Fixing the Mortgage Market

Lawrence B. Lindsey

February 28, 2008

It is my pleasure to be here today to discuss one of the most important economic problems facing our country: the collapse of the home mortgage market and its effect on real estate values and the overall economy. Of course, in America, housing is much more than a place to live. It is a key step on the ladder of our ownership society in which ordinary people, through their own hard work and saving, get to own and participate in the greatest economic story in history: the United States of America.

There are three points to stress. First, as severe as our current problems are, neither problems nor the search for creative solutions is anything new in the American mortgage market. We have seen the development and subsequent collapse of a number of different housing mortgage models in the past 100 years. Each time a new approach was developed which worked for a while and then failed. Today's problems are no different. The root cause of this cycle of creativity and collapse is the constant need to find low cost and liquid means of financing a product – housing – that is inherently illiquid.

Second, we must recognize that this is not a "subprime" crisis as some call it, but a problem faced by every homeowner. Over 75 million American homeowners face the prospect of historically unprecedented declines in the value of their most important asset, their homes. The consequences of this will make housing an even less liquid asset. This will not only curtail spending, but it will also have knock-on effects in our national labor market as worker mobility will become impaired. This happened in Japan during the 1990s. Solutions that focus on “subprime” problems like foreclosure but make the mortgage market even less attractive for new money are counterproductive both for lower end borrowers and for the broader public.

Third, at this stage in the cycle the most important thing public policy can do is to allow and possibly promote the development of creative solutions in the private mortgage market and avoid one-size-fits-all approaches that are so typical in political and bureaucratic approaches. This is politically quite a courageous thing to do as the clamor for short term fixes, protection of those who face losses, and a search for scapegoats is quite naturally and understandably the focus of media and public attention. But misplaced emphasis on these issues will likely lead to mistakes that will sow the seeds for future failures in the mortgage market to the detriment of our economy, tens of millions of homeowners, and ultimately the beneficiaries of politically based solutions.

There are things that the Congress can do to help liquefy the mortgage market and begin to put a floor under home prices. But understanding what these are requires some background on how we got where we are. Consider a brief review of the various cycles in housing finance that we have tried.

History’s Lessons on Housing Finance

We have not always had mortgages in America. They were in fact an innovation in the late 19th century. It has been changes in how we view our homes that have led to innovations in finance. It is actually quite logical once you realize that the basic problem any banker or other lender must ask: HOW AM I GOING TO GET PAID BACK? That is a simple question, but sometimes forgetting the basics leads to trouble, as it has today.

Prior to the 1890s or so, bankers wouldn't make mortgages because they didn't know how they'd get paid back. Loans were made for farms that included farm houses, but the house was incidental to the farm and the way the lender expected to get paid back was from the income that the farm generated. Urban housing was another matter. The Savings and Loan industry developed in New England along a basic premise related to a new type of house: the Triple Decker. If you are in an old New England mill town like Manchester New Hampshire or towns that surround Boston like Somerville, or in similar cities in the Midwest like Chicago or Minneapolis, you can still see these structures.

The idea behind the Triple Decker was simple. The owner takes one apartment and rents out the other two. Those rents paid the mortgage and the property taxes and the owner theoretically lived "free." Actually, he didn't live free at all. Generally there was a high down payment that paid for most of his "third" of the property and the owner also was responsible for maintenance. Still, mortgages became available to ordinary people to buy not only their own home, but an investment property as well. The days of the all rental tenement being the only option were gone.

Banks learned from this and after World War I a new invention, the automobile, greatly expanded the possible places where people could live and families wanted to move out of the densely packed Triple Decker areas into single family homes. The innovative answer to the question HOW DO I GET PAID BACK in a single family home took the realization that the homeowner didn't have to pay rent anymore and that money that would have gone to pay rent could service the mortgage. This was still viewed as somewhat risky and large down payments were needed to cover the risk. Moreover, banks didn't want to make a long term commitment so the mortgage was typically a Five

Year Balloon. In this mortgage the borrower paid interest every month and could pay what principal he could afford, but at the end of five years, the whole principal came due. Often times banks would rollover the mortgage into a second five year balloon for borrowers who had paid back a good portion of their principal. But, the borrower was potentially liable to lose the house at the end of five years if he couldn't pay the mortgage back.

The problem with this scheme became apparent in the Great Depression. Not only did many borrowers see their incomes decline, but the banks often did not have the spare funds to rollover a mortgage into another five year balloon. They were shrinking their balance sheets and the repayment of the old balloon mortgages allowed them to do that. The result was a catastrophe for homeowners. At one point in the 1930s about half of mortgage holders in America were in default on their mortgages.[1] Even homeowners who had steady incomes could not repay a five year balloon mortgage all at once. Government created innovations like the FHA were supposed to help, but only did so at the margin during the 1930s.

After World War II the nation had to find a new mortgage system. Returning GIs wanted to settle down, and new developments in home construction involved assembly line procedures that made houses more affordable, if financing could be found. The problem was finding a way to guarantee banks a source of long term funding so that they could make the long term mortgage loan and not have to issue Five Year Balloons. As mentioned in my introduction, the house is a fairly illiquid asset that must be funded in a much more liquid financial market.

[1] Pollock, Alex J. "Crisis Intervention in Housing Finance: The Home Owners' Loan Corporation," AEI Financial Services Outlook, December 2007.

The solution was the 30-year fixed rate mortgage and the parallel creation of an industry: the Savings and Loan industry. The Savings and Loan industry existed to find a stable source of funding for long term mortgage finance. At the time, interest rates were regulated on deposits, and checking accounts could not pay interest. Savings banks and other savings and loans offered an incentive to lock up your money with them. S&Ls were allowed to pay a quarter point more on savings deposits, thus reducing competition and the possibility that depositors would leave the bank and make it hard to continue to finance the mortgages that were issued. Other features such as not paying interest unless the money was in the bank for a full quarter were included to make sure the deposit base was secure. The depositor was automatically given FDIC Insurance to further reduce the chance of a run on the bank that would deprive it of the funds needed to finance mortgages. The S&L model was simple: pay depositors 3 or 4 percent and make home loans at 5 ½ to 6 percent. The difference more than covered the cost of running the bank.

That system worked well until the inflation of the 1970s. A 4 percent return on your money at the savings bank just didn’t make sense when inflation was 7 percent or more. So a gradual run on the savings banks started as more sophisticated depositors put their money into T-bills or other savings instruments. The bank was stuck with a bunch of long term mortgages but was losing the deposits that funded them. There were two problems. New money for mortgages became scarce and the Savings and Loan industry was essentially bankrupt by the end of the 1970s.

A partial solution to both problems was the development of the Adjustable Rate Mortgage or ARM. ARMs transferred the risk of inflation-induced rises in interest rates from the lender to the homeowner. This made mortgages more available and more affordable since an inflation risk premium had to be attached to the prevailing cost of funds to make a fixed rate mortgage. If the risk were transferred to the borrower, the need for the risk premium disappeared. Moreover, the borrower was the owner of an asset – the house – that went up with inflation. To a large extent he or she was compensated for the higher interest rate with home price appreciation. Today ARMs are sometimes criticized as finance mechanisms. But when they were introduced they had the full blessing of the Congress and the regulatory community as a solution.

However, the insolvent position of the Savings and Loan industry continued due to its inability to profitably cover the cost of funding older long term fixed rate loans. Again, a legislative and regulatory solution to a previous housing finance problem in turn sowed the seeds to the destruction of the new model. In the 1980s the Congress tried some partial attempts at solving this problem, such as Garn-St.Germain, but by the end of the 1980s the entire system collapsed and we had the famous S&L bailout. Real estate depressions in Southern California, Texas, and New England followed.

The solution to the problem was to find some way of funding mortgages without relying on particular banks and Congress, the regulatory community, and the financial industry came up with the idea of securitization. All of those jumbles of letters we now see on the financial pages today: ABS (Asset Backed Security), CDO (Collateralized Debt Obligation) and the like were outgrowths of the securitization process that seemed like the solution to the problem in the early 1990s. Securitization meant that the firm that originated the mortgage could sell it into the financial market place at large and not hold it on its own books. This solved the problem that the S&L industry faced: holding long term mortgages on its books that had to be funded out of short term borrowing.

However, securitization created two other problems, one that became obvious fairly quickly, the other that has become obvious only more recently.

Securitization by its nature required a standardization of mortgage products. This created a need for lending rules such as minimum down payment requirements and careful scoring of the creditworthiness of borrowers. In the early 1990s this led to a particular dearth of access to credit to low and moderate income individuals who lacked both the available saving and the credit histories needed to meet those standards. The regulatory community was placed under intense political pressure to come up with ways of providing access to credit for those populations, and did so, most notably with new rules under the Community Reinvestment Act. I was involved in that process and am proud of what was accomplished. In fact, most of those individuals could be and did turn out to be responsible borrowers and homeowners. But there can also be little doubt that in hindsight the new regulations did contribute to some of the excessive expansion in credit that has occurred. I note this mainly to provide a cautionary tale. Even very well intentioned and largely successful regulations can have unintended consequences. That does not mean that such actions were wrong, but that we should be very careful in how we use legislation and regulation in "solving" current problems.

The far bigger problem we have with securitization is that those who made the loans – the originators – and those who packaged the loans and sold them – the securitizers – have very little at stake in what happens to the mortgage. While the Savings and Loan had every incentive to make sure that the borrower was creditworthy and therefore knew the answer to the question – HOW DO I GET PAID BACK – this was no longer the case for those who originated mortgages in our new securitized world.

The big risk from all this is that the people who bought the mortgage securities, the ultimate providers of money for the mortgages that fund America's housing industry, were handed securities that they will no longer be able to trust. Unless their trust and confidence is restored, the future for America's mortgage industry and for the long term value of our homes is in jeopardy.

There are, of course, lots of other details in these problems, but a look at history shows that three things stand out. First, financial innovation has always been a part of the mortgage industry. Second, each innovation solved the problems that came before, but ultimately created new problems. Third, each time the so-called solution had the full blessing of the political and regulatory community of the day.

Those of us who are and have been involved in this process – and I would count myself among them – really should be quite cautious about our willingness to point the finger at others as having caused the current distress. Congress and the regulatory community were always actively involved in setting up systems for making sure credit flowed into the housing industry at as low a rate as possible. Moreover, many political figures have actively lobbied for ever more affordable access to housing finance over the years, with the inevitable albeit unintended effect of lowering the average credit quality of the borrowers in the mortgage pool. This latter development, carried to excess by the inevitable profit seeking behavior of both borrowers and lenders, pushed housing prices above a sustainable level. An examination of the consequences of that follows.

The Broader Problem

Media attention has naturally turned to individuals who are in danger of losing their homes to foreclosure. A family losing its home is a painful process and one that can easily stir the emotions of any thoughtful and sensitive person. Most of those now in immediate danger of foreclosure fall in a group of borrowers called "subprime" because of their relatively low credit quality, high loan to value ratios, and mortgage features that make repayment difficult.

But these relatively recent homeowners with subprime adjustable rate mortgages represent less than 5 percent of the homeowners in America. There are more than 75 million other homeowners who also are seeing the value of their most important financial asset, as well as the place in which they live, decline in value during the recent housing downturn. These homeowners generally had much better credit ratings, made larger down payments, and had better servicing ability than the group on which others are now focused. Some of these people are losing their homes as well due to job losses or other events. A far larger group are seeing their down payments and much of their life saving disappear as home prices plummet in value.

Some economists have been talking about a 20 percent drop in national home prices. My personal view is that is probably slightly on the high side, but perfectly plausible. If that were to happen, more than $4.5 trillion of household wealth would be wiped out. That amounts to $15,000 for every man, woman and child in America, $60,000 for a four person family. Think about it – a median priced home in America that once sold for around $220,000 is in danger of dropping to $176,000. That is hard earned money intended for retirement, paying for children's education, or to permit a few luxuries in life.

For many of these homeowners who did not take out subprime mortgages or take a variable interest rate, this would wipe out more than all of the equity they have in their house. The economic consequences of this would be far reaching. Families could afford to spend less on every day items as they struggled to stay in their homes. Possibly equally important, these families might find it difficult to relocate should a new job or job transfer occur because they could not profitably sell there house and acquire a down-payment on a new home. Nor could they afford to carry two mortgages. In our highly mobile society, a freezing of the liquidity of the housing market has potential far reaching implication for other markets as well, particularly the labor market.

So I believe the real challenge for America in the current home mortgage mess is to find a way of preserving home values over the long run. This broader focus in no way ignores the problems faced by those who took out subprime variable rate loans. In a very real sense, they have the same problem as the rest of us. If their houses go down, and stay down, in value, they too will be wiped out. A temporary fix that allows them to meet their current mortgage payment is just that, a temporary fix. If in five years their adjustable rate mortgage is no longer frozen and they are living in a house that has gone down 20 percent in value, they will find themselves in an even worse situation than they are in today.

In normal markets home prices do rise over the long term. They rise as incomes rises and with it, the ability to afford a home rises. These are not normal times. The problem is that incomes by themselves do not buy homes. People need access to mortgages to buy homes and our credit markets have shut down.

Establishing a secure and viable mortgage industry that has access to credit over the long term *is the only way* to give Americans the confidence that the value of their homes will be secure in the long run. None of the plans now being suggested, either by the current President or by those to be his successor have this as the focus. In fact, to some extent some of these plans work in the opposite direction. By proposing sweeping changes in the terms of existing mortgages by freezing interest rates involuntarily and retroactively changing foreclosure options and allowing bankruptcy judges a new and unilateral ability to change mortgage terms, the confidence of those who might commit new money to mortgage finance is being undermined. These plans might actually weaken the long term viability of the mortgage industry, by hurting access to credit for buyers, and thereby drive home prices down further.

The fact is that our current record level of homeownership is the product of more than a century of constant innovation. At each step along the way we made improvements that fixed the flaws in the system that came before it. We are now in one of those periods where we are going to have to innovate and possibly redesign our mortgage system to fix the flaws that have become apparent in the one that led us into this mess. The real solution to the housing problem is to find a new and sustainable housing finance system, and to do that, we must first recall the lessons of the past as to how we got where we are today.

Transitioning to the Next Mortgage System

The underpinnings of the next step in the evolution of our mortgage system must be to assure ample liquidity to those involved in the mortgage process. This will involve helping homeowners with cash flow and assuring lenders that they are investing in secure products. They must not be taken by surprise by rapid changes in the creditworthiness of the securities they underwrite. A triple-A mortgage security cannot be allowed to drop to

70 cents on the dollar overnight. They must also face some kind of reassurance that they will not have their principal seized when the political tenor of the times demands it.

First, let's consider what is needed to do this in the case of new mortgages. While our Government Sponsored Enterprises, Fannie Mae and Freddie Mac have their flaws, they do offer one very important assurance to investors: rules on the creditworthiness of borrowers that lets them have some comfort that they will not involve a wave of defaults. Both the flaws and this latter strength offer a clue to how we might proceed.

It is an understatement to say that Fannie and Freddie have not been using their position as constructively as they might have. They have engaged in dubious accounting practices, run a substantial hedge-fund like book that implicitly made bets on the direction of interest rates in an effort to increase shareholder returns, and used lobbying and campaign contributions to expand the scope of their activities. I can understand the attraction of allowing them more ample scope of operation, particularly to higher end borrowers. But, given their capital constraints and their lack of forthrightness about their past financing, the extension of their mortgage business to higher-end mortgages came at the direct expense of mortgage affordability to the moderate end borrower for whom they were created.

While Fannie and Freddie should certainly be allowed to continue what they were doing in the past, the best way to move forward is to build on the model of securitization standards that was the real strength of their franchise. A new set of standards needs to be established so that other potential securitizers, ones that do not rely on a government backstop, can become involved.

I am proposing that we create a Federal Board of Certification composed of the Comptroller of the Currency, a Governor of the Federal Reserve designated by the Chairman, the Secretary of Housing and Urban Development and the Under Secretary of Treasury for Domestic Finance to administer standards for mortgages that are packaged in mortgage backed securities and to certify – for a fee – that the mortgages represented in that security meet those standards.

This does not involve a federal guarantee of the security, even an implicit one. Nor does it involve a guarantee of the mortgage portfolio. All the Certification Board would do is assure investors that the mortgages in the security meet the standard they claim to meet with regard to such features as documentation, loan to value ratios, debt service to income ratios, and borrower credit standards. Obviously a variety of such standards could exist and investors could pick the standard and implied level of risk they want knowing that the mortgages in the security actually conform to that standard.

Nor does this preclude other institutions from offering mortgage backed securities without government certification. If the market has investors willing to buy such securities, so much the better. At the moment it does not at a reasonable price.

Most important, we should not expect that all mortgages would be securitized. Borrowers who do not meet certifiable standards but who lenders deem creditworthy should be able to borrow, but with the lender holding that mortgage on its own balance sheet.

Note that the existing rating agencies could choose to continue to perform their functions if there were a market demand for their services. Under current conditions, the trust in their performance is sadly lacking. The government can provide a similar type of product through this certification process. I can think of no single action by government that could do more to restore confidence in the mortgage lending process.

Similar creativity should be, and by and large is being, applied to current homeowners who are having problems making payments. Homeowners anticipating problems should contact their mortgage servicer as soon as possible. Servicers have little incentive to foreclose if the mortgagee has some capacity to make payments. More generally, creative approaches are being developed by new entrants to the industry. One example that is particularly interesting is the shared appreciation mortgage which allows lenders to lower the principal amount owed by the borrower, and in the process lower the borrower's monthly payment, but in return the lender keeps a share in the value of the house (equal to the proportionate loan reduction amount) which is collected when the house is sold. By lowering the monthly payment this process offers the homeowner every incentive to stay in the house, an attractive piece of the interest rate freeze plans. But it also fully compensates the lender when house prices recover. Government should not pick a single approach but should facilitate those good-faith approaches that are out there by making changes in tax and securities rules that might accommodate these approaches.

Finally, there is a role for this Committee to consider in its main area of jurisdiction: taxation. Like most economists, I would conclude that in the grand scheme of things, home ownership gets quite generous tax treatment, particularly through the housing mortgage interest deduction. In an ideal world this would not be considered an economically efficient program, although there are benefits to society in encouraging home ownership that should be considered. But this is not an ideal world, and whatever one may think of the tax treatment of housing generally, the economic risks to further home price declines are large and should be avoided.

In this environment of declining mortgage availability and home price declines, tax favored treatment of mortgage interest does provide a reason for people to hold on to more housing than they otherwise might while also easing the cash flow problems associated with homeownership. In the near term this should be considered an economically stabilizing action by government.

Two changes in the tax deductibility of mortgage interest should be considered as temporary measures. First, mortgage interest might become an "above the line deduction" available to non-itemizers as well as itemizers. Half of all homeowners do not itemize their tax returns. These are disproportionately moderate income individuals who might be bearing a disproportionate amount of the strains from the deteriorating housing market. On the other end of the housing scale, individuals who are either trying to obtain Jumbo mortgages or who are forced to carry two mortgages because they have had to buy a new home without being able to sell their old one are coming up against the $1 million limit on the size of a mortgage, the interest on which is tax deductible. A temporary lifting of that cap might be a worthy change to consider in this environment.

I would stress the advantages of having these measures be temporary. A lifting of the cap, for example, would be most effective for a period of two to three years while mortgage conditions stabilize. The above-the-line deduction should probably be in place longer, but with a phase-down period.

Certifying the standards of securitized mortgage pools, facilitating the search for creative solutions in the market place and a modest and temporary improvement in mortgagee cash flow through tax changes combine to offer the best way of easing the transition to the next model in housing mortgage finance.