US Housing Finance: A Clash of Economics and Politics

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Abstract

The great recession of 2007-2009 was sparked by bad mortgage policy. Since 1992 government efforts to promote homeownership for higher risk buyers led to reduced mortgage standards and subprime mortgages. Fannie Mae and Freddie Mac set those low standards to achieve their affordable housing goals assigned by Congress. The record low levels of interest rates during 2001-2004 sparked a huge speculation in mortgages, and house prices surged. As market interest rates increased during 2004-2006, the housing bubble burst and house prices fell for 36 consecutive months. The successful future of the home mortgage market depends on a return to high standards for prime mortgages, and a separate program for housing assistance for higher risk buyers, funded by Congress.

History of the Mortgage

Two hundred to four hundred years ago in North America and Europe, land ownership was primarily for the wealthy or the sovereign. The majority of citizens were tenants or indentured servants with little hope of becoming landowners. Land ownership perpetuated the divide between the rich and the poor. Land ownership began to change as world trade expanded under the Mercantilist doctrine. The Industrial Revolution and exploration of the New World created new opportunities for many. Hearty souls (and convicts) undertook the risks of seeking their fortunes in distant lands, such as the American continent, Africa, Asia, Australia, and New Zealand. Land grants by the sovereigns were an important tool used to encourage development of the "colonies", primarily to drive trade that would help the sovereigns accumulate gold, land, and other wealth.

Another very important development was the mortgage, a financial instrument that allowed a debtor to purchase land, take possession of the land, and pledge the land as collateral for the debt. This innovation - taking title to property before it was fully paid - was to create huge wealth and opportunity that would drive economic progress into the twenty first century.

In the US the first home mortgages were made by the savings banks. Depositors often waited for years for their turn to be funded from the limited pool of deposits. The first savings bank was the Philadelphia Savings Fund Society, created in 1838. These mutual savings banks

were created to serve the workers, most of whom were not wealthy enough to be served by the commercial banks of that day.

By the late 1880s insurance companies were issuing mortgages to homeowners. The Farm Mortgage Bankers Association was established in 1888 to promote this important link between farm and homebuyers and the investors who would loan the purchase money. Over the next 130 years this concept has evolved to the extent that now 65% of US households own their own homes, and some form of government sponsorship facilitates 90% of financed housing. (See Jaffee, 2013).

US Government Policy on Home Mortgages and Homeownership

In 1934 the Federal Housing Administration (FHA) was created to provide mortgage insurance for middle and moderate-income homeowners. These insured mortgage loans required a down payment of only 3%. After World War II, the Home Loan Guarantee program of the Veterans Administration was created to allow returning military veterans to become homeowners with zero down payment mortgage loans.

Other government policies also have favored home ownership. Home mortgage interest can be deducted from gross income for income tax purposes. Capital gain profit from homeownership has received favorable tax treatment. For many years capital gains from the sale of a home were tax deferred if a home of greater value was purchased, and now homeowners (a couple) can take up to $500,000 of capital gains tax free. A homestead receives favorable treatment in bankruptcy, regardless of other debts. These policies appeal to the middle class, and they seem to be a part of the social compact that includes a progressive income tax and expanded government programs for the poor.

The Savings and Loan industry played an important role in the promotion of homeownership among the growing middle class after World War II. S&Ls were expected to make mortgage loans in their market area, and they avoided income tax if they devoted 80% of their assets to home mortgage loans. They were not allowed to make business loans. Competition was limited by the maximum 5.25% interest they could pay on savings accounts. As of 1966 the rate S&Ls could pay savers was ¼% higher than the rates banks could pay, leading to large increases in S&L deposits and mortgage lending capacity. The S&L business was called a 3-6-3 business: take in money at 3%, lend it out at 6%, and be on the golf course by three o'clock. During those days before 1970, S&Ls were able to fund most mortgages in the US, with the remainder being funded by FHA-insured loans or VA-guaranteed loans. Almost all S&L loans were held in portfolio, and almost all FHA and VA loans were made by mortgage bankers and sold to insurance companies and other investors. Metropolitan Life Insurance Company operated retail loan offices in major cities to make mortgage loans directly to homebuyers.

The 1970s brought a major change to home mortgage finance. Inflation started rising in the mid-1960s, and this lifted interest rates to record high levels. Money market mutual funds offered consumers as much as 18% annual return by the late 1970s, while S&Ls still were limited to paying 5.25%. This imbalance led to disintermediation as S&L depositors withdrew funds from their S&L accounts to invest in money market funds or the stock market. Soon the S&Ls were no longer able to fund the majority of US home mortgage loans. To help S&Ls cope with disintermediation, the Federal Home Loan Bank Board allowed the creation of Certificates of Deposit (CD) with no cap on the interest rate that could be paid. The CD allowed S&Ls to attract (insured) deposits to replace withdrawals, but soon the cost of funds for many S&Ls exceeded their portfolio yield, and they were losing money. This led to the savings and loan crisis, the Resolution Trust Corporation, and losses of about $150 billion for the government. The net result was that government efforts to create the S&L industry as a protected source of home mortgage funding had failed. The next order of business in housing policy was to find an alternative source of funding for home mortgages.

The Rise of Fannie Mae, Freddie Mac and the Secondary Market

The next source of mortgage funds was to be the secondary mortgage market. In this market, mortgages are bundled into pools, and bonds (mortgage-backed securities - MBS) are sold to investors with the mortgage pools as collateral for the MBS. Fannie Mae, a federal agency, was reorganized in 1968 to buy mortgages from mortgage bankers and sell the resulting MBS to investors around the world. In 1970 Freddie Mac was created to do the same for S&Ls. Fannie and Freddie, as Government Sponsored Enterprises (GSEs), had a relatively small guarantee from the federal government, but investors treated them as though they had a full faith and credit guarantee from the government. As a result GSEs could borrow at interest rates almost as low as US government bond rates, and they could provide mortgage interest rates lower than most highly rated corporations paid for long term debt. Ginnie Mae was created in 1968 as an agency in the Department of Housing and Urban Development (HUD) to insure pools of FHA and VA mortgages, bringing the MBS concept to these loans.

These GSEs transformed mortgage finance by standardizing the MBS and gaining its acceptance. The secondary market became a huge source of funds for mortgages. The appeal of US real estate collateral and the implied US government backing drew funds from banks, governments, pension funds, corporations, and wealthy individuals around the world.

The MBS is a pass-through security that pays principal and interest every six months. By the 1980s MBS were structured in tranches, so investors could choose their preferred maturity. The loans were serviced by a mortgage banker who collected monthly payments, handled foreclosures, and kept records. As a result the investor had a bond-like instrument that was considered to be very low risk and paid almost as much as a US government bond.

Affordable Housing as a Political Goal

Since World War II, the US homeownership rate had been increasing. Many saw homeownership as the "American dream", and many politicians wanted to extend that goal for more of their constituents. As it has turned out, the efforts of politicians to increase homeownership rates for their constituents have backfired. Many speculators and low-income people jumped on the ownership bandwagon, added to housing demand and rising housing prices. Many paid too much. When the bubble burst, house prices declined for 36 consecutive months, and many homeowners found they owed more than their house was worth by 2009.

Legislation dealing with the GSEs in 1992 modified the goals of Fannie Mae and Freddie Mac. Until that time their goal had been to purchase "investment-quality" mortgages. The new goals included the support of "affordable housing", and HUD wrote implementing regulations that led the GSEs to lower standards for down payments and borrower credit history. (See Kling, 2013). Over the next 10 years the GSEs faced increased political pressure to increase home ownership rates, especially among lower income buyers.

The affordable housing goals were expressed as a percentage of homebuyers with incomes at or below the median income in their local market. The goals were increased steadily over the period 1992-2007. By 2008 40% of the loans owned or guaranteed by Fannie Mae were sub-prime or Alt-A (reduced standards). Freddie Mac had a similar experience. (See Wallison, 2013). This political pressure created the sub-prime mortgage bubble and collapse of 2003-2007. (See Pinto, 2010). During 2003-2007, the GSE mortgage portfolios remained constant while their MBS issuance increased. Because of the worldwide acceptance of the GSE-backed MBS, they could lay off all the default risk to investors and take none of it themselves. (See Acharya (2011a).

One component of the "affordable housing" goals assigned to the GSEs by HUD was the percentage of loans made to buyers of low- and moderate-income. During 1993-95, this goal was 30% of all mortgages purchased by the GSEs. During 1997-2000 it was 42%. During 2001-2004 the goal was 50%, and in 2006 it was 53%. Even after the crash, in 2008 the assigned goal was 56%. Senior executives earned bonuses based on meeting various goals. James Johnson, CEO of Fannie Mae from 1991-1999 was paid $200 million in salary and bonuses. Franklin Raines, CEO from 1999 until 2004, was paid $90 million in salary and bonuses. (See Morgenson and Rosner, 2011).

The Dodd-Frank Act

The Dodd-Frank Act was passed in 2010 to deal with the financial crisis and prevent future such events. That bill is very long and complex, and by early 2014 only about half of the required regulations had been written. It will be several more years before all the regulations have been written and implemented. Some of the provisions of the Act deal with mortgages, and an important feature is the definition of a "Qualified Residential Mortgage – QRM." The implication is that lenders making loans that are QRM are favored, and lenders making loans that

are not QRM will be required to retain 5% ownership of the loans as a first-loss backstop. The features of the QRM remain a topic of debate, and it appears that the ultimate result will be standardization on the QRM. Early discussions suggested this would be a 20% down payment loan, fully amortized over no more than 30 years, with good credit scores and underwriting ratios. More recent discussions suggest that a 10% or less down payment and relaxed underwriting standards may qualify as a QRM. (See Watt, 2014).

The Dodd-Frank Act also created the Consumer Financial Protection Bureau (CFPB) that is located in and funded by the Federal Reserve System. (The lack of budgetary oversight by Congress is an issue for another time). The CFPB had been assigned the implementation of the Truth in Lending Act, the Real Estate Settlement Procedures Act, and the regulation of "abusive practices", which have yet to be defined by the CFPB. The power and reach of the CFPB may discourage residential mortgage lending and raise costs for lenders and borrowers.

Title XIV of Dodd-Frank deals with mortgages. It gives the Consumer Financial Protection Bureau the authority to retroactively define "abusive" mortgage terms and to define the "qualified mortgage". Rather than market forces balancing consumer demand and lender underwriting, the CFPB will be setting standards and levying penalties. It is likely that lenders will avoid mortgages that deviate from the qualified mortgage, whatever that turns out to be. (See Peirce and Broughel, 2012).

Reform Proposal: Obama Administration Plan in 2011

The Obama Administration released a White Paper in 2011 that promised, "our plan dramatically transforms the role of government in the housing market". The plan laid out three potential solutions to the problems posed by Fannie Mae and Freddie Mac. Without proposing any specific proposal, the following options were listed:

1. A fully private mortgage finance system with on budget funding of assistance for low-income buyers in the HUD budget.

2. Government backstop of privately-issued MBS.

3. A private sector mortgage financing system with government backstop only in the event of a financial crisis. (See Department of the Treasury, 2011).

Since these options were listed in the White Paper, Fannie Mae and Freddie Mac has returned to profitability and they have paid $188 billion to the Treasury this year as dividends. None of those funds were applied toward the government cash injection, and the bailout loan of $155 billion remains outstanding. While option 1 is the private sector approach that protects taxpayers, it does not appear to be the option now favored by the Administration. (See Wallison, 2013). (See Miller, 2011).

Alternative Reform Proposals

The mortgage crisis of 2008 forced the US government to guarantee the debt of the GSEs and place Fannie Mae and Freddie Mac in conservatorship. The guarantee of debt was required because US MBS had become a huge international investment thought to be safe. Massive defaults would have directly caused the failure of many US and foreign financial institutions. The conservatorship and injection of $190 billion was necessary to keep the GSEs operating and buying mortgages so the housing market could continue to function. No recovery from recession in the post-war era has occurred without the support of the housing sector. The GSEs and FHA/VA programs have been supporting more than 80% of home mortgage finance, so continuing that support in the short term was a political and economic necessity. There was widespread consensus that the best short-term policy was to keep the GSE functioning.

There also was consensus in policy circles that over the longer term the GSEs needed to be phased out and replaced by private sector solutions. The US has long had housing programs targeting the lowest income households. The primary objective of the Federal Housing Act of 1934 was to provide "safe and sanitary housing", at a time when indoor plumbing and electric service was not available to many households. Programs to assist the lowest income households include the Section 8 rental assistance program, public housing in many cities, FHA insurance programs for low-income rentals, FHA insurance for low-income homebuyers, Farmers Home Administration programs for low-income rural homes, and others. The political constituency for these assistance programs generally supports using the GSEs for similar purposes, and that makes it difficult to separate the low-income targeted programs from the middle and upper income serving programs for the purpose of reform.

By 2009 many housing market observers supported some form of GSE reform that would salvage the market for home mortgage finance and avoid future taxpayer bailouts. A common thread of these proposed reforms was to gradually reduce the maximum loan amount that could be purchased by the GSE (the "conforming loan limit"), which is currently $775,000 in certain high cost areas. For many years the conforming loan limit was adjusted annually based on the average house price as published by the Federal Home Loan Bank Board. In recent years it has been increased more to accommodate higher income households. Although the GDEs could buy these large loans, they also were under pressure to achieve "affordable housing " goals by also buying more loans that usually were smaller. (See Jaffee, 2013). An advantage of this reform is that the subsidy of home mortgage finance would first be removed for higher income homebuyers, and later would be removed for middle and moderate homebuyers. A companion reform could be the phasing out of the home mortgage interest deduction.

Another element of reform is to have a private sector alternative for GSE-issues MBS. Many observers believe that an active private market in MBS can arise by expanding the current

private MBE market that exists for mortgage loans that are above the conforming loan limit. We also have an active market for various forms of collateralized loans, such as car loans and appliance loans, which are patterned after the MBS. To help achieve that level of standardization, it would help to have standard mortgage documents and terms. The Consumer Financial Protection Bureau is working on defining a "qualified residential mortgage" that could meet this challenge. Many market analysts believe the QRM should feature a 20% down payment, 30 year term, fixed payment, and fully amortized with debt–to-income ratios of 38% and payment-to income ratios of 26%. These terms would be consistent with the traditional conventional US home mortgage made by the S&Ls in the 1960s without direct government assistance.

Peter J. Wallison has made a strong case that a MBS finance system could work well with active government intervention. He reviews the history of past house price bubbles in 1980 and 1990, prior to the imposition of affordable housing goals or reduced underwriting standards. In each of those cases the mortgage foreclosure rate after the bubble burse remained below 1.4% in the year following the collapse in house prices. However after the 1997-2007 bubble in house prices, full-year foreclosure starts were 5.3%, even though there were government programs in place to reduce and postpone foreclosures. The great majority of the loans that went into foreclosure were the subprime and Alt-A loans made with reduced down payments and reduced underwriting standards. The contrast in performance of prime and non-prime loans also is illustrated by their delinquency rates. Fannie Mae prime loans in 2009 had an average delinquency rate of 2.6%, while their non-prime loans had a rate of 17.3%. The conclusion is that mortgages can be a low risk investment financed by the private sector if high standards are maintained in terms of down payments, underwriting ratios, and income verification. (See Wallison, 2013a). Housing assistance programs for lower income households need to be administered and financed separately from the mortgage finance delivery system.

Reform Proposal: The Johnson-Crapo Bill in 2014

Senators Johnson and Crapo have proposed a different approach to the ultimate elimination of Fannie Mae and Freddie Mac. Their bi-partisan approach would eliminate Fannie and Freddie over time, and it would create a new agency, the Federal Mortgage Insurance Corporation (FMIC). That agency would insure MBS, although the securitizer would pay an annual fee based on how well that securitizer served "underserved eligible borrowers". These "eligible borrowers" are defined by the CFPB based on down payment, income, underwriting ratios and other factors defining a "qualified mortgage". This low standard is another avenue to achieve political "affordable housing" goals. During 2005-2008 this type loan had a default or serious delinquency rate of 23%. The fees collected from some securitizers would be shared with "underserved borrowers" and selected advocacy groups that pressure lenders to make subprime loans. Clearly this approach promotes the "affordable housing" concept und forced low risk borrowers to subsidize higher risk borrowers. It would create a new class of citizens receiving a check from the government. (See Wallison and Gramm, 2014).

Reform Proposal: Revised Administration Plan in 2014

The most recent statement from the Administration on mortgage reform policy is the recent speech by Mel Watt, new Director of the Federal Housing Finance Agency, which regulates the GSEs. He said the goal is to not "contract the footprint" of the GSEs. He will reduce the efforts to force lenders to buy back questionable mortgage loans, and he has delayed increased fees that were announced in December 2013. He pledged use of GSE support to aid mortgage lending in Detroit. These policy shifts suggest that politics is alive and well, and that the GSEs will be retained as a means to provide assistance to homebuyers with lower incomes or credit quality. (See Watt, 2014).

Lessons for Abroad

In some European markets, home markets are financed through covered bonds. In this situation each mortgage or pool of mortgages used as collateral for a bond sold to investors. The mortgages are generally for a 30-year term, but the interest rate may be adjusted every three or five years. This places some of the interest rate risk on the homebuyer and some on the investor. It is important to note that among the industrialized nations only the US and Canada have any sort of government sponsored housing assistance for middle-income homebuyers.

Denmark has a system of mortgage banks that take credit risk, with no government support. Mortgage quality standards are high, and there has not been one failure of a mortgage bank in 200 years. (See Kling, 2013).

In Canada the predominant home mortgage is a 5-year adjustable loan amortized over 30 years. Many of these loans are help in portfolio by banks. Among the industrialized nations, only in the US and France are 30 year, fixed rate mortgages widely available.

Conclusions

The subprime mortgage boom and bust started with the affordable housing initiatives in 1992. Political pressures to increase homeownership and reward supporters led to steady relaxation of lending standards throughout the 1990s and 2000s. Unfortunately there was a perfect storm. Fannie Mae had standardized the mortgage-backed security in the 1970s, and it was in a unique position to use its control of the secondary mortgage market to achieve political goals. Congress applied pressure on the GSEs to increase homeownership, and the GSEs did that by lowering lending standards. Private lenders, who sold virtually all their loans to the GSEs, were forced by competitive pressure to adopt the GSE standards.

The great recession started in December 2007 as the housing market started to collapse. Mortgage delinquency rates rose, and soon MBS investors around the world started to bail out of the market. Secondary market prices for MBS plummeted. By September 2008, the GSEs were

insolvent and were placed in conservatorship by the government. Approximately $190 billion was spent by the Treasury to shore up the GSEs and keep them in operation. The US government guaranteed all GSE debt to reassure investors and prevent massive failure of financial institutions around the world.

After the great recession ended in June 2009, Congress passed the Dodd-Frank Act. It provides for new initiatives in mortgage regulation, including creation of the Consumer Financial Protection Bureau. In addition many policy makers have discussed the need for reform of the mortgage lending system. For several years there seemed to be a consensus that the GSEs should be phased out and the mortgage market should operate under private sector forces. Most policy discussions centered on a return the high underwriting standards that prevailed before 1990: 20% down payments, underwriting ratios of 28% and 36%, verification of income, and FICO scores of 660 or more.

Recently it appears that political forces are pursuing policies that would incorporate low-income housing subsidies into the mortgage finance system, much like the affordable housing policies attempted to do. The most recent administration proposals include down payments below 10% and hidden subsidies for low-income homebuyers. For example, they would collect fees from low risk borrowers to subsidize homeownership for high-risk borrowers, and to subsidize advocacy groups.

The overall conclusion, seven years after the mortgage market crash, is that the potential for development of an efficient and market-driven mortgage market is in jeopardy.

Recommendations

Homeownership is a very important goal of many families, and the industry has promoted it since World War II as the "American Dream". The only way homeownership can be a realistic goal for most families is for their to be a mechanism for mortgage finance that fits the needs of borrowers, lenders and investors. This market mechanism should be focused on market forces balancing the supply and demand for mortgage credit. It should be limited to high quality mortgages, fully qualified borrowers, sound property appraisals, and enforceable foreclosure contracts.

Any effort to assist high risk borrowers should be separate from the unsubsidized mortgage credit system, and it should be funded through appropriated funds administered by HUD. As shown in the great recession, attempts to force low risk borrowers to subsidize high risk borrowers will destroy both markets.

The mortgage finance system should encourage 15- and 30-year, fully amortizing, fixed rate mortgages. The success of the jumbo mortgage market, without government support throughout the great recession, shows that this mechanism can work. In addition, the mortgage finance system should encourage 3-year and 5-year adjustable rate mortgages, amortized over 30

years, which may be held in portfolio by S&Ls and banks. Covered bonds and conventional MBS should be encouraged to attract long-term investors to mortgage finance.

Prime mortgages should feature a 20% down payment (including private mortgage insurance), sound underwriting ratios, fully amortizing payments, and independent property appraisals.

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