What Can be Expected of Government in Supporting the U.S. Mortgage Market?

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BCLBE Conference, April 13, 2012: The Foreclosure Crisis: Challenges and Solutions to the Mortgage Meltdown

Government Interventions in the U.S. Mortgage Market

- The failure of government to regulate the GSEs and bank mortgage operations is not encouraging for government activity in the U.S. mortgage market.
- Nevertheless, there is strong advocacy for government interventions to moderate the crisis and to restart the mortgage market:
  - Public policies to expand mortgage modifications;
  - Policies to control predatory lending/securitization;
  - Longer-term government guarantees to replace the GSE role for conforming mortgages.

Positive Case for Mortgage Modification: Commercial Mortgages

- The owner of a half-occupied office building can expect a friendly loan modification from the bank:
  - The bank recognizes that rental income is the only source for loan payments—no recourse.
  - The rent rolls are objective and verifiable.
  - Other owners with fully occupied buildings cannot pretend to require similar modifications.
- Bottom line: commercial mortgage modifications are often the best alternative facing the bank.

Residential Mortgage Modifications are Vastly More Difficult

- It is impossible to control a borrower's cash flow decisions, past, current, and future.
  - Modifying loans for borrowers unable to make payments encourages more borrowers to default.
  - Modifying loans when borrowers are making payments is basically a gift.
  - Modifying loans is also a gift to 2nd lien holders.
  - Modified loans have high relapse rates.
- "Win-win" applies to a limited number of loans.

The Current Policy Role of the GSEs and FHA in Loan Mods

- GSEs/FHA are urged/required to modify (HAMP) or refinance (HARP). Since guarantees, no new costs.
  - Concern these actions eradicate fraud claims.
  - GSEs now have higher risk charges.
  - GSEs/FHA pay subsidy costs, face future losses.
  - Investors, including Government, lose on refis.
  - Principal forbearance > principal forgiveness.
  - Issues noted for private investor modifications—2nd liens, etc.--apply here as well.

The Moral Hazard of Securitization

- Sheila Bair:
  "All along the chain of securitization—from originators, to securities underwriters and rating agencies to investor and regulators—insufficient attention was paid to both safety and sound and basic consumer protection.
- <u>Argument fails</u> when investors at end of the line are the world's largest and most sophisticated firms.
- This is only case of failed securitization in 30 years.
- Dodd-Frank 5% risk retention requires banks to hold <u>more</u> risk. Contradicts securitization goal.

Predatory Lending and Predatory Foreclosures are a Different Matter

- Predatory lending is now regulated under the Fed's July 2008 additions to the Truth in Lending Regs. Key is new suitability requirements. Consumer Financial Protection Bureau may expand further.
- Predatory foreclosures remain open issue:
  - Judicial foreclosure rules were created for a good purpose over 100 years ago.
  - If banks felt they were archaic, they should have appealed for changes, not simply circumvented the intent.

Mortgage Reform: The Feb. 2011 Treasury White Paper

- GSEs to be closed down over the next 5 to 7 years with lower conforming limits, higher guarantee fees.
- Retain FHA/HUD programs for low income borrowers.
- Three Options on how to replace GSEs:

  Option 1 replaces GSEs with fully private markets.

  Option 2 adds FHA backstop for future crises.

  Option 3 has more complete government insurance.
- I favor plans 1 or 2: Private markets can work; Government insurance will fail.

Two Positive Final Thoughts

- Recycle foreclosed homes as rental properties:
  - Ken Rosen and Lew Ranieri have one plan.
  - New Fed White Paper strongly endorses idea.
- Redesign mortgage contract:
  - For principal reductions on existing loans, provide lender with "appreciation strip" for future appreciation.
  - For new mortgages, have loan balance adjust automatically to house price index changes.