CHAPTER 14:

Simple, Sensible Reforms for Housing Finance

Arnold Kling, PhD

At the peak of the boom in 2006, over a third of all U.S. home purchase lending was made to people who already owned at least one house. In the four states with the most pronounced housing cycles, the investor share was nearly half—45 percent. Investor shares roughly doubled between 2000 and 2006. While some of these loans went to borrowers with "just" two homes, the increase in percentage terms is largest among those owning three or more properties. In 2006, Arizona, California, Florida, and Nevada investors owning three or more properties were responsible for nearly 20 percent of originations, almost triple their share in 2000.

—Andrew Haughwout et al., "'Flip this House': Investor Speculation and the Housing Bubble," Federal Reserve Bank of New York *Liberty Street Economics*, December 5, 2011

Speculation played an important role in the sharp housing cycle that contributed to the 2008 financial crisis. Investors drove up prices during the speculative frenzy that prevailed from 2004 to 2006. Because they do not occupy the homes that they purchase, investors are prone to default at higher rates than owner-occupants. Moreover, the attempt to alleviate the distress in housing markets by modifying mortgage terms was thwarted by the fact that loan modifications hold much less appeal for investors than for owner-occupants.

This chapter makes the case for simple, sensible reforms for housing finance. One obvious improvement would be to eliminate all government subsidies for mortgages to non-owner-occupants. It seems likely that this policy change alone could have greatly reduced the severity of the financial crisis or prevented it altogether.

Another reform would be to establish a national title database. Such a database would eliminate the expense of title search and prevent the sort of clerical errors that plagued the foreclosure process during the housing crash of 2007 to 2009. It could ultimately reduce the cost of home purchases.

Next, this chapter makes the case for eliminating government support for mortgages with low down payments as well as for refinancing loans that increase the mortgage debt of the

borrower. Such loans encourage households to take on debt rather than accumulate wealth, and they should not be subsidized or encouraged by any form of government support.

The last recommendation is to phase out the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), and the Federal Housing Administration (FHA) altogether. This could be done by gradually reducing the maximum loan amounts that those agencies can purchase or guarantee.

NO MORE GOVERNMENT SUBSIDIES FOR INVESTOR LOANS

Investors purchase houses that they will not occupy for many legitimate reasons. Some investors want to own rental property to earn income. Others purchase run-down properties in order to rehabilitate them and earn a profit from the improvement. Still other investors purchase properties in neighborhoods where they see potential for housing values to appreciate.

There is no reason for government to step in to stop investors from buying properties or from obtaining mortgages to do so. However, for government to *subsidize* mortgages for investors serves no useful public purpose. On the contrary, to the extent that a goal of public policy is to encourage families to own their dwellings and in particular to purchase their first home, mortgage subsidies for investors are counterproductive. Such subsidies make it easier for investors to outbid families who would occupy homes as owners, thereby increasing the share of properties that are rented, and reducing the share of houses that are occupied by owners.

Currently, government subsidizes investor loans in two ways. First, the government-supported housing agencies purchase and guarantee such loans. Second, such loans are given favorable treatment along with other mortgage loans in risk-based capital regulations for banks.

Fannie Mae, Freddie Mac, the FHA, and the Federal Home Loan Banks should be immediately forbidden from making purchases or guaranteeing investor loans. Any government subsidy for mortgages should at most be given to purchasers who intend to occupy their homes.

In addition, risk-based capital regulations should be modified to reflect the reality that investor loans default at higher rates than comparable mortgage loans to owner-occupants. The simplest approach would be to give investor loans a 100 percent risk weight for capital purposes.

Ideally, risk-based capital ratios would be eliminated altogether and replaced by a uniform capital requirement. Regulators are unable to out-smart banks when it comes to measuring risk.[1]

Finally, regulators must be cognizant of the problem of occupancy fraud.[2] That is, knowing that owner-occupants can obtain mortgages on more attractive terms, investors occasionally fill out mortgage applications where they misrepresent their intentions by claiming to plan to occupy the home. Government-backed institutions should have policies and procedures for deterring and detecting occupancy fraud.[3]

A NATIONAL DATABASE OF PROPERTY TITLE INFORMATION

In the United States, property title information is contained in antiquated and fragmented systems. This directly raises the cost of housing transactions by forcing buyers to obtain "title insurance," which is a waste of resources. It also makes the processes of selling mortgages in the secondary market and handling foreclosures more costly and subject to error.[4]

There is no reason for title insurance to exist. With any other purchase, whether of a durable good or a financial asset, once one pays for something and take possession, one owns it unquestionably. Only with real estate is the issue of ownership in such doubt that the buyer must pay for a title search and for "insurance" against the possibility that such a search has failed to uncover an existing lien on the property.

The need for title insurance can be eliminated by switching to a system whereby a new owner obtains definitive title at the time of purchase, as long as the property is purchased properly from the current owner of record. Some have suggested that new blockchain technologies might be helpful in this process.[5] If an imperfection in the previous owner's title is subsequently discovered, any claim by an earlier lien-holder could be paid through compensation from a general fund, perhaps created by the state.

A national database of definitive title information could make title search less costly. It also could facilitate the sale of mortgage loans in the secondary market and reduce the costs and errors involved in foreclosure processing.

There is no ideological barrier to these reforms, which would lower the cost of buying a home, support the policy objectives of promoting home ownership, and help first-time homebuyers. However, Congress would have to overcome intense opposition from the title industry and housing attorneys who earn revenue under the current inefficient system.

NO SUBSIDIES FOR ZERO PERCENT EQUITY

Investors were not the only home purchasers engaged in speculation during the housing boom. Many owner-occupants were buying their homes with little or no money down. In addition, home owners were extracting equity from their homes, using cash-out refinances to treat their houses like automated teller machines to obtain money for consumer purchases.[6]

One reason to encourage home ownership is to foster the accumulation of wealth by families that purchase homes. Low down-payment loans and cash-out refinances do not serve that purpose.

Fannie Mae, Freddie Mac, and the FHA should stop purchasing mortgages where the borrower takes on a larger mortgage than the loan being refinanced. The agencies may continue to purchase "rate-and-term" refinances, meaning new loans that are obtained in order to reduce the interest rate or the duration of the borrower's mortgage. The rule should be that the agency will only purchase refinances for amounts less than or equal to the size of the loan being refinanced.

There will always be borrowers who wish to refinance their mortgages by taking out larger loans. There is no need to outlaw such activity. However, no public policy purpose is served by government subsidizing these cash-out refinances. Such loans can be provided by the private sector.

With government subsidies no longer available, fewer home owners will find it attractive to extract equity from their homes. This change will encourage home owners to build equity and accumulate wealth instead.

Home purchases are more financially sound and less speculative when buyers make down payments of at least 10 percent. Until relatively recently, most home purchases were made with down payments of 20 percent or more. This practice helped to keep mortgage defaults low and to keep cyclical movements of house prices relatively mild.[7]

Loans with low down payments have not served anyone well, including the borrowers. The FHA in recent years became increasingly eager to finance nearly the entire purchase price for a home. Whereas in 1991, only about 5 percent of FHA-guaranteed mortgages had down payments of 3 percent or less, by 2003, such loans constituted a majority of its new business.[8] When the housing boom ended, FHA loans were defaulting at several times their historical average. Even in relatively benign housing environments, the FHA's default rates have been unacceptably high. Too many families are being set up to fail when they purchase homes with little or no money down.

Government-backed mortgages with low down payments turn home purchasing into highly leveraged speculation. An individual who speculates in the stock market by buying on margin is required to put down at least 50 percent of the value of securities purchased. By encouraging people to speculate in real estate with little or no money down, Congress

puts families at risk and makes the entire housing market fragile.

There is a better way to encourage families to build wealth and reach home ownership. Instead of subsidizing high-risk mortgages, government could provide programs that enable families to save for a down payment. For example, housing economist Joseph Gyourko has proposed a tax-favored household savings program with the government contributing matching funds for families that are in the process of accumulating a 10 percent down payment.[9] It is also likely that reforming the tax code so that savings are not taxed would encourage higher savings. Furthermore, eliminating all forms of government subsidies—including rental-market subsidies, such as Section 8 vouchers, which effectively set a price floor for rental units—would make housing more affordable in the first place.[10] In housing, as in other areas, government tends to subsidize demand while restricting supply. This combination of policies only serves to raise prices.

PHASE-OUTS FOR FANNIE, FREDDIE, AND THE FHA

There is a good case to be made for phasing out the government's role in housing finance altogether. The United States has better uses for capital than to direct it toward heavy mortgage indebtedness that largely serves to drive up house prices. Despite all the government programs and guarantees, the U.S. homeownership rate is still essentially the same as it was in the late 1960s, when Fannie Mae became a government-sponsored enterprise (GSE). Taxpayer funds have better uses than to contribute to the privatized profits and socialized risks that are embedded in the agency mortgage markets.

Currently, there are ceilings on the size of loans eligible for purchase or guarantee by the agencies. One simple approach for phasing out the agencies would be to reduce these loan limits by 20 percent of their current amount each year for five years. At that point, the remaining servicing portfolios of the agencies could be sold to private companies.

Critics of turning mortgage lending back to the private sector might be concerned with two potential adverse consequences. One possibility is an increase in risky adjustable-rate mortgages. Another possibility is that ethnic minorities could face less credit availability or higher mortgage interest rates.

If government support were phased out, there might be a decline in the market share of 30-year fixed-rate mortgages. Such loans are difficult to finance safely. If they are funded by short-term deposits, a rise in interest rates can cause steep losses for lenders, as happened during the collapse of the Savings and Loans in the 1970s and 1980s. On the other hand, the use of long-term bonds raises the cost of funding mortgage assets, and it leaves the financial intermediary subject to prepayment risk: If interest rates fall sharply, the mortgage loans may be refinanced, leaving the intermediary with the long-term debt obligation and no high-yielding earning asset. The intermediary can hedge this prepayment risk by purchasing bond options or other derivatives, but this simply transfers the risk to another financial institution. For this reason, policies should ensure that financial firms can create the types of loans they need to best mitigate their risks.[11]

Most other countries maintain very satisfactory rates of home ownership without the 30-year fixed-rate mortgage.[12] For example, Canada's housing market has performed very well on the basis of a five-year rollover mortgage. After five years, the borrower obtains a new mortgage at competitive rates. These loans provide a good balance between the risk borne by home owners and that borne by financial institutions.[13]

Of course, there is no certainty that the U.S. mortgage market would evolve toward the Canadian five-year rollover. Many riskier mortgages have been tried in recent years, including loans with negative amortization (meaning that the loan balance can increase over time) and loans with monthly adjustment periods. Should there start to be an increase in the share of these risky loans as the

agencies are phased out, a number of policy options are available. These include legislation or regulation that prohibits loans with risky rate-adjustment characteristics or that requires that lenders only offer such loans to borrowers with high income and net worth.

The other concern is that underserved markets could lose access to credit or find credit available only on adverse terms. Anti-discrimination laws offer some protection against this problem, but, ultimately, market competition is the best protection for consumers who meet standard underwriting guidelines to maintain access to credit. However, in the event that during the phase-out period regulators identify underserved markets in which competition for consumers' mortgage business is not robust, they might recommend maintaining a government agency to make competitive offers to borrowers who otherwise are not receiving access to loans even though they meet typical underwriting standards.

CONCLUSION

Housing finance was at the epicenter of the financial crisis of 2008. Simple, non-controversial reforms can prevent a repeat of that disaster. In particular, given the role that investor loans played in the housing boom and bust, and given that such loans do not promote the goal of home ownership, Congress should immediately remove all government subsidies for investor loans.

Another reform that need not stir up partisan controversy would be to establish a national title database and to remove the need for buyers to obtain title insurance. This would contribute to the efficiency of the housing market, make it easier and less expensive to buy a home, and eliminate the costs and errors that cropped up during the foreclosure process.

Yet another simple reform would be to make cash-out refinances ineligible for purchase by government housing agencies. This would help underline that the goal of public policy is to encourage home ownership as a means for wealth accumulation, not for equity extraction.

Mortgage loans with low down payments are more conducive to speculation than to wealth accumulation. Congress should replace government guarantees and purchases of such loans with a program that helps households save for down payments.

Finally, Fannie Mae, Freddie Mac, and the FHA should be phased out while monitoring the mortgage market. Monitoring should focus on making certain that, as the mortgage market evolves, there is no surge in the riskiest forms of adjustable-rate mortgages, and that ethnic minorities do not lose access to fair, competitive mortgage offers.

—**Arnold Kling, PhD,** is a Senior Affiliated Scholar and a member of the Financial Markets Working Group at the Mercatus Center at George Mason University, as well as an Adjunct Scholar at the Cato Institute. He has testified before Congress on the collapse of Fannie Mae and Freddie Mac and is the author of five books.

ENDNOTES

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11. Other reforms are necessary to ensure that financial firms are not forced to pass on higher costs to borrowers. For instance, U.S. foreclosure laws (which vary by state) favor the borrower more than in many other countries. Even in strict states, such as Nevada, the foreclosure process can take years to complete, giving homeowners the option of staying in the home without making mortgage payments. See Jennifer Robison, "Will Nevada Foreclosure Law Slow Housing Recovery?" *Las Vegas Review Journal*, September 16, 2013, http://www.reviewjournal.com/business/economy/will-new-nevada-foreclosure-law-slow-housing-recovery (accessed April 1, 2014).
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13. More broadly, laws in many other countries force borrowers to accept some of the interest-rate risk on long-term fixed-rate mortgages by allowing monthly payments to vary with interest rates for the initial portion of the loan term. Long-term fixed-rate loans without government backing exist in some Western countries, such as Denmark and Germany, but in these countries it is more common to have fixed interest rates over shorter periods of time (five to 10 years) with options to reset for the overall longer-maturity loans. See European Central Bank, "Housing Finance in the Euro Area," March 2009, pp. 26–27, https://www.ecb.europa.eu/pub/pdf/other/housingfinanceeuroarea0309en.pdf (accessed March 17, 2014). German mortgage-lending institutions generally use a mortgage-lending valuation framework that is countercyclical and very different from what U.S. institutions use. See Reiner Lux, "Valuation for Lending Purposes: Appraisal Theory and Practice in Germany and the United States," The Geneva Association, March 28, 2014.