

The global financial crisis and US housing policy

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Key Words

Financial crisis, Mortgage Finance, Mortgage-backed Securities, Housing Policy

Abstract

In the post-war period, the standard of living in the US has increased significantly, and more than two-thirds of families have achieved the American Dream of homeownership. The recent sub-prime mortgage and financial crisis resulted from a perfect storm of bad housing policy, real estate speculation, and necessary monetary policy. A healthy future for the financial markets depends on effective reforms and institutions to regulate financial instruments with limited government manipulation.

1. The Past

The current US housing market evolved from a rich history over the past five hundred years. Historically land has been the source of power and wealth. Thousands of years ago power often was acquired by conquering other peoples. The victors would take control of the land, and enslave the people or tax them to support the conqueror. The Pharaohs of Egypt, Nebuchadnezzar, and the Caesars of the Roman Empire followed this pattern.

In most of the world before 1700, land ownership was claimed by the king or emperor who had the military power to keep it. As the Roman Empire lost power, fiefdoms and city-states of Europe started to develop into nations. Kings controlled the land, and they awarded use of some lands to loyal noblemen who would support the king with taxes and military service to fight off enemies. The noblemen would develop lands for farming or other uses, sometimes using tenant farmers or sharecroppers. Surviving kings were those who could manage the land and people under their control to acquire enough power to fight off any enemies, both foreign and domestic.

During the 1600s in England, there were essentially two classes of people: the land owners (rich) and the landless peasants (poor). There was very little opportunity for the poor to become landowners or move up the class ladder. That started to change as the Industrial Revolution developed in the 1700s and beyond, and a class of shopkeepers and craftsmen emerged. Urban centers started to grow, and there were new opportunities for some of the poor peasants from the countryside to come to the towns and learn a trade as an apprentice. Adam Smith wrote The Wealth of Nations in 1776 to explain this new environment and the market economy that was arising.

The young nations of Europe were interested in preserving their power and wealth. One initiative followed by most rulers was to explore the New World to the west to acquire new lands and the riches they expected to find there. Explorers were financed and dispatched by sovereigns to claim territory for future development. Once these land acquisitions were well established, sovereigns encouraged adventuresome citizens to relocate there and establish trading opportunities. Often these activities were done through the use of land grants to entrepreneurs or religious leaders who would marshal the resources needed and recruit people for the adventure. Often some parcels of land were awarded to these new citizens in the New World, because the opportunity to own land was a strong incentive to emigrate. After the US was established, land grants were used to encourage westward migration and the construction of transcontinental railroads.

Another very important innovation in England during the Industrial Revolution was the mortgage. Before the mortgage concept appeared, land purchases were cash transactions available only to the rich. The important innovation of the mortgage was that the purchased land could be pledged as collateral for a loan used to buy the land. The mortgage allowed the buyer to pay off the loan over time from the proceeds earned on the land over time. This important financial and legal innovation opened land ownership to the growing middle class of merchants, craftsmen, and farmers. The mortgage made possible the "American dream of homeownership", which was promoted by the Realtors, homebuilders, and others in the residential real estate industry. (See O'Toole, 2012, pages 4-5).

During the great depression (1929-1937), incomes and employment were depressed, and housing construction was nil. Then followed World War II (1937-1945), when incomes and employment were higher, but resources were needed for the war effort. Housing construction again was restricted. In the post-war era, there was significant government policy effort to reestablish the domestic economy and accommodate the returning members of the armed forces. The Federal Housing Administration (FHA) had been established in 1934 to insure home mortgage loans with a 3% down payment. Post-war, the GI Bill was passed to provide guaranteed home mortgages for most veterans with no down payment. Federal National Mortgage Association (FNMA) was created in 1938 to purchase home mortgages from mortgage bankers, which provided lenders additional funds for more mortgage loans.

By the 1950's the nation had a strong network of Savings and Loan Associations (S&Ls). These depository institutions had strong income tax incentives to devote 80% of their deposits to home mortgage lending, and they became the largest source of home mortgage funding in the US. The S&Ls were portfolio lenders and investors that held mortgages on their books until they were paid off. They typically made loans in the same areas where they took deposits. In addition federal law limited the interest rate S&Ls were allowed to pay in savings accounts to 5.25%, an indirect way to keep mortgage interest rates down and appeal to voters. This artificial protection of the S&L industry backfired due to the inflation and rising interest rates of the 1970s. As market interest rates increased, S&L depositors withdrew savings to invest in stock and money market mutual funds. This disintermediation of funds created a liquidity crisis for S&Ls because they had been built on a flawed system of short-term deposits and long-term loans. To attempt to shore up the S&L industry, they were allowed to use more relaxed "regulatory accounting practices (RAP) rather than "generally accepted accounting practices" (GAAP). Also S&Ls were allowed to issue Certificates of Deposit (CD) to attract new deposits at market interest rates. This patchwork of policy measures soon led to the S&L industry having more interest expense than interest income. The CD replaced the liquidity problem with a profit problem, and failure of the S&L concept was inevitable. That meant the S&L could no longer be the primary source of home mortgage funds.

The very high interest rates of the late 1970s put pressure on the S&Ls, leading to the failure or merger of many S&Ls by 1985. By 1971 Congress had reorganized FNMA and created the Federal Home Loan Mortgage Corporation (FHLMC) and Government National Mortgage Association (GNMA). These housing related agencies supported the creation of a secondary mortgage market by promoting the mortgage-backed security (MBS). The MBS was a bond sold to investors around the world, and its collateral was a pool of mortgage loans, often diversified by location and borrower characteristics. The genius of the MBS was that soon investors around the world replaced the US S&L industry as the primary source of US home mortgage loans. The secondary mortgage market was very successful until the crash of 2007, largely due to high mortgage underwriting standards, before 2000, centered on significant down payments and income requirements.

2. The Present

The housing bubble of 2007 was a creation of both market forces and government policy mistakes – a perfect storm. The bubble arose as US home prices increased by 39% between 2000 and 2006, and then suddenly dropped by 23% in 2007-08 (O'Toole, 2012, page 195). This roller coaster of house values was most pronounced in a few local markets. The most severe drops in home prices, and the slowest recoveries, were in South Florida, Southern California, Las Vegas, and Phoenix.

By 2000 most US home mortgages were in pools backing mortgage-backed securities (MBS), and FNMA, FHLMC, or GNMA guaranteed most MBS. Investors around the world owned these MBS. The GNMA securities were backed by the full faith and credit of the US, but the FNMA and FHLMC securities were not. However when the MBS crash occurred in 2008, Congress stepped up to guarantee all these MBS to avoid a worldwide contagion of liquidity crisis and financial losses. In addition FNMA and FHLMC were placed in conservatorship, where they remain today. The secondary mortgage market continues to function as before with government backing.

Starting in 1992, Congress assigned the Department of Housing and Urban Development the task of increasing the homeownership rate of low and moderate Americans. Initially the target was that 30% of mortgages supported by government programs should be issued to low and moderate-income buyers. Gradually that goal was increased until it reached 56% in 2008. (See Wallison, 2015).

The FHA and VA programs did serve many low and moderate-income buyers, but traditionally FNMA and FHLMC served middle and upper income buyers. To achieve the assigned goals, FNMA and FHLMC were pressured by HUD to increase their mortgage purchases of loans issued to low and moderate buyers. The only way to achieve these goals was to reduce traditional underwriting standards. Historically US mortgage lenders required a 20% down payment or private mortgage insurance. Monthly payments generally were required to be no more than 36% of monthly income (underwriting ratio).

As originally envisioned, FNMA and FHLMC programs were intended to serve middle-income homebuyers rather than the wealthy. This focus was achieved by setting a maximum loan amount for loans that could be purchased by these agencies. This limit, the "conforming loan limit" was indexed to the average new home price index published by the Federal Home Loan Bank Board, then the supervisor for FHLMC. In 1980 the loan limit for one-unit homes not in high cost areas was \$93,750. This limit increased gradually each year, reaching \$417,000 in 2007. During the financial crisis the limit was temporarily raised as high as \$729,750 in high cost areas. It is now \$417,000 and is no longer increased annually.

During the period after 2000, FNMA and FHLMC gradually relaxed their underwriting standards. By 2006 many mortgages had no down payment and no verification of income. In many cases it is impossible to determine actual underwriting ratios. Many of these loans came to be called "sub-prime" mortgages because they fell below the time honored standard for "prime" mortgage loans. The rating agencies continued to rate almost all MBS as AAA, their highest score, because US home mortgages had an excellent record of very few losses, largely because historically significant down payments and underwriting ratios had been the norm.

The availability of mortgages with such relaxed standards added to the speculative mania that developed during 2003-2006. Much of this speculation occurred in four popular resort and retiree areas: Phoenix, Las Vegas, Southern California, and South Florida. These were the areas where the housing bubble increased the most and fell the hardest.

For these reasons, during the period 1990-2003 FNMA and FHLMC produced an increasingly risky portfolio of mortgages and MBS. (See Acharya, 2011, Chapter 2). By 2003 the speculative rise in real estate prices attracted additional mortgage lenders. Wall Street firms entered the mortgage market to package mortgage into "private label mortgage-backed securities" (PLS). Many of the mortgages in PLS were not eligible to sell to FNMA or FHLMC because of low down payments or underwriting ratios. Most of the PLS were rated AAA by the rating agencies, and investors around the world accepted them as similar to MBS guaranteed by FNMA or FHLMC. The volume of PLS increased from \$1 trillion in 2003 to \$2.5 trillion in 2006. By contrast, since 1990 FNMA and FHLMC issued between \$2 and \$3 trillion of MBS each year. So while FNMA and FHLMC were increasing the risk in their portfolio, the rise of PLS added even more risk to the mortgage market. (See Acharya, 2011, pages 42-43).

The rapid rise in house prices during 2000-2006 resulted from both demand and supply factors. A very important supply factor was the set of land use controls, set-asides, green spaces, and nature preserves adopted in many places. These policies are usually claimed to protect nature and prevent "urban sprawl", but their effect is to reduce supply and raise land prices. Some counties in California have set aside more than 50% of their land area as green space where no development is allowed. Boulder, Colorado has set aside a green belt around their developed area, although the town is located next to a national forest of 1.5 million acres. (O'Toole, 2012).

Supply of houses is somewhat inelastic because it takes time and investment of resources to produce new homes for sale. Demand for houses can change quickly in response to changes in interest rates or consumer sentiment, but supply is almost always much slower to respond to market conditions. The result of this condition is that either increased demand or reduced supply tends to increase market prices sharply. We see in places where land use controls have been used extensively that house prices have increased much more than median incomes over many years. (O'Toole, 2012).

Demand factors also contributed to the sharp rise in house prices. During 2000-01 the US had a recession, and the Federal Reserve responded with reduced short-term interest rates to spur economic growth and job creation. After much criticism in 2002 about the "jobless recovery", the FED continued the record low interest rates of 1% until July 2004. Then the FED gradually raised

interest rates to 5.25% by July 2006 (in 17 consecutive steps of 0.25% at each meeting of the Open Market Committee). The extended period of 1% short term interest rates allowed adjustable rate mortgages to be issued with very low initial monthly payments. These payments often were lower than rent, and they attracted many marginal buyers, investors, speculators, and borrowers with falsified loan applications. Then when the FED started raising rates to 5.25% in June 2004, the attractiveness of the adjustable rate mortgage gradually was eliminated. Mortgages issued during 2002-2005 reached their annual adjustments and the monthly payments were adjusted upward to reflect rising market rates and the phasing out of temporary interest rate buydowns many loans had featured. These rising monthly payments started the process that would chase investors out of the market, slow the appreciation of house prices, and bring the speculation in houses to an end.

During the early 2000s there arose a growing speculation in housing, especially in certain resort areas popular with retirees and vacationers. Due to FED policy mortgage interest rates were very low, and the use of adjustable rate mortgages made it possible to structure a loan with monthly payments less than typical rent. Speculators were drawn into this market. Developers moved to develop single-family homes and condominiums, especially in Phoenix, South Florida, Southern California, and Las Vegas. By 2005 it was not unusual for proposed condo projects to sell out in a few days, long before construction began. Many buyers were buying not for shelter, but to resell at a quick profit. House prices rose rapidly, drawing more buyers into the market. For the ten-year period ending in 2006, US household mortgage debt increased from 54% of GDP to 89% of GDP (Acharya, 2011, page 44).

By July 2006 the FED had lifted short-term interest rates to 5.25%, and the terms on ARM mortgages became less friendly to speculators who were facing annual adjustments. Monthly ARM mortgage payments increased, and the flow of new buyers into the market slowed. Soon a few speculators began to have trouble selling their properties, and mortgage delinquency rates started to rise. In 2007 MBS investors around the world took note of the rising delinquency rates, although Moody's and the other rating agencies had rated most MBS AAA. In 2008 the MBS market crashed as MBS investors sought to sell their securities, and few were buying. At one point Merrill Lynch sold some MBS for 22% of face value. Lehman Brothers failed in the spring of 2008, and by fall of 2008 the FED and Treasury facilitated several large mergers and emergency liquidity measures. The mergers included JPMorganChase and Bank of America Merrill Lynch. The FED created eight "lending facilities" to provide liquidity to various segments of the financial markets when bank financing was essentially frozen. The FED was successful in restoring liquidity to the banking system. The damage done to the housing markets was more severe and is taking much longer to recover.

3. The Future

The future of US home mortgage finance is uncertain. Congress and the Obama Administration have discussed several alternatives for mortgage policy, but other issues have diverted policy attention away from the mortgage market. FNMA and FHLMC continue to be under conservatorship. The federal government provided \$186 billion to shore up these quasi-government agencies, and they have returned to profitability. To date the federal government, as majority shareholder, has received more than \$200 billion in dividends from FNMA and FHLMC, with none of it credited toward the debt. There have been proposals to shut down these agencies, merge them, or convert them to a fully private status. None of these proposals seems to have significant support at this time. (See Department of the Treasury, 2011).

An important lesson of the sub-prime mortgage bubble is that politically motivated housing policy increases risks to the housing markets and the taxpayer. Some political leaders continue to support policy measures to promote homeownership. FNMA and FHLMC have recently reduced the required down payment to 5% on some mortgages they buy. (See Watt, 2014). Some housing programs have required that low-income housing be included in new developments. Very recent initiatives by the Justice Department are focused on achieving desired levels of diversity within neighborhoods. In spite of the evidence from the sub-prime crisis, the lessons have not been widely understood.

Long-term increases in the standard of living, including housing status, can be achieved only through economic growth and rising productivity. Factors driving these measures include

education, jobs growth, and a positive climate for investment and production. Policy measures in these areas are much more likely to support the long term housing goals of all Americans.

4. Recommendations

The role of government in housing and mortgage finance should be limited to current programs. These include the FHA mortgage insurance, the VA loan guarantee for veterans, and the home mortgage interest deduction. Housing assistance programs such as various FHA financing programs for multi-family and Section 8 rental assistance should also be continued.

The future role and structure of FNMA and FHLMC needs to be determined. Many argue that these agencies should be privatized, and others want them restored to their former central position in the housing finance system. They have played a very important role in standardizing mortgage instruments and procedures, but they also have crowded out private firms from this market. A solution most likely would involve capping FNMA and FHLMC loans to the lower 30% to 50% of the market based on loan amount. Explicit federal backing of these agencies with a cap on their loan amounts, as is in place now, would gain support from those seeking a strong federal role in low and moderate income housing, and also could promote the development of a private sector MBS market in serving middle and upper income home buyers.

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