second, he uses selective observation by ignoring the supply-side of the market. This whole debate fits in the empirical cycle in a way that it started with an observation which was followed by many theses.

After the formulation of these theses they were tested by logical reasoning and correlation. As a final step, new theses theories will be formulated. However, this step is obstructed heavily by a lack of data. Other concepts of Babbie (2005), Gravetter and Forzano (2009) can also be applied to the examples. Meyer has authority in Carney's argumentation, logical reasoning is used by Carney to come to the conclusion that the CRA was a cause of the crisis and the argumentations used by Carney, Aalbers and Kroszner are all parts of theories, described by Babbie, Gravetter and Forzano.

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