Housing: The Root of it All

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Sometimes it seems as if the housing bubble – which was the trigger for the ongoing Long Depression, or as some call it, the Great Recession-- has been forgotten. And that is very unfortunate – both for the success of policies designed to restart the US economy and for building a politics that could change the US political economy to benefit the 99% rather than the 1%. This paper examines the political economy of housing as the roots of the Long Depression. I begin by summarizing the scope of the existing housing catastrophe and then provide an overview of the policies and practices that created the housing bubble and collapse. The final two sections describe the work of the Home Owners Loan Corporation in the 1930s/40s and, using this model, outline some possible policies to address the housing problem we face today.

A. The Political Economy of the US Housing Problem?[1]

US economic policy at the national and state levels has encouraged home ownership since at least the 1930s. Today, about two-thirds of US households live in owner-occupied dwelling units (OODUs).[2] At 67% of total households, the US home ownership rate ranks in the lower half among rich countries, although there are several countries with home ownership rates that are very similar. Singapore, Spain, Iceland, Belgium and Norway have home ownership rates at least 10% higher than in the US, while France, Germany, Austria, Denmark, Netherlands, and Switzerland have home ownership rates at least 10% below the US.[3]

Of course, to say that two-thirds of US households live in OODUs is not the same as saying that two-thirds of households actually own their own home. Most of these home "owners" have mortgages. As a result, the collapse of the housing bubble affects as many of us as does the persistent high levels of un- and under- employment (and, of course, the two are related).

The overall numbers are as follows. There are a little over 76 million OODUs in the US. (There are about 36 million rental units.) Roughly 1 in 3 OODUs (24 million) have no

[1] I have excluded renters from this discussion. It is true that renters are often harmed by foreclosures but renters as a group represent only 10% of total aggregate demand in the US economy, a focus of this analysis.
[2] US Census of Housing, 2010
[3] Sources for various countries include European Mortgage Federation, Eurostat, and Statistics Singapore.

mortgage; the owners have already paid in full for their home. That leaves 2 out of 3, over 50 million OODUs,with mortgages. Among that 2 in 3, there are a significant portion that have more than a single mortgage. There are 10 million households (1 in 5 of those with mortgages) that report 2 mortgages. There are another 5 million that have more than 2 mortgages and/or did not provide information. In addition, there are almost 10 million households reporting a home equity line of credit (HELOC). Of course, these are not mutually exclusive categories; many of the households reporting one or more mortgages may also have a HELOC. Both African-Americans and Hispanics have lower home ownership rates than the general population. However, among those that are home owners, African- American families in OODUs are about as likely to have mortgages as the overall population while Hispanic families are somewhat more likely to have mortgages.

Most US houses with outstanding mortgages have loans originated quite recently, reflecting the strong industry push for refinancing and home equity loans, including aggressive marketing to neighborhoods previously denied access to mortgage credit. Over 40% of all existing mortgages were written between 2004 and 2009, the peak bubble years, and another 28% were written between 2000 and 2004.[4]The relatively recent origin of most mortgages helps explain the extent of the boom in issuance of mortgage backed securities (MBS) and derivatives, such as collateralized debt obligations (CDOs), based on these issuances. In the peak years of the subprime and housing bubble frenzy, there were over $2.5 trillion/year in mortgage originations[5] that fed the demand of US and foreign investors for yield in instruments that were rated triple A but could provide returns above those of US bonds and notes.

How many households face negative equity? In January 2012 the Fed estimated that there were about 12 million households in this situation, or almost 1 in 4 of those with outstanding mortgages. The geographical pattern of negative equity reflected the geography of the housing bubble: in the "sand states" of Florida, Arizona and Nevada, almost half of all households with mortgages are underwater, and another sand state, California, has the largest absolute number of households with negative equity. For example, in 2008, these four states accounted for over 40% of foreclosures and California had just under half of that total.[6] Despite conventional media and political wisdom, the problem is not mainly attributable to subprime lending: almost half of the households with negative equity had prime mortgages (the common industry term is "conforming" mortgages). The recent sharp increase in delinquency rate for households with conforming mortgages is concentrated among in borrowers who were sold ARMs.[7]

There are two ways in which the collapse of the housing bubble has changed the financial situation for many and has an ongoing impact on aggregated demand in the economy. First, and

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[4]US Census, American Housing Survey 2010.
[5] Securities Industry and Financial Markets Association, http://www.sifma.org/research/statistics.aspx
[6] Mortgage Bankers Association data as reported to the FDIC.
[7] Data in this paragraph are taken from the Federal Reserve, op. cit.

most obviously, a large number of home owners find themselves paying down a loan that is larger than the asset on which the loan is based: the amount owed on their mortgages is more than the amount they could realize by selling their house. These are the home "owners" with negative equity, or what is commonly referred to as being "underwater." The variety of financial situations, and thus possible remedies, faced by these households are discussed in greater detail in the policy section below.
There is, however, a second, equally significant impact of the housing bubble collapse. For most households, their primary residence is their largest asset, usually accounting for more than half of their net worth. Between 2006and 2012, households lost over $7 trillion in net worth from the decline in housing prices.[8] Of course, the loss of wealth has not been evenly dispersed. The loss of net worth also varies by income level. For households in the middle income quintile, the average loss of housing value equaled two-thirds of annual income; for households in the top quintile, the figure was 36%. Between 2005 and 2009, median wealth for white households declined by 15.4% while the same period saw a decline of 52.9% for African-American households and 65.8% for Hispanic households.[9] The loss of wealth from the economic crisis also has a generational component. Overall household net worth declined 22.2% between 2004 and 2009 but households headed by individuals 25 – 34 lost 54.5% of their 2004 net worth.[10] Declining net worth directly affects a household's willingness to spend, acting to depress to aggregate demand in the economy as a whole. Underwater home "owners" are unlikely to provide much increase in aggregate demand for the economy as a whole.

How does the impact of declining house prices and thus household net worth impact the larger economy? On an annual basis, households spend an amount equal to about 5% of their home equity on consumer goods and services.[11] In addition, our perceptions of our wealth, its growth or decline, also impact willingness to spend. Thus, loss of net worth, especially when it occurs quickly and visibly – e.g., your neighbors had to sell their house for less than they paid for it – sharply reduces your willingness to spend and thus aggregate demand. The ratio of home equity to annual income has dropped to 55%, the lowest in the more than 60 years that this ratio has been reported.[12] Since consumption accounts for about 70% of US GDP, the impact of existing households reducing their consumption and the delay in the creation of new households ricochets across the entire economy: construction workers have fewer jobs, furniture stores sell less product, interior designers find less demand for their services, sales of building materials decline and appliance stores have reduced customer traffic. All of these items are associated with home ownership and cut backs in expenditures for them extend well

[8] Board of Governors of the Federal Reserve System, "The U.S. Housing Market: Current Conditions and Policy Considerations," January 2012.
[9] Calculated from Federal Reserve Board, Survey of Consumer Finances, 2007 and 2009.
[10] Calculated from "Rising Age Gap in Economic Well Being: The Old Prosper Relative to the Young," Pew Research Center, Nov 2011.
[11] See Glenn Hubbard and Chris Mayer, "First, Let's Stabilize Home Prices," Wall Street Journal, 10/2/08.
[12] Federal Reserve, op.cit.

beyond the households facing foreclosure. Thus, home owners not underwateralso have a stake in solving the problems of those who find themselves in financial difficulties because of mortgages that are too large and/or with too high interest rates. The decline in aggregate demand from the collapse of housing prices acts as a drag on all of the economy.

In addition, the overhang of real estate owned (REO) houses makes sales more difficult for those households not underwater, increasing the time to sell and reducing prices. REOs accounted for about one-quarter of the 2 million vacant houses for sale in 2011 and 1 million more per year are expected in 2012 and 2013 (and perhaps beyond).[13] Since REOs sell at a 25% or greater discount to house value, these sales pressure non-REO sellers who want to move to reduce their prices as well. Finally, there is also some – contested – evidence to suggest that underwater households are less geographically mobile. If that is the case, this would make job searches more difficult and act as another obstacle for policies to reduce the level of unemployment.

B. What Caused the Housing Bubble and Collapse?

Some [people] will rob you with a six-gun, And some with a fountain pen…[but] you won't never see an outlaw drive a family from their home.

- Woody Guthrie, "Ballad of Pretty Boy Floyd"

It is easy to forget, in the midst of all the policy debates about economic recovery or its absence, how we got into this mess in the first place. However, it is essential to understand the driving forces behind the housing bubble and bust for two reasons. First, we obviously want to avoid repeating this episode – a not unreasonable concern, since real estate has often been at the center of financial crises. Second, an analysis of causes is also useful in addressing the core of the policy problem: who should bear what portion of the costs (losses) involved in restoring people to their homes and restarting the housing market?

The best place to begin is by comparing the process of buying a house in the 2000s with that same process 20 or 30 years earlier. For the latter, I'll use the experience of my wife and myself. We bought our house in 1980. To obtain a mortgage we had to go through several steps. First, we had to make a significant down payment – in our case, 20% of the purchase price. Second, we had to submit pay stubs verifying our salaries. In addition, we had to submit letters from our employers verifying our employment and salary. Finally, we had to state, in writing, that none of the down payment was from borrowed funds. And, of course, this was a fixed rate, 30-year mortgage. While there are a few points in this process that could perhaps be fudged, overall the lender was getting a very accurate picture of our financial situation and resources. Why? Because the mortgage lender expected to hold the loan in their portfolio for

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[13] Federal Reserve, op. cit.

a significant period of time, perhaps even until we paid it off, either by selling the house or by accumulating enough in savings to pay back the loan. If we got into financial trouble and could not make the necessary payments, the lender was going to suffer as well. This model, important components of which originated out of the Great Depression, in part as a result of the Banking Act of 1933, more widely known as the Glass-Steagall Act, was called "originate and hold."

The functional division of labor in the finance sector that was at the core of Glass-Steagall was repealed by Gramm-Leach-Bliley (GLB, officially called the Financial Services Modernization Act) in 1999. GLBopened the door to a very different model of mortgage lending, "originate to distribute." From the perspective of the mortgage lender, the essential differences between the two models are (i) the shifting of the long term risk of holding the mortgage in a loan portfolio from the lender to other parties and (ii) the resulting diminution of lender concerns, at both the individual and institutional level, about the long term financial prospects of borrowers. These differences were exploited by the new shadow banking players that flocked into mortgage lending, fundamentally changing the way in which the industry operated.

The shadow banking sector includes mortgage brokers; investment banks that could, after the repeal of Glass-Steagall, also engage in commercial bank style lending; hedge funds; money market funds and SIVs. These entities have – and to a significant extent still have --in common the fact that, although like commercial banks they create credit, they are not subject to the regulatory constraints on commercial banks. In part as a result, the shadow banking sector had very different incentives in their mortgage lending. Mortgage brokers were particularly aggressive, increasing their market share of mortgage lending to 65% by 2006 – 07. Traditional commercial bank lenders lost market share and two government agencies, the Federal Housing Authority and the Veterans Authority, also found their services less in demand.

The new entrants used an already existing financial technology, securitization, to drive increased lending volume and to take market share away from established lenders. When mortgage loans were securitized into mortgage backed securities (MBS), they could then be sold directly to investors or, as was frequently the case, held as backing for collateralized debt obligations (CDOs). CDOs were usually divided into tranches (slices or portions) by risk level: "senior," "mezzanine", and "junior" with each tranche having a different rating provided by rating agencies Moody's, S&P or Fitch.

Selling off the mortgages was the key to changing the incentives in the mortgage lending business. Under the "originate to hold" model, the core question for the lender was "if I make this loan, what are the risks that I won't get paid back?" Under the "originate and distribute" model, the "definition of a good loan changed from 'one that pays' to one that could be sold."[14]

[14] Patricia Lindsay, former New Century fraud specialist, testimony before the Financial Crisis Inquiry Commission, quoted in *The Financial Crisis Inquiry Report*, p. 105, NY, NY, 2011 (hereafter cited as FCIC).

Long term risk was replaced with pipeline risk: the risk that the borrower would default in the 30 to 60 days required to securitize and distribute the MBS.[15]The incentive for lenders was to make as many loans as quickly as possible. And this institutional incentive structure was embedded in the compensation scheme for individual brokers who were usually paid, at least in part, on the basis of their loan volume. Thus brokers cold called homeowners to solicit refinancing and/or home equity loans (HELOC) business. Further, the compensation incentives were also skewed towards higher interest rate loans. Of course, these loans were the only ones offered borrowers with poor credit history. But the incentive structure was so strong that most borrowers steered into subprime loans actually qualified for conforming loans.[16]

The average profit to the mortgage brokerage as well as the payout to the individual broker on subprime loans was above that for prime mortgages. For example, at the institutional level, the profit margin for Countrywide Financial, for several years one of the largest subprime mortgage lender, on subprime loans was 3.64% vs. 0.93% on conforming loans.[17] For individual employees there were also strong incentives to push subprime and other non-conforming loans. The average payout to the individual mortgage broker on a subprime loan was 1.88% vs. 1.48% on conforming loans.[18] In 2006, when the average mortgage loan was $241,000, the payout difference amounted to almost $900. The CEO of Guardian S&L, one of the largest subprime lenders said it well:"If they have a house, if the owner has a pulse, we'll give them a loan."[19] Thus lenders drove down the lending standards – and why not? To quote a saying common in the industry, "I'll be gone, you'll be gone" (IBG/YBG), referring to what might happen in the future when the bubble collapsed – and, of course, there was always the "Greenspan put" if things got completely out of hand.[20]

However, lending standards were not just driven down – there was also wide spread and systematic fraud. At Ameriquest, for a while the largest subprime lender (and the sponsor of the famous "wardrobe malfunction" Super Bowl ad), individual loan officers had their specialties: some were best at doctoring W-2 forms, others at forging signatures, still others at pressuring appraisers to create value sufficient to support the proposed loan value. First Alliance Mortgage Company, another large mortgage broker, bugged the rooms where

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[15] For mortgage brokers the pipeline could be even shorter as the demand from Wall St. securitizers increased during the peak bubble years.

[16] In 2007 the Wall Street Journal commissioned an analysis of more than $2.5 trillion in subprime loans made since 2000 and found that over half – by 2006 it was over 60% - of borrowers had credit history that likely would have qualified them for conforming loans. Wall Street Journal 12/3/2007.

[17] Gretchen Morgenson, "Inside the Countrywide Lending Spree," NYT 8/26/07

[18] See Wall Street Journal, op cit.

[19]Russ Jedniak, CEO, Guardian S&L, quoted in Michael Hudson, *The Monster: How a Gang of Predatory Lenders and Wall Street Bankers Fleeced America and Caused a Global Crisis*, (Times Books, 2010) p. 30.

[20] Charles Morris (*The Trillion Dollar Meltdown*, Public Affairs, 2008) and Mark Zandi (*Financial Shock*, Pearson Education Inc, 2009) both make reference to this way of thinking among players in the mortgage lending business, e.g. Morris, p. 65, Zandi pp. 73-75; Zandi: the "Greenspan 'put' was the implied promise that if things ever went badly awry for Wall Street, the Fed would step in and cut rates enough to cushion the fall."

potential borrowers were given the chance, allegedly in private, to discuss the terms offered and Washington Muual (WAMU) routinely accepted loans lacking documentation. "Stated income" loans (as opposed to documented income loans) accounted for more than half of all subprime mortgages.[21]Subprime lenders encouraged borrowers to avoid the expense of mortgage insurance by taking out two mortgages, each small enough itself to be under the insurance radar.[22]All of these lending practices – and the many more – that characterized the finance driven housing bubble are remarkable, but my personal favorite is NINJA loans: no, job, no income, no assets (but presumably a pulse).[23]

Subprime mortgages rapidly gained market share, increasing from 1 of every 10 new loans in 2000 to 1 of every 4 by 2006. At the same time, private subprime lenders – the Ameriquests, Countrywides, WAMUs, New Centurys, Long Beach Mortgages and others -- displaced the established FHA (Federal Housing Administration) and VA (Veterans' Administration) and private securitizers displaced Fannie and Freddie (see below for more on this issue). The profits were too high to let the entities restrained by government regulations (with respect to levels of down payment and/or the requirement of stronger evidence of ability to repay) remain the largest players. And these new mortgage loan originators were, in turn, increasingly closely linked to the big Wall Street securitizers. Lehman Brothers bought six originators between 1998 and 2002, and it was vertically integrated with the largest, Countrywide. Bear Stearns bought three similar firms; Merrill Lynch bought First Franklin; Morgan Stanley bought Saxon Capital;and Goldman Sachs took equity stakes in Senderra, a subprime lender. In addition, firms such as Citi and Washington Mutual spent large amounts on creating and/or expanding their subprime lending units.[24] Thus it is not surprising that, by 2000, private mortgage credit was greater than that originated by government lenders and that, by the peak of the bubble, private mortgage credit accounted for almost two-thirds of total US mortgage debt. Freddie and Fannie were further constrained by the Bush Administration regulations that prevented them from purchasing subprime, Alt-A or jumbo loans because of a belief in the superior ability of the private market to better meet Bush's 2002 challenge to lenders:

> The President believes that homeownership is the cornerstone of America's vibrant communities and benefits individual families by building stability and long-term financial security. . . . The President also announced the goal of increasing the number of minority homeowners by at least 5.5 million families before the end of the decade.[25]

They took him seriously.

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[21]Zandi, p. 40.
[22]Zandi, p. 29.
[23] There are many accounts of the widespread fraud and predatory lending that occurred. One of the best is Michael Hudson's *The Monster, op. cit.*
[24] See FCIC, pp. 88 – 89.
[25]http://georgewbush-whitehouse.archives.gov/news/releases/2004/08/20040809-9.html

As the bubble grew, Bush later wanted both Fannie and Freddie to increase their funding of mortgage loans to lower income households, who were going to be the beneficiaries of the "ownership society." Both complied. Thus both later bought substantial AAA tranches of subprime and Alt-A securities.

And where did these AAA ratings come from? Ratings agencies – primarily Moody's, S&P and Fitch. Their business models embedded a significant conflict of interest: they were paid by the issuer seeking the rating. Staff at the rating agencies was very aware that the issuers could go elsewhere if they were dissatisfied with the rating at one of the three firms – and the rating agency did not get paid for deals they did not rate.[26] Moody's experience was typical. Their structured finance division increased revenue from rating MBS issuances more than four-fold between 2000 and 2007. By the latter year, structured finance contributed 50% of total revenue. How was this growth possible? Largely by ignoring the pre-housing bubble due diligence procedures. Moody's had previously taken 6 – 8 weeks to rate a CDO. In 2006, they gave AAA ratings to an average of more than 30 MBS on a daily basis.[27] Perhaps most telling, Moody's did not even develop a model for assessing the tiers of risk in subprime loans until 2006, at which point they had already rated more than 19,000 such securities.[28]

C. A Digression: Did the Poor Cause the Housing Bubble and Meltdown?

There has been an interesting evolution of explanations for the housing crisis advanced by defenders of the US financial sector, but the underlying claim has been the same: the poor – or concern for the poor – were the cause of the housing bubble and collapse. Although this assertion probably seems ludicrous on the face of it, at least to most rational people, it is worth rebutting these arguments.[29] The first point to emphasize is the difficulty this argument for assessing blame poses to conservatives – or at least would pose if conservatives in the US were not consistent sufferers from historical amnesia. After all, the private securitization market was the creation of the(sainted) Reagan administration. The key legislative action was the Secondary Mortgage Market Enhancement Act of 1984 (SMMEA) in which Congress preempted a variety of state laws that inhibited private home mortgage securitization.[30]

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[26] *FCIC*, see especially chapter 10, "The Madness." NY,NY 2011.
[27] FCIC, op. cit., pp. 210 – 211.
[28] FCIC, op. cit. p. 118.
[29] The basic outline of these arguments in their most recent form are laid out in Peter J. Wallison's "Dissenting View" in FCIC Report, pp 441 – 450. He in turn relies heavily on the work of Edward Pinto of the American Enterprise Institute. For detailed critiques of Pinto's conclusions, see David Min, "Faulty Conclusions Based on Shoddy Foundations," Center for American Progress, 2-2011. See especially the appendix tables.
[30] – Mike Konzal, Roosevelt Institute New Deal 2.0. http://www.newdeal20.org/2011/01/31/fcic-report-ownership-society-as-bridge-to-a-permanent-republican-majority-34363/

But the problem for conservatives goes much deeper. George Bush II had a vision, a vision of minority, especially Hispanic minority, homeowners. He called this vision "the Ownership Society." Bush argued that ownership of assets – and housing, as noted above, is the largest single asset for most households --would change political affiliations. Bush's *eminence grise*, Grover Norquist, put it well:

> Bush's vision also calls for efforts to increase homeownership. Here's a hint of what that could mean: in House Speaker Dennis Haster's[sic] Congressional district in Illinois, 75-80 percent of voters own their own homes. In Democratic minority leader Nancy Pelosi's district in San Francisco, the number is 35 percent. . . . A transition of great political importance is under way. Fifty years from now the move to an Ownership Society will be recognized as a change to America's political landscape as dramatic as the move from farms to factories.

So, conservatives wanted more low income/minorities (probably the same people in conservative thinking) to own houses. Or at least to be house buyers. And, of course, especially Hispanics, because Norquist and other right wing strategists are not clueless about the demographic changes occurring in the US. There was, however, a problem: the constraints on Fannie May and Freddie Mac's ability to fund loans to low income households meant that Bush's announced goal of increasing home ownership among minorities by 5.5 million households in less than 8 years was a very difficult task. Never mind, the answer was clear: remove the constraints on private lenders and have Fannie and Freddie get out of the way. The private sector lenders would step into the breach, and they could use the securitization powers granted under SMMEA.

Of course, after the collapse of the housing bubble, the story changed. Conservatives first argued that the Community Reinvestment Act (CRA) "forced" lenders to grant mortgages to house buyers who have no chance of making the payments and that these loans were made against the will of financially knowledgeable lenders. CRA, in short, drove the rise of subprime loans from the 8% of total mortgage market in 2000 to over 20% by 2005.

There are at least two major problems with this analysis. The first is obvious: how could legislation passed in the 1970s cause a housing price bubble more than two decades later? But the problem for this "causal" analysis runs considerably deeper. As a Fed study reported in 2003, the CRA had been effectively weakened by the very same piece of legislation that opened up mortgage lending to the new shadow banking entrants.[31] Most importantly, a majority of

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[31] Apgar, William C.; Mark Duda (June 2003). "The Twenty-Fifth Anniversary of the Community Reinvestment Act: Past Accomplishments and Future Regulatory Challenges" (PDF). *FRBNY Economic Policy Review* (Federal Reserve Bank of New York) (June 2003).

subprime lending was undertaken by entities not subject to CRA requirements: over 60% of subprime loans were made by non-CRA subject entities.[32]

Retreating from this argument,[33] defenders of "free market" finance have seized upon the government as the cause of the housing bubble and collapse, specifically government's efforts to increase access to mortgage lending for low income households. In order to avoid the obvious links to Bush's "Ownership Society" proposal, the emphasis has shifted to blaming Fannie May and Freddie Mac, particularly their efforts to increase funds available for mortgages.

In rebuttal, it is worth noting that Fannie May had been made a private company in 1968 and that Freddie was established as a private company in 1970. It is true that both entities faced more regulatory oversight than most other entities involved in mortgage lending. And both entities were assumed – although this was never stated in any legislative measure – to carry a federal guarantee of their debt. However, in most respects, Fannie and Freddie behaved as other private financial institutions, seeking to maximize profits and lavishly rewarding their top executives.

So, what does the actual record show with respect to how what are now referred to as "government sponsored enterprises" (GSEs) performed in the housing bubble and collapse? The first question that might be usefully asked is "did the GSEs in fact lead the growth of subprime and Alt-A securitization?" And here the answer, as evidenced in Table1, is a clear: no, they in fact lost market share to private label securitizers. Private label lenders share of total

TABLE 1
Single Family Mortgages Originated 2002 – 2008 and Sold into Secondary Market: Distribution by Source and Payment Type ($ in Billions)[34]
(PLS = private label securitized; ARMs = Adjustable Rate Mortgages)

	2002	2003	2004	2005	2006	2007	2008
PLS Share of Total Issuances	7.3%	9.2%	31.6%	36.5%	33.5%	16.0%	5.2%
PLS - % of ARMs Issuances	39.5%	43.5%	63.2%	71.0%	67.0%	13.6%	6.2%
ARMs - % of Total Issuances	13.9%	16.4%	39.2%	40.8%	33.9%	13.6%	6.2%

[32] Zandi, op. cit
[33] Pinto has not completely abandoned this position.
[34] The data is calculated from "The Risk Characteristics and Performance of Single-Family Mortgages Originated from 2001 through 2008 and Financed in the Secondary Market", Federal Housing Finance Agency, Figure 1, p. 6 (September 13, 2010).

securitization increased five-fold between 2002 and 2005 (line one of the table). More importantly, private label securitizers share of issuances based on adjustable rate mortgages (ARM) almost doubled during the same time period (line two of the table), resulting a tripling of the share of issuances that were based on ARMs (line three of the table).

These changes in market share were the result of two factors. First, the private label securitizers were not limited in the loans they could purchase and securitize but the GSEs were. Thus the private label securitizers grabbed market share, particularly in the higher yield, higher risk segment of the market. Second, the GSEs were pressured by the Bush Administration to restrict their role, again because of the belief in the superior ability of private sector to achieve the goals of the "Ownership Society." The result was a loss of market share by the GSEs, as their share of mortgages bought for securitization declined from over 90% to less than 65% during the 2002 – 2005 period.[35] This was particularly the case for adjustable rate mortgages (ARMS) that, as demonstrated in Table 1, were primarily the creation of, and certainly the marketing push, by private label originators/securitizers.

The second question that should be asked of any analysis that places the GSEs at the center of the bubble and collapse is "how have their securitized issuances performed compared to those of private label issuers?" After all, if the GSEs were the lead risk takers, snapping up high risk mortgages, securitizing them and dispersing the risk to the rest of the world, we would expect their issuances to show particularly high default rates. In fact, as the data in Table 2 below demonstrate, just the opposite has been the case: GSE-issued MBS have defaulted at a much lower rate than have private label issuances. This has been consistently true, both in the early years of relatively low default rates and at the peak when many issuances were experiencing defaults within 60 days of sale.

TABLE 2

Percent of Single Family Mortgages Originated 2002 – 2008 Ever 90 –Days Delinquent[36]

	2002	2003	2004	2005	2006	2007	2008
GSE Acquired	2.2%	2.5%	4.4%	7.8%	13.2%	14.9%	4.2%
Private	15.1%	11.8%	15.1%	28.6%	45.1%	42.2%	14.5%

[35] All commentators on the roles of GSEs (with the exception of Pinto) note the GSEs loss of market share. The restrictions on their ability to purchase and securitize high yield, Alt-A and jumbo mortgages (which are part of many issuances in default) were strengthened by the Bush Administration as a part of increasing the role of private sector in the mortgage market. See Zandi, Hudson and FCIC for more detail.

[36] The rate of MBS issuance dropped sharply after 2008. Jeff Madrick and Frank Partnoy make this point forcefully, "Did Fannie and Freddie Cause the Disaster?" *New York Review of Books*, Oct 27, 2011. The data is taken from Federal Housing Finance Authority, op. cit. Table 3C, p. 27.

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D. Lessons from the Past: The New Deal and the Home Owners Loan Corporation

> "[Interest only] Mortgage contracts called for no reduction of principal. . . . Mortgage debt was entered into by individuals with confidence that . . .over long periods the borrower's equity would grow [while] renewal [of mortgage loans] was generally taken as a matter of course by both borrower and lender. . . . Mortgage loans were made by financial agencies with satisfaction over the quality of the investment. . . . Second mortgages and other junior obligations were commonly used in home financing. . . . " But suddenly "the ability of individual borrowers to meet mortgage payments was reduced by large scale unemployment. . . . Insolvent and illiquid institutions were compelled to dispose of real estate under the most unfavorable conditions . . . depress[ing] prices and, further undermine[ing] the security of other mortgage investments. . . . In this context mortgagors were frequently unwilling to continue debt payments and lenders . . . were unable, hesitant or altogether unwilling…to make new loans."[37]

This could have been a retrospective on the financial panic of 2007 – 08. However, it is actually a description of home mortgage lending in the 1920s – and its Great Depression aftermath.

It is striking that, while there has been much written about, and controversy over, the job creation lessons we could learn from the 1930s, there is significantly less written about the New Deal response to widespread mortgage default and foreclosure. Yet the New Deal response, primarily in the form of the Home Owners Loan Corporation (HOLC), has much to teach us.

The US home ownership rate in 1930 was 47.8%, considerably lower than today. However, reflecting the economic growth of the 1920s and the interest of lenders to increase loan activity, this was an increase from the 45.6% rate reported in 1920 and the highest recorded until the 1950 housing census.[38]About 4.8 million of the 10.5 million, non-farm, OODU 1 – 4 family dwellings were mortgaged in 1930. As the economy collapsed in the early 1930s, the pressure to do something to stop foreclosures and keep families in their homes grew rapidly. On April 13, 1933, less than a month after taking office, FDR asked Congress for legislation that would:

(i) protect home owners from foreclosure;

[37] These descriptions are taken from a now out of print NBER paper on the Home Owners Loan Corporation, published in 1951. This is the most extensive analysis of the background and workings of the HOLC that I have been able to discover. It can be found at http://www.nber.org/books/harr51-1. A short summary of HOLC is also found in a paper by Paul Davidson, Jan. 2008: http//mpra.ub.uni-muenchen.de/7427/.

[38] See US Housing Census, relevant years.

(ii) relieve part of the burden of high interest and principal payments;
(iii) declare home ownership a national policy, and
(iv) avoid injustice to the mortgage investor while limiting the debt burden on the federal treasury.

The Home Owners Loan Corporation was the result.[39]

How did the HOLC function? The following section describes the operation of HOLC in some detail. It may be useful, however, to briefly outline main points here. HOLC could issue debt that was backed by the federal government. That debt was swapped for mortgages held by lenders and in turn HOLC became the holder of refinanced mortgages, at lower rates and, usually, reduced principal, for longer terms, on over 20% of the 4.9 million eligible OODUs that existed at the time. By the time HOLC closed its books in 1951, the agency turned a small profit for taxpayers, largely because the cost to borrow for the federal government was quite low.

The HOLC was, in essence, a large refinance capability. The Agency was granted the power to issue tax exempt bonds that were to be exchanged for mortgages held by lenders. The initial legislation, The Home Owners Loan Act passed in May 1933, had a federal government guarantee only of the interest on the bonds but, by January 1934, FDR and Congress added guarantee of the principal. Initially, HOLC bonds paid 4% and had terms as long as 18 years, but were callable.[40] Most mortgages in the 1920s were for a much shorter term.

To administer the Act, HOLC created its own appraisal capability, training and supervising appraisers. This action was essential because HOLC was limited to offering bonds for mortgages on OODUs that represented no more than an 80% loan-to-value (LTV) as appraised by HOLC. HOLC's appraisals did not simply reflect the depressed housing prices of the times. Instead, HOLC appraisals were based on (i) an estimate of the current market price, (ii) the cost of a similar dwelling plus the cost of reproducing the building, and (iii) an estimate of the trailing ten-year capitalization of monthly rents. The resulting values were generally higher than prevailing market prices but likely below the last sale prices, and thus the value underlying the outstanding mortgages for many of the OODUs eligible for HOLC refinancing.[41]

The universe of OODUs eligible for HOLC refinancing were (i) 1 – 4 family owner-occupied non-farm dwellings; (there was as separate New Deal facility to handle farm dwellings),(ii) with an outstanding mortgage, (iii) that was delinquent (including in foreclosure – see below) and/or the lending institution was in "financial distress," and finally (iv) on an OODU that was

[39] This discussion draws heavily upon the NBER paper cited above.
[40] FDR had initially opposed a federal guarantee on the principal, likely out of the same concern he had for insuring bank deposits.
[41] See NBER, op. cit., p. 2.

appraised by HOLC for $20,000 or less. In addition, the par amount of the HOLC bonds offered to the lender or mortgage holder could not exceed the lesser of $14,000 or 80% of HOLC appraised value. While these figures may sound low by today's standards, a house appraised at $20,000 in 1935 would be about a $330,000 house today.[42] HOLC was not restricted to newly foreclosed OODUs but could reach back to January 1, 1930, in order to get OODUs out of foreclosure. Interest on HOLC loans to borrowers who became mortgagors of HOLC could not exceed 5%.

The big question that faced HOLC was, would private lenders accept the bonds? The 4% interest rate on HOLC bonds was lower than that for the standard mortgage, the latter usually around 6%, but the bonds were tax exempt and, after January 1934, federally guaranteed for both principal and interest. In addition, and these are important lessons for today, taking the bonds and surrendering the mortgage to HOLC meant an end to costly efforts to collect from borrowers, many of whom, as is the case today, had no realistic prospects of staying current in their payments unless the labor market improved substantially. Further, with housing prices significantly depressed from 1920s levels, a lender who foreclosed was not assured of doing any better – and might do much worse – than take the bonds based on HOLC appraisals. For all of these reasons, HOLC was quite successful in getting lenders to surrender mortgages.[43] In addition, the Roosevelt Administration worked to insure an aftermarket in the bonds by getting them listed on the New York Real Estate Securities Exchange.

The response to HOLC was overwhelming. HOLC received almost 1.9 million applications, about 40% of the total 1 – 4 OODUs existing in 1930. Many applications had to be rejected because they did not meet the criteria established in the legislation creating the agency. There were some from farms, others from applicants with too high LTV and some from OODUs with appraised value above what HOLC could accept. A large number of applications were also withdrawn because the borrower and lender were subsequently able to come to terms. As the authors of the NBER paper note, HOLC's operating procedures were to encourage borrower and lender to negotiate first. In this respect, the very existence of HOLC assisted many borrowers even if their loans remained in the hand of private lenders. In total HOLC took over mortgages on more than 1 million properties, 21% of eligible mortgaged properties, and 1 in every 10 non-farm OODUs. HOLC's loans averaged about $54,000 in 2011 dollars. Nationally the average LTV was 68.6%.[44]

HOLC also had to deal with the problem of second (or junior) loans that, as is the case today, were often part of a borrower's debt. HOLC was creative in dealing with this problem. If the

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[42] In 2007, the peak of the bubble, the median price for a new house was $247,900 and the average price was $313,600. (US Census 2010)

[43] HOLC also had the power to offer cash loans when lenders would not take the bonds – but only for up to 40% of appraised value.

[44] See tables in chapter 2, "Original Lending Activities" NBER op. cit. for these details.

80% LTV limit was insufficient to purchase the primary mortgage plus the second mortgage, HOLC encouraged the use of a new secondary lien but with stringent limits on the ability of the junior debt holder to force payment or foreclosure. Despite these and other attempts to make HOLC's refinancing extent as wide as possible, there did remain lenders who refused to cooperate, often ending up foreclosing rather than taking HOLC's appraisal and bonds.

HOLC was not successful in saving the homes of all of their new mortgagees. Although the agency worked diligently to keep home buyers in their homes, HOLC ended up foreclosing or receiving voluntary deed transfer on, and thus owning, about 200,000 OODUs, or almost 4.5% of the 4.5 million total mortgaged OODUs. HOLC foreclosures were not geographically random – the housing and lending boom of the 1920s made some areas more vulnerable than others. In New York and Massachusetts, over 40% of HOLC loans were foreclosed compared to only 11% in the Mountain and Pacific Coast states. Higher foreclosure rates were found among the more expensive OODUs, among the young and the elderly, higher LTV rates – and those with higher negative equity. Some things don't change.

HOLC spent money reconditioning the acquired dwellings and sought to rent them until a sale was possible. As is the case today, this approach was much superior to letting the dwellings stand vacant. HOLC did not seek to sell the acquired properties at the prevailing depressed prices but did offer buyers financing at rates superior to those offered in the private lending market. In the end, HOLC realized 93% of the original loan amount on houses acquired through foreclosure and later sold.[45]

HOLC closed its books and went out of business in 1951; the few remaining balances were sold off to private investors. A small profit accrued to taxpayers, something most people - supporters or opponents - would not have predicted in 1933. Key to this result was the very low rate at which the US government could borrow. HOLC's average cost of funds was 2.24%, and its yield spread was 2.5%.[46]

E. What Should Be Done?

Can we apply the experience of HOLC today?

There are some differences between the mortgage and foreclosure problems of the 1930s and those today. Obviously, the scale of today's housing bubble and collapse is larger. In addition

[45] See "Summary," ibid.
[46] "Summary," Ibid.

the widespread securitization of mortgages in the 2000s presents some complications. Nonetheless, the HOLC experience does, I think, provide a useful model.[47]

A HOLC2012 could readily utilize the basic framework of the 1930s HOLC. The place to begin is with the large number of home buyers who are struggling to meet mortgage payments and/or are delinquent or in default but who cannot take advantage of the current low mortgage rates because of negative equity. Table 3 below provides some numbers as a guide.

A HOLC2012 would have many of the important advantages that the 1930s HOLC did. First, because of the very low cost to borrow for the federal government, HOLC2012 could acquire funds cheaply. Second, because of the increasing popular resistance to foreclosures, courts are now looking more closely at the actions of lenders. Third, as a result, many lenders want to get out of the foreclosure business. Finally, many lenders are also eager to get mortgages off their

[47] Others have also suggested applicability of at least some of the HOLC structure. See for example Davidson, op. cit. and Hubbard and Mayer op. cit.

TABLE 3:

Mortgages with Negative Equity, January 2012[48]

	Number of Mortgages	Total Negative Equity	Negative Equity/Mortgage
Mortgages with negative equity	12 million	$700 billion	$58,300
Of which, current	8.6 million	$425 billion	$49,400
Of which, not current	3.4 million	$275 billion	$81,000
Of which, 30 - 59 days delinquent	660,000	NA	NA
Of which, 60 - 89 days delinquent	310,000	NA	NA
Of which, >= 90 days delinquent	1 million	NA	NA
Of which, in foreclosure	1.4 million	NA	NA

books, replaced with debt that has much more surety of payment. All of this suggests that the basic HOLC model should still be viable.

At the beginning of 2012 there were about 12 million underwater borrowers (out of a total of somewhat more than 50 million mortgages nationwide) with an aggregate negative equity of approximately $700 billion. However, most of these borrowers, about 8.6 million representing $425 billion of the $700 billion total, remain current in their payments. Of the remaining 3.6 million, a little less than one-third are more than 90 days delinquent and over 41% are in foreclosure.[49] If policy does not change, the latter number will continue to grow. In addition, failure to adopt an effective policy will likely result in some number of those households underwater but current in their payments falling behind and eventually increasing the number of foreclosures.

1. What Should the Legislation Include?

There has been much concern expressed about the "moral hazard" risk of extending principal or interest reduction or stretching out loan terms to underwater borrowers. To date, however, it seems clear that the beneficiaries of moral hazard have been lenders and securitizers, not borrowers. It was lenders who created interest only, "pick and pay" and other mortgages that allowed them to reduce or virtually eliminate established mortgage lending criteria; it was lenders who pressured appraisers to create "value," at times even establishing captive appraisal units; and it was lenders who manufactured fictitious documents

[48] All data in the table is calculated from Federal Reserve, op. cit.
[49] All data from Federal Reserve, op. cit., p. 21.

to back lending decisions. It was securitizers who pushed more and more mortgages into the securitization chain, it was securitizers who paid Moody's, S&P and Fitch to get AAA ratings and it was securitizers who created MBS issuances in which delinquencies became rampant less than 6 months after issuance. Yet to date, no lender or securitizer has faced criminal liability for their actions.[50]

Considering the causal forces in the housing bubble and collapse, it is more than fitting that lenders and securitizers absorb some of loss involved in restructuring outstanding mortgage loans. As much we may not like to accept it, however, there is also some risk that forcing very large financial institutions into bankruptcy will drag down the real economy (this was one of FDR's concerns about investors). What follows tries to balance these risks while at the same time facilitating the necessary clean up of lender balance sheets and requiring creditors, both lenders and others, to shoulder most of the losses.

The legislation to create HOLC2012 must have several pieces.

(1) HOLC2012 should be granted the power to issue debt guaranteed by the full faith and credit of the US government.
(2) Following the 1930s experience, issuing this debt on a tax exempt basis would also make it more attractive and allow HOLC2012 to further benefit from the low cost for US government borrowing as did HOLC in the 1930s.
(3) Congress should reinstate the power of bankruptcy judges to force renegotiations on primary residences (removed by Congressional action in 1978). Bankruptcy judges retained this power for second residences, yachts, etc. Who benefits by this strange distribution and denial of power? Certainly not the 99%.

The exchange of HOLC2012 debt for mortgages should also convert all mortgages tendered by lenders into fixed rate, long term (15- 30 year) loans.[51] Since HOLC2012 bonds, while callable, would be fixed rather than variable rate, this should be relatively easy to accomplish. As noted previously, ARMs are disproportionately likely to end up in default because the interest rate risk is shifted to the borrower. Borrowers cannot structure their salaries – their income stream - to fluctuate with interest rates so the risk of interest rate movements too often results in delinquency and default.

For lenders reluctant to make the exchange of mortgages for HOLC2012 debt, there are two additional incentives. First, the reinstatement of bankruptcy judges' power to force

[50] There has been some limited financial penalties imposed on large securitizers and lenders, for example the recent settlement between 49 AGs and 5 banks. However, the extent of these penalties is very small when compared with the size of the mortgage lending and securitization market during the early 2000s.
[51] The importance of turning ARMs into FRMs has also been stressed by James Grosfeld, "A Plan from James Grosfeld," NYT, 10/31/08 and Glenn Hubbard and Chris Mayer, "First Let's Stabilize House Prices," Wall Street Journal, 10/1/08.

renegotiation of mortgages on primary residences will make lenders more willing to come to the bargaining table. Second, HOLC2012 could be given the power to offer amnesty to a lender **on the condition that all mortgages held by the lender be tendered for HOLD2012 bonds.** In addition, of course, the lender would cease all current foreclosure proceedings, since the subject properties would be included in the deal. The details of any such a deal need to be further thought through. For example, perhaps this offer should be available for only a limited period of time, analogous to the amnesty period offered to holders of off shore bank accounts designed to evade income taxes. And/or the rate on HOLC2012 debt in exchange for removal of legal liability could be lower than for other debt for mortgage exchanges. In either case, the mortgagee would obtain legal certainty on a forward looking basis. Of course, there may be, in HOLC2012's judgment, lenders whose legal violations are too egregious to be made this offer.

Even with the best efforts, there will be borrowers who cannot or will not make the necessary payments to HOLC2012 on their new mortgages. Thus, like the 1930s HOLC, HOLC2012 will find it necessary to foreclose on many properties. Here, however, we can apply some of the creative ideas that have already been suggested to address the housing crisis. In particular, HOLC2012 could institute a rent-to-own or right-to-rent program of a size that would benefit from economies of scale.[52]Assuming that holders of real estate owned (REO) properties tender loans for bonds – as they probably would - this program could include REO houses in cases where the original buyer is unable or unwilling to reenter a mortgage agreement.

The bonds for mortgages swap, coupled with the conversion of ARMs into FRMs, will negatively impact many buyers of MBS issuances and CDOs. These include both "good" buyers such as pension funds and "bad" buyers such as hedge funds, SIVs and other vehicles of the top 1%. The same issuance is likely spread between both "good" and "bad" purchasers. The effective reduction in principal, as well as loss of the gains from increased interest rates in high inflation periods will stimulate some of these purchasers to seek legal redress.

(4) Thus the final piece of the HOLC2012 legislation should address this problem by specifying that there can be no class actions against fiduciaries who seek, in good faith, to modify loans in an effort to prevent foreclosure[53] and, further, that an exchange of HOLC2012 bonds for mortgages de facto constitutes such good faith effort.

[52] Dean Baker has outlined a right to rent plan as has The New America Foundation. On the former, see http://www.cepr.net/documents/publications/right-to-rent-2009-07.pdf; on the latter see http://newamerica.net/publications/policy/the_way_forward. The Obama administration has already suggested rent to own for house owned by Fannie May and Freddie Mac. See http://www.nytimes.com/2011/08/11/business/us-seeks-to-rent-out-its-foreclosures.html.

[53]Grosfeld, op, cit. makes a similar proposal.

The possibility of a reduction in principal for some number of MBS and/or CDO purchasers, and thus of income flow, will, in any event, occur in as a result of the recent agreement between state AGs and five large banks (and occurred as a result of a previous settlement with Bank of America).

2. Who Should Be Eligible?

Almost one in four mortgage borrowers have negative equity. As noted above, however, most of these are current in their payments. In order to prevent borrowers from taking unfair advantage of the HOLC2012 legislation by, for example, deliberately falling behind in their payments, there needs to be a relatively objective method for determining eligibility. Negative equity of 10% or more compared to the original loan both covers the majority of borrowers in financial trouble and removes a large amount of the overhang in the housing market. This should be the first criterion for mortgages subject to HOLC2012 bond for debt swap.

In addition, however, there are a significant number of mortgage borrowers who may be current in their payments and/or may be less than 10% underwater but who are facing severe financial problems because of unemployment. A second sufficient criterion for the bond for mortgage swap should be any household with a currently unemployed person who has been out of work for 6 months or more. This is the Bureau of Labor Statistics trigger for counting as long term unemployed and is thus already widely in use. This criterion is floating in the sense that an individual currently unemployed for 2 or 3 months will not qualify but failure of the labor market to add sufficient jobs will mean that, at some point in the future, that individual will be unemployed for 6 months and thus qualify.

Finally, although the labor market has shown some recent signs of life, there are still many layoffs occurring. Any household where an adult wage earner becomes unemployed and does not find a job within two months should also qualify for the HOLC2012 bond for mortgage swap.

F. Summary

To conclude, the following outlines the approach to our housing/foreclosure morass that would help to regenerate aggregate demand in the economy, stabilize house prices and the housing market and provide justice to the many homebuyers facing foreclosure through no fault of their own.

Create a 2012 Home Owners Loan Corporation that would operate on the following prinicipals.

(1) HOLC 2012 would issue federally guaranteed, tax exempt debt that could be exchanged for mortgages.
(2) This debt for mortgage swap would be eligible for any mortgagors with 10% or more negative equity.
(3) Any household with a long term unemployed individual would also be eligible for the bond for mortgage swap.
(4) HOLC2012 would conduct independent appraisals of house values.
(5) No debt for mortgage swap could exceed loan-to-value (LTV) of more than90%.
(6) Any mortgages tendered under the program that are not FRMs would be converted into the same.
(7) HOLC2012 would also operate a rent-to-own program for OODUs whose buyers either would not or could not make the necessary payments on their rewritten mortgages.
(8) This rent-to-own program would be extended to REOs that HOLC2012 acquired via the bond for mortgage swap.
(9) The Act creating HOLC2012 would also restore to bankruptcy judges the power to compel renege tiation of mortgages on primary residences.