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A Non-Prescription for Confronting the Sub-Prime Crisis

Congress Should do Nothing

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I am so busy doing nothing...that the idea of doing anything—which as you know, always leads to something—cuts into the nothing and then forces me to have to drop everything.
- Jerry Seinfeld

Over 160 American mortgage lenders have gone bankrupt since late 2006.[1] Many observers have blamed a "sub-prime crisis." Media accounts have portrayed a crisis that will drive millions of American families from their homes.[2] There is some truth to this: Many Americans face a risk of losing their homes and many have taken out loans they cannot afford. Executives in the home lending business have lost their jobs. This paper attempts to clearly define the problems facing the American mortgage market and outline proposed measures to confront them.

There are several proposals. The Federal Housing Finance Reform Act of 2007 (H.R. 1427) attempts to reform the Federal Housing Administration (FHA). The Expanding American Homeownership Act of 2007 (H.R. 1852) seeks to overhaul the regulations governing Fannie Mae and Freddie Mac. The Mortgage Forgiveness Debt Relief Act of 2007 (H.R. 3648)—almost certain to become law—would provide tax relief for people who have mortgages discharged because of a decline in the home's value or a foreclosure. And the Mortgage Reform and Anti-Predatory Lending Act (H.R. 3915) would enshrine into law a lending standard called "suitability," which would impose liability on lenders for making loans that individual borrowers could not afford.

The above proposals are unlikely to provide relief to homeowners in trouble, and may even make things worse. To date, the crisis has been relatively minor—a small decline in homeownership combined with a small uptick in foreclosures, with well-off investors absorbing the bulk of the damage. Doing too much could turn a minor crisis into a major one affecting ordinary Americans.

This paper consists of three sections. The first section describes the sub-prime credit market and the dimensions of the current crisis. The second considers several proposals for reform and describes their flaws. The conclusion makes the case for letting the crisis resolution develop on its own.

About Sub-Prime Credit. The sub-prime credit market has always existed but only recently has it come "above ground." Between the 1930s and 1980s, the government largely dictated the interest rates banks could charge: Those dictates guaranteed bank profits, restricted their ability to innovate, and let them compete mostly by offering premiums—the now-clichéd toasters—to depositors.

Nearly all banks kept "banker's hours"—closing in the early afternoon, opening rarely on Saturdays, and never on Sundays. For well-off people, this system provided predictable banking services and essentially eliminated the need to shop around for the best account or loan. Services like interest-bearing checking accounts, free coin counting, and savings accounts that pay interest rates similar to certificates of deposit were unavailable. People seeking mortgages usually had only two choices—15- or 30-year fixed-rate—and only well-off professionals could get credit cards.[3]

By locking many people of modest means out of the legitimate banking economy, the system, created a black market for capital. For decades, loan sharking was the single most lucrative organized crime activity.[4] Other options included pawn shops, credit unions, and informal community networks.

With gradual deregulation between 1979 and 1995, banks gained the freedom to set their own interest rates, charge what they wanted on loans, and extend credit to nearly anybody. This made credit cards available to everyone, increased interest savings rates, reduced loan interest rates, and, most importantly, let banks and other legitimate lending institutions extend credit to people not previously considered creditworthy: those with modest incomes, spotty employment histories, poor bill payment records, or a combination of these. Since the chances that they would repay were lower, lenders could not extend to them lending at or near the prime lending rate. The sub-prime crisis largely involves such loans with vastly higher rates. Beginning in the late 1990s, a number of factors increased the number of sub-prime loans, including:

- Rising incomes and, during the 2000s. lower tax rates made it possible for people of modest means to afford their own homes for the first time—but only barely.
- Innovative financial products, including adjustable rate mortgages, interest-only mortgages, and low-documentation/no documentation loans opened housing opportunities to more people.[5] Although widely utilized in other countries such as Great Britain,[6] these mortgages were virtually unknown in the United States before the 1980s. Loans with initially low interest rates, known as "teaser" rates, which carried large "balloon" payments at the end of the loan's duration had been offered for decades, but only to the rich. Improved credit scoring technology gave banks the ability to offer these types of loans to middle and even lower-income borrowers.[7]

- New investment strategies pioneered by private hedge funds, the major government supported enterprise mortgage-backed security marketers (Freddie Mac and Fannie Mae), and mortgage lenders themselves, made it easier for lenders to sell loans to investors. This freed up capital to make additional loans and lowered lending—and thus, borrowing—costs.
- Spurred by new opportunity, dozens of new firms—many of them mortgage-only lenders—entered the market. For a variety of reasons ranging from low overhead business models to a willingness to accept lower profits, these firms wrote loans that could not have been issued before. As evidenced by the massive number of mortgage lender bankruptcies, many of these firms were managed poorly and lost nearly all of their investors' money.

Rise of Home Ownership. After hovering around 64 percent between 1981 and 1996, the home ownership rate began to rise sharply in 1997. Between 1996 and 2006, the percentage of Americans who owned their own homes rose from 64 percent in the beginning of 1994 to an all-time high of 69.4 percent in the second quarter of 2004, the highest reported quarterly homeownership rate in American history.[8] The crisis that has evolved since then has two parts: a series of massive losses for well-heeled investors coupled with minor consequences for the American housing market as a whole.

The crisis hit home for major world financial markets when, on June 20, 2006, the investment firm Merrill Lynch took $800 million in assets ouf of two mortgage-oriented hedge funds run by fellow investment banking firm Bear Stearns. Merrill Lynch believed that the fund's high-stakes bets on sub-prime mortgages would not pay off. This left those funds with almost no assets.[9] In July 2006, a major mortgage lender, American Home Mortgage Investment Corporation, announced it was filing bankruptcy and, in August, Countrywide Financial, the nation's second largest mortgage lender, announced it was on the brink of bankruptcy.[10] The firm was saved, for the moment, with a $2 billion investment in special preferred stock by Bank of America later that month.[11]

Other large investment banks—including Goldman Sachs, the British bank Northern Rock, and Citigroup—also reported enormous losses in their mortgage and real estate investment businesses. The problem appears to stem less from homeowners defaulting on individual loans than from the flawed methods of bundling the mortgages together for investors. In the United States, the losses happened almost entirely within hedge funds—lightly regulated leveraged investment pools limited to wealthy investors.

Muted Effect. Outside of these sectors, however, the consequences seem muted. Ordinary investors in real estate-related securities did not take a big hit: For instance, earlier this year, the Nuveen Real Estate Income Fund (JRS), one of the largest consumer funds of its type, lost over a third of its value, but, as of early October, was trading above its levels of January 2006.[12] The Dow Jones U.S. Real Estate Index stands at the same levels it did in October 2006. In other words, a lot of well-off people lost a lot of money because they made bad bets on the sub-prime crisis. Individual real estate investors have sustained losses similar to those in a cyclical stock market downturn, but since real estate investments are much less widely held than stocks, fewer people have felt the effects.

Even a much-heralded decline in home values—the first since statistics have been compiled—has little consequence for most homeowners. Unlike stocks or bonds, day-to-day home values do not matter much to their actual owners—people maintain homes to live in, not primarily as investments. While people do use their homes as collateral for loans, a tiny 0.7-percent decline, as projected by the National Association of Realtors, does not impact the amount of money that people can borrow against the value of their homes, since hardly any bank will lend somebody 100 percent of equity.[13]

In fact, for people who do not own real-estate related investments in their personal portfolios, it is difficult to see how things have changed: Home ownership has declined slightly but still stands near historical highs. Foreclosures have risen slightly but do not appear vastly out of whack with historical ranges. Since its all-time high in the second quarter of 2004, the homeownership rate has declined slightly and most recently stands at 68.4 percent.[14] Homeownership trends have always fluctuated from quarter to quarter—since 1981, only three years have seen movement of home ownership in the same direction each quarter. In short, the decline appears well within historical ranges.[15]

The same is true for foreclosure and delinquency rates. In the second quarter of 2007, the Mortgage Bankers Association reports that delinquency rates on loans were 5.12 percent, while in the second quarter of 2006 the rate stood at 4.39 percent.[16] Although the current rate is higher than is typical in a healthy growing economy, it is not outside of historical norms.[17] The total numbers of foreclosures is near historical highs, but, as a percentage of all loans, foreclosures are more rare than they were in the brief, mild recession of the early 2000s.[18]

To the extent that individual consumers are facing more trouble, it is because lenders extended them loans they never should have made. While some lawmakers denounce making certain loans as "predatory," such loans are the result of foolish business practices. Some companies may be able to hand off bad loans on marketers of mortgage-backed securities—as many of them did—but many more will end up stuck with loans on which they cannot collect or which they will have to sell for pennies on the dollar.

Contrary to popular belief, banks do not make money on foreclosures—they can lose 30 to 60 percent of the outstanding loan balance because of legal fees and property expenses associated with foreclosure.[19] Lenders who make too many mistakes go out of business.

Homeownership is not declining rapidly and foreclosure rates remain within historical norms. The sub-prime crisis has mostly occurred within financial markets and affected the well-off. Foreclosures are terrible for families, but on balance, the current proposals are unlikely to deal with them. Thus, the best prescription is simple: Do nothing.

Doing Nothing. This section examines several major proposals: an "affordable housing fund," an increase of the ceilings at which Freddie and Fannie can securitize loans, an expansion of the FHA's lending authority, a "suitability" proposal that would make banks legally liable if the government deems a borrower unable to afford a loan made, and a mortgage tax forgiveness proposal. None of these proposals is likely to do much to help individual homeowners, and some may make housing problems worse

The Affordable Housing Fund. The Federal Housing Finance Reform Act (H.R. 1427) contains a provision to tax Fannie Mae and Freddie Mac to set up an "Affordable Housing Fund" of roughly $450 million a year. Originally directed toward hurricane-damaged Louisiana and Mississippi, the fund would eventually expand to cover all 50 states. Its official objective is to build 1 million new affordable housing units through a variety of grants, subsidies, and insurance programs.[20]

Not only will this do little with regard to the sub-prime crisis, it could even reduce homeownership in three ways. First, if government is serious about providing more low-income housing, it will almost certainly find it easier to build more rental housing, which, at the margins, might encourage people to rent rather than buy.

Second, providing down-payment assistance to people who could otherwise not afford homes will necessarily attract more marginal buyers into the market. Since many people unable to save for a down payment would also be unable to pay a mortgage, this might actually increase default rates.

Third, taxing Fannie Mae and Freddie Mac to pay for this could make credit less available. Both Fannie and Freddie function by purchasing loans from banks, packaging the loans into securities, and selling those securities. The purchase of securities drives down the rates that banks charge for loans and frees up more capital to lend. Higher taxes on Fannie and Freddie will, at the margin, decrease their activity in the loan purchasing market and raise interest rates,[21] which will, in turn, make it impossible for some people, especially marginal borrowers, to afford homes.

Let Fannie and Freddie Securitize Bigger Loans. The Federal Housing Finance Reform Act also proposes letting Fannie Mae and Freddie Mac securitize bigger loans than they did before. The limit would rise from $417,000 to $622,000 with additional increases in high-cost areas. Allowing Fannie and Freddie into the "jumbo"—over $417,000—market would slightly reduce interest rates within that market, but there is no good reason for people buying houses at that price level to get any help at all from the government supported enterprises. In 2007, the median home price in the United States was $223,800,[22] and even in the most extreme outlier, the San Jose-Sunnyvale-Santa Clara market, the median price of a home was a high but not stratospheric $698,500. Few people who would look for sub-prime loans now will be able to buy houses costing more than $622,000 if interest rates for those homes fall a small amount.

An Expanded FHA. The Federal Housing Administration (FHA) provides loans to low-income people and mortgage insurance to lenders that provide mortgages for low-income borrowers. Rep. Barney Frank's (D-Mass.) Expanding American Homeownership Act (H.R. 1852) would expand the FHA's mandate to let the it write more insurance, insure zero-down-payment loans, make more loans overall, and insure sub-prime loans. This will make more credit available to low-income borrowers.

Rep. Maxine Waters (D-Calif.) argues that there is an "affordable housing crisis in America" and increases in homelessness largely because the FHA "has seen a precipitous drop in its market share in recent years," falling from 11 percent in 1991 to 3 percent in 2004.[23] Contrary to Rep. Waters's claim, however, higher FHA market share historically correlates with *lower* homeownership rates.[24] In the first quarter of 1991 only 64 percent of Americans owned their own homes. In 2004, the all-time low for FHA lending, the percentage had, as noted, approached 70 percent.

Expanding FHA's mandate could have other negative consequences: Allowing more zero-down loans and getting FHA more squarely into the sub-prime market will likely increase the total number of sub-prime loans to marginally qualified borrowers. This might create a bigger sub-prime crisis by providing guarantees to poorly managed lenders making loans which they never should have made in the first place.

Loan "Suitability" And Affordability. The Mortgage Reform and Anti-Predatory Lending Act (H.R. 3915), also sponsored by Rep. Barney Frank, would force banks to ensure the "suitability" of loans for borrowers. This and similar proposals would go beyond improved disclosure to essentially outlawing certain types of loans if the risk of borrower default is too high, thus limiting the choices of both lenders and borrowers.

This bill commands that "no creditor may make a residential mortgage loan unless…the consumer has a reasonable ability to repay the loan," and that "no creditor may extend credit for refinancing" unless the loan meets a government-set definition of "net tangible benefit to the consumer."[25] Its "anti-steering" provision requires lenders to offer consumers the "best terms for a mortgage loan for which the consumer qualifies." The subjective language of the bill's proposed standards would clearly go beyond disclosure and prohibit both borrowers and lenders from designing a certain type of loan, *even if the terms and conditions were clearly understood*

What proponents of both suitability and banning "steering" ignore is that borrowers have financial goals other than housing. Thus, a "cheaper" loan that requires larger cash payments at one time may hinder borrowers' ability to perform other costly endeavors such as saving for retirement or sending a child to college.[26]

Moreover, one of the most important reasons home buyers take out adjustable-rate, interest-only, or any of the plethoras of new types of mortgages is to have the cash flow to start or grow a small business. Typically, someone starting a business either cannot get a commercial loan or would pay much higher rates than they would on a home loan.[27]

Suitability rules would also likely worsen current mortgage problems by making it harder to sell homes. If homes were purchased with new mortgage instruments, these same instruments would likely be helpful to resell or refinance them. And home equity loans are often the best options for homeowners who have to move for job-related reasons, yet have trouble selling their old homes. The rates are often lower than the alternative method of financing the down payment for the new home, such as a bridge loan.[28]

As noted, banks lose a lot on foreclosures, and thus have powerful incentives to make loans that they believe can be paid back. But neither lenders nor borrowers can predict the future. In foreclosures and bankruptcies, a "trigger event," such as a layoff or health crisis, makes borrowers fall behind on their bills. But pricing a loan to take account of every contingency would result in a lack of credit for many deserving borrowers.

Mortgage Cancellation Tax Relief. In early October, the House of Representatives passed the Mortgage Forgiveness Debt Relief Act (H.R. 3648) to provide "mortgage cancellation tax relief." The bill changes the tax code so that people who lose their homes through foreclosure—or any other factor related to their financial condition—do not have to pay income taxes on forgiven mortgages. This makes some sense: People who lose their homes should not be socked with a huge tax bill. However, the measure will do nothing for the sub-prime crisis, and could even make things slightly worse for lenders making already risky loans and could slightly *increase* default rates, interest rates, or both. Some people may give up houses they otherwise would keep—with no taxes, it becomes easier to simply walk away from a difficult-to-pay mortgage.

Conclusion. A series of bad investments, bad loans, and bad business decisions caused the current sub-prime crisis, which has had devastating consequences for the sub-prime mortgage industry itself and for wealthy investors who made big bets on its health using exotic investment vehicles. It has had minor effects on individuals in a nation that still enjoys homeownership rates near its all-time high. Current proposals to deal with the crisis are unlikely to do anything about the modest increases in foreclosures and similarly modest decline in homeownership

Quite simply, the federal government is best off doing nothing to "fix" the crisis. The failure of hedge funds and mortgage firms sends a clear signal indicating bad business practices. To the extent that mortgage firms engaged in predatory lending, they will likely pay the ultimate price and go out of business. Expanding the FHA and letting Freddie and Fannie buy bigger loans will probably prop up unsound mortgage lenders. Providing tax relief for homeowners makes some sense, but could hurt some mortgage firms that are already teetering.

Some well-off people made a series of losing bets on the sub-prime market. So far, the "crisis" has impacted them the most. Some proposed reforms could actually deepen the crisis and none will end it. Right now, Congress should sit still.

Notes

[1] Aaron Krowne, "The Implode-o-Meter," http://ml-implode.com/ (As of October 3, 2007).

[2] For one example see Democracynow.com, "Subprime Lending Crisis: Millions of Families Face Losing Their Homes to Foreclosure," April 4, 2007, http://www.democracynow.org/article.pl?sid=07/04/04/1343214 .

[3] Robert Manning.,*Credit Card Nation: The Consequences of America's Addiction to Credit.* Basic Books: 2000, 167-8.

[4] Selwyn Rabb, *The Five Families: The Rise, Decline, and Resurgence of America's Most Powerful Mafia Empires* (New York:Thomas Dunne Books, 2005), p. 325.

[5] Michael Fratantoni, The *Residential Mortgage Market and Its Economic Context in 2007*, Mortgage Banker's Association, 2007, 23. In 2006, for example, over 40 percent of borrowers opted for adjustable rate mortgages.
[6] Kate Norton, "British Housing Nears the Upper Limit," *Business Week*, August 23, 2006, http://www.businessweek.com/investor/content/aug2006/pi20060822_164733.htm?campaign_id=rss_null.
[7] Testimony of Richard A. Brown, Chief Economist, Federal Deposit Insurance Corporation, before the Senate Banking, Housing and Urban Affair Committee, September 13, 2006, http://banking.senate.gov/_files/ACFE05D.pdf.
[8] Bureau of the Census, "Census Bureau Reports on Vacancies and Homeownership," July 27, 2007, Table 4SA, http://www.census.gov/hhes/www/housing/hvs/qtr207/q207press.pdf.
[9] CNNmoney.com, "Merrill sells assets seized from hedge funds," June 20, 2007, http://money.cnn.com/2007/06/20/news/companies/bear_stearns/index.htm.
[10] Gretchen Morgenson, "Inside the Countrywide Lending Spree," *The New York Times*, August 29, 2007.
[11] Jonathan Stempel, "Bank of America Invests $2 bln in Countrywide," Reuters, August 22, 2007, http://www.reuters.com/article/businessNews/idUSN2218820920070823?feedType=RSS&feedName=businessNews.
[12] Author Eli Lehrer owns shares of JRS in his personal portfolio.
[13] Chris Isidore, "Home Prices Decline for the First Time in 40 Years," *Money*, April 11, 2007. See also, National Association of Realtors, "Home Prices Decline for First Time Ever," April 10, 2007.
[14] Bureau of the Census, 2007.
[15] See National Association of Realtors, Bureau of the Census, Ibid.
[16] Mortgage Banker's Association, "National Mortgage Delinquency Survey, Second Quarter, 2007."
[17] Ibid, 32.
[18] Six-tenths of one percent is a little more than 9 percent of 4.39 percent. That's the basis for a "ten percent increase."
[19] Karen M. Pence, "Foreclosing on Opportunity: State Law and Mortgage Credit," *Credit*, May-June 2003, http://www.afsaonline.org/publications/credit/2003/MayJune/pdf/foreclosure-study.pdf.
[20] See e.g. Barney Frank et al., "Dear Colleague: Support an Affordable Housing Trust Fund," October 4, 2007.
[21] It is possible that this might not be a bad thing for the economy overall. Doing this would also reduce Fannie and Freddie's total liabilities and thus, the liabilities that taxpayers would be stuck with were either firm to encounter severe financial problems.
[22] National Association of Realtors, "Median Sales Price of Existing Single-Family Homes for Metropolitan Areas," Second Quarter, 2007, 1, http://www.realtor.org/Research.nsf/files/MSAPRICESF.pdf/$FILE/MSAPRICESF.pdf.
[23] Rep. Maxine Waters, "Expanding American Homeownership Act of 2007," September 10, 2007, http://www.house.gov/apps/list/speech/ca35_waters/FS070918_homes.html.
[24] Bureau of the Census, 2007, Table 4SA.
[25] "Section-by-Section Summary," House Financial Services Committee website, undated, http://www.house.gov/apps/list/press/financialsvcs_dem/section_by_section_10_22_07_(2).pdf.
[26] Home equity rates were 7 percent, while PLUS rates were 8.5 percent. Lynn O'Shaughnessy, "Loan Shark on Campus," *Money*, May 3, 2007, http://money.cnn.com/2007/05/03/pf/college/studentloans.moneymag/index.htm?section=money_mostpopular.
[27] Stephen C. Harper, *The McGraw-Hill Guide to Starting Your Own Business* (New York: McGraw-Hill, 2003), p. 172.
[28] Holden Lewis, "Timing Is Everything When You Buy a Home," Bankrate.com, http://moneycentral.msn.com/content/Banking/Homebuyingguide/P76869.asp.

The sub-prime crisis which emanated from the USA in 2007 has had profound effects around the world and is providing new insights into financial interlinkages and risk management issues. This paper examines the effects of the sub-prime crisis on the Australian financial sector with three objectives in mind. One is to provide a concise, but comprehensive, overview of these effects for readers interested in understanding the impact of the sub-prime crisis on economies outside of the USA. The second objective is to identify the main channels of transmission of effects. The third objective is to so