Financing Home Mortgages in the 21st Century

Submitted for the Decision Sciences Institute, Southwest Region

February 29 – March 3, 2012

New Orleans, LA

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Abstract

For many years the real estate industry has promoted homeownership as the "American Dream". Government policy was directed to favor homeownership over other forms of capital investment. The homeownership rate reached 68% in 2007, just before the recent housing bust. Among the costs of this policy have been the Savings and Loan failures of the 1980s and the failure of Fannie Mae and Freddie Mac in 2008. In June 2011 the Obama administration announced plans to "unwind" (close) Fannie Mae and Freddie Mac, so the time is right to set a new course for US home mortgage finance for the 21st century.

The ideal home mortgage finance system would be to allocate capital in accordance with risk and productivity. The homeownership rate should be a result, not a goal. Sound policy would avoid favoring homeownership, as that would concentrate risk and divert capital from more efficient uses. Policy goals such as assistance to low and moderate income home owners and renters should be considered separately, and the funds should be appropriated by Congress.

To correct past errors, home mortgages need to incorporate a significant down payment of 10-20%, and income should be verified to be at least four times debt service payments. To attract investors, mortgages should have interest rates adjusted every 3-5 years, with suitable caps on the periodic and total adjustment. Standard mortgage instruments would aid the development of a private secondary market.

The role for government should be limited to the current activity of the VA home loan guarantee program, the FHA insurance program, and the GNMA MBS program. An additional initiative might be an agency to provide re-insurance of Mortgage Backed Securities (MBS), modeled after the FDIC insurance of bank deposits. Otherwise mortgage investments would compete for capital as corporate bonds do now without government guarantees.

Failure of the (subsidized) Savings and Loan Model

After World War II, there was a huge pent-up demand for housing. Essentially no homes had been built during the war or during the depression, and the rate of household formations had been very low. The late 1940s was marked by the return of military men and women to civilian life, and there was a rush to make up for lost time in civilian production and family formations. The widespread availability of the automobile (compared to the 1920s) made possible the development of suburban neighborhoods. Workers could drive to work in the cities while enjoying new and larger homes on relatively cheap rural land. Homebuilders were ready to meet this new demand for homes.

The new supply and demand for suburban homes was supported by government policy that encouraged mortgage lending. The Veterans Administration home loan guarantee program provided military veterans a no-down payment mortgage at a low, controlled interest rate. The Federal Housing Administration operated an insurance program for mortgages up to a set amount that serves middle and moderate home buyers with a down payment as low as 3%, also with a low interest rate. The VA and FHA served about 20% of the market, and most of the remainder was served by the Savings and Loan Associations (S&L).

The S&L industry was the primary source of home mortgage loans in the 1950s, largely because of government policy. S&Ls could avoid income tax if they devoted 80% of their lending to home mortgages. They were not allowed to make business loans, and they were prohibited from paying more than a controlled rate of interest on their savings deposits. Commercial banks were not allowed to pay competitive interest on savings deposits, and S&Ls were not allowed to offer checking accounts. As a result S&Ls took deposits from local households, and dedicated most lending to mortgages, which they typically held in portfolio. Most VA and FHA mortgages were made by mortgage bankers who sold them to insurance companies that needed diversified long term investments. This system provided a dedicated pool of capital that was available for home mortgages.

The S&L model began to break down in the mid-1960s when interest rates started rising along with inflation. S&Ls were allowed to pay only 5.25% interest on savings deposits, but by the early 1970s market rates were higher. The money market mutual funds paid 18% by 1978. S&L depositors responded by withdrawing their savings and moving them to money market funds or the stock market, and this disintermediation of funds from the S&Ls threatened the solvency of S&Ls, which had loaned out their assets for 30 year mortgages.

The Federal Home Loan Bank Board was the primary regulator of S&Ls, and they worked to save the industry and the mortgage market. They adopted "regulatory accounting practice" (RAP) as a substitute for generally accepted accounting practice (GAAP), and RAP allowed S&Ls to postpone booking losses. They also allowed S&Ls to issue certificates of deposit (CD) paying a market interest rate, and this tool allowed S&Ls to replace lost deposits by paying 18% or more. However the CD raised the cost of funds so that the typical S&L was paying more in interest expense than its interest income, resulting in losses. Eventually many S&Ls failed, and the Resolution Trust Corporation was established to sell off the assets of closed S&Ls. The experiment in using government policy to fund home mortgages had failed.

Failure of the (subsidized) Secondary Mortgage Market

Government policy makers and the housing industry saw the need for a source of mortgage credit to replace the S&L industry. In 1968 Fannie Mae (first created in 1938) was restructured to buy mortgages from mortgage bankers and then re-sell them as mortgage-backed securities (MBS) backed by Fannie Mae (not the US government). In 1971 Freddie Mac was created to buy mortgages from S&Ls in the same way. The two government sponsored enterprises (GSE) were stockholder-owned but charted by Congress with a limited mission of supporting the housing market for middle and moderate income home buyers. They paid federal income tax but not state tax, and they were exempt from regulation by the Securities and Exchange Commission. They were politically active, and became among the largest contributors of political campaign funds. The market accepted GSE securities as quasi-government debt, so the interest rates they paid were artificially reduced. Recent estimates are that half of this subsidy went to senior executives as bonuses. James Johnson served as CEO of Fannie during 1991-1998 and was paid $100 million in salary and bonus. Franklin Raines served as CEO of Fannie during 1999-2004 and was paid $90 million in salary and bonus.

In the 1980s and 1990s Fannie and Freddie were instrumental in developing a standardized secondary mortgage market. As they approved the first nationwide adjustable rate mortgages in 1980, they set the standards for mortgage documents, down payments, and underwriting standards. They supervised lenders and dominated the market. By 2000 the GSEs owned or securitized more than half of all US home mortgage loans. They made extensive use of leverage, as their capital relative to their risk exposure was much lower than for other financial institutions. Fannie and Freddie played a central role in the development of the secondary market by setting mortgage standards and securitization procedures that were accepted around the world.

In the 1990s there was growing political pressure to use Fannie and Freddie to assist low income home buyers and increase the rate of homeownership. Congress established programs to assist low income renters and apartment owners as well. By

the late 1990s the GSEs were promoting reduced-document lending, lower down payments, and delegated underwriting that eliminated or limited loan review.

In 2000-2001 the US endured a recession, and the Federal Reserve reduced short term interest rates to 1%, a 40 year low. During this time of low interest rates, lenders found they could structure adjustable rate mortgages with extremely low payment rates for the first few years of a mortgage. This enticed many home buyers to enter the market, greatly increasing housing demand. Housing supply increases slowly, so home prices rose sharply in the 2002-2006 period. Much of the increase was concentrated in South Florida, Southern California, Phoenix, and Las Vegas. Although not clear at the time, we now know that the sub-prime mortgage was a widely used tool to feed this new demand. The widespread issuance of sub-prime mortgages was possible only because there were buyers (investors), and the leading buyers were Fannie and Freddie.

In 2007 the sub-prime mortgage problems started to unfold because the Federal Reserve had started increasing short term interest rates. The 1-3 year ARM loans reached the point of resetting, and in some cases monthly payment rose sharply. Some new owners, including speculators, had trouble making payments or selling units, and mortgage delinquencies began to rise. In August 2007, investors in the MBS market became alarmed and started selling their MBS. Prices fell and by August 2008 there was a worldwide freezing of the capital markets. Suddenly the GSEs suffered losses, and in December 2008 the US government placed Fannie and Freddie in conservatorship, guaranteeing their debts. So far government losses have reached $165 billion.

Lessons from Other Nations: Canada, Germany, Spain

Canada provides an interesting example of a successful mortgage market. Canada has no equivalent of the GSEs, and there is no income tax deduction for home mortgage interest. There are no 30 year, fixed rate mortgages. Mortgages are adjustable rate and reset every five years or less, so the home buyer takes part of the interest rate risk. Lenders have recourse against borrowers, so there is no incentive for borrowers to walk away from an underwater mortgage. This system has led to a homeownership rate of 68%, now above the US rate.

Germany offers no special assistance to homeownership. There the homeownership rate is 45%. As a result relatively more German capital is directed toward industrial uses, and Germany leads the world in export of advanced machinery.

Spain has a group of savings banks (cajas) that focus on mortgage lending. The cajas have powers similar to the GSEs in the US awarded by the Spanish government, and they are politically protected. Recent EU stress tests have shown the cajas are

capital-deficient by 20-40 billion euros. As recently as December 2010 the cajas were still offering 100% mortgage loans (no down payment). They have fueled speculation in house prices, which have fallen 22% since their peak in 2007.

A Model System of Home Mortgage Finance

In a perfect world, free markets would direct most resources where they would be most productive. In the case of public goods, government would need to identify and administer allocation of resources to meet social needs. After World War II, the US policy treated housing as a public good to some extent. The result has been that credit was over-allocated to housing, and excessive risk was accepted by some home buyers, lenders and the government. This means that credit was under-allocated to non-housing sectors, and interest rates were higher for those sectors than they would have otherwise been.

The recent failures in subsidized home mortgage finance have shown that there can be huge costs when government tries to direct market outcomes. An ideal mortgage market would compete for capital on par with other sectors. The VA and FHA programs should be the extent of assistance for housing. These programs target middle and moderate income families. In addition FHA programs for multi-family housing provide indirect assistance for lower income renters.

Not considered here is the Section 8 rent subsidy program, rent controls in some areas, and public housing agencies in many cities and states. Congress should consider these programs and other initiatives to support housing as a separate matter, and they should appropriate the needed funds. When government tries to achieve its goals indirectly through subsidies, market distortions occur and the risks to society can often be much more than the direct cost of the intended support.

Current Plans for Fannie Mae and Freddie Mac

The onset of the subprime mortgage crisis in August 2007 started a cycle of falling prices of mortgage-backed securities (MBS). Many MBS had been issued or guaranteed by Fannie Mae or Freddie Mac, and the market for new issues was effectively closed as MBS prices fell. Rising mortgage delinquencies and pending foreclosures quickly led to losses by the GSEs, and in December 2008 they were placed in conservatorship (taken over) by the US government. The government continues to fund the losses of Fannie and Freddie, which have reached $140 billion since 2008.

In February 2011 the Treasury Department presented a report to Congress detailing a plan for Fannie and Freddie. The plan is to gradually wind down the GSEs and divert more mortgage funding to the private sector. The tools used would be

gradually raising fees charged by GSEs to reflect their government subsidy, increase the risk assumed by borrowers and lenders, and reduce the current high loan limit that applies to the GSEs as of October 2011as scheduled. The public comment period on this plan runs through August 2011, and then a final plan will be presented. It is expected to take two years for Congress to pass the necessary legislation.

Recommendations

The future home mortgage finance system in the US should be a private system of capital allocation with minimal government intervention. The home mortgage interest deduction should be eliminated, which should be relatively painless in an era of very low interest rates. The VA home loan guarantee program for military veterans should be continued as a benefit of service. The FHA mortgage insurance program for mortgages up to a ceiling amount should be continued as support to well qualified middle and moderate home buyers. The Government National Mortgage Association (Ginny Mae)

MBS guarantee program should continue. It poses no additional risk to the government, and it supports the VA and FHA programs as well as the standardization of the secondary mortgage market.

Fannie Mae and Freddie Mac should be gradually phased out. Until that can happen, they should be managed by the US Department of Housing and Urban Development, and their budget, staffing and salaries should be made consistent with other government agencies. This action would eliminate the huge salary and bonuses received by senior executives.

There may be a role for a GSE in helping to support a standard mortgages that would attract capital without an explicit government guarantee. The problem with a 30 year fixed rate mortgage is that lenders do not generally want such a long term, especially one that may pre-pay without notice and without penalty. The Canada example of a 5 year, adjustable rate mortgage may be a good model. Such an instrument may meet the needs of borrowers and lenders without explicit government support.

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