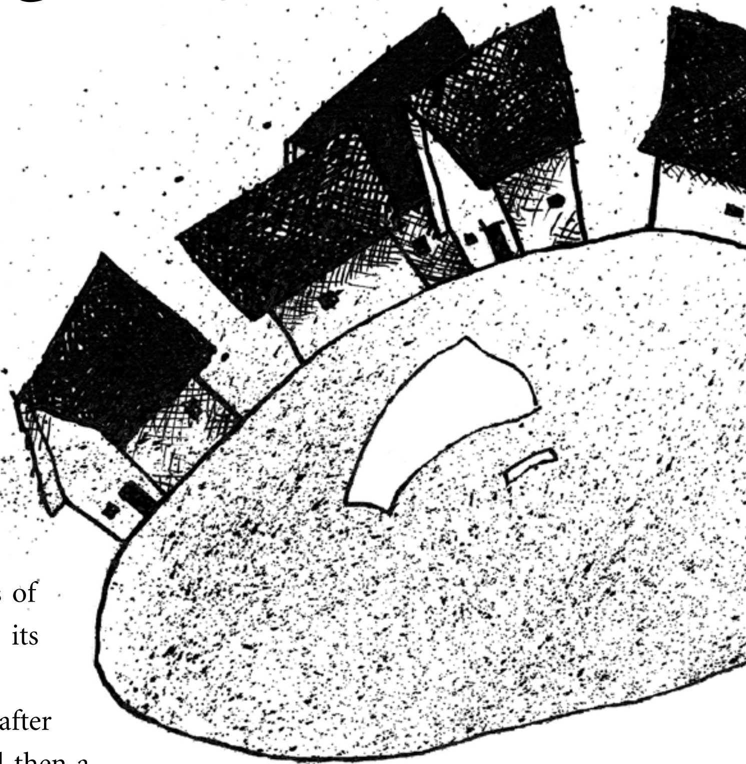
It's time for real change in housing finance

Bursting the



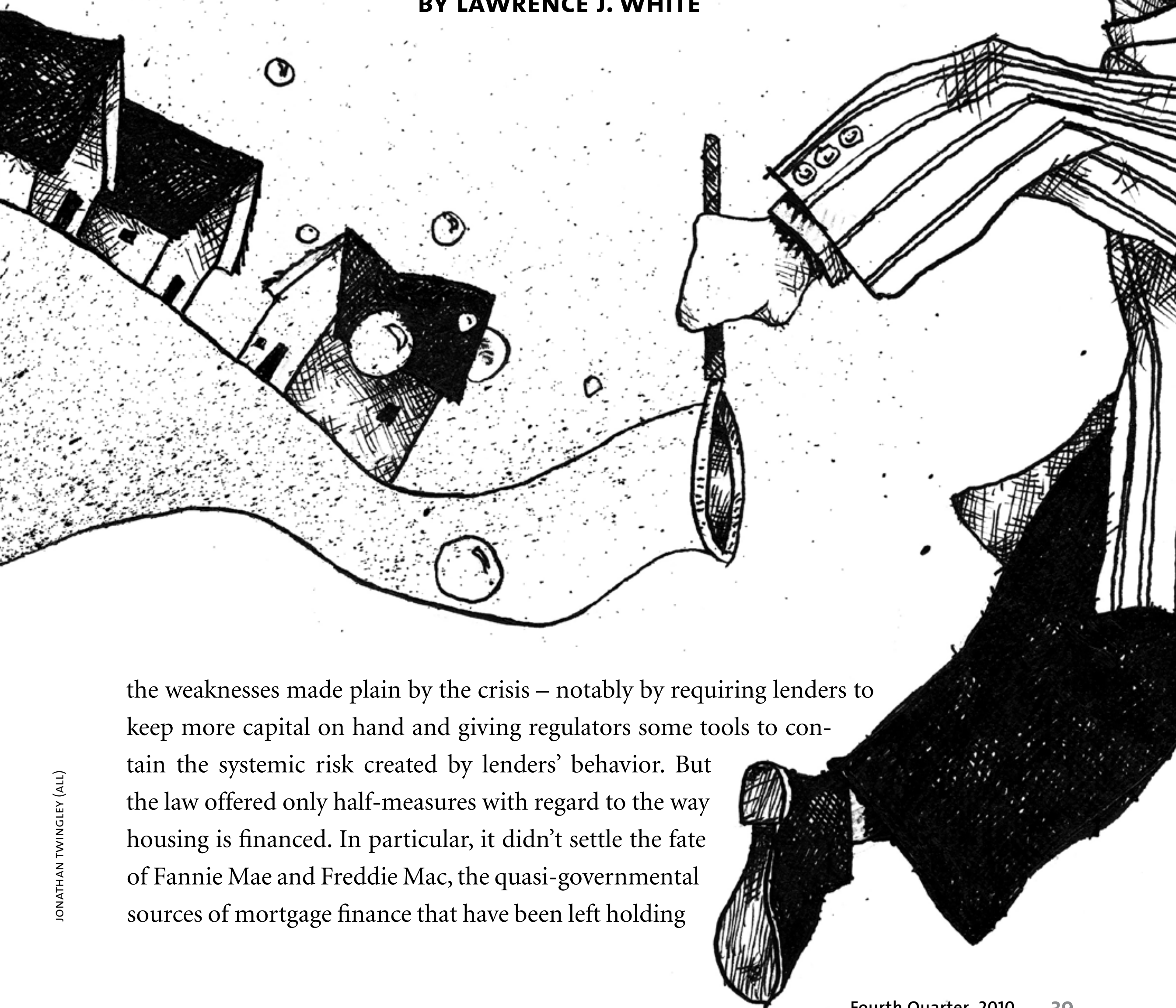
The financial crisis of 2007-09 was, of course, triggered by the puncture of a great housing bubble that had been inflated by mortgage lenders and their agents. And while the full story of this debacle (like every story involving trillions of dollars in capital) is complicated, its outline is pretty straightforward.

When home prices began to slip after peaking in mid-2006, a trickle and then a flood of borrowers defaulted on their mortgage payments. This generated losses for lenders and, in turn, the owners of securities that had been backed by those mortgages. A few very large investment banks and commercial banks figured prominently among the ranks of those owners. And their thin capital proved inadequate to absorb the losses, bringing the global financial system to the brink of a true collapse that was prevented only by massive government intervention.

The Dodd-Frank Act of 2010, signed by President Obama in July, addresses some of

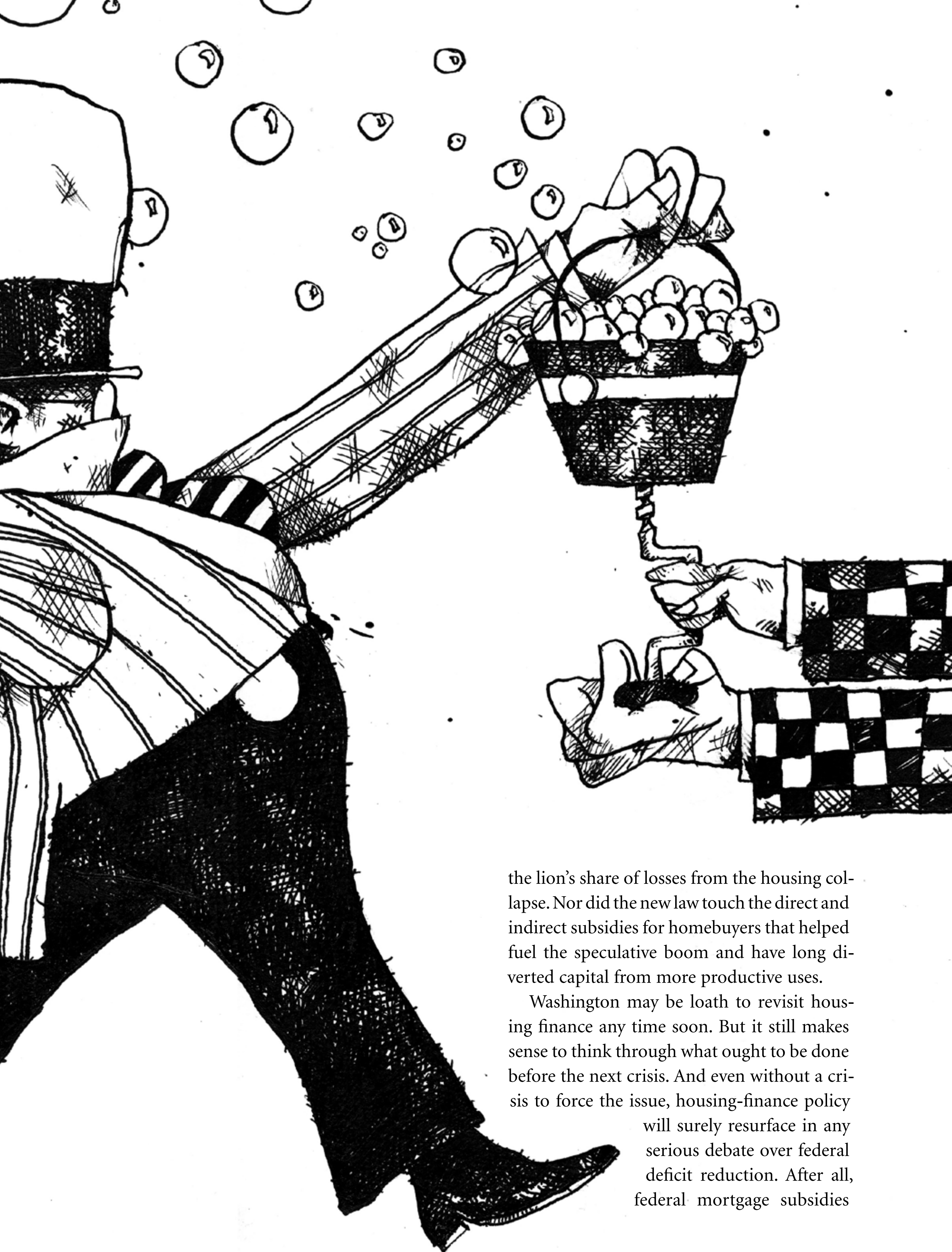
Bubble

BY LAWRENCE J. WHITE



the weaknesses made plain by the crisis – notably by requiring lenders to keep more capital on hand and giving regulators some tools to contain the systemic risk created by lenders' behavior. But the law offered only half-measures with regard to the way housing is financed. In particular, it didn't settle the fate of Fannie Mae and Freddie Mac, the quasi-governmental sources of mortgage finance that have been left holding

JONATHAN TWINGLEY (ALL)



the lion's share of losses from the housing collapse. Nor did the new law touch the direct and indirect subsidies for homebuyers that helped fuel the speculative boom and have long diverted capital from more productive uses.

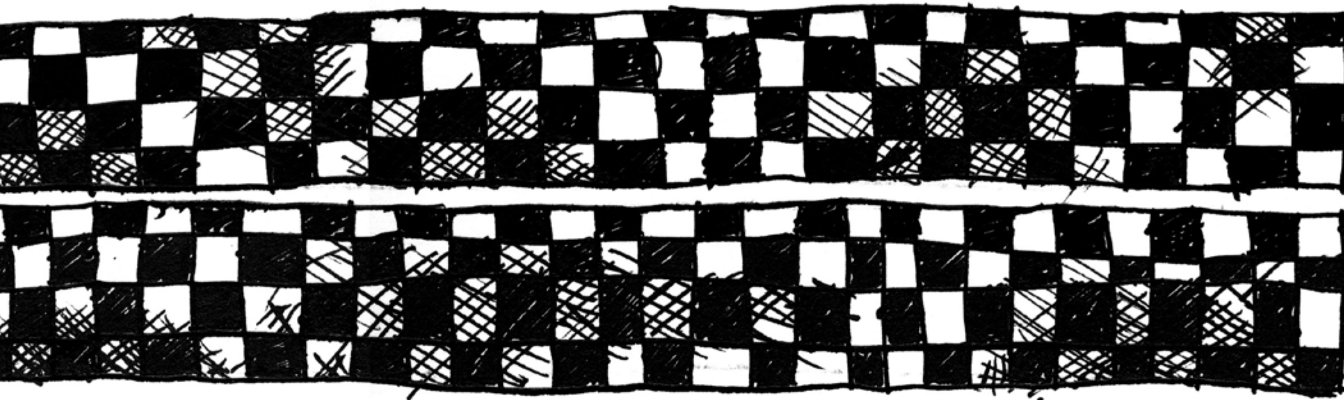
Washington may be loath to revisit housing finance any time soon. But it still makes sense to think through what ought to be done before the next crisis. And even without a crisis to force the issue, housing-finance policy will surely resurface in any serious debate over federal deficit reduction. After all, federal mortgage subsidies

cost hundreds of billions of dollars annually, much of which is frittered away in building oversized dwellings that savings-strapped America can ill-afford.

GILDING THE LILY

Housing-finance policy is a creature of interest-group politics, designed to feed huge construction and finance sectors as well as to please voters by making homeownership cheaper. Consider this embarrassment of riches:

The deductibility of mortgage interest and property taxes from taxable income… The exclusion of the ongoing "services" – the equivalent of rent – provided by owner-occupied



housing from taxable income… The exclusion of much or all of the capital gain from selling a personal residence… Reduced costs for mortgages that are routinely insured by the government and government-supported companies for less than the cost… Tax credits for first-time home purchases (which come and go)… Rent subsidies for low-income households… Subsidies for the construction of rental housing… Direct government provision of low-income housing… Myriad indirect subsidies to mortgage lenders…

Last year, the nonpartisan Congressional Budget Office estimated that these measures cost Uncle Sam a whopping $290 billion – some $2,800 per American household. That figure, of course, doesn't count the cost of regulation that is largely devoted to protecting housing interests from the pain of competition – like many local building codes, states' effort to protect both full-service real estate brokers and title insurers, and restrictions on imports of building materials, notably lumber.

Housing policy is driven by a variety of motives. On the high-minded end, there's the encouragement of homeownership on the grounds that owners are better citizens than renters and, thanks to the accumulation of home equity, less likely to become burdens on the state or on their families. Another virtuous goal: redistribution of income (in the form of housing) to needy families in a country that is otherwise reluctant to redistribute income to the poor. But the rock on which the policy is built is the sustenance of a vast commercial ecosystem – the care and feeding of everyone from specialized craft workers to homebuilders to earth-moving-equipment manufacturers to appliance makers.

SWAMPED BY TECHNOLOGY

Before the 1980s, residential mortgages were largely originated, financed, serviced and held

to maturity by local deposit-taking institutions – usually savings-and-loan associations and occasionally commercial banks or credit unions. This "vertical integration" of housing finance made economic sense in an era of high-cost data processing and telecommunications. Local lenders were best positioned to judge the creditworthiness of borrowers and to provide funds for and service loans.

But the information technology revolution made it practical (and often remarkably profitable) to look to broader markets for mortgage finance and to specialize in component services like mortgage origination and mortgage servicing. The crowning glory of this transformed market: securitization. In 1970, the federally owned Ginnie Mae (the Government National Mortgage Association) first created residential mortgage-backed securities – RMBS, for short. The federally chartered Freddie Mac (the Federal Home Loan Mortgage Corporation) was just a year behind, while the federally chartered Fannie Mae (the Federal National Mortgage Association) entered the great game in 1981. Securitization grew modestly in the 1980s, and then took off in the 1990s as the privatized Fannie and Freddie saw gold in the business. [For a more extensive discussion of Fannie and Freddie, see White's article in the Second Quarter 2008 issue of the *Review*.]

With securitization, home loans could be originated by specialized mortgage bankers, which immediately sold the mortgages to packager-securitizers, who bundled loans into pools with predictable risk characteristics. The routine servicing of individual mortgages – collecting checks, dunning late payers, managing defaults – could be done by yet another specialized party. And since investors no longer needed local knowledge to assess these mortgage-backed securities, institutions ranging from insurance companies in San Francisco to banks in China could participate. Meanwhile, cheap, fast information technology minimized the cost of the dauntingly complex process of creating and evaluating both the risks and the likely pace of amortization of RMBS.

One more invention was needed, though, to push securitization into hyperdrive: securities insurance. Conservative investors needed to be assured that they would receive their interest and principal repayments in a timely fashion. This guarantee was provided by Ginnie Mae (which had the explicit backing of the federal government and which securitized mortgages that were themselves individually insured by the Federal Housing Authority and the Veterans Administration) and by Fannie and Freddie (which, despite being publicly traded companies, had special and very reassuring ties to the federal government). In turn, these securitizers (along with the Federal Housing Administration and Veterans Administration) inherited the task of policing the accuracy of the credit-quality claims made by the mortgage originators.

Starting in the late 1990s "private label" securitization by both commercial banks and by investment banks began a rapid ascent. These issuers faced the same problem of how to convince distant, passive investors that they would get their money back. The banks solved this problem with combinations of overcollateralization (backing the mortgages with more than 100 percent of their value in property), reserve funds, and – most important – by slicing the securities into "tranches" with distinct risk characteristics. This last technique arrayed the cash flows from the un-

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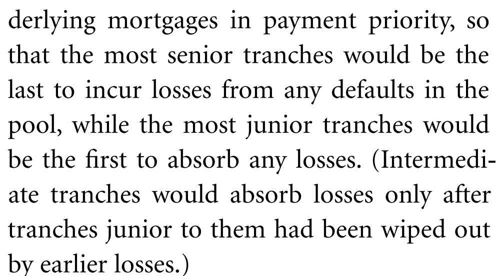

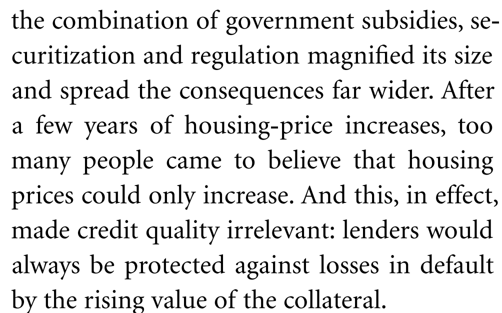

derlying mortgages in payment priority, so that the most senior tranches would be the last to incur losses from any defaults in the pool, while the most junior tranches would be the first to absorb any losses. (Intermediate tranches would absorb losses only after tranches junior to them had been wiped out by earlier losses.)

With the government not in the picture, investors in the private-label RMBS made use of credit-rating agencies to help assess risk. Indeed, prudentially regulated institutional investors like banks, insurance companies, pension funds, broker-dealers and money-market mutual funds were largely restricted to tranches with "investment-grade" ratings.

Securitization generated large, very real benefits. It allowed borrowers to draw capital from a vast market, increasing competition and lowering mortgage costs. It permitted greater specialization of functions (and thus efficiency) in creating, financing and servicing mortgages. And it managed mortgage risk more effectively through a combination of diversification and tranche creation.

On the other hand, the complicated, vertically deintegrated chain of services in securitization opened the door to cheating – economists prefer the more neutral term "moral hazard" – in which the agents at one or more stages had incentives to fudge on the creditworthiness of the mortgages and make some extra loot in the transaction. Moreover, with private-label securitizations, the question of whether a servicer should make concessions to a defaulting borrower – a common practice in simpler loan transactions – wasn't really addressed until it was too late.

PATHOLOGICAL OPTIMISM AND SEE-NO-EVIL REGULATION

Financial bubbles are nothing new. What made this last housing bubble different is that the combination of government subsidies, securitization and regulation magnified its size and spread the consequences far wider. After a few years of housing-price increases, too many people came to believe that housing prices could only increase. And this, in effect, made credit quality irrelevant: lenders would always be protected against losses in default by the rising value of the collateral.

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By the same token, if mortgage defaults would never be a problem, neither would defaults on mortgage-backed securities. So, in this world of ever-rising house prices, the vertical partners in the securitization process did not need to be vigilant.

These middlemen might fudge credit quality or suck in borrowers with back-loaded repayment terms that would eventually become unaffordable. But with all that collateral being created by rising house prices, default was nobody's problem.

Just why a few years of rising housing prices convinces otherwise rational people that prices will never go down is a puzzle more likely to be solved by psychologists than by economists. Of course, housing prices did peak in mid-2006 and then began to fall, stripping away home-equity collateral that was supposed to protect owners of private

label RMBS. The consequences were exacerbated by the fact that large investment banks and commercial banks, along with their holding companies, owned great quantities of RMBS. Their thin (though not illegally thin) capital buffers were inadequate to absorb the losses, and the term "too big to fail" became part of the American vernacular.

Fannie Mae and Freddie Mac were not immune. Although they had previously maintained high underwriting standards on the mortgages that they bought and securitized, their standards slipped toward the middle of the decade as their executives sought a bigger piece of the profit from the housing boom. By mid-2008, losses had wiped out their capital, and both became wards of the federal government in September 2008.

Excess leverage wasn't just a problem for the lenders. In the go-go years of the housing boom, homeowners were encouraged to minimize down payments and to refinance as soon as possible with the goal of pocketing the cash from the inevitable gain in value. Thus, while one of the reasons for encouraging homeownership was to give households a way to build wealth by amortizing mortgages, the system encouraged them to minimize the equity in their homes. Why wait to renovate the bathroom or to take a cruise? Just cash in the "free money" buried in your house!

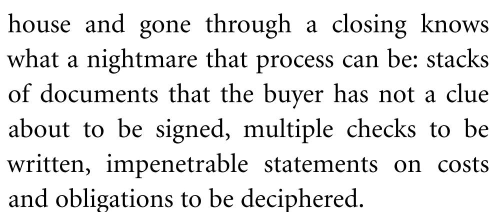
Note, too, that, the system created incentives to buy (or rent) too much housing. In part, of course, that followed from the relaxation of credit standards and the rise of back-loaded mortgage-payment plans that arose during the inflation of the bubble. But it was also the consequence of all those housing subsidies discussed above. Research in the 1980s concluded that long before the housing boom, people were buying or renting 30 percent more housing than would have been the case absent the financial incentives.

So what's the big deal? It's that the resources spent on all that housing had to come from somewhere – in particular, from industrial capital, education and social infrastructure. All told, the capital diverted to excessive housing could have increased GDP by an estimated 10 percent.

These findings don't necessarily contradict claims that we have spent too little on low-income housing, where distorting housing markets with subsidies-in-kind (like rent vouchers) has been seen as one of the few politically palatable ways to redistribute income to the poor. But a disproportionate share of the subsidies has gone to affluent households – people who were likely to buy anyway and who were in a position to get the most mileage from the tax-deductibility of mortgage interest and property taxes. That largely explains why homeownership rose just five percentage points (from 64 percent to 69 percent) between 1975 and the peak in 2005, while the square footage of new houses grew by about a whopping 50 percent across the same period. It also helps to explain why new dwellings in Germany, France, Belgium and Sweden – countries with living standards and homeownership rates close to those of the United States – are roughly half the size.

Ironies pile on ironies. While subsidies and preferences reduce the cost of housing, restrictive zoning, excessively stringent building codes, import restrictions on building materials, and state protection of title insurers and full-service fixed-fee real estate brokers have served to keep housing prices high – especially along the East and West Coasts.

Though fraud perpetrated on borrowers was not the major cause of the debacle, there clearly were such instances – especially among low-income, elderly and less-educated households. Further, anyone who has bought a



house and gone through a closing knows what a nightmare that process can be: stacks of documents that the buyer has not a clue about to be signed, multiple checks to be written, impenetrable statements on costs and obligations to be deciphered.

FIXING THE MESS

As this is being written, in the late summer of 2010, housing and mortgage markets have not fully recovered from the trauma of the bubble. Housing prices have not yet stabilized; mortgage lenders and residential mortgage-backed securities investors have not adopted a comfortable stance toward the trade-off between risk and return in housing. Consequently, radical moves – like changing the structure of Fannie and Freddie, or eliminating the mortgage interest deduction – are not only politically unrealistic, but would also be unwise in the short run.

Nevertheless, it's time – long past time – to think hard about the rationale for government intervention in housing markets:

Homeownership is not for everyone. A house is a large, illiquid asset that often serves as an impediment to job mobility. Homeownership is not an automatic route to building wealth. Indeed, it can be a heavy burden for people with highly variable incomes and expenses.

Modest encouragement of homeownership is probably justifiable in economic and social terms. But subsidies should be modest and – equally important – limited to cash incentives for first-time homebuyers with modest incomes. And government aid should be accompanied by counseling with respect to the responsibilities and burdens of homeownership. Subsidies of any sort to higher-income households serve no social purpose and divert resources from more-productive investments.

Using cheap loans to increase homeownership is bad policy. Borrowing means leverage; subsidized borrowing means excessive leverage. Leveraging is the antithesis of building equity and makes defaults more likely in the event of house-price declines.

By contrast, lowering the cost of housing by making the inputs cheaper may make sense. That can be done by making land cheaper (by reducing or eliminating unwarranted zoning), by making materials cheaper (by allowing competition from imports), by making construction cheaper (by not using restrictive building codes as a way to protect favored contractors and workers) and by making sales transactions cheaper (by not protecting full-service real estate brokers, title insurers and other providers of closing services).

Using government supported agencies like Fannie and Freddie to mediate housing markets is a mistake. They haven't made much difference in homeownership rates. But they have distorted mortgage markets, indirectly subsidizing credit and leaving taxpayers holding the bag.

Direct government intervention, with the FHA and VA insuring mortgages, and Ginnie Mae packaging them as securities, constitutes a problematic subsidy, even though it has not generated comparable financial losses. Historically, this route was restricted to lower-priced homes (the maximum FHA/VA insured loan was in the vicinity of 65 percent of the maximum Fannie/Freddie loan), so moderate-income buyers were the primary beneficiaries. But when the FHA/VA mortgage limit was raised above $700,000 in 2008, the rationale for such insurance evaporated.

Deductions (as opposed to credits) are an inherently inferior means of providing subsidies, because the benefits are higher for higher-income taxpayers and only go to those who itemize deductions on their tax returns.

Subsidies for housing do create jobs, but so does pretty much any other form of government spending. It's especially hard to justify permanent housing-subsidy programs when the nation faces large and growing budget deficits.

In light of all this, here's how I would reform housing policy:

1. Phase out tax preferences. The deductibility of mortgage interest and local property taxes and the exclusion of capital gains on home sales will reduce government revenue by about $160 billion next year. In five years, the cost will be pushing $235 billion annually. It would be unfair (and politically impossible) to eliminate the deduction for existing home mortgages. But a 10-year phaseout, in which the interest deduction on new mortgages would become progressively less valuable, might be palatable. Better yet would be a reform that transformed these deductions into refundable tax credits, so the benefits would not go disproportionately to the affluent.

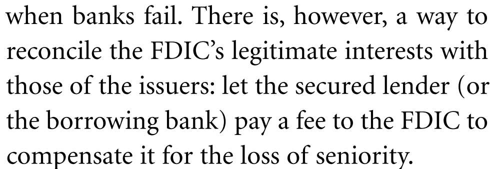
2. Truly privatize Fannie and Freddie. Once mortgage markets stabilize, securitization can and should become a matter for private markets – and securities regulators who compel transparency. If the brand names, systems and personnel of Fannie and Freddie still have value, they should be able to survive as wholly private entities; if not, then the market will pull the plug. In any event, alas, the accumulated losses of the two companies ($145 billion, and counting) must simply be absorbed by the federal government. Even if true privatization proves to be a political nonstarter, the scope of their mission could be scaled back. One straightforward way: gradually (say, over 10 years) reduce the size of the maximum mortgage that they can purchase and securitize, perhaps to $200,000 or maybe to the median house price.

3. Private mortgage insurers could pick up the slack. Although private insurers were damaged by the debacle, they appear to be healing, and others will likely arise. The need for Ginnie Mae would also disappear.

4. Focus remaining subsidies. My preference here would be to strip down the subsidies to a flat $10,000 check for moderate-income first-time homebuyers. The goal should be to encourage purchases by households that can afford and benefit from homeownership, but are short on the down payment.

5. Encourage competition. The elimination of protection against lumber imports from Canada would make a material difference in construction costs. The larger and more pervasive restraints on competition – everything from interest-group-driven building codes to laws protecting incumbent brokers and title insurers – are creatures of state and local governments. This makes them tough nuts to crack. But one could imagine a combination of mandates and financial incentives from Washington that would induce reforms.

6. Keep the door open to innovative finance. The goal, as with securitization, is to reduce the cost of capital. Take the case of "covered bonds," which are bank-issued debt instruments that use pools of mortgages as collateral and are widely used in Europe. The bond investor's first claim is on the issuing bank. But if the bank becomes insolvent, the investor has a direct claim on the collateral. This collateralized form of borrowing is already used in the United States, in the form of banks' very-short-term repurchase arrangements ("repos") with securities dealers and banks' short- and medium-term advances from the Federal Home Loan Bank System. But it has never been tried for long-term bank debt. The Federal Deposit Insurance Corporation has discouraged such secured borrowing, because it gives lenders priority over it



when banks fail. There is, however, a way to reconcile the FDIC's legitimate interests with those of the issuers: let the secured lender (or the borrowing bank) pay a fee to the FDIC to compensate it for the loss of seniority.

7. Revive prepayment fees. The option to prepay a fixed-rate mortgage – especially the option to refinance when interest rates decrease from the levels at which the mortgage was originally extended – is valuable to borrowers and costly to lenders. If lenders are not permitted to charge explicitly for the exercise of the option, they can (and surely do) add the expected option cost into the interest rates that they charge on mortgages generally. As a result, borrowers who do not refinance pay part of the costs of those who do. Better, then, to have an explicit fee for the exercise of the option. Note, moreover, that explicit pricing of the prepayment option would make investments in residential mortgage-backed securities more attractive to life insurance companies and pension funds, which need long-term assets to offset their long-term liabilities.

8. Make originators more responsible for mortgage decisions. Most buyers are clearly at a disadvantage in obtaining a mortgage. The transaction is infrequent and unfamiliar; the sums are large; the options can be many. Stockbrokers have an obligation not to bamboozle their customers by selling them investments that are inappropriate for them – say, by selling pork-belly options to retirees with modest incomes. Mortgage originators should have a parallel obligation to steer borrowers away from, say, back-loaded payment structures that they won't be able to afford.

9. Make closings consumer-friendly. Because there are likely to be multiple – and unfamiliar – services provided at a closing, with multiple fees, homebuyers are in a poor position to shop around. Far better to encourage one-stop shopping through "aggregators," who would work like general contractors, competitively bidding to provide all closing services. Aggregators, in turn, would have incentives to pressure subcontractors to deliver specialized closing services at competitive prices. By the same token, buyers deserve something better than an incomprehensible heap of paper outlining the mortgage terms. It is quite possible to devise a one-page statement in reasonably sized print that lays out the basics of the mortgage and the closing costs. Indeed, this should be "job one" for the new Bureau of Consumer Financial Protection that has been established by the Dodd-Frank Act.

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Housing finance can't be reformed overnight. But the experience of the last few years (in which housing played a key role in triggering a terrible global recession), and the likely experience of the next few (in which the need for deficit reduction will be hard to ignore), could serve as the opening. Eight decades of housing preferences heaped on preferences must be gradually stripped away, with substantial savings for the federal budget. Regulators must focus on creating a competitive private mortgage market – one in which lenders are less likely to destabilize the whole financial system and consumers are protected from abuse.

In that world, Americans would likely buy less housing. But grass would not grow in the streets of America as a consequence. Indeed, successful reform could free hundreds of billions of dollars of capital annually for more productive uses – which might even include more parks in which to grow grass. M