ADVANCING THE REFORM AGENDA REFORM BRIEF

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Learning Lessons and Living the Dream: Principles for Restoring Sanity to the Housing Market

The emergence of the subprime market, which consists of loans to borrowers with high credit risk, has enabled families that previously could not obtain a home loan to realize their dreams and purchase a house. This increased access to credit helped fuel the housing boom that played a significant role in the strong economic growth of recent years.

However, the booming housing market and easy access to credit spawned risky and sometimes unscrupulous lending practices on the part of mortgage lenders, poor and uninformed decisions by homebuyers, and the placing of short-term profit over long-term risk on Wall Street. All this combined to produce an unsustainable situation. The inevitable slowing of the housing market and subsequent tightening of credit has become a serious drag on the economy. Although such a correction is a basic part of the economic cycle and will eventually lead to more reasonable home prices and a more stable economy, such a fact is of no comfort to the families who face the possible loss of their home.

"[A] nation of home owners, of people who own a real share in their own land, is unconquerable."
— President Franklin Roosevelt, Address to the United States Savings and Loan League

Recent statements from key figures indicate that the slumping housing market and the credit crunch caused by the meltdown in home mortgages represent a serious threat to the economy. Federal Reserve Chairman Ben Bernanke recently stated that the housing slump and credit crunch will affect economic growth into next year. Treasury Secretary Hank Paulson recently warned that the housing slump is "the most significant current risk to our economy."[1] Congress, regulators, and industry players are pointing fingers and assessing who's more to blame. Yet, as Peter Eavis recently warned in *Fortune* magazine, we need to be careful how we distribute responsibility and help find a way to stop the crisis from deepening.[2]

Rising home foreclosures and a deteriorating economic outlook are intensifying the pressure on Washington to do something. Recent comments by Treasury Secretary Paulson calling for an overhaul of laws and regulations involving mortgage lending strongly indicate that significant action is on the horizon. As they consider a response, legislators and regulators must balance the short-term goals of stabilizing financial markets and

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keeping Americans in their homes with the critical need to introduce more transparency and accountability to the process in order to ensure that such a situation does not arise again.

THE VALUE OF HOMEOWNERSHIP

Policy makers must take great care in how they address the current dilemma, because of the eminent place that homeownership holds in both our economy and the American psyche.

The housing sector is a crucial part of the economy and has been a key contributor to recent economic growth. Homeownership is also an ideal that epitomizes the American dream. The prospect of owning a home motivates families across the country to work towards this dream. It fuels the energy and entrepreneurialism of many Americans. Unfortunately, the current situation is turning the dream into a nightmare for a growing number of families. There are approximately 10 million outstanding subprime mortgages and 2 million of those loans will reset to higher rates in the next 18 months.

The prospect of widespread home foreclosures is contributing to the growing anxiety among the middle class that the system is no longer working for them. Forcing families out of their homes en masse and placing credit to purchase a home outside the grasp of aspiring middle class families will exacerbate this trend and weaken support among a key constituency for our market-based economy, which could lead to well-intentioned, but ill-advised policies and programs that constrain economic growth.

In addition to the sizeable economic benefits, the social benefits tied to home ownership are immense. Homeownership provides a foundation for stable families and communities. Children of homeowners are “forty percent less likely to give birth as an unmarried teenager, fifty percent lower to remain idle at age twenty and rely on welfare and one hundred and sixteen percent more likely to graduate from college.”[3] These children ultimately become better citizens and more productive contributors to our economy and society.

THE SUBPRIME LENDING MARKET

In considering action, policy makers must recognize that subprime mortgages have been both a blessing and a curse, and search for ways to limit the abuses while preserving the benefits.

The availability of subprime mortgages enabled consumers to own homes who previously would have been denied such an opportunity because of less-than-ideal credit history. On the other hand, the availability of such credit encouraged many people to purchase more home than they needed or to make speculative investments in real estate that otherwise would not have been made. Some deceitful lenders also used teaser rates and complicated language in the lending agreement to lure susceptible borrowers into accepting mortgages they could not afford.

In a nutshell, the high-risk loans at issue work this way -- consumers are offered loans that due to the high default risk, carry prepayment penalties, and two year interest-only adjustable rate mortgages (ARMs). The two year ARM has a fixed, low rate for the first two years (known as a teaser) that then becomes adjustable semiannually for the remaining terms of the loan. This adjustable rate often balloons the mortgage payments well beyond the means of the consumer, resulting in ultimate foreclosure. Over “eighty percent of subprime loans come with adjustable interest rates, making them higher risk for financially at-risk families; [and] roughly one in five of subprime home loans goes into foreclosure at least once.”[4]

While homes bought with subprime loans have allowed many Americans to achieve upward mobility through the development of equity, the credit crunch caused by the collapse of the high-

risk loan market has far-reaching implications for the economy and individual consumers.

THE CREDIT CRUNCH

The financial market credit crunch that emerged in August 2007 was precipitated by the subprime meltdown. In the fourth quarter of 2006, the housing market began to slow for the first time in two years. Although any rational observer could predict that the sky-high growth in housing was unsustainable, homeowners, brokers, lenders, and investors acted as if the housing boom would never end. Nicolas P. Retsinas, a lecturer of business administration at Harvard Business School and Director of Harvard University's Joint Center for Housing Studies, points out how all parties were benefiting from this tight arrangement contingent upon the steady escalation of house prices: "Homeowners got their dream, brokers got their commissions, lenders got their return, investors got rich. If a homeowner could not make the monthly payments, particularly after the grace period of the low opening rate, he could sell the house, maybe make a profit."[5]

Unfortunately, as the housing market continued to slow down, builders continued to build new houses and the market became flooded with houses that would not sell. New homeowners, who could not make their monthly payments after the teaser rates on their mortgages expired, found that selling their houses was no longer an option. Thus, banks were burdened with homes that they could not sell, and subprime mortgage companies crumbled under the weight of unpaid loans.

Wall Street was highly exposed to the mortgage meltdown because financial firms created bonds made up of mortgages and sold them to investors. Investors had no way of knowing the quality of the mortgages the bonds were tied to, but they didn't much seem to care. Investors, especially hedge funds, bought up the bonds at a high rate.

The mortgage meltdown turned investors sour on all securities backed by mortgages. Essentially, they have withdrawn liquidity from the market because they no longer have faith in the bonds produced by Wall Street. This is making it more difficult for all borrowers to obtain credit. According to a new survey from the National Association for Business Economics, approximately a third of businesses report that the tightening of credit is affecting their business.[6]

PRINCIPLED NEXT STEPS FOR REFORM

As regulators, lawmakers, and industry confront the dilemma, reform should seek to restore the confidence of investors in the mortgage banking industry and the confidence of homebuyers in the home buying process. Increased transparency and accountability at all levels of the home buying and lending process must be at the heart of such reforms. An effective system seeks to ensure that consumers and other participants have an opportunity to review and digest all the necessary information in order to make a sound economic decision. Any government action must consider the value of the housing industry to the economy and take pains to not inadvertently limit the availability for reasonable credit. Reform must also promote comprehensive consumer education, reduce the influence of special interests, and guarantee enforcement and administrative support. Some basic principles should guide government action.

Consider the value of the housing industry on the economy and be careful not to limit inadvertently the availability of reasonable credit.

The effort to curb the practice of risky lending must be pursued thoughtfully and cautiously. Unintended consequences of legislation that is overly expansive can have as devastating an affect on the economy as the practice of risky lending itself.

Excessive regulation that cuts off all subprime credit would deny many worthy families the ability to purchase a home. As former Federal Reserve Vice Chairman Alan Blinder recently wrote in the *New York Times*, "We don't have to destroy the subprime market in order to save it."[7]

Ensure transparency and accountability at all levels of the mortgage banking process.

At the peak of the housing bubble, lenders attracted homebuyers and investors with no or low down-payment offers and teaser interest rates that began low and would later skyrocket. Homebuyers were caught up in the frenzy and either failed to read the fine print on the loans or failed to understand the loan terms. In many cases lenders contributed to the problem by glossing over the details and failing to fully disclose to consumers that their monthly payments would swell exponentially. These risky lending practices are marked by the use of deceptive marketing and "steering," a term describing lenders that pushed first-time homebuyers and low-income families into subprime mortgages, even when in many instances the family could qualify for a mainstream loan.

Rules that promote transparency and public review can be an effective vehicle for identifying and addressing financial abuse, but rules alone can only be so effective. Consumers and investors, both individual and institutional, at all levels of the process must be more diligent in knowing exactly what they are purchasing when they buy a house, take out a loan, or buy a mortgage-based security.

At the heart of this mess is the fact that no one involved believed that they were assuming any risks. All investments involve risk. The investor is rewarded financially if the investment pays off and is punished if it does not. Recognizing the risks encourages rational behavior. However, in the case of the mortgage sector, risk was pushed so far down the line that none of the players felt they were exposed, until the consequences visited them with a vengeance.

In many cases, homebuyers purchased houses that they could not afford because introductory teaser rates and rising home prices allowed them to sell or refinance their home when the rates went up. Mortgage lenders often felt no risk in providing loans that borrowers had little chance of repaying because they planned to immediately sell the loan to a financial institution. The institutions usually performed little due diligence concerning the loans they were purchasing because they had no intention of keeping those loans on their books. The loans were packaged into bonds and sold to investors, often hedge funds. The hedge funds were too concerned with short-term profit to worry about the quality of the loans that the bonds were tied to.

The best way to ensure accountability is to make sure that actors are properly punished for bad judgments, which is why a massive government bailout would be unwise. The lesson taken from such a bailout would be that the government will always intervene in such a situation, which will eliminate the incentive for any of the players to change their behavior – the dreaded "moral hazard" that economists legitimately fear.

At the same time, allowing hundreds of thousands of families to lose their homes is not politically feasible. The financial sector must recognize that it is in its own best interest to find solutions that ease the strain on homeowners and the market. Government must encourage such efforts without letting anyone completely off the hook for causing the mess.

The recent agreement by Citigroup, J.P. Morgan Chase, and Bank of America that was brokered by Treasury Secretary Paulson and the latest announcement from Countrywide Financial that it will refinance thousands of loans due to reset in the coming months offer some hope that Wall Street and mortgage lenders will take the lead in confronting the situation. Although opinions are mixed on how useful these efforts will be, they represent a step in the right direction.

Increased disclosure is also key to ensuring transparency. Lenders must disclose the terms of lending agreements to homebuyers in plain English and point out the provisions that affect the buyer's

bottom line. Financial institutions must also better disclose what is behind the mortgage-backed securities they offer and account for these bonds on their financial statements.

Promote comprehensive consumer education.
A critical component to resolving the current mortgage banking crisis is empowering consumers to make sounder decisions through education. Facilitating consumer access to information on mortgage choices and a clear, concise explanation of the different lending options will empower citizens to take responsibility for their financial decisions. This educational component should not only be limited to financial literacy however, but include all aspects of the home buying process from selecting a real estate agent, to the information included in an appraisal and what it means for their mortgage, to the importance of a home inspection. Cash-strapped consumers dissuaded by the large fees involved in the closing process should not forgo the home inspection in an attempt to cut costs. A home inspection allows the buyer to offset the cost through credits, or provide the opportunity for the seller to make the repairs at their expense. Homebuyers should also be educated as to the contents of the appraisal and what it means for their mortgage and the cost of their home. The appraisal provides the value of the collateral, or home, for the lender, ensuring that the homebuyer is getting a fair price on the value of the home. The homeowner should be educated to recognize the importance of this step and secure an independent appraiser committed to working in their best interest.

Currently, pieces of consumer education exist, but there is no comprehensive resource. Achieving a comprehensive component should be the goal of policy makers in empowering consumers and building confidence in the home buying process.

Reduce the influence of special interests.
A primary complaint in the mortgage industry is the influence of special interests in the home buying process. Reforms of the mortgage process should not favor monied interests and should protect the integrity of those participating in the process, including the appraisers and realtors. For example, appraisers are increasingly subjected to what has become known as "client pressure." Client pressure is "a phenomenon in the appraisal profession whereby parties with an interest in the transaction, such as lenders, brokers or realty agents, apply pressure on the appraiser to meet the predetermined value [of the home] to help justify the mortgage transaction or exchange of real estate."[8] The result of this client pressure is that too often appraisers who do not meet the expected value are "black balled" or are denied future work from other players. An inaccurate appraisal is harmful to both the lender and the consumer. "An overwhelming number of appraisers, upwards of ninety percent have experienced pressure to meet targeted values. The pressure is often subtle with an appraiser being asked whether or not they can provide an appraisal to match a general price. Over seventy-five percent of appraisers report concerns that if they do not meet such request, they will lose both the appraisal job and future business."[9] An inaccurate or inflated appraisal can leave consumers with a mortgage worth more than the value of the house itself, or negative equity. By reducing the influence through increased independence, appraisers can continue to ensure that the consumer's and the lender's best interests are represented without bias or fear of repercussions on their own livelihood.[10]

Guarantee effective enforcement and administrative support.
Effective administration and enforcement of the law is essential to any regulatory structure. Any effort to regulate the subprime market must give due regard

to the need to administer and enforce the law. This approach, as with reform in general, must be comprehensive. Those that engage in risky lending activities without due regard for the interests of the consumer must be held accountable. Oversight should be conducted by existing state and federal regulatory agencies, however, steps must be taken to ensure state regulatory agencies are properly equipped to handle such a challenge. Specifically, adequate budgetary support and staffing is essential, since the agency tasked with enforcement can only carry out its functions if it has the resources to perform all of its duties. The law should seek to support the states in an effort to improve regulation and enforcement, as many of the entities in the home buying process are state regulated. Failure to do so will diminish the benefits of reform and fail to curb the practice of harmful risky lending practices.

CONCLUSION

No one is without some blame for the current debacle and no one should escape suffering some consequences. Fundamental reforms that ensure basic concepts such as accountability, transparency and reasonable oversight can go a long way in restoring investor confidence and allowing our resilient economy to bounce back.

ENDNOTES

[1] Remarks by Secretary Henry M. Paulson, Jr. on Current Housing and Mortgage Market Developments, Georgetown University Law Center, October 16, 2007. <http://www.treasury.gov/press/releases/hp612.htm>
[2] Peter Eavis, "Oh, the People You'll Blame," *Fortune Magazine*, September 17, 2007.
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[9] National Association of Realtors, Testimony of Pat V. Combs, President, Before the Senate Banking, Housing and Urban Affairs Subcommittee on Housing, Transportation and Community Development, June 26, 2007. <http://www.realtor.org/fedistrk.nsf/files/testim_mortgage_abuse_062607.pdf/$FILE/testim_mortgage_abuse_062607.pdf >
[10] Appraisal Institute, "What is Client Pressure?" <http://www.appraisalinstitute.org/govtaffairs/issues/client_pressr.asp>

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