The mortgage solution Government should tighten not the terms, but the banking regulations


The current crisis in the mortgage market should force the nation to reconsider many assumptions about home ownership, mortgage lending and securitization - the process of generating bonds from mortgages and other forms of debt. It is important, however, that any regulatory changes made in response to this crisis not dismantle the progress of the past two decades in making homeownership more available for low-income and minority households and communities.

The capital markets' sudden aversion to mortgage-backed securities has dried up a key source of funding for mortgage lending, driving a growing number of mortgage lenders into bankruptcy. As a result, the nation now faces a "credit crunch" - something that securitization was supposed to have relegated to history. Lawmakers are therefore likely to tighten the regulatory environment for mortgage lending, with the intention of preventing the current spate of bad mortgages from occurring again.

The mortgage market went overboard in providing credit to people who couldn't afford it. This was especially true in 2006, when lenders seemed to throw caution to the winds and issue mortgages that were clearly not sustainable. These included high-interest subprime mortgages that soaked up an unacceptably high percentage of income, adjustable-rate loans that were barely affordable at the initial below-market "teaser" interest rate (much less after they reset to market rates), and "no documentation" mortgages (aka "liar loans") that required no confirmation of income or assets.

The financial market's growing hunger for high-yield mortgage-backed securities meant that mortgage lenders could originate highly problematic, if not fraudulent or predatory, loans at little or no risk to themselves - since the loans would quickly be sold off and converted into mortgage-backed securities. Unfortunately, about 20 percent of all subprime loans issued in 2006 are currently delinquent or in foreclosure, a much larger percentage compared to subprime loans issued earlier. The relatively high interest rates of subprime loans were supposed to compensate for the higher risk of default, but apparently the risk was even higher than anticipated.

An underlying cause of the current crisis, in other words, is a cavalier, often irresponsible, attitude among mortgage lenders and investors toward risk. All too often lenders issued mortgages, and investors purchased them, with little if any attention to the ability of the borrower to afford the loan. In the worst cases, predatory lenders pushed vulnerable, often elderly households to take out loans far beyond their means to pay back. The inevitable result was widespread foreclosure.

This was not the first time irresponsible and sometimes fraudulent mortgage lending led to such results. In the late 1960s and early 1970s unscrupulous lenders provided low-cost federally
insured mortgages to minority and inner-city households to purchase what were often substandard and overpriced homes. Soon faced with major repairs they couldn't afford, thousands of these home buyers defaulted on their mortgages, leaving behind swaths of vacant property in working-class and minority neighborhoods - a pattern much like that of today.

Mortgage lending to low- and moderate-income families need not be so disastrous, and seldom is. The subprime fiasco must not overshadow the advances since the early 1990s in making homeownership affordable and accessible. Although subprime lenders no doubt originated mortgages to hundreds of thousands of families who could not afford them, many more households of modest means succeeded in becoming homeowners thanks to responsible innovations in the mortgage market.

These advances in homeownership have often been due to government innovation and intervention. When the Great Depression caused millions of families to lose their homes to foreclosure, Washington intervened. It refinanced millions of homes and created what has become the standard mortgage - long-term, self-amortizing and low-down-payment.

As a result of these changes, along with postwar prosperity, homeownership rose from less than 44 percent in 1940 to 62 percent by 1960, when it was often cheaper to own a home than to rent. These gains in homeownership, however, were not shared by all deserving Americans. Racial discrimination shut much of the minority population, especially African-Americans, out of the mortgage market. The practice of redlining similarly closed off many inner-city neighborhoods.

To address discrimination in mortgage lending, the government passed the Community Reinvestment Act in 1977, which required banks and savings institutions to serve all the areas from which they drew deposits. Lenders found to be in violation of the CRA risked having their applications for mergers, acquisitions and interstate expansion rejected.

Although it took more than a decade for the CRA to be enforced with any rigor, by the early 1990s lenders had negotiated hundreds of CRA agreements with community groups and local governments to improve their mortgage lending to low-income and minority families and communities. The nation's largest banks, perhaps to pre-empt a CRA-based challenge to their mergers and acquisitions, announced ever-larger community reinvestment commitments. These CRA agreements and commitments, totaling more than $1 trillion by 2005, made lenders reconsider their mortgage-lending criteria and provide mortgages to applicants that may have been rejected previously.

Then again, in 1992, Congress passed a law that required the nation's two dominant actors in the secondary mortgage market, Fannie Mae and Freddie Mac, to increase their purchases of mortgages involving low-income and minority households and communities. To achieve these goals, the two institutions relaxed some of their underwriting criteria, making more mortgages eligible for purchase in the secondary market.

Partly as a result of these changes, mortgage lending to minority and low-income households and communities has increased rapidly since the mid-1990s, rising faster than loans to white and
upper-income borrowers. Moreover, there is no evidence that the revised underwriting standards resulting from the CRA and the 1992 legislation caused mortgage foreclosures to rise.

In addressing the current problem, we must be careful not to overreact and throw the proverbial baby out with the bathwater. Mortgage terms, especially debt-to-income ratios, must not be tightened excessively. Renters long accustomed to paying 40 percent of their income on rent should not be automatically denied mortgages because their housing cost burden would exceed 30 percent - as was often the case until the 1990s.

It is probably more important to impose greater oversight of the mortgage banking industry, which is not regulated by the Community Reinvestment Act, and which has generated the majority of subprime mortgages.

One aspect of mortgage lending that deserves particular attention is the minimum allowable down payment. The practice of offering mortgages with extremely low, or no down payments became increasingly common in the past few years. While no-down payment loans address the chief barrier to homeownership among low-income households - insufficient savings - they put home buyers and communities in a vulnerable position.

With no down payment, monthly mortgage payments will be relatively high. Moreover, homeowners with no-down payment mortgages are especially vulnerable to downturns in the housing market; with even a slight decrease in property values, they will owe more than their home is worth. It will even be difficult to refinance at a lower rate if the value of their home has decreased. Finally, without a down payment, homeowners may feel that they have less at stake in their home and community and may be more inclined to walk away in the event of economic hardship than to try to work out a solution.

There may be times when zero-down-payment mortgages are viable, but they should not be taken lightly, and they should involve mandatory homeownership counseling. It may be wiser to help low-income families save for a down payment (through such means as personal development accounts) than to have them purchase a home with no money down.

Homeownership is not for everyone. Many low-income households lack the assets and income necessary to purchase and maintain a home; affordable rental housing continues to be a huge need. Nevertheless, the past 15 or so years have shown that many low-income households can become homeowners with the right type of financing and other forms of assistance. We must not let the mortgage market's excesses of the past couple years wipe out this achievement.

Reproduced with permission of the copyright owner. Further reproduction or distribution is prohibited without permission.