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# **An International Perspective for Mortgage Market Reform**

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# The Extremely High Costs of Mortgage Borrower Default, Foreclosure, and Recourse

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- Borrowers, lenders, homeowners, and governments have all suffered from the mortgage defaults and foreclosures resulting from US subprime mortgages.
- European countries have historically avoided high rates of default and foreclosures through recourse.
  - Recourse, however, is currently creating separate costs in Spain and Ireland.
- I focus on reform measures to avoid future replays.

# Some Obvious Steps For Safer Mortgages

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- Fed Regulation Z (TILA) has long required disclosures concerning APR and payments.
- Dodd-Frank Act and new Consumer Finance Protection Bureau have expanded requirements:
  - QM sets mortgage Ability to Pay rules for safe-harbor.
  - QRM likely to provide similar MBS safe-harbor.
- My view is that Ability to Pay rules provide good balance between Type 1 and Type 2 errors.

# European-Style Recourse for Safer Mortgages

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- European recourse rules historically led to implicit suitability requirement on most mortgage loans.
  - Recourse was effective with easy access to deficiency judgment and limited bankruptcy.
- With current crash in Spain and Ireland, however, borrowers now face lifetime of garnished wages on negative equity mortgages.
- While I believe recourse option should be available on mortgage contract menus, it is not a panacea.

# Ex Post Loan Modifications are an Ineffective and Inefficient Tool

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- Contrary to “win-win” goal of loan modifications, in practice they are very costly to carry out:
  - HOLC experience of Great Depression bears this out: See Well Worth Saving (Fishback et al).
  - Today, banks have even less incentive.
  - Proof: HAMP subsidies got few takers.
- My proposal: design ex ante tools within mortgage.
  - Wide-spread adoption of long-term, fixed-rate, mortgage was major lasting effect of HOLC.

# Automatic (Ex Ante) Loan Modifications

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- The idea is to reduce loan balance and loan payments if and when house prices decline sharply.
  - Could readjust if/when house prices recover;
  - While lenders would charge for the cost of reduced mortgage payments, this eliminates the costs of foreclosure, so more modest net change;
  - Ambrose and Buttimer have formal model.
- Main technical issue is how best to measure the house price index.

# Option to Convert Mortgage to Rent

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- A major externality of mortgage foreclosures is the fire sale of the home, forcing the family to move, and leading to further neighborhood decay.
- An alternative is for the mortgage to include an option to rent that can be exercised by borrower:
  - Voluntary trial plans underway in U.S; Spain is currently designing a full plan.
  - Of course, the option has value, and the option writer (i.e. the bank) must be compensated.

# Fannie Mae and Freddie Mac (GSEs)

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- Consensus is that GSE public/private hybrid failed.
- European data shows no evidence of GSE benefits:
  - European countries have no GSE equivalent;
  - Yet lower housing start and price volatility;
  - Average homeownership > U.S.
- Role for government mortgage market intervention?
  - Yes for HUD/FHA aid to low-income borrowers;
  - Warner-Corker has feasible structure, but gov't insurance plans have generally poor track record.

# Portfolio Lending, Mortgage-Backed Securitization (MBS), and Covered Bonds (CBs)

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- MBS and CBs have the shared benefit of directly accessing the capital markets to fund mortgages.
  - European CB rules keep bank in first-loss position, thus creating strong incentive for safe mortgages.
  - U.S MBS (prior to Dodd-Frank 5% retention) allowed banks to transfer risk to 3<sup>rd</sup> party investors.
- Questions:
  - Does 5% rule/QRM provide useful middle ground?
  - What will it take for FDIC to allow CBs?

# Comparison of U.S. and European Mortgage Markets

Table 1: The Performance of Western European Mortgage Markets in Comparison with the US <sup>(1)</sup>

Statistical Measures Computed with annual data by country for the years 1998 to 2011

	(1)	(2)	(3)	(4)	(5)	(6)
	Rate of Owner Occupancy	Coefficient of Covariation	Standard Deviation of House Price	Mortgage Adjustable Rate Average Level	Mortgage Interest Rate Average Spread <sup>(3)</sup>	Mortgage To GDP Ratio 2011
	Latest Available	Housing Starts <sup>(2)</sup>	Inflation			
Western Europe						
Austria	57.4%	7.2%	2.4%	4.69%	1.79%	27.8%
Belgium	78.0%	14.5%	7.2%	5.47%	2.57%	47.2%
Denmark	53.5%	55.4%	8.9%	5.68%	2.54%	100.9%
Finland	74.1%	12.3%	3.5%	4.02%	1.09%	42.7%
France	57.8%	15.2%	6.1%	4.77%	1.80%	42.4%
Germany	43.2%	26.5%	1.6%	4.97%	2.05%	45.3%
Ireland	74.5%	99.2%	13.9%	4.25%	1.15%	83.5%
Italy	80.0%	25.7%	3.4%	4.65%	1.56%	22.9%
Luxembourg	68.1%	16.6%	4.5%	3.92%	1.05%	47.3%
Netherlands	55.5%	14.5%	6.6%	5.01%	2.06%	106.2%
Norway	85.0%	24.0%	4.8%	5.98%	1.44%	68.6%
Portugal	74.9%	40.5%	3.0%	4.42%	1.35%	66.6%
Spain	85.0%	101.7%	18.3%	4.11%	1.08%	62.1%
Sweden	65.5%	47.9%	3.4%	3.78%	0.91%	83.7%
United Kingdom	65.5%	25.0%	6.6%	5.01%	0.93%	83.7%
EU Average	67.9%	35.1%	6.3%	4.71%	1.56%	62.1%
US	66.1%	48.7%	7.2%	4.93%	2.26%	76.1%
US Rank	9th of 16	4th of 16	5th of 16	7th of 16	3rd of 16	6th of 16