

Executive Summary Backgrounder

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The Subprime Mortgage Market Collapse: A Primer on the Causes and Possible Solutions

Ronald D. Utt, Ph.D.

The collapse of the subprime mortgage market in late 2006 set in motion a chain reaction of economic and financial adversity that has spread to global financial markets, created depression-like conditions in the housing market, and pushed the U.S. economy to the brink of recession. In response, many in Congress and the executive branch have proposed new federal spending and credit programs that would greatly expand the role of government in the economy but do little to alleviate the distress caused by the financial crisis that has spread rapidly to nearly all sectors of the economy.

The Financial Crisis. These problems originated in the mid-1990s, when mortgage lenders relaxed the previously strict financial qualifications for obtaining a mortgage to buy a house by offering mortgage loans to credit-impaired households, albeit at higher interest rates to compensate for the greater risk. Despite the many different forms that these mortgages would ultimately assume (e.g., no down payment, interest-only, and negative amortization), they were designated “subprime” because of the borrowers’ checkered credit histories. Despite the risk associated with these subprime mortgages, many mortgage lenders further relaxed their underwriting standards and in the process introduced even more risk into the system, some of it motivated by fraud and misrepresentation.

Looser lending standards enabled previously unqualified borrowers to become homeowners, and the homeownership rate soared from the 64 percent

range of the 35 years before 1995 to an all-time high of 69 percent in 2004. While most celebrated this accomplishment, lending to riskier borrowers under diminished underwriting standards led to an escalating number of loan defaults and foreclosures beginning in 2006. Because many of these loans had been repackaged into mortgage-backed securities, the growing default problem soon spread to investors in national and international financial markets where these instruments were sold.

The first to suffer was the housing market when new construction and sales of new and existing homes plunged. This was soon followed by a decline in home values, which worsened the mortgage market’s financial problems by reducing the value of the collateral securing these loans. As many subprime borrowers found themselves owning houses worth less than the debt owed on them, their incentive to default increased. By the end of 2007, more than 17 percent of subprime borrowers had fallen behind on their loan payments.

Many hope that the housing market has reached bottom and will soon revive, but this seems unlikely. The subprime default and foreclosure

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problems first emerged when the economy was healthy, most borrowers were employed, and housing values were stable or rising. In 2008, home prices and sales are falling, some borrowers may soon be unemployed, tightened credit standards will exclude many from homeownership, and the number of subprime mortgages resetting to higher payments will be much greater than the number that reset in 2006 or 2007.

As a consequence, the homeownership rate will likely fall from its record levels near 69 percent to something closer to the historic norm of 64 percent. This trend implies that a greater number of lost homes will come onto the market at a time when sales are already depressed.

Proposed Solutions: Good and Bad. Under the circumstances, government policies should focus on cost-effective ways to facilitate the transition to a sustainable housing market of fewer homeowners and/or lower home prices, as opposed to costly exercises to prop up the inflated and unsustainable market of the sort that existed from 2004 to 2006.

One way to do this might be to encourage creation of a privately funded version of the Resolution Trust Corporation that helped to wind down the portfolios of the dead and dying savings and loan industry during the catastrophic collapse of the real estate market in the late 1980s and early 1990s. Capitalized by financial institutions looking to sell off portions of their troubled mortgage portfolios (an ownership share of the entity would be a prerequisite for using it), the corporation would be tasked with choosing the most cost-effective way to deal with each troubled mortgage, ranging from foreclosure to restructuring. A new private entity, the Private National Mortgage Acceptance Company (PennyMac) has already been created to do just that. More will be needed and should be encouraged.

This approach would be superior to many of the costly plans that Congress and the Administration have been discussing, all of which would expand existing federal programs to some degree and/or

create new ones, often at substantial taxpayer expense. While only a few of these proposals have been acted on, the threat of a worsening economy and upcoming presidential and congressional elections may encourage members of both parties to succumb to the temptation of a massive bailout. As this report reveals, the history of such government intervention in housing markets is not marked by much success. Many of the current proposals promise to carry on this tradition of failure.

Conclusion. Among the many risks confronting the United States is that many of the proposed relief measures would substantially and permanently expand the scope of the federal government while doing little to address the current financial crisis. Few will remember that, while the New Deal of the 1930s substantially and permanently increased the scope of the federal government, the process was well underway before Franklin Roosevelt took office in 1932. Following the stock market collapse in October 1929, the Hoover Administration attempted to spend its way out of the Great Depression, increasing federal spending by 47 percent between 1929 and 1932. As a result, federal spending as a percentage of GDP increased from 3.4 percent in 1930 to 6.9 percent in 1932 and reached 9.8 percent by 1940. During that period, many of the federal programs now being buffed up for expanded action—Fannie Mae, Home Owners' Loan Corporation, FHA, FHLBB—were created for much the same purpose.

While this point of nostalgia has excited many advocates of an expanded federal government, ordinary citizens and taxpayers should note that, despite all of the new government spending and bureaucracy, fewer Americans had jobs 1940 than in 1929. Furthermore, the homeownership rate of 43.6 percent in 1940 was the lowest recorded by the Census Bureau, even below the 47.6 percent rate of 1890.

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Background

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The collapse of the subprime mortgage market in late 2006 set in motion a chain reaction of economic and financial adversity that has spread to global financial markets, created depression-like conditions in the housing market, and pushed the U.S. economy to the brink of recession. In response, many in Congress and the executive branch have proposed new federal spending and credit programs that would greatly expand the role of government in the economy but do little to alleviate the distress caused by the financial crisis that has spread rapidly to nearly all sectors of the economy.

The Subprime Bust

Exactly when the subprime boom became the subprime bust is open to debate, but 2006 is a good estimate of when the system began to unravel. In 2006, many sophisticated investment institutions in the U.S. and abroad realized that their vast portfolios of subprime mortgages and derivatives thereof were not as safe as they had assumed and that they would likely incur significant financial losses. Little did they know at the time that these financial losses would be quite substantial and that this discovery would send financial markets and parts of the U.S. economy into a downward spiral that some fear will lead to a recession.

Although the subprime market encompasses a highly diverse set of financial instruments and types of borrowers, the Congressional Research Service (CRS) has offered a workable definition of a subprime mortgage:

Generally, subprime mortgages are defined in terms of the credit bureau risk score (FICO) of

Talking Points

- The collapse of the subprime mortgage market has created depression-like conditions in the housing market and has driven the economy to the brink of a recession.
- Many of those who call for more federal regulation fail to recognize that earlier and more comprehensive regulatory efforts did little to deter housing market problems and in some cases may have made them worse.
- The combination of record foreclosures and tighter credit standards will lead to a gradual reduction in the homeownership rate and increase the number of unsold homes on the market.
- As home prices continue to fall, federal policies should strive to smooth the transition to more affordable housing for more qualified buyers.
- Many of the policies now before Congress would substantially expand federal involvement at minimal benefit to the housing market or the economy.

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the borrower. Other credit imperfections... can also cause borrowers to be classified as subprime for a particular loan. For example, the addition of the mortgage loan might increase the borrower's debt-to-income level above traditionally prudent thresholds. Generally, bank supervisors look for one or more of the following credit-risk characteristics when deciding to label a loan subprime:

- Recent payment delinquencies (30-day or 60-day depending on recency)
- Judgment, foreclosure, repossession, or charge-off within prior two years
- Bankruptcy in last five years
- Relatively high default probability (FICO below 660 or similar measure)
- Limited ability to cover living expenses after debts (debt-service-to-income ratio of 50 percent or more).¹

The CRS report also noted:

In recent years, subprime borrowers increasingly used *alternative mortgage products* that had previously been used primarily by sophisticated investors. Interest only (I-O) mortgages provide an introductory period during which monthly payments cover only loan interest. After the introductory period, loan payments reset to a higher amount to also cover the loan's principal. Negative amortizing mortgages (NegAms) allow borrowers to pay less than current interest due and result in a higher loan balance and higher future payments... [A]djustable rate mortgages (ARMs) reset the interest rate with changes in market interest rates and therefore can result in

higher or lower monthly payments depending on market conditions.²

In addition, subprime mortgages include mortgages with very low or no down payments and second mortgages that serve as the "down payments" for first mortgages to eliminate the need for a cash down payment and/or a monthly premium for private mortgage insurance.

Although subprime and other risky mortgages were relatively rare before the mid-1990s, their use increased dramatically during the subsequent decade. In 2001, newly originated subprime, Alt-A, and home equity lines (second mortgages or "seconds") totaled \$330 billion and amounted to 15 percent of all new residential mortgages. Just three years later, in 2004, these mortgages accounted for almost \$1.1 trillion in new loans and 37 percent of residential mortgages. Their volume peaked in 2006 when they reached \$1.4 trillion and 48 percent of new residential mortgages.³ Over a similar period, the volume of mortgage-backed securities (MBS) collateralized by subprime mortgages increased from \$18.5 billion in 1995 to \$507.9 billion in 2005.⁴

Much of this expansion reflects increased use of these mortgages by households with less-than-perfect credit records, moderate incomes, and/or limited wealth to access the credit to buy a house or refinance an existing home. Because of this greater access to mortgage credit, falling interest rates, and rising incomes, the homeownership rate has soared to record levels.

Because of the post-World War II economic boom and improvements in the mortgage credit market, the U.S. homeownership rate rose steadily from 44 percent in 1940 to 62 percent in 1960 to about 64 percent in 1970, where it remained until 1995. When the subprime market began to grow

1. Edward Vincent Murphy, "Subprime Mortgages: Primer on Current Lending and Foreclosure Practices," Congressional Research Service *Report for Congress*, March 19, 2007, pp. 2 and 3. FICO is a credit scoring system developed by Fair Isaac & Co. in the 1950s. It uses a mathematical formula to develop a score based on an individual's credit history. For more information, see "What Is a FICO score?" at www.mtg-net.com/sfaq/faq/fico.htm (April 10, 2008).
2. Murphy, "Subprime Mortgages," p. 3 (emphasis added).
3. Inside Mortgage Finance, Web site, at www.imfpubs.com (April 10, 2008).
4. Darryl E. Getter, Mark Jickling, Marc Labonte, and Edward Vincent Murphy, "Financial Crisis? The Liquidity Crunch of August 2007," Congressional Research Service *Report for Congress*, September 21, 2007, p. 3, at http://assets.opencrs.com/rpts/RL34182_20070921.pdf (April 10, 2008).

in 1995, homeownership jumped from the 64 percent that characterized the previous 35 years to record levels at or near 69 percent between 2004 and early 2007.⁵

Boom and Bust. The economy also benefited from the building and financing boom that took the homeownership rate to record levels. New housing unit starts (single and multi-family) reached 2,068,000 units in 2005, compared to an annual average of about 1.4 million starts during the 1990s. In 1972, generous federal subsidies propelled the market to unsustainable levels and the all-time record of almost 2.4 million new units.

Although total starts in 2005 fell short of the 1972 record, the impact on subprime mortgages shows up more clearly in the single-family home market. Starts of single-family homes reached 1.6 million units in 2004 and 1.7 million units in 2005, compared to 1.3 million in 1972 and an annual average of about 1.1 million during the 1990s.⁶ Not surprisingly, sales of new homes reached record levels in 2005, as did sales of existing homes.

As a consequence of this housing boom, construction workers, mortgage brokers, real estate agents, landscapers, surveyors, appraisers, manufacturers and suppliers of building materials, and many other professions and businesses saw record levels of activity and incomes. This activity, in turn, flowed through the rest of the economy during the first half of this decade, contributing to the expansion that began in 2001.

Nevertheless, 2005 was the peak level of activity in the housing market. Escalating home prices in many markets with strict land-use regulations made housing unaffordable, even for those using increasingly risky mortgages to finance the more expensive homes. Early defaults in some subprime mortgages

began to emerge—often after just one or two payments—revealing a pattern of fraud in many such transactions. As the problems worsened, housing starts and new home sales fell sharply in 2006, and the weakening market ended the price escalation in many regional housing markets.

This contributed to additional defaults in recently originated subprime mortgages in which the borrowers had assumed that perpetual home price increases would allow them to refinance their way out of onerous loan terms, including the scheduled “resets” to higher monthly mortgage payments. A growing number of borrowers who had used subprime mortgages and/or seconds to buy at the peak of the market with 100 percent financing found themselves carrying debt loads that exceeded the values of their homes, making refinancing impossible. It also made selling the homes largely impossible because the proceeds would fall short of outstanding debt, forcing the owners to cover the differences out of other financial resources, which many did not have.

Because of these financial market problems, America’s housing and mortgage market is experiencing a catastrophic decline. After reaching more than 1.7 million units in 2005, single-family housing starts in February 2008 fell to 707,000 units at a seasonally adjusted annual rate—less than half the production level of February 2006 and a 40.4 percent decline from February 2007.⁷

Sales of new homes also fell precipitously over the same period. After reaching 1,283,000 units in 2005, new home sales fell to a seasonally adjusted annual rate of 590,000 in February 2008—less than half of the 2005 level and down 29.8 percent from February 2007.⁸ For existing homes, sales peaked at 7,076,000 units in 2005, fell to 6.4 million units in 2006, and fell to a seasonally adjusted annual rate

5. Wendell Cox and Ronald D. Utt, “Smart Growth, Housing Costs, and Homeownership,” Heritage Foundation *Background* No. 1426, April 6, 2001, p. 2, Chart 1, at www.heritage.org/Research/SmartGrowth/BG1426.cfm (April 10, 2008).
6. Executive Office of the President, *Economic Report of the President*, February 2008, p. 291, Table B-56, at www.gpoaccess.gov/eop/2008/2008_erp.pdf (April 10, 2008).
7. U.S. Census Bureau News and U.S. Department of Housing and Urban Development, “New Residential Construction in February 2007,” CB08–46, March 18, 2008, Table 3, at www.census.gov/const/newresconst.pdf (April 10, 2008).
8. U.S. Census Bureau News and U.S. Department of Housing and Urban Development, “New Residential Sales in February 2008,” CB08–50, March 26, 2008, Table 1, at www.census.gov/const/newressales.pdf (April 10, 2008).

of 5 million units by February 2008—nearly 30 percent below the 2005 peak levels.⁹

Mortgage default and foreclosure rates¹⁰ also began to rise, and defaults soon hit the highest levels seen in recent years. After the beginning of the modern subprime market in 1995, default rates on subprime mortgages rose steadily, from around 10 percent in 1998 to almost 15 percent in early 2002, as a result of the economy's weakening early in the decade after the dot-com stock market bubble collapse and the 9/11 attacks. Foreclosures also jumped from below 4 percent of outstanding subprime loans in 2000 to just over 9 percent in early 2002. In the years that followed, interest rates fell, the economy grew more rapidly, and housing starts and sales boomed.

The subprime market also boomed, reflecting the fast growth of fresh, new (and untested) loans. The default and foreclosure rates on subprime loans fell. Defaults were around 10 percent in 2004 and 2005, which was below the approximately 12 percent default rate on Federal Housing Administration (FHA) mortgages for the same years. However, subprime default rates increased to 13 percent by the end of 2006 and to more than 17 percent by the end of 2007, surpassing the FHA default rate, which remained near 13 percent. Over the same period, subprime loans in foreclosure also soared, from a low of 3.3 percent in mid-2005 to almost 9 percent by the end of 2007.¹¹

As the housing and mortgage markets began to unravel, many market analysts debated whether the damage would be confined to the housing market or would spill over into the rest of the economy and contribute to a recession. While overall economic trends during the first half of 2007 seemed to indicate that the damage would likely be confined to the housing market, the deterioration in the mortgage and housing markets during 2007 seems to have spread to

other sectors. Data from late 2007 and early 2008 suggest that the weakness is spreading beyond the housing sector and that the economy's health is at risk.

The Deterioration Accelerates. The destructive decline now unfolding in the housing and credit markets is something that the U.S. economy has experienced on several occasions during the previous several decades. Serious credit crunches in the mid-1960s, mid-1970s, early 1980s, and early 1990s led to major declines in housing production and slowdowns or recessions in the overall economy.

However, while housing downturns have been common, the origins of this downturn are remarkably different from those of the preceding downturns. Past housing declines and credit crunches often resulted from some combination of Federal Reserve efforts to restrict credit to deter inflation and/or from a weakening economy that discouraged buyers and contributed to higher default rates and foreclosures caused by rising unemployment. This housing/mortgage downturn began when the economy was growing at a healthy pace, personal incomes were at record levels, and the unemployment rate was relatively low.

With the overall economy seemingly blameless for the current housing market problems, all evidence suggests that something went terribly wrong in the mortgage market and that it needs to be repaired to prevent a repeat in the future. At the same time, the need for essential repairs to the mortgage market should not be confused with efforts to prevent the existing problems from spreading further and causing a recession.

In response to problems in the mortgage market, the Administration has already taken several steps to provide limited relief to deter foreclosures and allow those with good credit opportunities to refinance and adjust payments to keep their houses and stay current on their payments.¹² As the White

9. National Association of Realtors, "Existing Home Sales," 2008, at [www.realtor.org/Research.nsf/files/EHSreport.pdf/\\$FILE/EHSreport.pdf](http://www.realtor.org/Research.nsf/files/EHSreport.pdf/$FILE/EHSreport.pdf) (April 10, 2008).

10. A default is a missed payment and is generally measured in terms of 30 days, 60 days, and 90 days or more. A foreclosure generally occurs following a series of missed payments, after which the lender concludes that the borrower will never be current, takes the collateral, and resells it to satisfy the outstanding debt on the loan. A deed in lieu of foreclosure occurs when the borrower voluntarily vacates the house and turns the deed over to the lender.

11. Mortgage Bankers Association, National Delinquency Survey, 4th quarter, 2007, December 31, 2007.

House has taken these steps, Congress is considering a number of pieces of legislation to provide additional relief to borrowers and/or impose new regulations on mortgage market participants.

On the broader issue of the economy's health, the President¹³ and the congressional leadership responded to early signs of weakness and the devastation in the housing and finance sectors by passing a business bailout package in February 2008 to protect the economy and revive the housing market.¹⁴

Since the second session of the 110th Congress began, dozens of legislative remedies have been introduced. Many of these proposals would impose substantial regulations on mortgage market participants to deter future problems. While many of these regulatory efforts are well meant, implementing them would likely limit access to mortgages to only those with high incomes and existing financial assets. In the end, such regulations are unlikely to make the mortgage market any safer and could make it more vulnerable, as the painful experiences of the 1970s and 1980s demonstrate.

During the 1970s and 1980s, the federal government imposed strict and cloying regulations—overseen by tens of thousands of federal bureaucrats—on the mortgage market and the many financial institutions that served it. Yet this imposing and costly regulatory regime did not deter massive mortgage fraud in the FHA insurance program in the late 1960s and early 1970s, nor did the regulators prevent the complete collapse of the heavily regulated savings and loan industry in the late 1980s. When the smoke finally cleared, both federal deposit insurance agencies—the Federal Savings and Loan Insurance Corporation (FSLIC) and the Federal Deposit Insurance Corporation (FDIC)—were insolvent, and covering their losses cost taxpayers an estimated \$130 billion.

However chaotic and costly the current mortgage market collapse has been to the largely unreg-

ulated residential mortgage market, all of the losses to date have been and will be borne by private participants, not by the taxpayer. Indeed, federal regulation of such mortgage market participants as Citigroup, Washington Mutual, Wells Fargo, Countrywide Financial, and Fannie Mae did not prevent them from racking up tremendous losses in their residential mortgage operations. Assuming that they and other federally regulated depository institutions remain solvent, all of their losses will be borne by their shareholders, partners, employees, and creditors.

In an effort to inject a note of reality into the growing nostalgia for the heavily regulated mortgage markets that existed in the pre-securitization era of mortgage finance, the next section of this paper reviews the heavily regulated mortgage market from the early 1950s up to the spectacular and costly collapse of the savings and loan industry in the late 1980s.

The Mortgage Market, 1946–1990

The financial upheavals of the Great Depression fell most heavily on the housing and mortgage finance markets, and a disproportionate share of bank insolvencies was associated with financial institutions with loans concentrated in residential and agricultural real estate. As borrowers defaulted and real estate values fell, worried depositors attempted to withdraw their funds, causing many depository institutions to fail.¹⁵

Key federal initiatives emerged from the collapse, including the Federal National Mortgage Association (FNMA, now Fannie Mae); the Federal Home Loan Bank Board to serve as a kind of Federal Reserve for the savings and loans and the mutual savings banks; the FHA; the FDIC; and the FSLIC to insure deposits at savings and loans. Importantly, the FHA and FNMA pioneered the use of the long-term, fixed-rate, level-payment, fully amortized mortgage, replacing the then-common five-year

12. Ronald D. Utt and David C. John, "The Subprime Mortgage Situation: Bailout Not the Right Solution," Heritage Foundation *WebMemo* No. 1604, September 10, 2007, at www.heritage.org/Research/Economy/wm1604.cfm.

13. John D. McKinnon, "Bush to Revive Push for Housing Remedy," *The Wall Street Journal*, January 2, 2008, p. A2.

14. Agence France-Presse, "Bush Signs Economic Stimulus Package," Google News, February 13, 2008, at http://afp.google.com/article/ALeqM5j0JeV2tycpeHWizSFX_aAZ6n_WMg (April 12, 2008).

15. *It's a Wonderful Life* (1946) revolves around just such a fictional collapse of a savings and loan association.

balloon mortgage, thereby providing mortgage lenders and investors with a more stable cash flow.

Because of postwar prosperity and millions of returning GIs eager to form families and buy homes, housing construction accelerated, and homeownership rates reached record levels. By 1950, the homeownership rate went above 50 percent for the first time since the 1890 census, when the U.S. Census Bureau began collecting such data.

During the first several decades after World War II, savings and loan (S&L) associations and mortgage bankers became the dominant players in the market, and many of the FHA mortgages originated by mortgage bankers were sold to Fannie Mae, while their conventional loans were sold in the secondary market to life insurance companies, pension funds, and depository institutions. During this period, life insurance companies, pension funds, and individuals began to reduce their investments in residential mortgages in response to federal efforts to keep mortgage interest rates low, leaving the S&Ls and government-sponsored enterprises (GSEs) as the dominant lenders in the field.

S&Ls grew rapidly because they benefited from a number of regulatory advantages over commercial banks, their chief competitors. The Glass-Steagall Act of 1933 limited the banks' ability to compete by prohibiting them from paying interest on checking accounts and allowed the Federal Reserve to set a ceiling on the interest rate that they could pay on passbook savings deposits (Regulation Q). For part of that period, savings and loans had no such limits and were able to offer a higher rate on savings deposits and thereby attract money and customers from banks.

However, this advantage came with a cost. In return for the deposit rate advantages and important concessions on federal income tax liabilities, S&Ls agreed to strict regulations on their deposits and loans. They could not offer demand deposits and were prohibited from investing in anything other than long-term, fixed-rate residential mortgages. As a result, S&Ls were in the potentially unstable position of financing 30-year loans with short-term deposits that could be withdrawn essentially on demand. While this precarious position

“worked” if the yield curve remained upward-sloping (long-term rates higher than short-term ones) and interest rates remained stable from year to year, volatility in either could jeopardize the solvency of the dominant S&L industry.

The first blow to this unstable, heavily regulated system came in the early 1960s, when the pressure to finance the housing and population boom in California induced the federally insured California S&Ls to seek deposits from the rest of the country by offering higher savings account rates and easy bank-by-mail transactions. As depositors from the Midwest, South, and East responded enthusiastically to higher interest rate earnings, eastern S&Ls were unable to compete because all of their funds were tied up in long-term, lower-yielding mortgages. To prevent deposit funds from flowing from the East to the West, Congress imposed deposit rate ceilings on S&Ls in 1966 but gave them a 0.5 percentage point advantage over commercial banks.

The worst blow to S&Ls came in the mid-1960s, when a decade of interest rate stability was ended by nearly two decades of volatile and steadily escalating interest rates. This culminated in the early 1980s when short-term interest rates (as measured by the three-month Treasury bill) rose steadily from 3.5 percent in 1964 to 14 percent in 1981, with sub-peaks in 1970, 1974, and 1990. In every instance, S&Ls had difficulty holding deposits and competing with other attractive short-term investment opportunities while their interest earnings growth was severely limited by their portfolios of fixed-rate, long-term mortgages that changed only slowly.

By 1980, the S&L industry was technically insolvent because the market value of its mortgage loan portfolio was less than the value of the deposits financing it. Congress belatedly responded by reducing the regulatory burden on the industry.

Yet it was too late. By the end of the 1980s, the S&L industry began to collapse. In the late 1980s, more than 1,000 S&Ls became insolvent and filed for bankruptcy. By 1995, only 1,645 S&Ls were in operation compared to 3,234 in 1986, and the industry's share of the mortgage market had fallen from 44 percent in 1970 to 21 percent by 1990.

Because the value of the insolvent S&Ls' assets was less than that of their deposits, the FSLIC was required to cover the difference between the value of the assets and what was owed to the federally insured depositors. The losses quickly exceeded the reserves of the FSLIC, which was subsequently merged into the FDIC. The debacle ultimately cost federal taxpayers approximately \$130 billion.

A New System Arises from the Rubble. As the old system was collapsing, a new system was emerging to take its place. Unhindered by the counterproductive regulations that Congress had imposed on the previous system, the new one was largely free of federal regulation. Some of the belated reforms adopted during the 1980s shaped the new system that emerged in the 1990s, pushing homeownership rates to record levels but also contributing to the current financial debacle, although it has imposed few burdens on taxpayers so far.

Among the institutional changes made during this period was the breakup and privatization of Fannie Mae in 1968, which was then limited to buying only mortgages insured by the FHA or guaranteed by the Veterans Administration (VA). One of its new parts, renamed the Government National Mortgage Association (GNMA or Ginnie Mae), was transferred to the U.S. Department of Housing and Urban Development and tasked with operating the new "pass-through" (a type of MBS) mortgage securities program. Consisting of bundled FHA-insured and VA-guaranteed mortgages, these new pass-through securities were guaranteed by the full faith and credit of the federal government. They also marked the first serious effort to systematize the securitization of mortgages, a process that would later come to dominate the mortgage market in response to the diminishing role of depository institutions.

In 1970, two years after privatizing Fannie Mae, Congress created a companion GSE named the Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac). Initially "owned" by the savings and loans, the FHLMC was created to serve and facilitate a secondary market for conventional mortgages on behalf of the savings and loan industry at a time

when Fannie Mae largely served the mortgage banking industry because it was legally limited to buying only FHA-insured or VA-guaranteed mortgages. The FHLMC soon also developed pass-through securities for conventional mortgage loans. Over time, the limits on types of mortgages allowed to each GSE were dropped, and both now focus largely on conventional mortgages.

The 1970s also saw the revival of the private mortgage insurance industry, which had been largely destroyed by the collapse of the housing finance industry during the Great Depression. Absent mortgage insurance, conventional loans generally required a down payment of 20 percent to satisfy lender/investor risk concerns, in contrast to 3 percent for the FHA and zero percent for the VA, thereby limiting their use to those with sufficient savings. However, with private mortgage insurers (PMIs), the down payment on a conventional loan could be as low as 5 percent, giving more households access to this type of financing, particularly for homes that cost more than the loan cap for FHA mortgages. Both the FHA and PMIs charged the borrower an insurance premium equal to 0.5 percent of the outstanding loan balance.

Finally, beginning in the late 1970s, S&Ls and other lenders began to offer borrowers adjustable-rate, conventional mortgages in which the interest rate changed periodically in accordance with some agreed-upon index. Today, the London Interbank Offered Rate (LIBOR) is used. The purpose of this change was to help the beleaguered S&Ls enhance their solvency and better survive unsettled market conditions by allowing them to match the return on their assets more closely with the cost of their liabilities.

Before this, S&Ls offered only one type of mortgage: the fixed-rate, level-payment, fully amortized mortgage. Although S&Ls were not prohibited from offering adjustable-rate mortgages, relatively low state usury ceilings in 48 states often made them impractical.¹⁶ Later in the 1970s, the FHA and VA were also permitted to insure and guarantee adjustable-rate mortgages.

16. Federal Reserve, *Ways to Moderate Fluctuations in Housing Construction* (Washington, D.C.: Board of Governors of the Federal Reserve System, 1972), p. 394.

The American Mortgage Market, 1990–2005

The collapse of the S&L industry and the growing popularity of conventional mortgages (now that private mortgage insurance allowed for low down payments) led to a number of significant changes in the residential mortgage finance market. In 1955, conventional mortgages accounted for 56 percent of outstanding mortgage debt (the FHA accounted for 16 percent, and the VA the remainder), and their share of the market grew steadily over the next several decades, reaching 94.7 percent of outstanding one–four family residential mortgage debt by 2006, with VA and FHA sharing the remaining 5.3 percent of the market.¹⁷

As FHA/VA market share declined, FNMA was allowed to join FHLMC in the conventional market, and their pass-through securities quickly dominated the securitized secondary market at the expense of the GNMA, which was still limited to the FHA/VA mortgages. Among the major changes in the mortgage market was a significant change in the role played by the different types of lenders/investors, as Table 1 illustrates.

From 1960 to the early 1980s, the savings institutions (S&Ls and mutual savings banks, in states where they could be chartered) were by far the primary source of residential mortgage credit. However, the legacy of heavy-handed federal and state regulation impaired both their financial solvency and their ability to compete beginning in the 1970s. Their market share began to fall, while FNMA and FHLMC filled the vacuum and expanded at a rapid pace.

Between 1980 and 1990, savings institutions' share was cut in half as a result of the S&L collapse, while the regulated but protected GSEs doubled their share. By 2000, GSEs accounted for approximately the same market share as savings institutions

Table 1 B 2127

Share of Mortgage Market by Major Type of Financial Institution, 1955–2007

Year	Savings Institutions	Commercial Banks	Life Insurance Companies	Government-Sponsored Entities	Individuals and Others
1955	37.6%	16.6%	22.6%	4.1%	20.1%
1970	43.9%	15.6%	15.7%	8.0%	16.7%
1980	41.2%	18.0%	8.9%	17.5%	14.2%
1990	21.1%	22.3%	7.0%	33.1%	16.5%
2000	10.6%	24.4%	3.5%	41.7%	19.7%
2005	9.4%	24.3%	2.3%	34.8%	29.0%
2006	8.0%	25.2%	2.2%	33.7%	30.8%
2007*	8.0%	24.5%	2.2%	34.6%	30.7%

* As of the third quarter.
Source: Executive Office of the President, *Economic Report of the President*, February 2008, pp. 314–315, Table B-76, at www.gpoaccess.gov/leopl/2008/2008_erp.pdf (April 10, 2008).

controlled during their earlier peak between 1960 and 1980. Over these same periods, commercial banks gradually expanded their share, while life insurance companies abandoned the market, which no longer provided a competitive yield compared to other debt instruments.

However, this state of affairs was only temporary because a series of major management failings at the leading GSEs forced government regulators to curb FHLMC and FNMA lending activities as their accounting scandals were unraveled and a new set of federal regulations was developed for them. At the same time, a new market emerged, driven in part by a host of new subprime mortgage instruments and a financial industry that developed a variety of new mortgage-backed securities to sell on global secondary markets to investors that heretofore had little participation in America's residential mortgage finance system. As the last column of Table 1 shows, between 2000 and 2005, the GSE share shrank by 7 percent, and the market share for non-GSE, privately issued, mortgage-backed securities jumped by nearly 10 percentage points.

17. Executive Office of the President, *Economic Report of the President*, p. 316, Table B-75.

In effect, as the troubles and scandals confronting the GSEs limited their investment activities, the private sector more than stepped into the void and contributed to a record-breaking boom in mortgage lending and homeownership and a near record in new housing construction.

Subprime Mortgages Emerge and Expand

With the U.S. homeownership rate plateauing at 64 percent from 1970 through the early 1990s, future growth prospects for the mortgage finance industry were limited to whatever growth in household formation and price appreciation could add to a predictable stream of refinancings and resales, unless a new product was introduced to expand homeownership and refinancings. That new product was the subprime mortgage, which from about 1995 through 2006 helped to boost the performance of the housing and housing finance markets to and sometimes beyond all previous records.

As noted earlier, a wide variety of new and innovative debt instruments were available to consumers in the subprime and prime markets. This section lists and briefly describes some of the more common types offered by lenders.

A subprime mortgage is generally defined as a mortgage in which the borrower's credit quality is impaired relative to the volume of debt incurred. Within the subprime category are a number of different types of mortgage instruments that offer alternative repayment and loan-to-value plans. In many instances, elements of these different types of mortgages are combined in a single instrument.¹⁸

Adjustable-Rate Mortgages. The term "adjustable-rate mortgage" describes any mortgage with an interest rate and payments that adjust according to some formula agreed upon by the borrower and lender. ARMs have been generally available to borrowers for about three decades on prime mortgages, but variants have been common to subprime mort-

gages over the past 10 years. The traditional ARM linked the mortgage's interest rate to the LIBOR plus several percentage points (the "margin").

Often, the interest rate is fixed for the first few years and then resets annually or semiannually as market rates change and according to the contractual "cap" on the allowable increase in the rate on the reset date. Thus, even if the LIBOR rate does not rise over the term of the loan, the loan's interest rate and required monthly payment would still rise.

For example, New Century (once a major subprime lender) offered a 2/28 ARM loan with an 8.64 percent rate for the first two years and subsequent rates that would be linked to the LIBOR at a 6.22 percent margin. After the first two years, the interest rate would be updated every six months at an initial cap of 1.49 percent, a period cap of 1.5 percent, and a lifetime cap of 15.62 percent. Under this arrangement, the monthly payment would rise 32 percent by the 31st month, assuming no change in the LIBOR.¹⁹

When applied to subprime mortgages in recent years, some lenders for the first year or two would charge a low initial interest rate (a "teaser rate") that would then reset to a much higher rate in subsequent years. In some cases, these new rates were above market rates and could significantly increase the monthly payment. A 2/28 ARM was a 30-year mortgage with a teaser rate that would reset after two years, and the new rate would be linked to market rates for the next 28 years. A 3/27 ARM follows a similar pattern.

Alt-A Mortgages. Sometimes referred to as a "low-doc" mortgage, an Alt-A mortgage is structured like the other mortgages described in this section but is made available only to prime borrowers or those with FICO scores above 660. However, these prime borrowers were required to offer only limited documentation on their qualifications, so many may not have been as "prime" as they repre-

18. For more detail, see Edward Vincent Murphy, "Alternative Mortgages: Causes and Policy Implications of Troubled Mortgage Resets in the Subprime and Alt-A Markets," Congressional Research Service Report for Congress, updated September 27, 2007.

19. Adam B. Ashcraft and Til Schuermann, "Understanding the Securitization of Subprime Mortgage Credit," Federal Reserve Bank of New York Staff Report No. 318, March 2008, pp. 16–17, at www.newyorkfed.org/research/staff_reports/sr318.pdf (April 10, 2008).

sented themselves to be, as subsequent default rates indicate.

Extremely Low- or No-Down-Payment Mortgages. As home prices appreciated and as mortgage originators and lenders looked to expand their pool of potential customers beyond those with sufficient savings and net worth to make the required down payment (generally 5 percent to 20 percent), lenders and investors began to offer and buy mortgages with little or no down payment. Sometimes they provided more than 100 percent financing by allowing buyers to borrow a portion of their settlement costs.

For the most part, these borrowers were believed to have incomes and credit histories sufficient to meet future payment obligations, and continued home price appreciation was expected to create an equity cushion sufficient to protect the lender. The most common FHA mortgage requires only a down payment of 3 percent, or even less if the borrower finances half of the closing costs, as is permitted. Not surprisingly, between the end of 2003 and 2006, the default rate on FHA mortgages exceeded the default rate on subprimes.²⁰

In some cases, a no- or low-down-payment financing package was arranged by using a first mortgage equal to 80 percent of the property's value (thereby avoiding the 0.5 percent PMI premium) and a separate second mortgage (often called a "naked" or "silent" second) to cover the remaining 20 percent. In the event of a foreclosure, the first mortgage holder would have first claim on subsequent sale proceeds, while the second mortgage holder would receive whatever remained, if anything.

Mortgages with no down payment are considered risky because the absence of equity provides the lender with little cushion in case of losses at foreclosure and limits the borrowers/owners' incentive to keep up their payments because they have little to lose through default and foreclosure. As one analyst noted, "A home without equity is just a rental with debt."²¹

Interest-Only Mortgages. Most mortgages today are fully amortized, meaning that each monthly payment covers both the interest and a portion of the principal. Over the life of the mortgage (typically 30 years), the principal amount will gradually be paid down to zero.

An interest-only mortgage permits lower initial monthly payments by allowing the borrower to defer any repayment of principal until a year or more into the loan. For example, if principal payments are deferred for three years, payments after the third year would rise to a higher level than they would have been if the mortgage had been amortized beginning with the first payment because the principal must now be paid down over 27 years rather than 30. The mortgages carry risks similar to no- and low-down-payment mortgages and ARMs.

Negative-Amortization Mortgage. A negative-amortization mortgage is much riskier than an interest-only mortgage because the initial payments do not cover all of the interest, so the interest deficiencies are added to the loan's principal, which increases over time along with the borrower's indebtedness. Once the flexible payment period ends, the monthly payments are even larger because the loan amount has increased and the amortization period is shorter. Risks to the lender are more severe than the risks that are encountered with interest-only mortgages.

Increasing Risk in the Past Few Years. A recent study by the Federal Reserve Bank of New York tracked a number of the changes in the quality of Alt-A and subprime loans that originated from 1999 through 2006 and were packaged in MBSs. In the Alt-A market, the loan-to-value ratio increased from 76 percent in 2002 to 80 percent in 2006, and the share of loans with silent seconds increased from 2.4 percent to 38.9 percent. Over the same period, loans with full documentation declined from 36 percent to only 16.4 percent.

For subprime mortgages, the loan-to-value ratio increased from 80.7 percent in 2002 to 85.5 percent in 2006, and the share of loans with silent sec-

20. Mortgage Bankers Association, National Delinquency Survey.

21. Josh Rosner, "Housing in the New Millennium: A Home Without Equity Is Just a Rental with Debt," *GrahamFisher Housing Trends*, June 29, 2001 (capitalization altered).

onds increased from 2.9 percent to 27.5 percent. Over the same period, subprime loans with full documentation declined from 65.9 percent to 57.7 percent.²²

As noted earlier, newly originated subprime, Alt-A, and home equity lines (seconds) totaled \$330 billion in 2001 and accounted for 15 percent of all residential mortgages. Just three years later, in 2004, they accounted for almost \$1.1 trillion in new loans and 37 percent of residential mortgages. Their volume peaked in 2006 at \$1.4 trillion in loans and 48 percent of residential mortgages.

Impact on the Housing Market

Giving less creditworthy borrowers access to mortgage credit increased the U.S. homeownership rate by more than 4 percentage points during this rapid expansion of subprime mortgages. In 1995, just when the subprime market was starting to expand, the homeownership rate was 64.7 percent of households—comparable to the average rate for the preceding three decades. However, as the subprime mortgage market grew, so did homeownership, which reached an all-time peak of 69 percent in 2004.²³

Based on the most recent Census estimates (2006), the homeownership rate increased from the pre-subprime rate of 64.7 percent in 1995 to 68.8 percent in 2006. In other words, looser credit standards allowed an additional 4.6 million American households and families to become homeowners than might otherwise have been the case without these mortgage market innovations.²⁴ As the subprime market has unraveled and homes have gone into foreclosure, the homeownership rate has declined from its peak of 69 percent in 2004 to 68.1 percent in 2007, diminishing the number of net new owners who may have been created by the growth of the subprime market.

The more liberal qualification terms and creative payment streams also encouraged existing homeowners to refinance their homes, often converting their increased home equity into cash to spend on home improvements, debt consolidation, and other consumer goods. The Federal Reserve Bank of New York study reports that more than half of the subprimes that originated between 1999 and 2006 and were repackaged in MBSs were used for purposes other than to purchase a house. In six of the eight years, less than 40 percent of loans were used to purchase an owner-occupied home.²⁵

Such refinancings and respendingings were encouraged by the federal and state income tax codes, which allow the deduction of mortgage interest payments from taxable income, but not interest paid on other forms of consumer debt. Thus, using a mortgage refinancing or a new second loan to purchase a car, remodel a kitchen, or pay off credit card debt or student loans would yield tax savings that the other types of debt would not.

The more generous terms and qualifications for subprime loans also encouraged and allowed otherwise qualified prime borrowers to buy beyond their means, giving them access to more expensive houses than would have been unaffordable with a traditional mortgage, which would require a larger down payment. In a similar vein, these easy financing terms encouraged many households to buy a second home for recreation or investment, and some owners/investors bought several.

Subprime Mortgage Market Unravels

While many believed that carefully underwritten subprime mortgages provided manageable risks, the evidence suggests that underwriting standards in the prime and subprime mortgage markets collapsed at some point during the past 10 years for reasons that are not yet fully apparent. Part of the decline in standards may have stemmed from the

22. Ashcraft and Schuermann, "Understanding the Securitization of Subprime Mortgage Credit," p. 16, Table 5.

23. U.S. Census Bureau, "Housing Vacancies and Homeownership (CPS/HVS)," Table 13, at www.census.gov/hhes/www/housing/hvs/annual07/ann07t13.html (April 10, 2008).

24. U.S. Census Bureau, 2006 American Community Survey, Table S1101, at http://factfinder.census.gov/servlet/STTable?_bm=y&-qr_name=ACS_2006_EST_G00_S1101&-geo_id=01000US&-ds_name=ACS_2006_EST_ (April 10, 2008).

25. Ashcraft and Schuermann, "Understanding the Securitization of Subprime Mortgage Credit," p. 16, Table 5.

rapid price escalation in the value of the underlying collateral—the land and structures that secured the mortgage. This led many strapped borrowers and their lenders/investors to believe that the borrowers could refinance their way out of any payment problems. Lenders and investors also came to believe that ever-escalating home prices would eliminate any loss in the event that a risky borrower defaulted and the loan was foreclosed.

While such optimism seems foolish in hindsight, it seemed appropriate at the time and provided important economic benefits for all involved. An obvious benefit is that as many as 4.5 million additional homebuyers and borrowers generated new business and revenues for real estate agents, mortgage agents, real estate and mortgage brokers, and commercial banks. The many participants in the subsequent securitization process earned fees for each packaging and repackaging as the risks were sliced and diced to tailor securities to each investor's needs. On top of this was the boom in refinancing for those who already owned their homes but were attracted to better terms and the opportunity to convert home equity to cash.

A less appreciated benefit of the diminished underwriting standards was the reduction in costs for many involved in the process. The advent of no-documentation (“no-doc”) loans in which borrowers are on the honor system to provide information on their incomes, assets, debts, and credit and employment histories saved the lender/investor the considerable expense of establishing the borrower's suitability, which involves sorting through and verifying the copious documentation by calling or writing employers, banks, brokerage firms, utilities, and other parties. Reducing these and other loan origination costs in the due diligence process increases the profit from a given stream of revenues.

Similar economies in costs occurred during the subsequent securitization process, thereby allowing for a more attractive return to the end buyer while still yielding handsome fees to the many loan bundlers, securitization packagers, and securitization repackagers that formed a gantlet of fee-earning opportunity between the initial borrower and the

ultimate investor. In the past, the secondary market financial institutions that repackaged mortgages into mortgage-backed securities would reexamine the portfolio of mortgages to confirm their quality. This entailed examining a random sample of as many as 10 percent of the backing mortgages to confirm their promised quality. This costly and time-consuming process was replaced by a faster and much less costly process called “representations and warranties,” in which the originator/consolidator of the loans being securitized and sold would confirm that the loans were of a certain quality and would agree to buy back any loans that failed to perform as promised. The representations and warranties in turn were often based on the borrowers' credit scores.

As events soon revealed, many of these representations and warranties were exaggerated. When the loans defaulted and the ultimate investors returned them for the required repurchase, originators and down-market consolidators faced financial obligations well in excess of their capital and soon filed for protection under the federal bankruptcy laws.

This left many investors holding devalued mortgages and with no remedy beyond pushing for foreclosure. The CRS reported in September 2007 that 90 mortgage lenders/brokers had gone out of business since the first of the year.²⁶ And mortgage originators were not the only financial institutions forced to compensate down-market investors. Merrill Lynch, Citigroup, and the merged Bear Stearns were among several major firms forced to buy back mortgage securities that they had sold to investors.

The National and Global Subprime Risk

The collapse of the savings and loan industry (see Table 1) ended the “originate and hold” era of mortgage lending and, out of necessity, greatly expanded the housing industry's reliance on the “originate and sell” process. Today, more than 65 percent of all outstanding mortgages have been sold to investors in the secondary market, including the federally sponsored GSEs. Many of these mortgages have been sold through the securitization process in which a bundle of mortgage loans serves as collat-

26. Getter *et al.*, “Financial Crisis?” p. 6.

eral for some form of mortgage-backed security, which is sold to institutional and individual investors in the secondary market. The monthly payments from the millions of individual mortgagors (borrowers) are passed through a gantlet of servicers, arrangers, and asset managers (net of fees) to the ultimate holder of the MBS.

Typically, the originator, which could be a bank or a mortgage broker, makes the loan to the borrower/homebuyer, collects a fee in the process, and sells the loan to an arranger who borrows from a warehouse lender (or uses internal funds) to acquire the pool of mortgages. The arranger then repackages the mortgages into an MBS, insures the payment of interest and principal through a bond insurance fund, and then has a rating agency (i.e., Fitch, Moody's, or Standard and Poor's) rate the MBS. The pool is transferred to a trustee, an asset manager is selected, and the MBS is sold to investors. In the early stages of the pool's formation, the originator services the loans (collects the monthly payments, passes them on to the arranger, and places tax and insurance payments in escrow). Once the pool is completed, the asset manager selects a permanent servicer to replace the originator.

At each stage of the process, the various entities involved collect service fees. Yet the further a subsequent participant is from the mortgagors, the more difficult it is for the participant to assess the risk of the pooled mortgages accurately. As the Federal Reserve Bank of New York study contends, as many as seven separate key "frictions" are involved in the process of mortgage securitization.²⁷

In the past, these subsequent participants in the process would have confirmed the stated quality of the pool by inspecting a portion of the mortgages in detail, but the diminishing amount of documentation over the early years of this decade may not have provided much useful information. Thus, participants increasingly relied on the originator's representations and warranties. In effect, the process relied largely on trust among individuals whose compensation depended on closing the deal.

Adding to the risk, some MBSs were repackaged into highly leveraged securitized investment vehicles (SIVs) and collateralized debt obligations (CDOs), further compounding the risk to the ultimate investor. Default on a small portion of the underlying mortgage portfolio could dramatically reduce the security's value, causing huge losses for the investor or for those who guaranteed the payment of principal and interest on the security.

The multibillion-dollar write-offs taken by Citigroup, Merrill Lynch, Bear Stearns, and other investment banking firms are attributable to their decision to repurchase such highly leveraged, mortgage-backed securities that they had previously sold to investors. As the problems worsened, it became apparent that financial institutions throughout the world were experiencing significant losses.

What Went Wrong?

While the political debate and media discussion of the issue sometimes tend to reduce the problem to a single cause and process, the problem is really a series of independent problems. Some of these problems are geographically concentrated in only a few states and/or metropolitan areas.

Economic Adversity. In some cases, economic adversity has been an important contributing factor in mortgage defaults and foreclosures, notably in the manufacturing-dependent states of Michigan, Indiana, and Ohio. In these states, unemployment is rising, and the shares of mortgage loans listed as seriously delinquent (over 5.5 percent) or in foreclosure (3.3 percent to 3.8 percent) are the highest in the nation. (Nationally, 3.62 percent are seriously delinquent, and 2.04 percent are in foreclosure.) According to a recent survey of delinquency and foreclosure rates, borrowers in these three states were not overly reliant on subprime mortgages, which accounted for 13.8 percent to 14.3 percent of these states' mortgages compared to 12.7 percent nationally.²⁸ This suggests that the economic problems concentrated in these states, not necessarily the quality of the underwriting, were an important cause of the loan problems.

27. Ashcraft and Schuermann, "Understanding the Securitization of Subprime Mortgage Credit," pp. i-ii.

28. Mortgage Bankers Association, National Delinquency Survey.

Florida, Louisiana, and Nevada rank among the six states with the highest rates of seriously delinquent mortgages (90 days or more), and Florida and Nevada are among the states with the highest foreclosure rates (over 2.8 percent).²⁹ A combination of higher subprime use (16.0 percent) and high-cost housing in comparison to buyer incomes may have contributed to Florida's problems.

The survey also calculates a "next worse" group, with six states in the seriously delinquent category and nine states in the next-worse foreclosure category. California is in both groups and is the worst-performing of the Pacific states. California fares worse than the national average, although not as badly as the Midwestern manufacturing states.³⁰

In another national survey of foreclosures that attempts to capture the rate of deterioration over the past year (February 2007 to February 2008), California and several other states performed very poorly. Compared with a nationwide increase of 57 percent, foreclosures increased by 131 percent in California, 210 percent in Arizona, and 145 percent in Wisconsin.³¹

Affordability and Land-Use Regulations. While Wisconsin's deterioration stems from its concentration on manufacturing, the problems in California, Florida, Nevada, Arizona, and selected parts of the D.C., New York, and Chicago metropolitan areas stem largely from their restrictive land-use regulations and the effect of these regulations on housing prices and affordability.

Beginning in California in the 1960s and Oregon in the 1970s, states and localities began to implement a variety of land-use regulations to control, limit, manage, and/or guide the growth of residen-

tial development in their states and communities.³² For the most part, these regulations involved the adoption of growth boundaries, mandatory green space, farmland preservation, downzoning, exclusionary zoning, large lot zoning, high impact fees, and infrastructure concurrency. The implementation of such land regulations accelerated over the past decade as more and more states and localities adopted them.

As a consequence, the volume of land available for development shrinks and its cost rises. The escalation in land prices leads directly to higher house prices, and as house prices rise faster than incomes, homes become less affordable.

Because of its long history of counterproductive land regulation, house prices in California are the highest in the nation. San Francisco is one of the least affordable areas in the United States. The median sales price for homes in the San Francisco area was an estimated \$777,300 in the fourth quarter of 2007, down from \$846,800 in the second quarter.³³ According to one survey, the median-priced home in San Francisco was more than 10 times the median household income in the region,³⁴ making it one of the country's least affordable regions.

Because of statewide land restrictions, similar unaffordability trends characterize most California cities, making California one of only two states where the 2007 homeownership rate was below 60 percent. By contrast, because of their less regulated land markets, median home prices in Dallas (\$145,000), Houston (\$150,300), and Atlanta (\$164,300) are very affordable and equal to less than three times their regions' median incomes.

29. *Ibid.*

30. *Ibid.*

31. Press release, "Foreclosure Activity Decreases 4 Percent in February," RealtyTrac, March 13, 2008, at www.realtytrac.com/ContentManagement/pressrelease.aspx?ChannelID=9&ItemID=4284 (April 10, 2008).

32. See Wendell Cox and Ronald D. Utt, "Housing Affordability: Smart Growth Abuses Are Creating a 'Rent Belt' of High-Cost Areas," Heritage Foundation *Backgrounder* No. 1999, January 22, 2007, at www.heritage.org/Research/SmartGrowth/bg1999.cfm.

33. National Association of Realtors, "Median Sales Price of Existing Single-Family Homes for Metropolitan Areas," 2008, at [www.realtor.org/Research.nsf/files/MSAPRICESF.pdf/\\$FILE/MSAPRICESF.pdf](http://www.realtor.org/Research.nsf/files/MSAPRICESF.pdf/$FILE/MSAPRICESF.pdf) (April 14, 2008).

34. Pavletich Properties, "4th Annual Demographia International Housing Affordability Survey: 2008," Demographia, at www.demographia.com/dhi.pdf (April 11, 2008).

As noted, California also suffers from high default and foreclosure rates, and this trend is worsening. Similar influences and outcomes characterize Phoenix, Las Vegas, and many cities in Florida. This partially reflects the fact that the high cost of housing has compelled many middle-income homebuyers to incur excessive levels of debt to fulfill the American dream of becoming homeowners.

Table 2 illustrates this correlation, using data from a CRS table that show the connection between the preponderance of ARM usage in a community and an independent measure of mortgage risk. This report adds a third column to provide a measure of a region's affordability and a fourth column to describe its land-use practices. As is apparent, the high-risk, ARM-dependent regions also have high measures of unaffordability and land-use regulation.

Predatory Lenders, Predatory Borrowers. For much of the past decade, some in Congress and the advocacy community have complained about the prevalence of "predatory lending," a practice in which individuals of modest means and limited sophistication are seduced into taking on debt, often secured by their home. Some define predatory lending as occurring when the lender convinces the borrower to borrow "too much." Sometimes, outright fraud is involved, and the nature of the obligations is misrepresented. In other cases, individuals may willingly agree to a loan that carries high interest rates, large fees, and harsh terms that are beyond their capability to service with their modest incomes and financial skills, hoping that something will work out in the

Table 2

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Adjustable Rate Mortgages, Market Risk, and Affordability

Metropolitan Area	ARM Share in 2006	PMI Risk Index	Affordability Index (Demographia)	Land-Use Practices (Brookings)
San Francisco	65%	587	10.8	Growth Control
San Diego	62%	603	10.0	Growth Mgmt.
Los Angeles	57%	590	11.5	Growth Mgmt.
Las Vegas	51%	540	5.9	Containment
Sacramento	48%	601	5.8	Growth Mgmt.
Phoenix	41%	353	4.7	Growth Mgmt.
Chicago	40%	147	4.5	Traditional
Seattle	39%	153	6.0	Containment
Miami	39%	471	7.1	Growth Mgmt.
Denver	36%	187	4.2	Growth Control
Orlando	34%	313	5.2	Growth Mgmt.
Tampa	34%	404	4.7	Growth Mgmt.
Portland	32%	158	5.1	Containment
Atlanta	31%	140	2.8	Traditional
Milwaukee	31%	140	4.2	Traditional
New York	30%	543	7.0	Traditional
Boston	30%	596	6.1	Exclusion?
Virginia Beach	29%	413	4.8	Traditional
Minneapolis	27%	393	3.4	Traditional
Detroit	25%	379	2.4	Traditional
Columbus	24%	74	2.8	Traditional
Washington, DC	22%	540	5.5	Containment-Lite, Traditional
St. Louis	21%	133	2.7	Traditional
Indianapolis	19%	63	2.3	Traditional
San Antonio	17%	78	3.2	NA
Kansas City	16%	109	2.7	Traditional
Philadelphia	13%	179	4.0	Traditional
Dallas	11%	89	2.5	Wild Wild Texas
Cincinnati	9%	72	2.7	Traditional
Houston	9%	88	2.9	Wild Wild Texas
Pittsburgh	6%	61	2.7	Traditional
Cleveland	3%	74	2.8	Traditional

Sources: Edward Vincent Murphy, "Alternative Mortgages: Causes and Policy Implications of Troubled Mortgage Resets in the Subprime and Alt-A Markets," Congressional Research Service Report for Congress, updated September 27, 2007; Rolf Pendall, Robert Puentes, and Jonathan Martin, "From Traditional to Reformed: A Review of the Land Use Regulations in the Nation's 50 Largest Metropolitan Areas," Brookings Institution Research Brief, August 2006, at www.brookings.edu/~lmedia/Files/rc/reports/2006/08metropolitanpolicy_pendall/20060802_Pendall.pdf (April 14, 2008); and Pavletich Properties, "4th Annual Demographia International Housing Affordability Survey: 2008," Demographia, at www.demographia.com/dhi.pdf (April 11, 2008).

future. Some fall behind in their payments and ultimately lose their homes through foreclosure.

For some debtor advocates, subprime loans are synonymous with predatory lending because they typically carry higher interest rates and fees to compensate lenders for the additional risk of default that they assume by lending to such borrowers. As noted earlier, the many definitions and characteristics of a subprime loan relate entirely to the lackluster credit history of the borrower. While there have certainly been instances of fraud, there is little evidence to suggest that they constitute a significant component of the subprime problem nationally, although there are instances of localized abuses. The high foreclosure and default rates in low-cost Atlanta and Detroit may be examples of such abuses.

In contrast, as more evidence emerges from the millions of faltering mortgagors (subprime, Alt-A, and/or prime), it is becoming apparent that some portion of the problem—perhaps a significant portion—may stem from “predatory borrowing,” defined as a transaction in which the borrower convinces the lender to lend too much. As underwriting standards declined and as this decline became obvious to many in the real estate business, some people took advantage of the lax standards to buy homes that they could not otherwise afford, to refinance homes to acquire other consumer durables or pay down credit card debt, or to buy homes for investment (renting or selling) without revealing that the homes were not their primary residences.

In many cases, the growing use of low- or no-documentation mortgages (sometimes called “liar loans”) allowed people to exaggerate their incomes and receive loans that they were not qualified to receive.³⁵ On top of this was the growing proclivity to use a second mortgage to pay a down payment to an unwitting first mortgage lender—prime or

subprime—with the lender believing that the borrower had no other significant debt obligations.

A variant of predatory borrowing is the seemingly naïve and unwitting borrower who is victimized by an organized combination of real estate investors, appraisers, agents, and loan officers who combine to sell overpriced homes to unqualified borrowers to earn substantial commissions, fees, and capital gains by misrepresenting the borrower’s qualifications. In a number of these cases, the victims have been modest-income immigrants with limited financial sophistication and English language skills, while the perpetrators are their ethnic cohorts who take advantage of their language and real estate skills to encourage the borrowers to agree to financial transactions that are beyond their means. While the hapless borrower soon defaults, the perpetrators receive their fees up front at closing, and all losses are borne by the downstream holder of the resulting mortgage or by the participants who warranted the quality of the mortgage.³⁶

Overcommitted Borrowers

Beginning in the 1990s and accelerating through this decade, American households on average reduced their savings rates and embarked on a debt-fueled binge of consumer spending, including acquiring homes that many could not “afford” without incurring excessive debt. From 1970 to 1989, Americans saved more than 9 percent of their personal income. In the 1990s, the savings rate fell by almost half to a little over 5 percent, dropping close to 2 percent by 1999. It remained at about 2 percent from 2000 until 2005, when it fell below 1 percent, where it has remained since.³⁷ Because these savings rates include contributions to 401(k) plans and other retirement savings programs—funds that are unavailable for current spending purposes—the

35. Michael Coit, “Loans Built on Lies,” *The Press Democrat* (Sonoma County, Calif.), February 10, 2008, at www1.pressdemocrat.com/apps/pbcs.dll/article?AID=/20080210/NEWS/802100349/1033/NEWS01 (April 11, 2008).

36. For examples of these sorts of arrangements, see Brigid Shulte, “My House. My Dream. It Was All an Illusion,” *The Washington Post*, March 22, 2008, p. A1, at www.washingtonpost.com/wp-dyn/content/story/2008/03/21/ST2008032103607.html (April 11, 2008); Michael Corkery, “Fraud Seen As a Driver in Wave of Foreclosures,” *The Wall Street Journal*, December 21, 2007, p. A1; and Allan Lengell, “FBI Probes Virginia Mortgage Scam,” *The Washington Post*, December 18, 2007, p. A1, at www.washingtonpost.com/wp-dyn/content/article/2007/12/17/AR2007121701993.html?nav=rss_realestate/dcarealiving (April 11, 2008).

37. Executive Office of the President, *Economic Report of the President*, p. 262, Table B-30.

“discretionary” household savings rate, including money that could be used for a down payment on a house or for an unexpected expenditure, has been substantially negative in recent years.

With the nation awash in easy credit and with many mortgage lenders willing to provide subprime mortgage loans and/or risky second mortgages that obviated the need for any down payment, households had little incentive to save and began to spend more than they earned. At the same time, car loans, credit card debt, and equity lines of credit became available on similarly generous terms, further undermining incentives to save while enhancing a household’s ability to spend.

As debt burdens increased, new monthly “mandatory” spending commitments such as cable television, Internet service, and cell phones added to the traditional monthly spending obligations that include electricity, heat, water and sewage, and taxes. As inflation has worsened for some essential consumer products and services—Merrill Lynch reports that spending on food, energy, and medical care is at its highest share of personal income since 1960—the pressures on personal incomes have intensified. As a result, a growing number of households are experiencing difficulty staying current on their mortgages, credit cards, and auto loans.³⁸

Declining House Values. As the subprime problems have led to weakness in the housing market, home prices in many communities have declined. According to the S&P/Case Schiller Index of 20 metropolitan areas, home prices in January 2008 fell by 10.7 percent from a year ago.³⁹ The National Association of Realtors reported that median sales prices of existing homes in February 2008 had fallen 8.2 percent nationwide from a year ago.⁴⁰

With many borrowers buying their houses with little or no down payment and having little or no

equity in their homes, the decline in prices has left many holding assets that are worth less than what they owe on them. Merrill Lynch estimates that as many as 9 million households may have “upside down” mortgages in which the debt exceeds the value of the house and the equity is negative.⁴¹

With further price erosion likely, this situation will only worsen. As a consequence, many borrowers/owners are deciding that the wiser course is to relinquish their homes and debt obligations and move to a less costly rental. As home prices decline, this could spur even more defaults, particularly among borrowers whose mortgage loans are about to reset to a higher payment.

Of course, with many of these mortgages repackaged into securities and resold to investors around the globe, the hundreds of thousands of defaults and subsequent foreclosures caused by some combination of these factors have undermined the value of these securities and have shaken global confidence in U.S. financial markets and institutions.

Potential for Continued Deterioration

While many hope that the worst is over and that the economy and the housing and finance markets will bottom out in mid-2008, there are many reasons to be cautious about the near-term and longer-term prognoses for the housing and housing finance markets. Unlike past real estate recessions, much of the deterioration experienced so far has occurred when the economy was healthy, jobs were abundant, and credit was readily available at reasonable rates.

By early 2008, credit had become scarce for all but the best risks, and slowing economic activity has raised the risk of increased unemployment and depressed incomes. With inflation starting to cut into discretionary spending and many consumers maxed out on debt, a consumer spending retrenchment may be more likely than a consumer spending boom.

38. Robin Sidel, “American Express to Take Big Charge As Loans Sour,” *The Wall Street Journal*, January 11, 2008, p. C1.

39. Alejandro Lazo, “January Home Prices Down 10.7% from ’07,” *The Washington Post*, March 26, 2008, p. D1, at www.washingtonpost.com/wp-dyn/content/article/2008/03/25/AR2008032501169.html (April 11, 2008).

40. Allan Lengel, “Existing Home Sales Rise As Prices Plummet,” *The Washington Post*, March 25, 2008, p. D1, at www.washingtonpost.com/wp-dyn/content/article/2008/03/24/AR2008032400986.html (April 11, 2008).

41. Rachel Beck and Erin McClam, “Into the Economic Abyss: How Deep Will It Go?” ABC News, at <http://abcnews.go.com/Business/wireStory?id=4508624> (April 11, 2008).

For housing and mortgage finance markets, the problems will likely take longer to resolve. This year and the next may be as bad or as worse as 2007. In the short run, the number of contractual mortgage payment resets in 2008 will be significantly greater than the number of resets in 2007. The number of resets in 2009 will be lower but still high by past measures.⁴²

Because the subprime and Alt-A mortgages approaching reset are of a lower quality and higher risk than those that have reset over the past few years, defaults and foreclosures could be higher. With foreclosures up 60 percent but foreclosed properties selling at a rate of only 4.4 percent, the growing inventory of unsold homes will dampen any revival of the new home construction market and the dependent industries.

Over the longer haul, the housing market and the vast volume of debt that it collateralizes will likely continue to be depressed as a return to higher quality lending standards permanently excludes from homeownership many millions of potential buyers/borrowers with moderate incomes and/or no net worth. Meanwhile, continued turmoil in the subprime market and the economy will push many of their income-class cohorts from ownership to renting.

As noted, the more exacting pre-1995 credit standards kept the U.S. homeownership rate fluctuating at about 64 percent of households, with the remaining 36 percent either uninterested in homeownership or unable to afford it or to qualify for the necessary loans. However, the lowering of credit standards to qualify for a subprime mortgage steadily raised the homeownership rate from 64 percent in 1994 to the all-time record of 69 percent in 2004. Given the estimated 110 million U.S. households, this increase means that an additional 4 million to 5 million new households became homeowners, many of whom would not have qualified for homeownership in the past. This increase helped to fuel the boom in construction and finance and contributed to the economic growth during this period.

With credit standards tightened to something closer to past standards, many of these households

will again be excluded from the housing market, and marginal borrowers who lose their houses through default and foreclosure are unlikely to return to homeownership anytime soon. Tightened credit standards will likely cause the homeownership rate to drift back toward the 64 percent of the recent past. In the process, approximately 4 million to 5 million owner-occupied houses could gradually come back onto the market, keeping downward pressure on home prices and new home construction and contributing to more defaults and foreclosures as a growing number of “upside down” borrowers choose not to remain homeowners.

While some may view this prospective outcome as unlikely or extreme, the U.S. homeownership rate had already fallen by 0.9 percentage points from its 2004 peak by the end of 2007—almost 20 percent of the distance back to the 1995 rate of 64.7 percent. This 0.9 percent decline in the homeownership rate represents about 1 million households eliminated from homeownership.

Possible Courses of Action: Good and Bad

With the near future likely to bring more housing market stress, it is essential that any federal and state remedies not exacerbate matters as some of the proposed (and implemented) policies would certainly do. Nor should they undermine the ability of moderate-income households to access mortgage credit and homeownership. Importantly, federal, state, and local policies should focus on facilitating the orderly transition to a housing market that is characterized by lower prices and fewer owners. They should attempt to prop up the current levels of both, which will be unsustainable without large taxpayer subsidies and continued instability.

Policies That Undermine a Lender's Security. Many proposals at the federal and state levels would compel borrowers and lenders to renegotiate the terms of the mortgage loan or would force such changes on a lender on behalf of a borrower. While some view these efforts as essential to avoid a costly foreclosure and loss of a home, such proposals could undermine the certainty of the contract between borrower and lender and thus reduce the credit available to less creditworthy borrowers

42. Murphy, “Alternative Mortgages,” p. 3.

because lenders would be unsure of their right of recovery in the event of a default.

Proposals that would create such uncertainty include those that would allow borrowers facing foreclosure to file for bankruptcy in the hope that a judge would compel the lender to change the loan's terms.⁴³ For example, Ohio officials are urging lawyers in the state to offer defaulting borrowers *pro bono* services to fend off foreclosure,⁴⁴ and a federal judge in Milwaukee is urging borrowers to join a class-action suit to cancel their loans for what may be minor errors in loan-related paperwork.⁴⁵

Federal Reserve Board Chairman Ben Bernanke's recent urging of lenders to reduce the principal owed by struggling borrowers to lessen the likelihood of foreclosure was viewed by many as unhelpful.⁴⁶ Such recommendations could lead many investors, including those abroad, to believe that investment in a U.S. financial instrument is an even riskier proposition if leading government officials recommend the voluntary breaking of contracts. It could also create the moral hazard of encouraging struggling borrowers who are current in their payments to fall behind in order to become eligible for a reduction in principal and/or interest rate.

More Regulation? A common response by many Members of Congress and the Administration is to impose greater (or different) federal regulation on all participants in the mortgage lending process in the misguided belief that a deficiency of federal regulations contributed to the current subprime problems.⁴⁷ Yet, as the pre-1990 mortgage market demonstrated, the tight and cloying federal and state regulatory system in place at that time did not prevent a massive collapse of the housing finance

market in the late 1980s. Indeed, abundant evidence suggests that these regulations contributed to the collapse by preventing the savings and loans from establishing stable balance sheets. This collapse cost taxpayers about \$130 billion.

More recently, anyone who has gone through a real estate settlement is familiar with the abundance of paperwork (and costs) associated with purchasing a home and acquiring a loan. This paperwork is the consequence of a host of federal regulations that have accumulated over several decades.

In the same vein, many of today's financial institutions that have suffered significant losses from the subprime problem (some of which stand accused of irregular lending practices) were federally chartered and subject to regulation and oversight by multiple federal agencies. Closer to home, the presumed intense federal oversight of Fannie Mae and Freddie Mac, the two major GSEs, did not prevent employees of either agency from engaging in massive accounting fraud in the early part of this decade.⁴⁸ Nor did this intense oversight prevent them from incurring major losses (almost \$9 billion in the second half of 2007) from bad mortgage investments in their most recent fiscal year.⁴⁹

While a careful review of the extant federal regulatory regime is certainly in order, any changes should be consistent with maintaining a free and open system that continues to serve those households that are capable of achieving homeownership and those investors and lenders who are willing to help them achieve their dreams. The history of federal mortgage finance regulation is largely one of costly failure. There is no rational reason to expect better results from more regulation in the future.⁵⁰

43. Jeffrey H. Birnbaum, "Lenders Fighting Mortgage Rewrite," *The Washington Post*, February 22, 2008, p. D1, at www.washingtonpost.com/wp-dyn/content/article/2008/02/21/AR2008022102687.html (April 11, 2008).

44. Peter Lattman, "Ohio Urges Pro-Bono Help for Troubled Homeowners," *The Wall Street Journal*, January 2, 2008, p. B2.

45. David Cho, "Door Could Open to Class Actions," *The Washington Post*, February 27, 2008, p. D1, at www.washingtonpost.com/wp-dyn/content/story/2008/02/26/ST2008022603748.html (April 11, 2008).

46. Greg Ip, "Fed Chief to Lenders: Cut Mortgage Principal," *The Wall Street Journal*, March 5, 2008, p. A3.

47. Elizabeth Williamson, "Political Pendulum Swings Toward Stricter Regulation," *The Wall Street Journal*, March 24, 2008, p. A1.

48. Ronald D. Utt, "Time to Reform Fannie Mae and Freddie Mac," Heritage Foundation *Background* No. 1861, June 20, 2005, at www.heritage.org/Research/GovernmentReform/bg1861.cfm.

49. James R. Hagerty, "Fannie, Freddie Shares Suffer Hit As Mortgage-Default Fears Mount," *The Wall Street Journal*, March 11, 2008, p. A3.

GSE Expansion. In March 2008, the Office of Federal Housing Enterprise Oversight (OFHEO) announced that it would permit Fannie Mae and Freddie Mac to invest a portion of OFHEO's directed capital surplus in MBSs and mortgages. In February, the OFHEO increased the dollar cap on the mortgages that they are permitted to purchase. The capital surplus change will allow these two GSEs to increase their mortgage purchases by up to \$200 billion.⁵¹ The Federal Home Loan Banks, another GSE, will be permitted to invest up to \$100 million in this expansion.

As structured, this expansion will do little to address the problem at hand and may hinder the recovery of struggling but still viable mortgage lending institutions. No restrictions limit how the two GSEs can invest their newly expanded portfolio limits, and any debt that they issue will be viewed by the market as government guaranteed. These two advantages will position them to cherry pick among the new, conforming first mortgages for the estimated 5.5 million homes that will be bought, sold, and financed this year by qualified buyers.

As the evidence indicates, qualified buyers seeking conforming loans have no problem obtaining credit these days, so this change may be largely negative because the GSEs will be competing unfairly with private lenders/investors for whatever little business is available. This will further undermine private lenders' and investors' revenues and profits when both are under pressure.

In addition, while this initiative is unlikely to ameliorate any of the manifest problems confronting the mortgage market this year, it will reverse several

years of reform efforts to pare back the substantial influence that these two troubled GSEs exert on the financial markets. This proposal amounts to yet another significant and unnecessary federal intrusion into the nation's financial and housing markets.

FHA Expansion. The Federal Housing Administration has been intimately involved in the subprime process, first as a part of the recent trend toward providing mortgage credit to borrowers of limited means by offering them risky no- or very low-down-payment mortgages to help them buy homes⁵²—much as many subprime lenders were doing at the same time. A 2007 Government Accountability Office report on these new riskier loans stated:

In...examining FHA's actions to manage the new risks associated with the growing proportion of loans with down-payment assistance, we found that the agency did not implement sufficient standards and controls to manage the risks posed by these loans.... According to FHA, high claim and loss rates for loans of this type of down-payment assistance were major reasons for changing the estimated credit subsidy rate from negative to positive for fiscal year 2008.... [I]ncorporating the impact of such loans into the actuarial study of the Fund for fiscal year 2005 resulted in almost a \$2 billion (7 percent) decrease in the Fund's estimated economic value.⁵³

The growing riskiness of the FHA's mortgages can also be seen in its sharply increasing default rates, which exceeded the default rate on subprime

50. Damian Paletta, "Fed Admits Missteps on Banks," *The Wall Street Journal*, March 5, 2008, p. A11.

51. News release, "OFHEO, Fannie Mae and Freddie Mac Announce Initiative to Increase Mortgage Market Liquidity," U.S. Department of Housing and Urban Development, Office of Federal Housing Enterprise Oversight, March 19, 2008, and Damian Paletta and James R. Hagerty, "U.S. Puts Faith in Fannie and Freddie," *The Wall Street Journal*, March 20, 2008, p. A3.

52. See Ronald D. Utt, "American Dream Downpayment Act: Fiscally Irresponsible and Redundant to Existing Homeownership Programs," Heritage Foundation *WebMemo* No. 378, December 5, 2003, at www.heritage.org/Research/Budget/wm378.cfm, and "Congress's Risky Zero Down Payment Plan Will Undermine FHA's Soundness and Discourage Self-Reliance," Heritage Foundation *WebMemo* No. 529, July 7, 2004, at www.heritage.org/Research/Budget/wm529.cfm (April 11, 2008).

53. William B. Shear, Director, Financial Markets and Community Investment. U.S. Government Accountability Office, "Federal Housing Administration: Ability to Manage Risks and Program Changes Will Affect Financial Performance," testimony before the Subcommittee on Transportation, Housing, and Urban Development, and Related Agencies, Committee on Appropriations, U.S. Senate, GAO-07-615T, March 15, 2007, p. 6, at www.gao.gov/new.items/d07615t.pdf (April 11, 2008).

loans between 2003 and 2006 before subprime defaults surged ahead in 2007 to 18.82 percent, compared to 14.11 percent for FHA mortgages.⁵⁴ With the Administration's Hope Now plan extending FHA mortgage refinancing opportunities to existing subprime borrowers under certain conditions, FHA default rates will likely rise over the next several years.

More recently, Representative Barney Frank (D-MA) and Senator Christopher Dodd (D-CT) have proposed using the FHA to refinance certain existing subprime loans at lower principal amounts and interest rates and to compensate existing mortgagees with cash payments to relinquish any claims on the borrowers. The plan is expected to cost America's taxpayers \$20 billion to refinance up to \$300 million of subprime mortgages.⁵⁵ To the extent that these new riskier, refinanced borrowers incurred high default rates that threatened the FHA's reserve fund, the taxpayers could be on the hook for even higher outlays.

Tax Subsidies. In addition to the many finance-related legislative proposals, a few Members of Congress have proposed offering generous tax credits (\$5,000 to \$15,000) to buyers who purchase certain types of homes—including homes facing foreclosure and unsold, newly built homes completed before an earlier date—to aid some builders who are holding unwanted inventory. The problem with these targeted approaches is that they largely concentrate the benefits on the more irresponsible participants in the market at the expense of those who acted responsibly.

Few responsible homebuilders build homes on speculation. Instead, they build only in response to confirmed sales supported by substantial deposits. With the new home market having peaked in 2005, any business building on speculation in 2007 deserves no sympathy or support from the taxpayer. With new home sales now deeply depressed, this plan would undermine responsible builders' efforts to survive by giving their less responsible competitors a taxpayer-funded advantage.

This proposal could also become extremely costly, especially if it is expanded to all sales in an effort to address the counterproductive inequities inherent in some of the existing plans. With home sales running at an annual rate of about 5.5 million units, the lost tax revenue from such an expansion would amount to about \$27 billion per year.

Private Credit Relief Facilities. Both Members of Congress and independent analysts have proposed the creation of a new federally funded and operated credit facility that would acquire troubled mortgages from a lender/investor, presumably at a discount, and then rewrite the terms of the mortgage to allow mortgagors to meet the payments and keep their houses. Such a facility would be modeled on the Home Owners Loan Corporation that was created during the Great Depression to perform a similar role.

While eligible but troubled mortgagors would presumably be limited to those who engaged in no fraud, misrepresentation, refinancings, or silent seconds, federal bureaucracies have a decidedly checkered record in exercising good judgment when evaluating credit risks. FHA borrowers have very high default rates that exceed the default rate on subprime mortgages in some recent years. Furthermore, federally sponsored GSEs have recently engaged in major accounting fraud and have lost billions of dollars in mortgage investments, despite regulations that limit them to the safer sectors of the market.

A better bet would be for the Treasury Department and the Federal Reserve to encourage the creation of private entities that would perform the same function, albeit with no taxpayer money. One source of funding might be all of the mortgage lending and investing institutions that would benefit from selling some portion of their holdings to such a facility. In this regard, it is worth noting that in their early days, Fannie Mae, Freddie Mac, and the FHLBB were capitalized and "owned" by their clients.

54. Mortgage Bankers Association, National Delinquency Survey.

55. For more analysis of this legislation, see David C. John, "Frank-Dodd Approach Won't Fix the Mortgage Mess," Heritage Foundation *WebMemo* No. 1864, March 24, 2008, at www.heritage.org/Research/Economy/wm1865.cfm.

While some may contend that the potential risks are such that no private investors would be interested in such a proposal, former executives of a major mortgage lender have recently announced plans to raise \$2 billion to buy distressed mortgages at a discount, restructure them, and resell them as performing mortgages at a profit. Other financial firms are looking to enter the same market. For example, the Private National Mortgage Acceptance Company (PennyMac) was created for just this purpose.⁵⁶ Congress, the U.S. Treasury, and the Federal Reserve should look for ways to encourage the private sector to create many more such entities, including a review of relevant tax laws and regulations that may hinder their creation.

Limiting Aid to Restoring Property Rights and Affordable Housing. In some regions, home prices increasing much faster than personal incomes have been a chief cause of the overuse of risky forms of mortgage finance and the recent mortgage debt explosion, including the even faster growth in subprime mortgage debt. As a consequence, both prime and subprime borrowers have been forced to take on more debt than is sometimes prudent in order to become homeowners, while lenders have had to accept lower down payments to make the numbers work for the typical borrower.

Both the Administration and Congress have accommodated abusive land-use regulations that have caused this house price inflation. In many cases, the chief purpose of these regulatory abuses is to raise home prices as part of exclusionary zoning practices and to allow a community to “upgrade” its demographic profile by excluding lower-income residents.

Regrettably, by raising the loan caps on GSE lending and FHA mortgages, Congress and the Administration are accommodating and encouraging these land-use abuses, which will continue to make homeownership unaffordable for many

moderate-income families. An important first step would be to rescind the loan cap increases and make their restoration contingent on reform of a region’s land regulations.

Conclusion

Among the many risks confronting the United States is that many of the proposed relief measures would substantially and permanently expand the scope of the federal government while doing little to address the current financial crisis. Few will remember that, while the New Deal of the 1930s substantially and permanently increased the scope of the federal government, the process of federal expansion was well underway before Franklin Roosevelt took office in 1932.

Following the stock market collapse in October 1929, the Hoover Administration attempted to spend its way out of the Great Depression, increasing federal spending by 47 percent between 1929 and 1932. As a result, federal spending as a percentage of GDP increased from 3.4 percent in 1930 to 6.9 percent in 1932. By 1940, federal spending had reached 9.8 percent.⁵⁷ During that period, many of the federal programs now being buffed up for expanded action—Fannie Mae, the Home Owners’ Loan Corporation, the FHA, the FHLBB—were created for much the same purpose.

While this point of nostalgia has excited many advocates of an expanded federal government, ordinary citizens and taxpayers should note that, despite all of the new government spending and bureaucracy building, fewer Americans had jobs in 1940 than in 1929.⁵⁸ Furthermore, the homeownership rate of 43.6 percent in 1940 was the lowest recorded by the Census Bureau, even below the 47.6 percent rate of 1890.⁵⁹

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56. Diya Gullapalli, “Who Says You Can’t Go Home Again?” *The Wall Street Journal*, March 24, 2008, p. C1.

57. Office of Management and Budget, *Historical Tables, Budget of the United States Government, Fiscal Year 2009* (Washington, D.C.: U.S. Government Printing Office, 2008), pp. 21–23, Table 1.1, and pp. 24–25, Table 1.2, at www.whitehouse.gov/omb/budget/fy2009/pdf/hist.pdf (April 11, 2008).

58. Executive Office of the President, *Economic Report of the President*, p. 268, Table B-35.

59. Cox and Utt, “Smart Growth, Housing Costs, and Homeownership.”