An International Perspective for Mortgage Market Reform

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

- 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

- 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

- 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

- 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

- 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

- 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)

- 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)

- 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 3rd 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 (1)

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

<table>
<thead>
<tr>
<th></th>
<th>(1) Rate of Occupancy</th>
<th>(2) Coefficient of Housing Starts (2)</th>
<th>(3) Standard Deviation of Inflation</th>
<th>(4) Adjustable Rate of House Price</th>
<th>(5) Interest Rate of Average Level</th>
<th>(6) GDP Ratio of Average Spread (3)</th>
<th>2011</th>
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</thead>
<tbody>
<tr>
<td>Western Europe</td>
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<td>Finland</td>
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<td>Spain</td>
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<td>EU Average</td>
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<td>US</td>
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