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Stripping off Market Accountability: Housing Policy Perspectives on the Crises in the Financial System

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If an analyst purported to find that mortgage failures by unworthy borrowers were the sole cause of the crises that threaten to push the financial system over the virtual precipice, that analyst either should be canonized for the insight or should be suspected of being a fool, fraud, or fabricator. Note that I used the word crises to suggest that it may be accurate to think that the challenges of financial market deterioration may best be explained on the theory that many things have gone terribly wrong, only one of which was the housing financing system.

A single-cause hypothesis to explain how we got to this near disaster or actual disaster is likely to be inadequate in fundamental ways and on multiple levels. We are dealing with complexities interwoven from webs of financial systems, innumerable transactions of disparate varieties, new-fangled and complicated financial instruments, widely diverse kinds of institutional actors, several governmental agencies that have housing assistance missions, as well as regulatory and oversight duties, and global financial transactions and institutions with far-flung tentacles. I am comfortable in trying to debunk what might be regarded as one theme seeking to attribute full responsibility for the crises to some kind of failure of housing policy or to aberrant manipulations of the housing market mortgage system.

Whatever the ultimate causes are found to be, I think the short version of the explanation slyly advancing the notion that somehow the crisis was provoked by fiscally-challenged people who went out and bought homes they could not afford by taking out home mortgages they could not pay reflects no known reality.

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and, therefore, has no explanatory power about causes of the crises and should be discounted to zero in credibility. Similarly, the explanation that one reason the mortgage problems arose is a result of the institutional separation of the mortgage issuer from the mortgage holder has importance as a necessary condition but is not sufficient to be the cause, in even a limited analysis, of how the mortgage system failed. A proffered single-factor analysis is even more abjectly inadequate to explain why the process of mortgage-marketing and mortgage-making failed not only homebuyers, but everyone up the accountability hierarchy until the end was reached. At that point, we have begun shifting the ultimate market risks of nonperforming mortgage portfolios onto taxpayers. This final shift would come from a proposed, and then apparently abandoned, governmental bailout of financial institutions by buying “toxic” instruments in their portfolios to provide liquidity for loan making or from governmental bailout in the form of “investments” of various sorts to keep the financial system from seizing up because of the meltdown of institutions in danger of collapse.

At earlier, pre-1930s times, the home mortgage system was remarkably straightforward; if not simple, at least as compared to the version that was beginning to collapse in the 2000s generating the first wave of the financial crises that struck about 2005. Back before and into the early 1930s, a home buying borrower went to the office of a local financial institution, mostly banking institutions and savings and loan associations, to secure a mortgage on a home located within the institution’s service area. The lender qualified the borrower, ascertained the value of the property, issued a mortgage, collected the monthly payments the borrower made on the mortgage, and anticipated holding the mortgage to maturity or until it was sooner paid off or refinanced.

The system was simple but it was not “buyer friendly.” Loan terms were not favorable. Loan periods were short (as short as ten years). Loans required a low loan-to-value ratio reflected in very high down payments (as much as fifty percent of the value of the home). Loans did not “self liquidate” thus leaving a “balloon” at the end of the loan period of as much as a third of the original loan amount. The Great Depression of the 1930s wrecked this
system. Mortgagors who could not make their monthly payments or who could not come up with cash to pay the balloon because of job losses or other problems, and who could not qualify for refinancing the balloon, crashed the housing market and that mortgage system. There were too few buyers and the mortgagee financial institutions that foreclosed upon the homes because of borrower default, could not sell the properties. The mortgagees, such as banks, then had their funds tied up in non-performing and illiquid assets. They, therefore, could not honor all of their depositors' withdrawal demands for their funds. Word then spread that the banks were failing, depositors made "runs" on the banks, and the banks failed.

The mortgage lenders under the old mortgage system had built-in market accountability measures to which they adhered. If the mortgage went bad it was on the lenders' nickel, as it were, because lenders were both originators and holders of their mortgages. So the lenders had ample incentives grounded in their own self-interest to make a financially reasonable effort to assure the success of the mortgages by examining their underlying fundamentals. These examinations included reasonable verification of their borrowers' capacity to pay the mortgages, their borrowers' credit worthiness, and the values of the homes as assets securing the mortgages. The lenders' self interest was an effective market accountability measure because the lenders (whether banks, savings and loan associations, or other financial institutions) would suffer the loss if the mortgage failed.

The home mortgage financial system of the 1930s era, and for a significant time thereafter, could possibly be characterized as a horizontal world in which mortgagors as borrowers dealt directly with mortgagee lenders in face-to-face relationships. But even that world's home mortgage financial system could not weather the storms of the Great Depression, so the housing market was among the financial systems that crashed. In comparison to the system in place that helped create our present problems there is one difference, and it is a major or even critical difference: failure of the home mortgage system was a consequence of the crisis of the 1930s that became the Great Depression. The home mortgage system was not even a putative catalyst, not to mention cause, of
that crisis. Today, the failure of the home mortgage system is seen, at least by some, as a catalyst, or even an almost single-factor cause of the present crises that have engulfed the entire financial system in the first decade of the twenty-first century.

Changes wrought in the home mortgage financial system to bring us out of the Great Depression, along with the market changes that were created incrementally over the next half century thereafter, sowed the seeds for the present housing mortgage crisis by creating a steeply vertical structure. First, governmental programs and government sponsored enterprises enabled the secondary market system of mortgage finance by creating ways qualified lenders could sell qualified home mortgages securing home loans of qualified borrowers. Second, in stages along the way, government sponsored enterprises and, later, private financial market players, put in place further aspects that created a steeper vertical system of home mortgage finance. Brokers entered the picture to seek borrowers whose paperwork was shopped to distant lenders. Lenders, at first, sold mortgages to government sponsored enterprises and later to other players. Servicers sprang up to collect mortgage payments for distribution to those who had a call on the proceeds. Mortgage companies entered the scene and made mortgages with proceeds of funds raised on capital markets. Investment and mortgage bankers bought mortgage paperwork (it is not clear whether the paper should still be called a mortgage). Government sponsored enterprises, and later other entities, found new vehicles to raise money on capital markets by packaging mortgages in securities and other debt-backed instruments. Rating agencies came about to rate the financial instruments. Private insurers arose to provide some kind of thinly-reserved coverage against losses. Market investors bought these securitized financial products and other debt-backed instruments in various forms. Money flowed into the housing mortgage market.

What was started and pioneered by government, setting up a secondary market tapping non-traditional capital funds, was a victim of its own success. It succeeded as a way of increasing the availability of capital for the housing market by tapping the non-traditional housing-funding sources of the capital markets. The
expanded secondary market also eased the disequilibrium in
demand for mortgages and the supply of capital available in the
mortgage finance system. The pioneering succeeded so well that it
was imitated and stretched by private players who entered the
markets, both at the mortgage-issuing level (mortgage companies,
for example) and extending all the way up the vertical hierarchy to
those who created and issued new investment vehicles (investment
and mortgage bankers, for example) backed by mortgages that
now found their way from local borrowers and local issuers’ vaults
and assets to remote portfolios of remote and unknown investors.

Whether purposeful or incidental, the one clear
consequence of the new vertical housing mortgage market
relationships with remote parties higher up the line who were
“not-responsible” for the mortgage or its underlying fundamentals,
was to completely divorce the basic mortgage transactions from
any market-driven discipline. Put differently, the bona fides of the
underlying fundamentals not only escaped the discipline of the
self-interest of any particular player in the vertical hierarchy of the
new mortgage financing system, but competition to make more
mortgages created perverse incentives that put emphasis on
volume of transactions rather than financial worthiness of those
transactions. Almost every player was rewarded for either volume
or demand, both of which were disconnected from or remote to
the underlying fundamentals. Volume created maximization
incentives for those players who were paid when deals were closed,
such as brokers. Demand incentivized players were paid when
they sold packages of mortgages as securities to waiting investors
promising better yields than other investment vehicles or simply
remarkably high yields, however measured.

There seems to be very little, if any, evidence that any of
these private market systems were put in place in the housing
finance system based on any considered analysis of desirable
national housing policy. That appears to be true whether we think
of a policy of increasing the rate of homeownership, providing
inducements to favor homeownership (as contrasted with renting,
for example), fostering the building of affordable housing, creating
conditions of pursuing a national housing goal of “a decent home
in a suitable living environment for every American family,"\(^1\) or any other articulated aspect of national housing policy. It is not that some of the private market housing mortgage activity did not in some ways aid housing policy ends. Homeownership reached its highest level of sixty-seven percent, just before the crash began. We do not yet know the extent to which the housing market crisis will wipe out or reverse homeownership gains.

Some of the other effects of the new housing financial system were not positive. Easy credit for housing may have contributed to "overconsumption" of bigger and bigger McMansions which put inevitable upward cost pressures on land, labor, and materials thus pushing homeownership farther and farther out of reach of those with marginal capacity to squeeze more out of family resources to devote to housing "consumption."

Some putative explanations for the causation of the housing market crisis, not to mention causation of the broader financial markets crises, do not have much credibility. One claim mentioned in the media is that too many people got into mortgages they could not afford by taking out subprime mortgages. Subprime failures do not appear to account for a sufficient proportion of failed mortgages to have caused a housing finance crisis of the magnitude we have. This is not to mention the adverse housing policy impacts on people who were put in subprime, higher interest rate products, and adjustable rate mortgages who now face foreclosure that might have been avoided because the borrowers were objectively eligible for and could have afforded mortgages with lower interest rates.

Similarly, a proposition that pressures under the Community Reinvestment Act\(^2\) (CRA) induced behaviors of lenders to make unworthy loans, especially to minorities, is subject to refutation. First, on its own, the CRA has proved difficult to see as having any such kind of impact when the assessment of applications led to a denial in only twenty of 77,000 applications for a deposit facility (which includes requests to expand or merge),

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thus averaging about one CRA based application denial per year. Second, the CRA applies, with certain exceptions, to regulated financial institutions that have deposits insured by the federal government. Many of the players in the present housing mortgage crisis do not have insured deposits, are not banks, and are not subject to the CRA. Third, one hears that the greatest incidences of mortgage market failures have occurred to date in Florida, Nevada, and California. There is nothing to suggest why, or how, the CRA was somehow a more robust inducement to even the banks to which it applied only in those three states than in the remaining forty-seven.

At all events, the activity and the instruments that lead to the downfall of the housing finance system and contributed in whatever causal way to the corruption of the financial market system that now is beset by multiple crises was not engineered by players seeking to fulfill any housing policy. The motive was to derive market driven profits. But that is what capital markets are supposed to do.

The new system of mortgage finance was not all bad. Wider and somewhat easier availability of credit for home buying was a good thing, up to a point. Mortgages that would not be sustainable, however, were pushed not only because there were no up-the-line incentives to rein-in the increases in volume, but as mentioned above, many if not most intermediate players’ benefits were achieved when the transaction occurred rather than when the mortgagors made the payments on their mortgages. This system destroyed effective incentives for any player to verify the soundness of the underlying fundamentals. The new instruments made such checks extraordinarily difficult or excessively costly (cutting into that player’s gains), if not impossible, even in systems with computerized and automated underwriting. But even a player who might have had the capacity to make verifications had virtually no incentive to do so. In addition to a lack of incentives, the high and increasing volume of mortgage transactions fueled a rise in housing prices that eliminated the concern that mortgages might be issued with terms that buyers would not be able to meet in a few years (because of the assumption that the mortgage could be refinanced to bring payments back to an affordable level based
on the increased appraisal value of the home). That lack of concern spawned adjustable rate and other fancy mortgages with initial “teaser” rates that made mortgages on high cost homes affordable at the start until the interest rates reset with payments buyers could not make. But with home prices rising at double-digit rates, the worst case scenario would be that buyers who fell on hard times because of lack of sufficient resources to keep up payments or whose payments went beyond the buyers’ capacity to pay would sell their homes at appreciated, higher prices sufficient to possibly yield a profit, even after deducting the sellers’ transaction costs. In that rosy environment, everything would work out fine.

Something bad began to happen. Home buyers began to default on the very instruments that had fueled the market demand that, in turn, had pumped up prices. Then the market began to collapse. Prices began to decline. Buyers could not be found. Mortgage payments were not being made. Securities backed by mortgages crashed. Portfolios of institutions heavy with these new instruments had to write down their worth in a system where there was no “free” market to set value. Fiscal viability of even venerable institutions was destroyed; many failed and more are threatened. All of these troubles created uncertainty virtually everywhere. The macroeconomic beneficial effects of housing construction crashed when new construction stalled. Jobs directly in the housing construction industry fell and jobs related to supplying construction materials fell. With lenders in distress, money for non-housing-related businesses dried up. Consumer spending declined. Demand for goods and services plummeted. A recession set in. The economy of the United States went into tailspin and is dragging down the world economy.

So we end up with a passing of the market risk that the new system of housing finance created and assiduously ignored to taxpayers in efforts to save “institutions too big to fail” because that would trouble the nation’s financial system and could spread to the global marketplace.

One of the lessons we have already learned is that for want of market accountability mechanisms in the system of housing finance to assure that mortgages had a reasonable asset underlying
them and a real prospect that the borrower could sustain the mortgage over time, one mortgage that should not have been issued multiplied by millions and millions has caused enormous and untold damage affecting billions and billions of dollars in the entire financial system. The problem will cost taxpayers in the very least over the short term billions of their hard earned tax dollars. So it was not bad mortgages that caused the problem. Bad mortgages were a symptom of widespread lack of discipline in the financial system. That lack of discipline arose from a lack of market accountability which was stripped off instruments in the financial markets generally and not just in the housing finance system. It was also attributable to the failure of regulatory systems, unrestrained free market ideology, deregulation, lax governmental oversight, consolidation in financial markets, runaway excesses in various categories of the capital markets, and an untold number of other forces and conditions.

It strains credulity to attribute these crises either to a wayward cohort of unworthy home purchasers who got mortgages they did not deserve or to an overly aggressive implementation of a wrongheaded federal housing policy that promotes homeownership. Neither mere failures in the housing finance system nor the pursuit of a normatively supportable goal of promoting the “American dream of homeownership” should be tasked as the cause of the crises of the financial markets. One should not in any sense ascribe the cause of the financial markets crises solely to even the disastrous collapse of the housing finance system. It was part of a much larger system of failure of accountability. One wonders about what combination of additional factors were and are still in play. One thing to me seems certain: there is no justification to sacrifice on the altar of the financial market crises the more than half century vintage goal of homeownership as one way of assuring adequate, affordable, and accessible housing for every American family.