UC Irvine School of Law

The Future of Housing Finance Reform

Arizona Housing Alliance

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Government Guarantees Have Been a Key Part of Modern U.S. Housing Finance

Pre-Depression Mortgage Finance

- Very limited and costly availability of mortgage credit
  - The typical mortgage was 50% down, 2-5 years in length and non-amortizing (interest-only).
  - Lender-friendly characteristics: no prepayment risk, limited interest rate risk, and large buffers against credit risk.
  - Homeownership rate around 40%, despite policies encouraging homesteading through cheap or free land grants. In DC and NY State, HO rate around 30%.
- Unstable financial system
  - Bubble-bust cycles every 5-10 years.
  - Large systemic costs in terms of economic and capital markets retardation.

The Post-Depression Era of Mortgage Finance

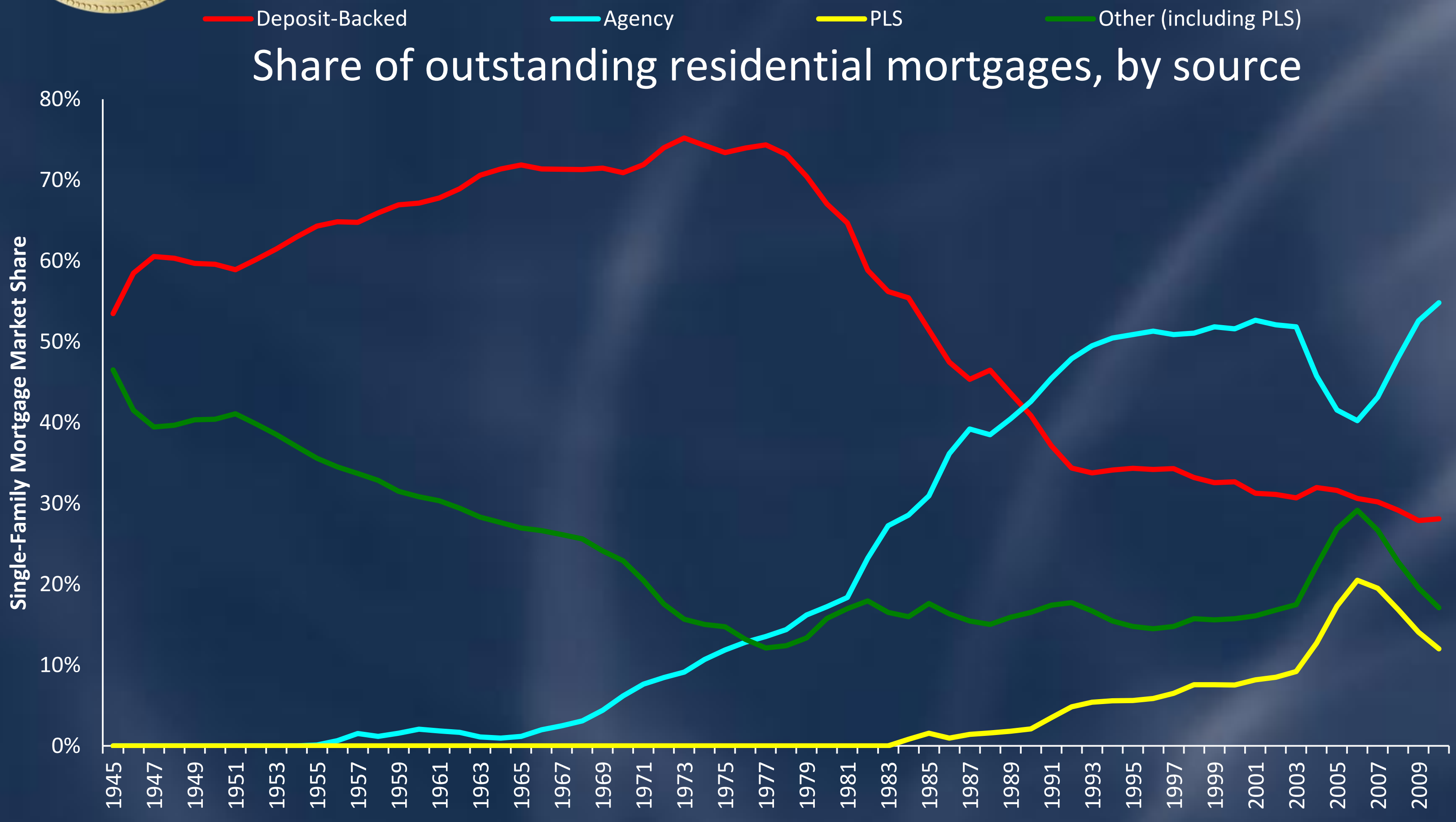
- Introduction of govt support transformed mortgage finance
  - The establishment of the modern mortgage– high LTV, long-term, fixed-rate, fully self-amortizing.
  - Broad access– HO rate from 43.6% in 1940 to 64.4% in 1980.
  - Stability– The so-called “Quiet Period” in banking

- The transition from deposits to Agency MBS
  - Interest rate shocks from the 1970s/80s
  - Deregulation/regulatory forbearance in the 1980s

- The transition from Agency MBS to private-label MBS

Govt Guarantees Prevalent Since the Great Depression

Sources of U.S. mortgage financing, historical



Source: Federal Reserve Flow of Funds Data, Statistical Release Z.1, Table L218 (historical)

Govt Guarantees Coincide with Financial Stability

Source: Gary Gorton (2009), FDIC

The Stabilizing Effects of Govt Guarantees

The government guarantee imposes systemic stability on mortgage finance in three ways:

1) Provides confidence to investors, solving the problem of bank panics

2) Mitigates the inherent procyclicality of mortgage finance by:
   - Directing most mortgage finance into highly regulated conduits
   - Providing a source of countercyclical liquidity

3) Encourages stability in the housing markets by promoting the origination of the 30-year, self-amortizing, fixed-rate mortgage

Examining the Causes of the Mortgage Crisis

Two Competing Narratives

- Mainstream narrative: <u>primarily a market failure</u>
  – This was primarily a failure of the markets, and a demonstration of why we need strong regulatory oversight of banking and particularly mortgage banking.

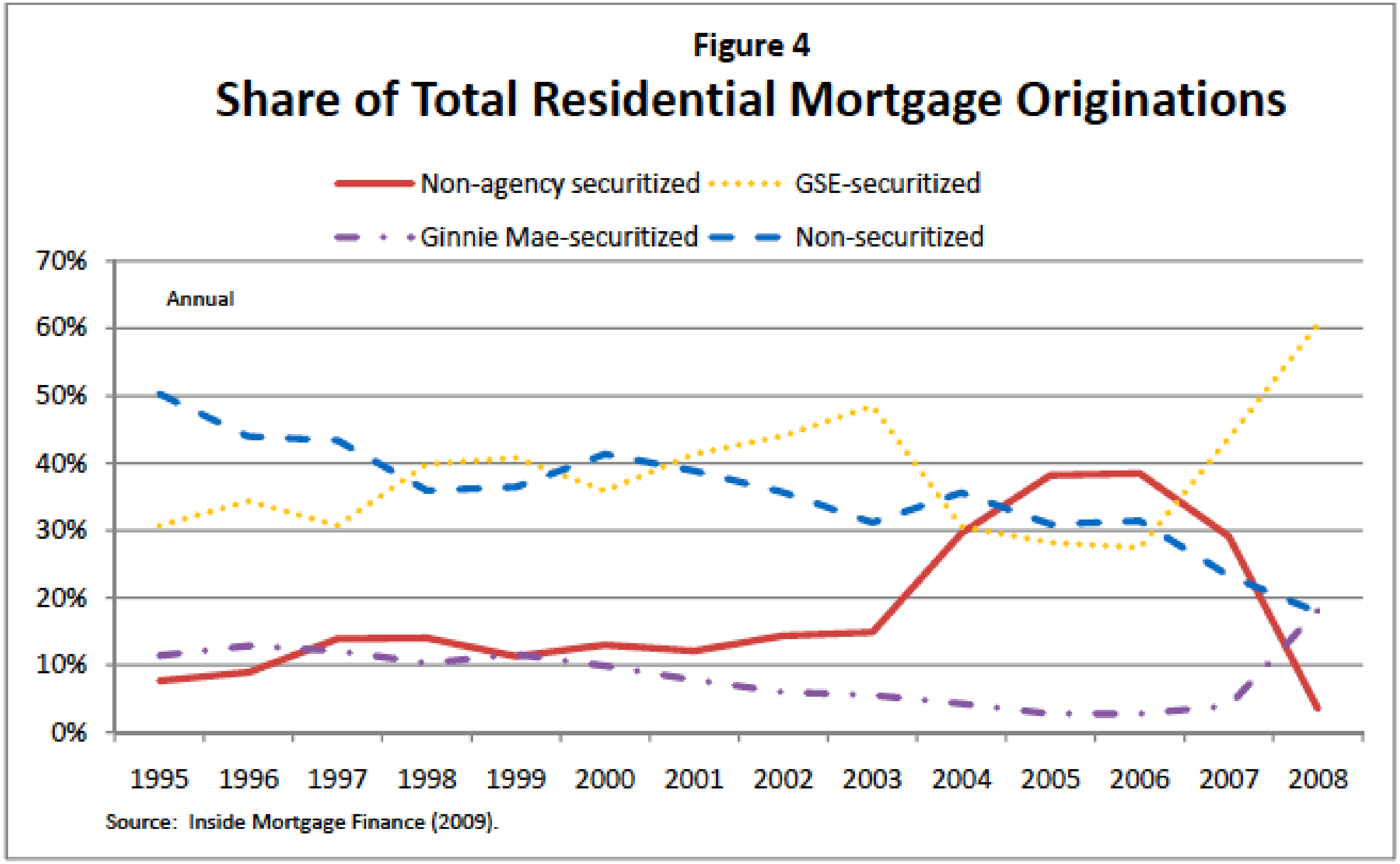
- Counter-narrative: <u>primarily a government failure</u>
  - This was primarily a failure of government policy, which stressed affordable housing goals and homeownership targets that were unattainable without high risk lending and the degradation of lending standards.

The Mainstream Narrative

- Financial deregulation and regulatory neglect, driven by a libertarian viewpoint that had gained momentum during the 1990s and early 2000s, allowed credit intermediation to migrate towards the "shadow banking system," which was crucially dependent on the private-label securitization of mortgages.

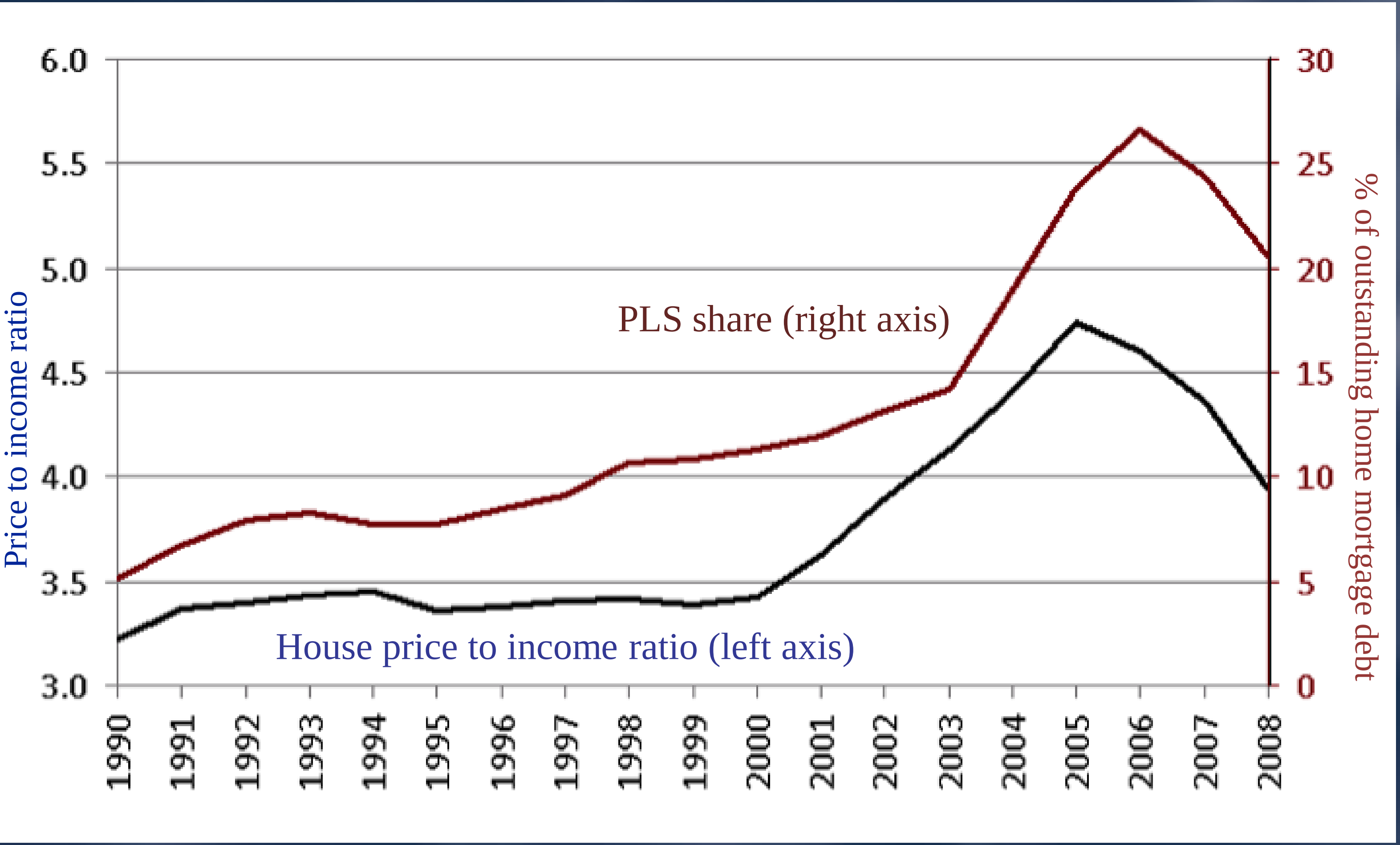
- Regulatory failures played an important role, but these were primarily deregulatory in nature.
  - E.g., OFHEO/FHFA regulation of Fannie and Freddie capital standards
  - E.g., OCC preemption of state predatory lending laws
  - E.g., SEC's "consolidated supervised entity" program

Market share data supports the view that PLS caused the crisis



… as does the relationship between PLS market share and house price appreciation

Increases in home price appreciation mirror increases in PLS market share



The Counter-Narrative

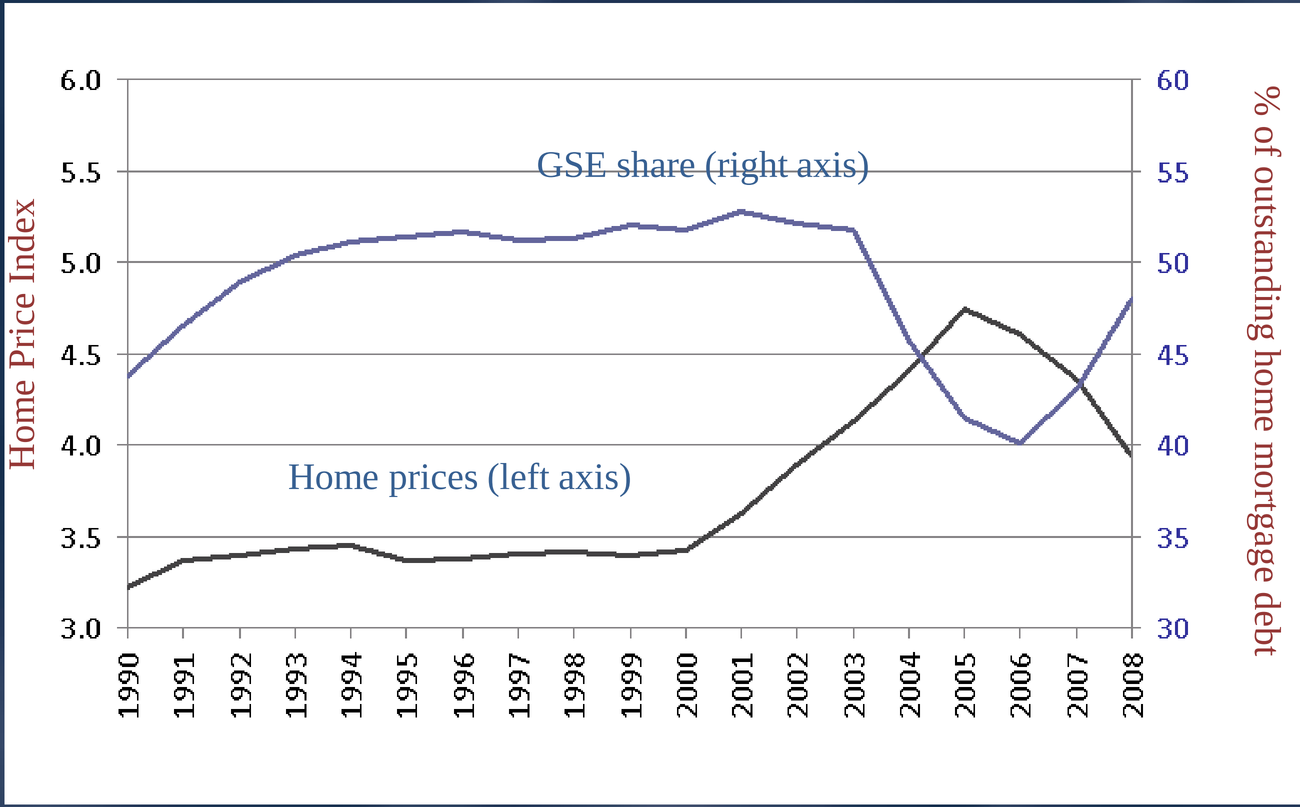
- In an attempt to raise homeownership levels, the Clinton Administration, along with its Congressional allies (including Rep. Barney Frank (D-MA) and Sen. Chris Dodd (D-CT)), imposed affordable housing requirements onto regulated institutions (CRA for regulated banks and thrifts, affordable housing goals for Fannie and Freddie), which caused a relaxation in loan underwriting standards. This was the proximate cause of the 2008 financial crisis.

Problems with the Counter-Narrative

- Explaining how underwriting changes in 1992 caused a housing bubble in the mid-2000s
- Delinquency rate data contradicts the claim that mortgages originated for affordable housing purposes were high risk
- Market share data contradicts the claim that high risk mortgages were originated for affordable housing purposes

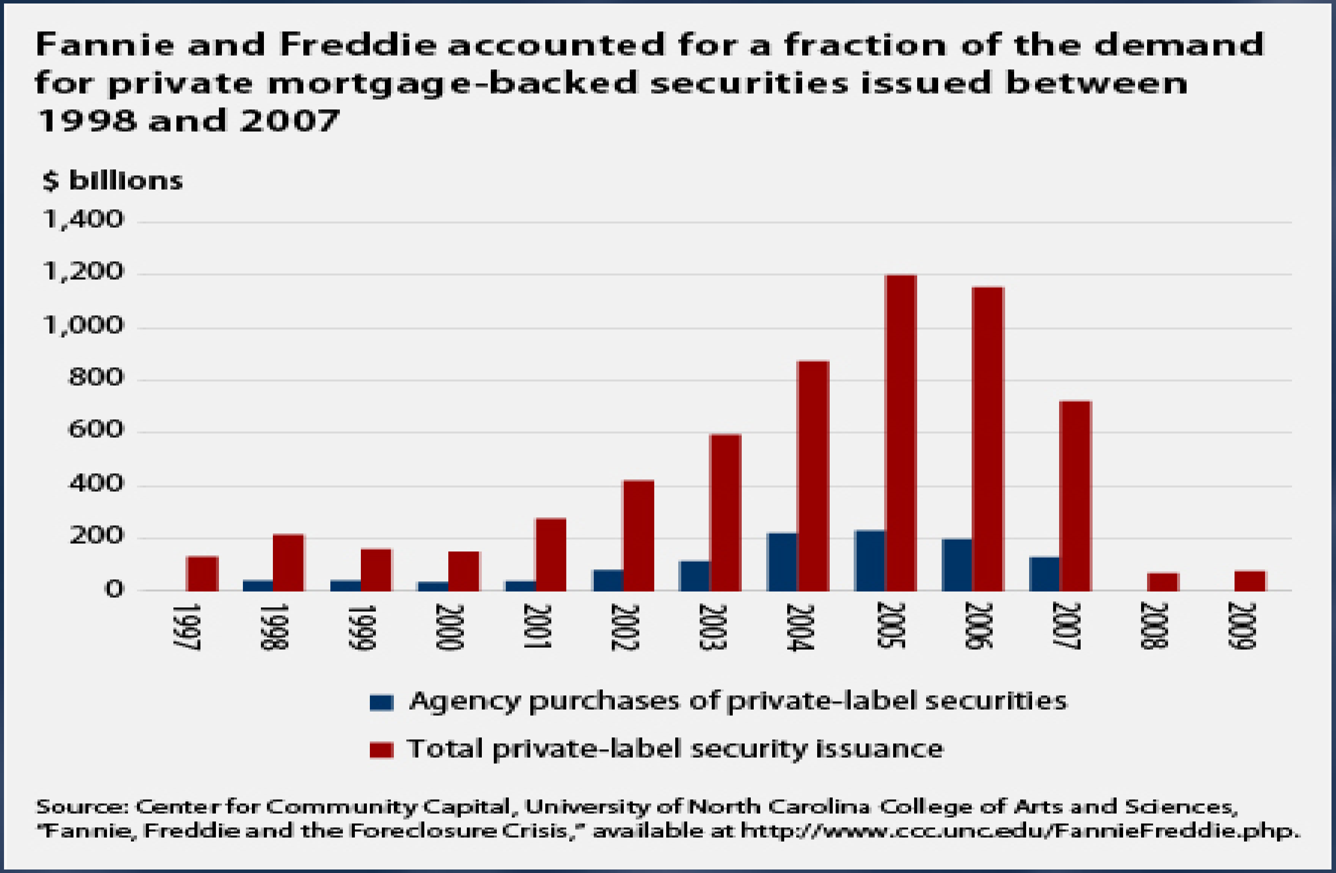
Did Affordable Housing Policy Changes from 1992 Cause the Housing Bubble?

- GSE market share displayed an inverse relationship with housing prices– as GSE market share went down, prices went up
- GSEs accounted for less than 30% of originations in 2005 and 2006.



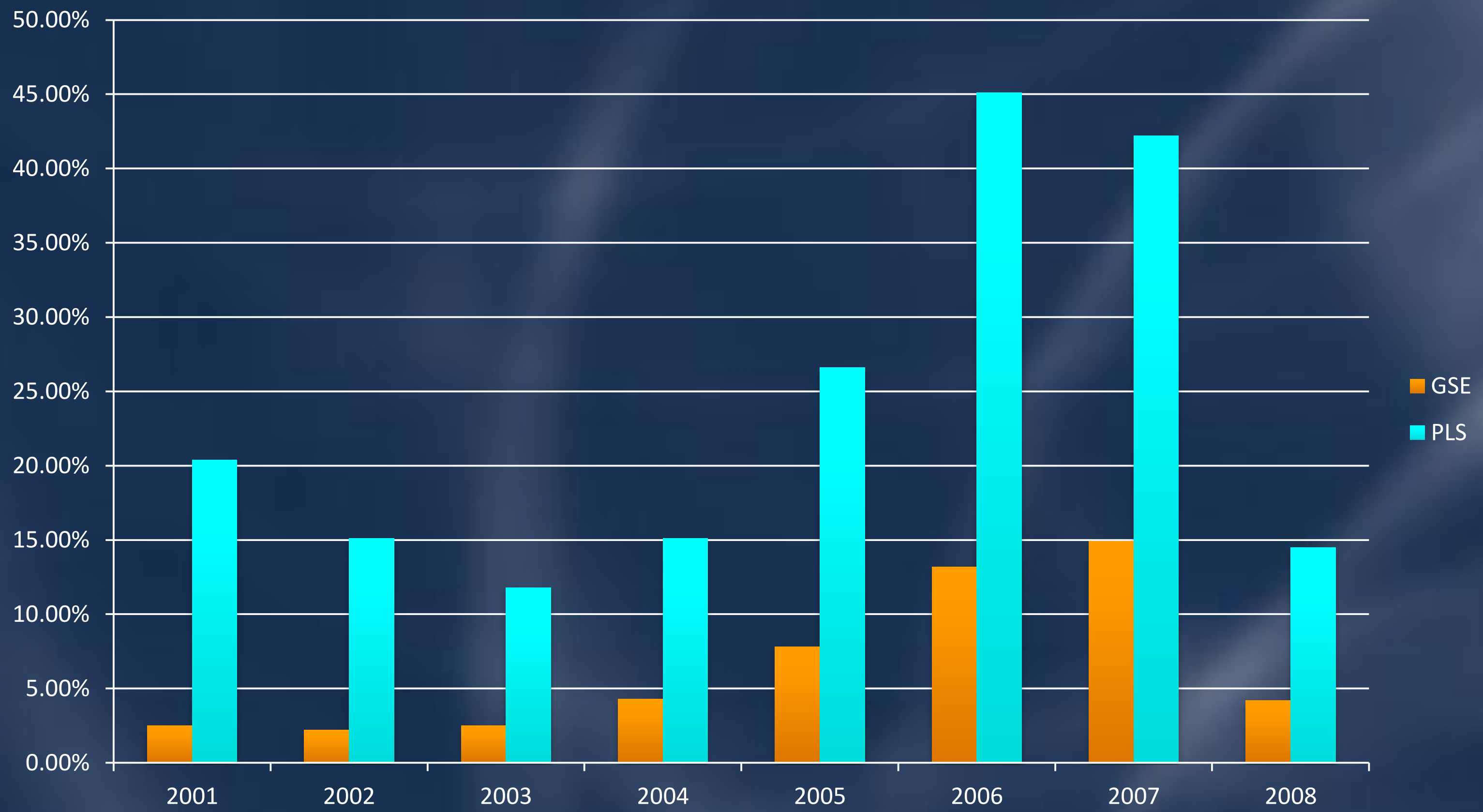
Notes: Price-to-Income Ratio defined as median sales prices of single-family, condo or co-op divided by median household income; Federal Government includes federal government, government-sponsored enterprises, and agency- and government-sponsored enterprises-backed mortgage pools
Sources: Federal Reserve Flow of Funds; Current Population Survey; National Association of Realtors

Fannie and Freddie did not drive the market for PLS



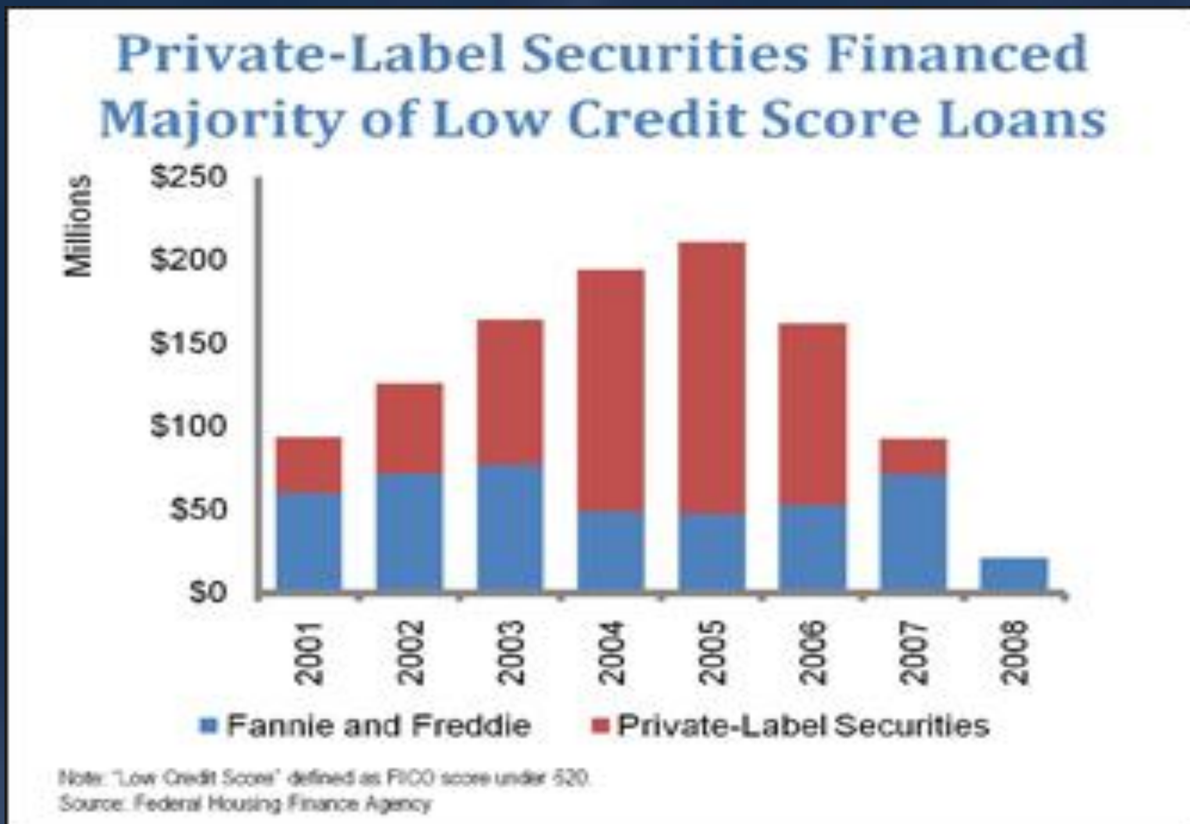
Delinquency rate data suggests that PLS mortgages, not GSE loans, were high risk

90 day delinquency rates by channel and origination year



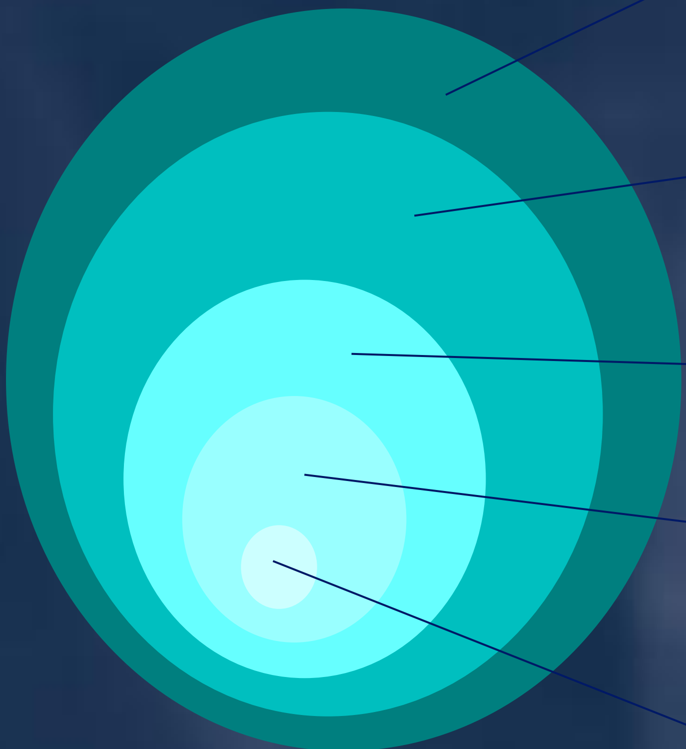
Source: Federal Housing Finance Agency (using data from Inside Mortgage Finance, Fannie Mae, Freddie Mac, and CoreLogic, Inc.)

Private-label appetite for low credit score loans indicates the demand was not driven by public policy



CRA Loans Did Not Cause the Crisis

2004-2007



All Loans (first-lien, 1-to-4 unit properties in metropolitan areas, home purchase or refinance)

66.3% Banks and Thrifts - CRA-regulated + their subsidiaries and affiliates

28.8% within CRA Assessment Areas

11% eligible for CRA credit (lower-income borrowers or neighborhoods)

1.3% Subprime CRA-eligible (only 5.9% of high-cost loans)

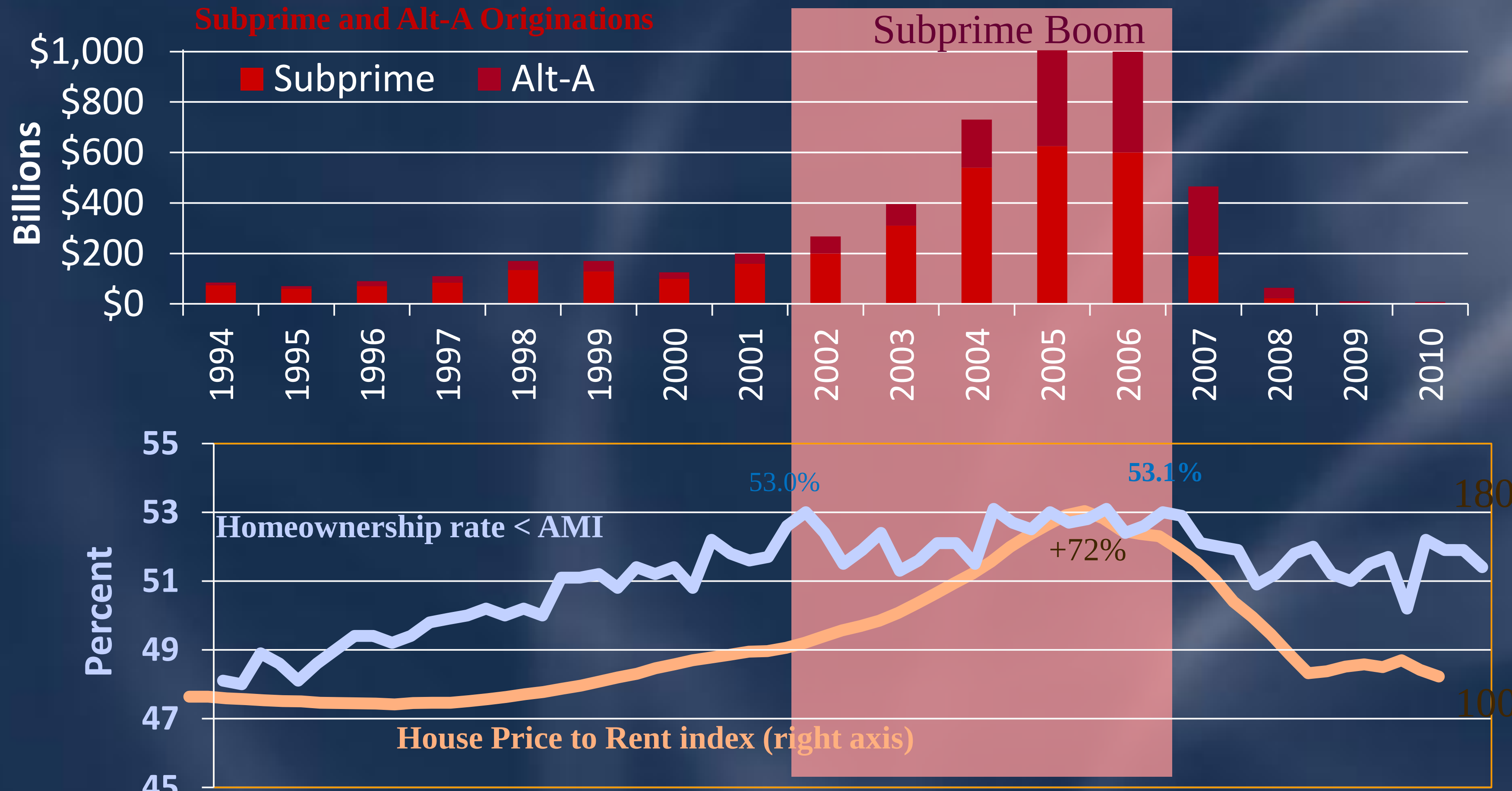
Note: Circles are drawn to scale.

Source: UNC Center for Community Capital (utilizing data from the Home Mortgage Disclosure Act)

CRA-type Lending Did Not Cause the Crisis

- The loans that caused the financial crisis -- subprime and Alt-A loans -- were overwhelmingly originated by non-CRA lenders
  - LMI borrowers who received loans through CRA lenders within their assessment area were significantly less likely to receive a subprime loan or loan with a risky feature, even after controlling for borrower and neighborhood risk characteristics
- CRA loans have performed better than non-CRA loans
  - CRA loans made in California were half as likely to go into foreclosure as loans to similar borrowers made by lenders not covered by CRA (*Lederman and Reid)*
  - CRA-motivated loans in CAP program, default risk was three times lower than subprime loans made to borrowers with similar risk profiles (*Ding, Quercia, Li, Ratcliffe)*

Crisis caused by products, not homeownership



Source: *Inside Mortgage Finance; US Census Bureau*

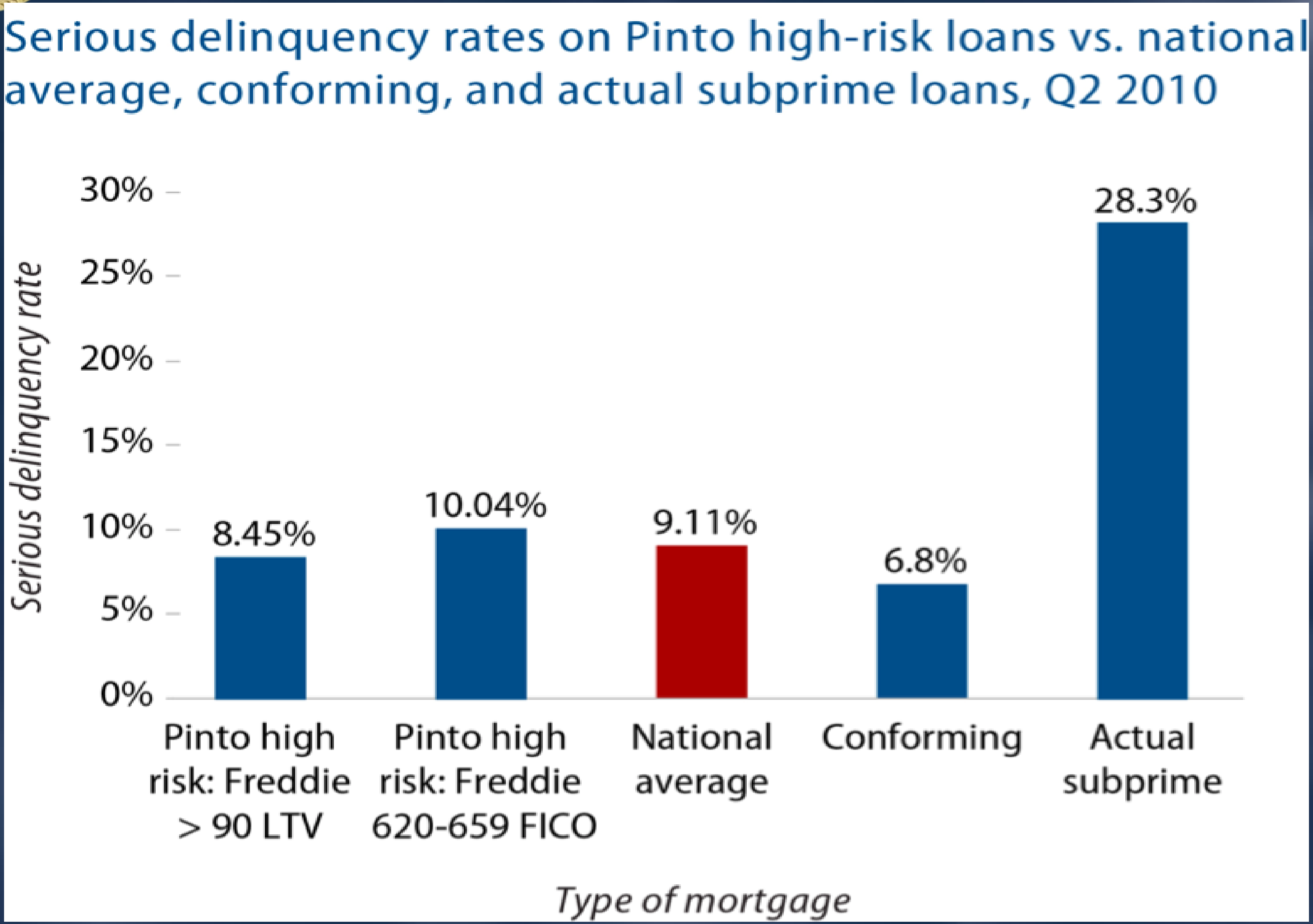
The AEI (strong form) Argument

- AEI argues that the mortgages guaranteed by Fannie and Freddie are the same mortgages that caused the financial crisis. This argument is based on the work of AEI Fellow Ed Pinto, who categorizes loans with LTV>90 or FICO<660 as “high risk”.

- This does not match up with the delinquency data. As the FCIC has found, Pinto’s “high risk” categories of mortgages are very heterogeneous.

- Pinto also ignores at least two loan characteristics that were demonstrably higher risk than LTV>90 or FICO<660: whether a mortgage was originated for PLS and whether it had an adjustable rate.

AEI's "High Risk" Mortgages are Not High Risk



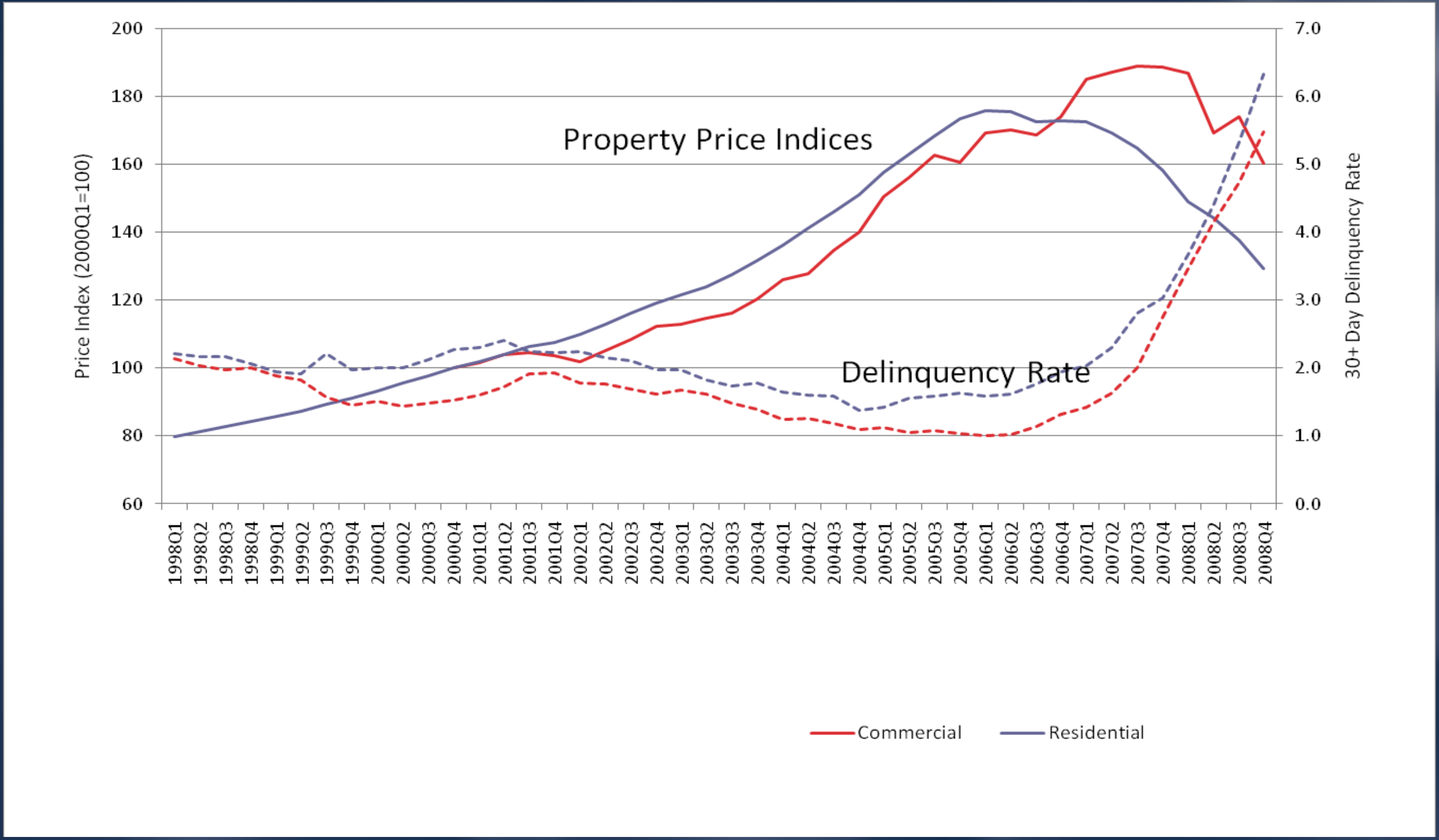
Source: Freddie Mac Q2 2010 Credit Supplement, Mortgage Bankers Association National Delinquency Survey

The Morgenson/Rosner (weak form) Argument

- Morgenson and Rosner acknowledge that the "high risk" loans they attribute to affordable housing policies that began in 1992 are not the same as the subprime loans of the 2000s. Instead, they argue that Wall Street institutions learned a "cultural" lesson from Fannie and Freddie of loose underwriting, high leverage and intense lobbying of politicians.

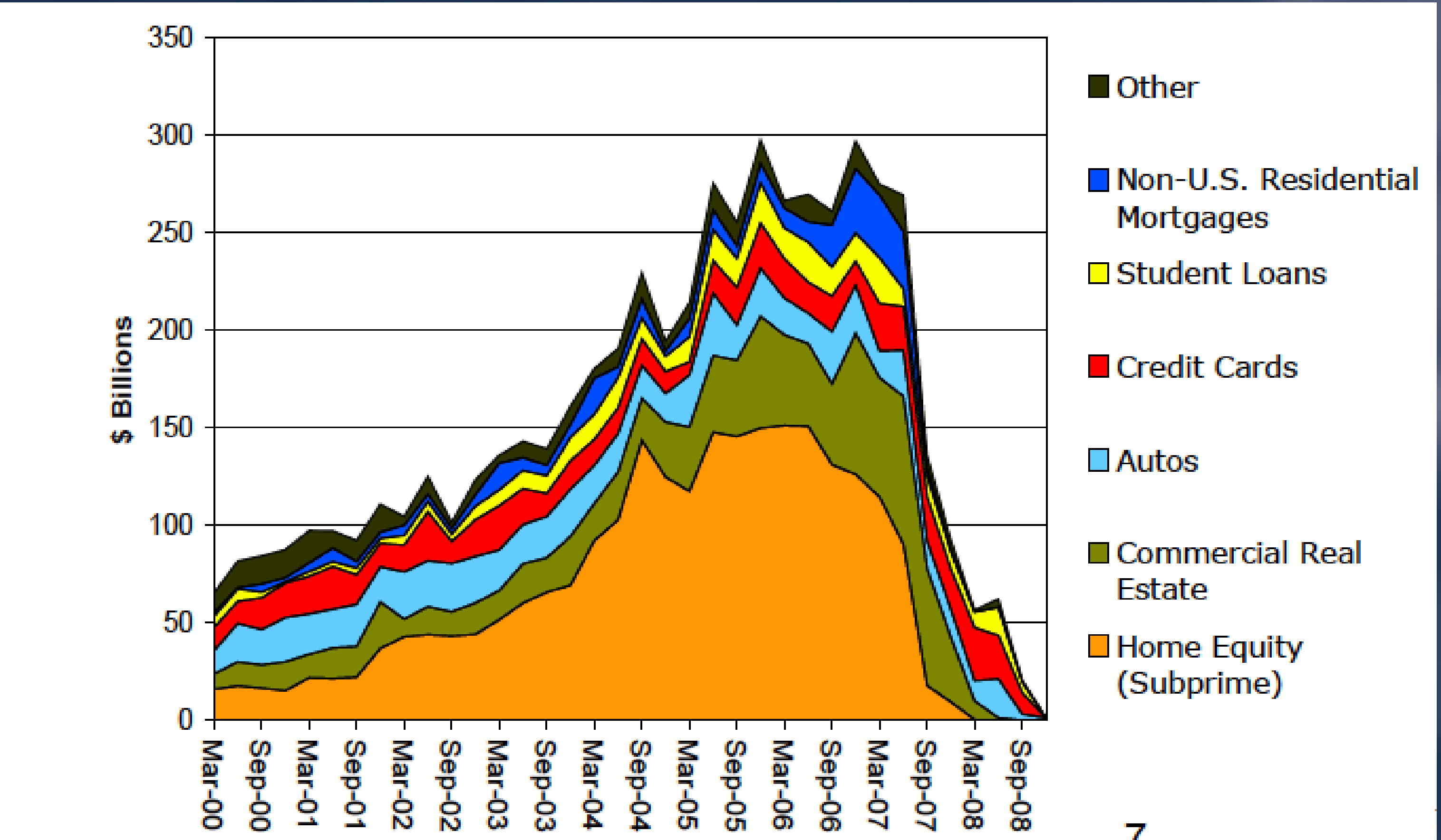
Commercial real estate did not have affordable housing policies but had a more severe bubble

- We see the same bubble-bust pattern in Commercial Real Estate…



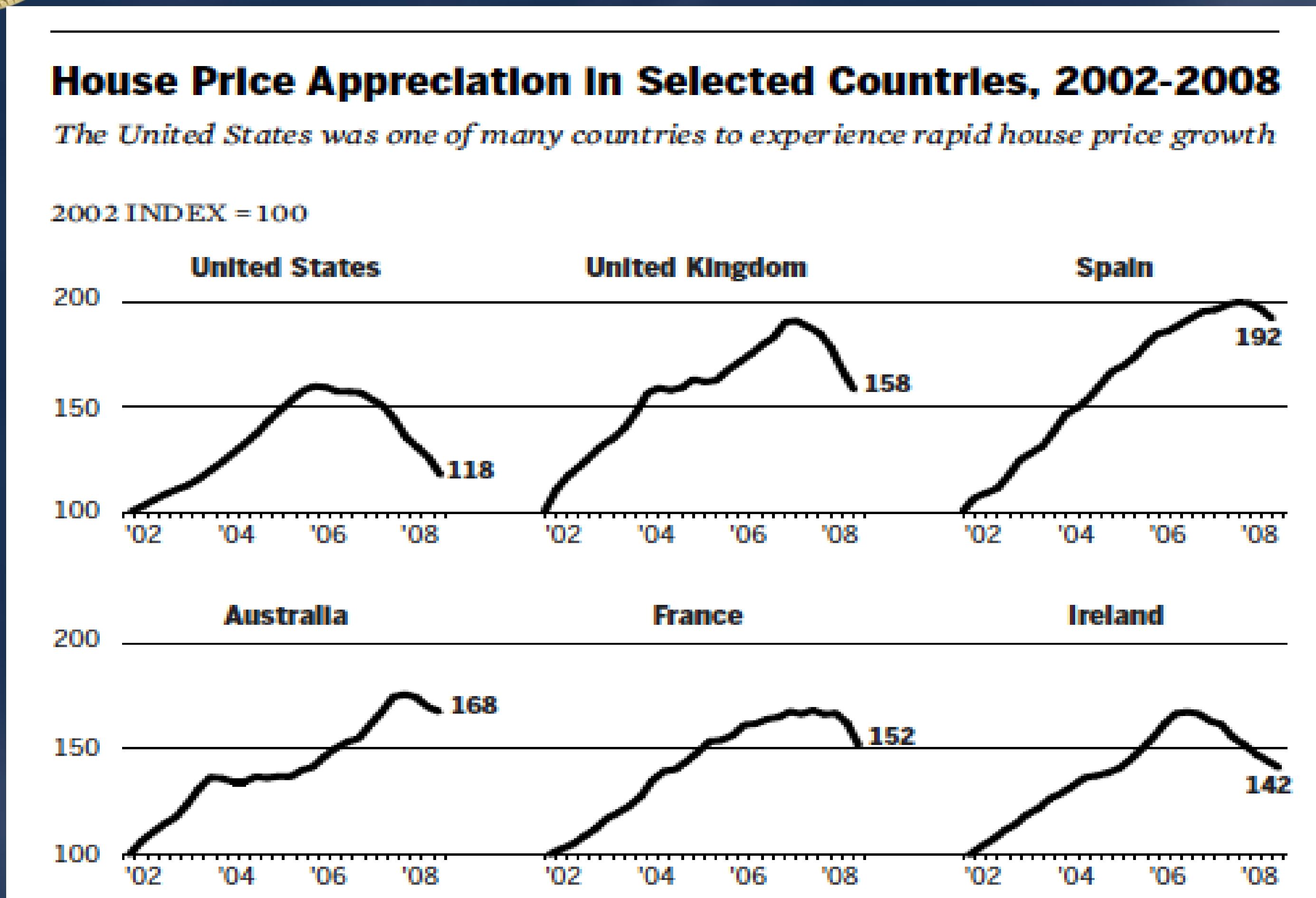
Securitized credit suffered a boom-bust cycle across asset classes

ABS Issuance by Asset Class



Source: Adam Ashcraft (FRBNY), Discussion of "Do Global Banks Spread Global Imbalances," *available at* http://imf.org/external/np/res/seminars/2009/arc/pdf/ashcraft1.pdf.

The Global Nature of the Housing Bubble



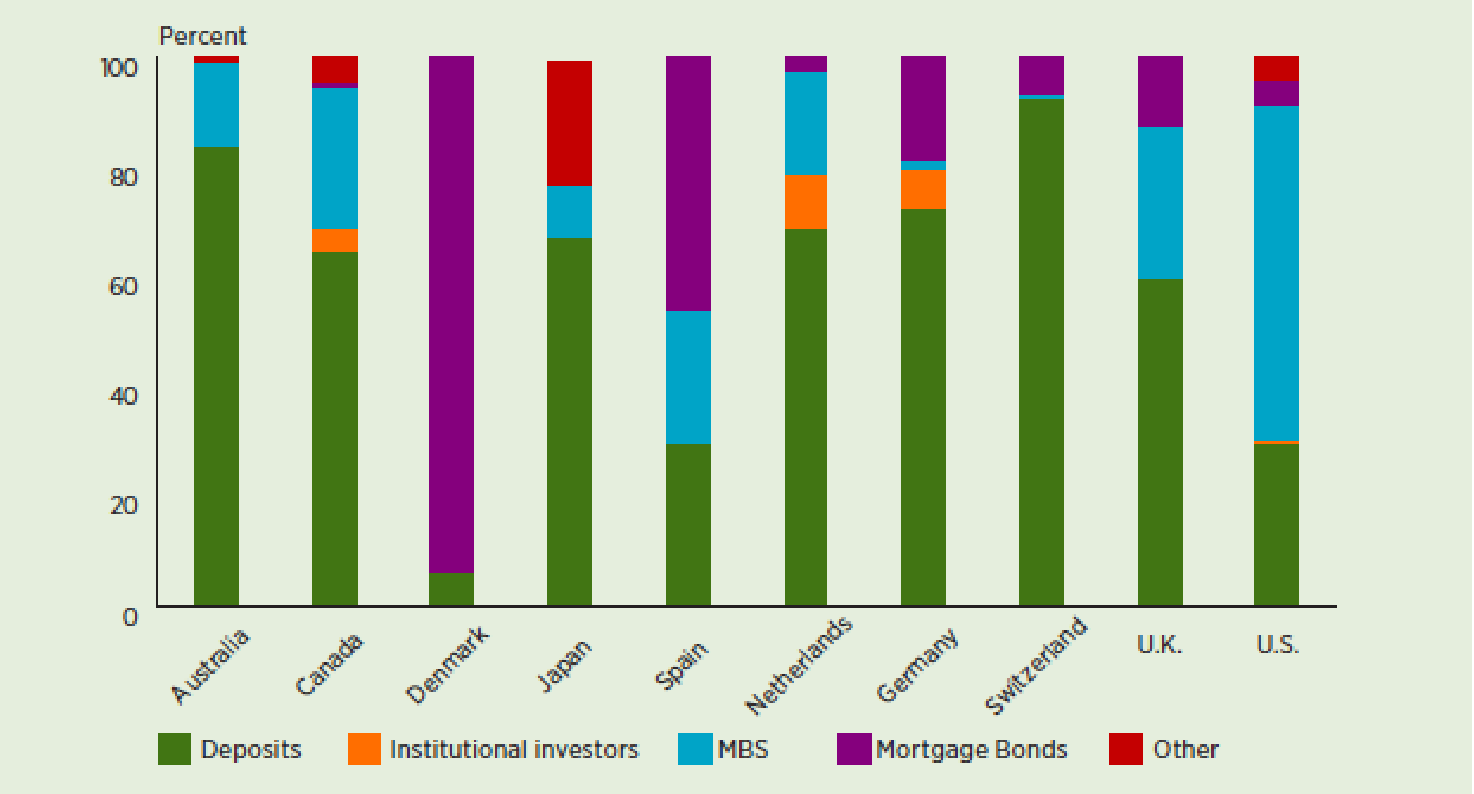
Source: Financial Crisis Inquiry Commission Report, Dissenting Statement of Commissioners Keith Hennessey, Douglas Holtz-Eakin, and Bill Thomas (citing Standard and Poors, Nationwide, Banco de Espana, FNAIM, and Permanent TSB).

Government Guarantees in Housing Finance are Prevalent Throughout the World

Sources of Mortgage Funding

Figure 11

Developed Country Mortgage Funding



Source: ABS, CMHC, EMF, ESF, FRB, Merrill Lynch Europe, AU, CA, U.S. 2008, Japan 2006.

Source: Michael Lea (2010)

International Govt Support for Mortgage Finance

Country	Government guarantee on mortgage insurance?	Government guarantee on securitization?	Government guarantee on bank deposits?	Government guarantee on covered bonds?
USA	Yes, Federal Housing Administration (explicit)	Yes, Ginnie Mae (explicit), Fannie Mae/Freddie Mac(implicit)	Yes, Federal Deposit Insurance Corporation (explicit)	Possibly, "Too big to fail" (implicit)
Canada	Yes, Canada Mortgage and Housing Corporation (explicit)	Yes, Canada Mortgage and Housing Corporation (explicit)	Yes, Canada Deposit Insurance Corporation (explicit)	Yes, "Too big to fail" (implicit)
Denmark	No	No	Yes, Garantifonden for Indskydere og Investorer (explicit)	Yes, "Too big to fail" (implicit)
France	No	No	Yes, Le Fonds de Garantie des Depots (explicit)	Yes, "Too big to fail" (implicit)
Ireland	No	No	Yes, Central Bank of Ireland (explicit)	Yes, blanket guarantee on all Irish bank obligations (explicit)
Spain	No	No	Yes, Fondo de Garantia de Depositos (explicit)	Yes, "Too big to fail" (implicit)
UK	No	No	Yes, Financial Services Compensation Scheme (explicit)	Yes, "Too big to fail" (implicit)

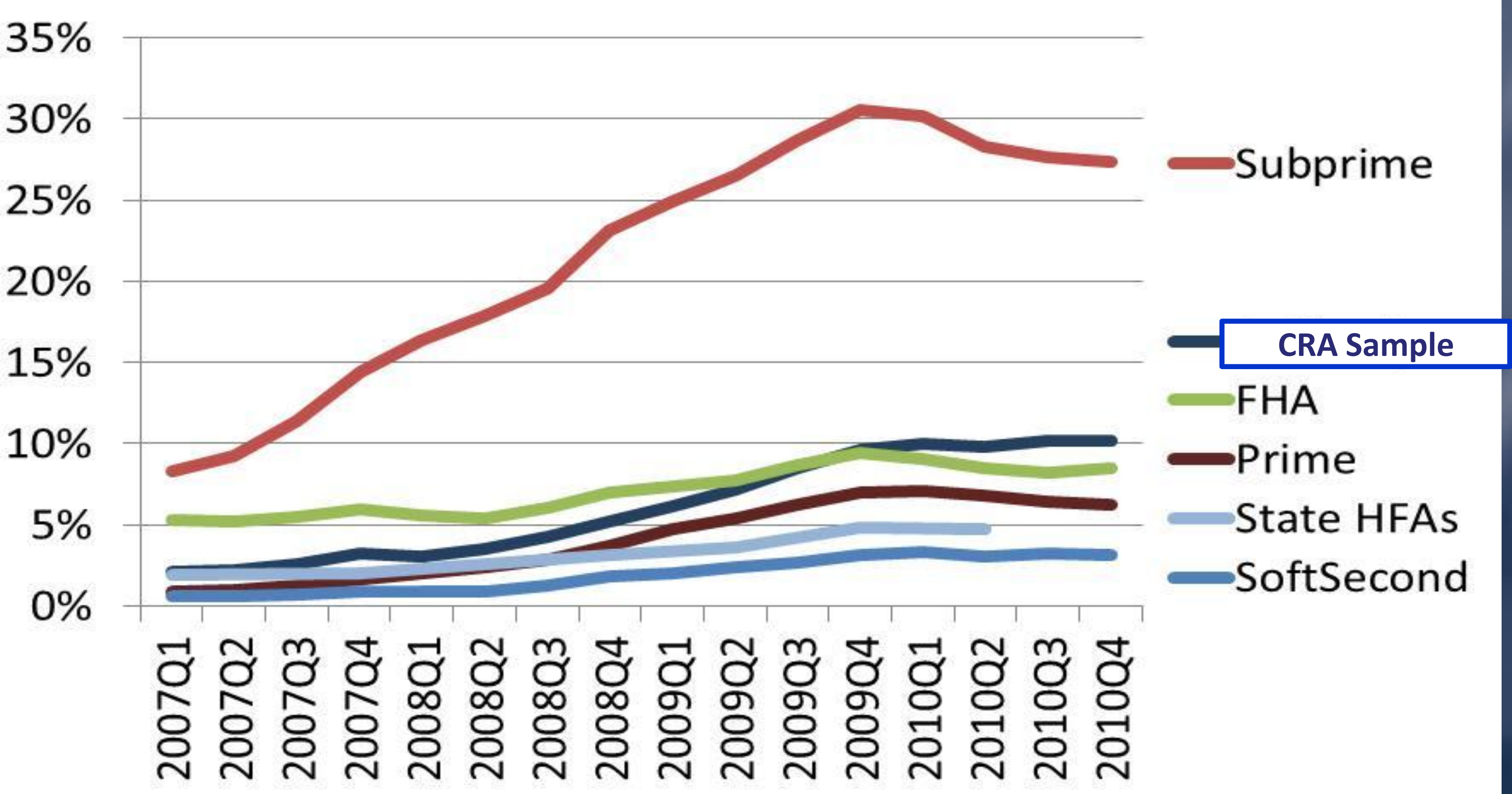
Source: David Min (2012) (utilizing data from FDIC, CDIC, FGD, Central Bank of Irealnd, FSCS)

Select Non-US Bank Bailouts

Country	Bailout	Amount	Type
Belgium, France, Luxembourg	Dexia bailouts (Oct. 2008, Oct. 2011)	€100 billion	2008: Initial recapitalization of €6.4 billion; 2011: €4 billion nationalization of Belgian sub; €90 billion in guarantees.
Belgium, Netherlands, Luxembourg	Fortis bailout (Sept. 2008)	€11.2 billion	Recapitalization of €11.2 billion + liquidity guarantees.
Canada	IMPP (Oct. 2008)	$125 billion	Purchase of insured mortgage pools to ensure liquidity
Denmark	Roskilde Bank nationalization (Aug. 2008)	$8.3 billion US (41.8b kroner)	Nationalization of Denmark's eighth largest bank
Denmark	Financial Stability Act (aka Bank Package I, Oct. 2008)	Unlimited	2 year blanket guarantee on all obligations of Danish banks
Denmark	Bank Package II (Jan. 2009)	$17.1 billion US (100b kroner)	100 billion kroner recapitalization fund
European Central Bank	Covered Bond Purchase Programmes (June 2009, Oct. 2011)	€100 billion	€60 billion for covered bond purchases in June 2009, €40 billion in Oct. 2011, to ensure liquidity in these instruments.
France	SFEF/SPPE (Oct. 2008)	€360 billion	€320 billion liquidity facility providing interbank lending guarantees, €40 billion recapitalization fund.
France	Natixis bailout (Oct. 2008)	€40 billion	€5 billion investment, €35 billion in guarantees on toxic assets
Germany	Financial Market Stabilization Act/SoFFin (Oct. 2008)	€480 billion	€400 billion for guarantees, €80 billion for recapitalization. Sunset December 2010, but reactivated Jan. 2012.
Ireland	Blanket guarantee (Sept. 2008)	Unlimited	Blanket guarantee on all obligations of Irish banks
Ireland	Nationalization of four (of six) banks (Jan. 2009 – July 2011)	€65 billion	Nationalization of Anglo Irish, Irish Nationwide Building Society, Irish Life & Permanent, Allied Irish Banks
UK	Nationalization of Northern Rock (Feb. 2008)	£100 billion	Nationalization of the UK's fifth largest mortgage lender after a £4.6b deposit run.
UK	Bank rescue plan (Oct. 2008)	£500 billion	£50 billion recapitalization fund, £250 billion in credit guarantees; £200 billion in short term loans to ensure liquidity.

"We don't let banks fail. We don't even let dry cleaners fail."
Anonymous senior ECB official (as quoted by David Wessel (2009)).

Evidence of Homeownership Done Right

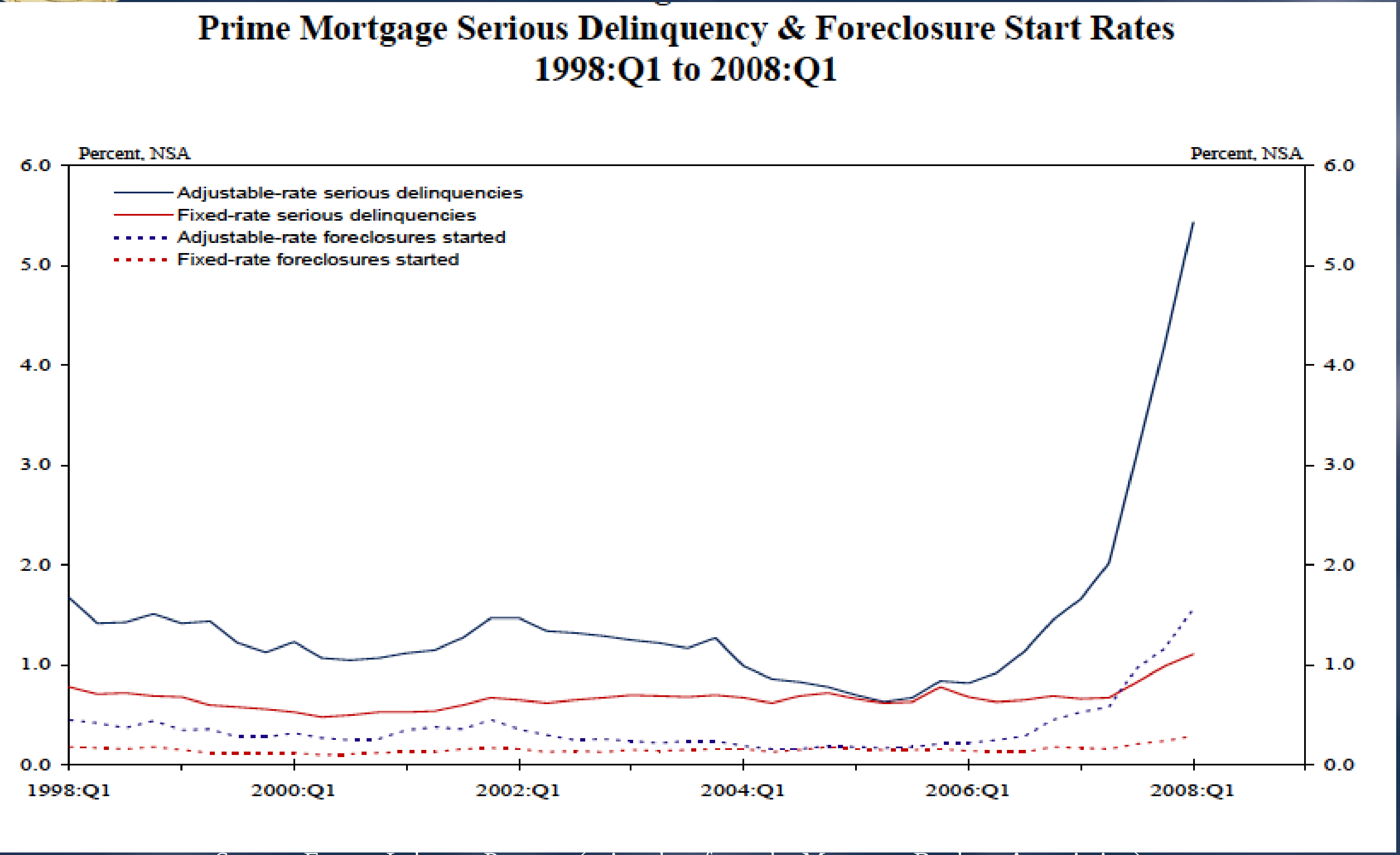


Sources: Mortgage Bankers Association; Self-Help; Massachusetts Housing Partnership; Moody's Investor Service

What are the Hallmarks of Sustainable Homeownership?

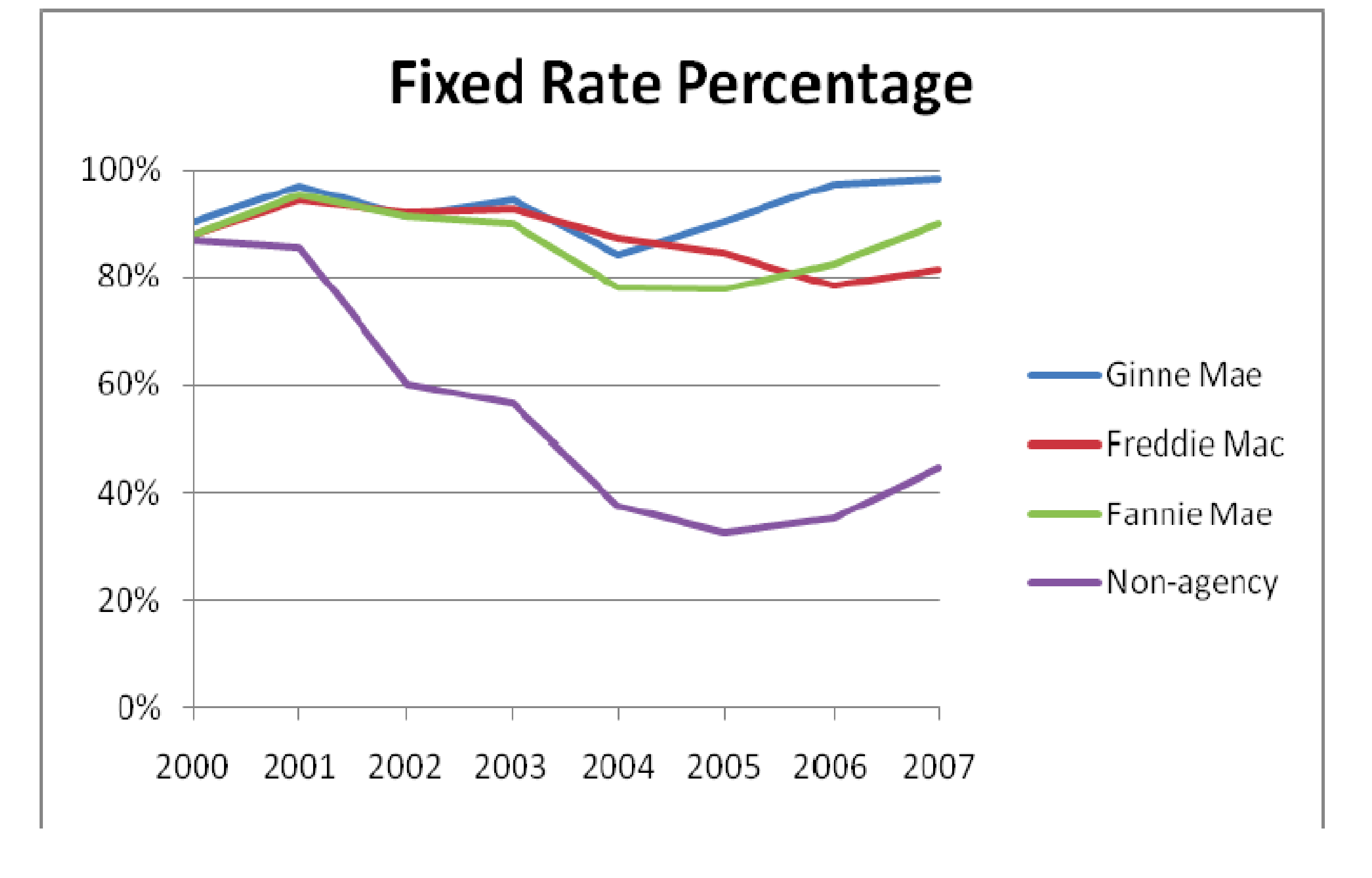
- Safe product – fixed rate, long-term amortizing loan
- Fairly priced with no hidden fees and/or costs
  - E.g. no prepayment penalties, yield spread premiums, teaser rates
- Underwritten for ability to repay
- Responsible servicing
- Additional supports where needed (e.g. downpayment assistance, counseling)

Adjustable-rate vs. fixed-rate mortgages



Source: Frame, Lehnart, Prescott (using data from the Mortgage Bankers Association)

FRM vs. ARM Originations



Near-Term Issues

- Stagnant economy
  - Loan modifications and HARP 2.0
  - Neighborhood stabilization and REO
- Reviving the PLS market
  - Dodd-Frank “qualified residential mortgage” standard
  - Reduction in loan limits
- Reducing the government footprint
  - FHFA
  - House GOP

Long-Term Issues (Mortgage Finance Reform)

- Options 1, 2, and 3
- Continued govt guarantee?
- Alternatives to the status quo
- Political risk

The Debate Over the Govt Guarantee

- Pros: <u>Broad</u>, <u>consistent</u>, and <u>affordable</u> mortgage finance

- Cons:
  - The benefits of the guarantee are overstated
  - The guarantee distorts markets
  - The guarantee exposes taxpayers to too much risk

- The importance of the guarantee for market stability

Do We Need a Government Guarantee?

- Argument: Jumbo markets (pricing and products) prove that the guarantee is unnecessary

- Response:
  - Where will the liquidity come from?
  - Will the private sector continue to emphasize low-cost and consumer-friendly products in the absence of market pressure?
  - Will the private sector be able to provide low-cost and consumer-friendly products in the absence of Agency markets?

- Understanding the difference between credit risk investors and interest rate risk investors

Housing Finance Reform

- Option 1
    - Rep. Hensarling, Rep. Garrett, Sen. Corker, AEI
    - Key questions: Whither the 30-year FRM? How can liquidity be replaced?

- Option 2
    - Scharfstein

- Option 3
    - Reps. Campbell/Peters, Rep. Miller, CAP's Mortgage Finance Working Group, Mortgage Bankers Association, Nat' Ass'n of Homebuilders, Credit Suisse, FS Roundtable, Marron/Swagel, Passmore/Hancock, Mark Zandi.

- Key questions: How to deal with the public/private conflict inherent in GSEs? Is there political will to propose something that looks like GSEs? How do we ensure affordable housing finance?