Financing The American Dream

By David Reiss

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Two movie scenes can bookend the last hundred years of housing finance. In Frank Capra's It's a Wonderful Life (RKO Radio Pictures Inc. 1946), George Bailey speaks to panicked depositors demanding their money back from Bailey Bros. Building and Loan. This tiny thrift in the little town of Bedford Falls had closed its doors after it had to repay a large loan and temporarily ran out of money to return to its depositors. George tells them:

> You're thinking of this place all wrong. As if I had the money back in a safe. The money's not here. Your money's in Joe's house…right next to yours. And in the Kennedy house, and Mrs. Macklin's house, and a hundred others. Why, you're lending them the money to build, and then, they're going to pay it back to you as best they can.

Local lenders lent locally, and local conditions caused local problems. And in the early 20th century, that was largely how Americans bought homes.

In Adam McKay's movie The Big Short (Plan B Entertainment 2015), the character Jared Vennett is based on Greg Lippmann, a former Deutsche Bank trader who made well over a billion dollars for his employer by betting against subprime mortgages before the market collapse. Vennett demonstrates with a set of stacked wooden blocks how the modern housing finance market has been built on a shaky foundation:

> This is a basic mortgage bond. The original ones were simple, thousands of AAA mortgages bundled together and sold with a guarantee from the US government. But the modern-day ones are private and are made up of layers of tranches, with the AAA highest-rated getting paid first and the lowest, B-rated getting paid last and taking on defaults first.
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> Obviously if you're buying B-levels you can get paid more. Hey, they're risky, so sometimes they fail. . . .
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> Somewhere along the line these B and BB level tranches went from risky to dog [excrement]. I'm talking rock-bottom FICO scores, no income verification, adjustable rates. . . dog [excrement]. Default rates are already up from one to four percent. If they rise to eight percent—and they will—a lot of these BBBs are going to zero.

After the whole set of blocks comes crashing down, someone watching Vennett's presentation asks, "What's that?" He responds, "That is America's housing market."

Global lenders lent globally, and global conditions caused global and local problems. And in the early twenty-first century, that was largely how Americans bought homes. This article provides an overview of the strengths and weaknesses of each aspect of the housing finance system in order to enable discussion of how to design a stronger system for the rest of the 21st Century. For a much more extensive treatment of this topic, see the author's forthcoming book, *Paying for The American Dream: How To Reform The Market for Mortgages* (Oxford University Press, 2019).

Heart of the American Dream

So how did we get from the housing finance system in It's a Wonderful Life to the one in The Big Short? And what are the consequences of that journey? The system was not perfect when mortgages came from lenders like Bailey Bros. Building and Loan and neither is today's version when borrowers access the global capital markets.

Although the 2008 financial crisis splashed residential housing finance across the front page day after day, many people still find the topic pretty murky. Yet it is important to our lives, because fewer than 63 percent of Americans—a recent low—owned their homes in 2016. U.S. Census Bureau, *Quarterly Residential Vacancies and Homeownership, Third Quarter 2018*, Table 4 (Oct. 30, 2018) (Release Number CB18-161). This was down from an all-time high of 69 percent in 2006. Id. For most people, homeownership carries strong emotional connotations, forming the heart of the American Dream. If we are fortunate, our home is the place where we feel safest, the place we share with our loved ones, the place we raise our children. The drop in homeownership rates over the last decade means that millions fewer households own the place where they live. There are 127 million households in the United States, so even a one percentage point change in the homeownership rate affects more than a million households. Statista, *Number of Households in the U.S. from 1960 to 2018*, The Statistics Portal, https://www.statista.com/statistics/183635/number-of-households-in-the-us/ (last visited Feb. 17, 2019). People may not get the same warm feeling about their rented or shared home that they would get from owning their home.

People burned by underwater mortgages, defaults, and foreclosures have seen their version of the American Dream betrayed. Entire communities—especially African-American communities—have seen their home equity evaporate in the face of falling housing prices and other big shocks to the local economy. These shocks were sometimes compounded by mortgages with predatory terms, which had become all too common starting in the late 1990s. As a result of these broad shocks and personal experiences, many people don't trust that they will get a fair shake as homeowners. That may be bad for people individually as well as for the economy as a whole because residential real estate is big money—both for individual households and for the overall economy. Homes are generally the single biggest investment that families make and are potential engines of wealth creation. All of these individual investments combine to create a residential real estate market worth roughly $27 trillion toward the end of

2018. Urban Institute, *Housing Finance At A Glance: A Monthly Chartbook* 6 (Dec. 2018). By way of comparison, the market capitalization of all domestic companies listed on US stock exchanges was about $30 trillion at the end of that year.

The Wilshire 5000 Total Market Index SM measures the "performance of all U.S. equity securities." Wilshire Associates, *Wilshire 5000 Family: Wilshire 5000 Total Market Index*, https://wilshire.com/indexes/wilshire-5000-family/wilshire-5000-total-market-index (last visited Feb. 17, 2019). The Wilshire 5000 was at 25,750 at the end of 2018. MarketWatch, https://www.marketwatch.com/investing/index/w5000?countrycode=xx. Each point of the index is equivalent to about $1.15 billion, so the market capitalization of all domestic equities listed on US stock exchanges was a bit under $30 trillion. See Wilshire Association, *Wilshire 5000: Myths and Misconceptions* 5 (Nov. 2014), https://wilshire.com/Portals/0/analytics/research/wp/wilshire5000myths.pdf.

The run-up to the financial crisis saw the wealth-creation engine go full throttle, as home equity increased by more than $7 trillion between 2004 and 2006. Urban Institute, supra, at 6. But from 2007 through 2011, residential real estate lost more than $6 trillion in value, devastating countless homeowners and driving many investors to ruin. See id.

There is no question that housing finance has a tremendous effect on America as well as on Americans. But how should the post-crisis discussion of the topic be framed? Is the subprime crisis-foreclosure crisis a story about a free market run wild or a story about out-of-control government regulation? On the surface, the massive residential real estate sector has some of the characteristics of a free market. Innumerable buyers and sellers negotiate, agree on prices, and close millions of transactions each year. But undergirding that market is a whole host of government interventions in every aspect of the transaction. The federal government exerts an extraordinary amount of control in the housing finance market in particular, most notably by subsidizing a shockingly large proportion of mortgages. About 60 percent of the roughly $10 trillion in outstanding residential mortgage debt is backed by federally-related entities. Id.

New Deal to Big Short

This government-dominated housing finance system of today grew up piecemeal from the earliest days of President Franklin Roosevelt's administration. The New Deal included a variety of interventions such as the creation of the Federal National Mortgage Association (Fannie Mae) and the Federal Housing Administration. These interventions were made to address the catastrophic failure of the housing and housing finance markets that were part and parcel of the Great Depression. In the eight-plus decades since then, the federal government has repeatedly intervened in the housing finance market to achieve a range of additional goals, but policymakers have rarely stopped to thoroughly consider when it makes sense for the government to intervene and when it makes sense to let markets operate on their own. The 2008 financial crisis provides an opportunity to design a housing finance system that lets the free market concentrate on its strength (pricing risk) and permits the government to focus on regulating and subsidizing aspects of that market to achieve various consumer protection, redistributive, and safety goals.

Although this may sound reasonable enough, it is in fact highly contested. Some influential members of Congress believe that the government should have no role at all in the housing finance market. Jeb Hensarling, who just stepped down from Congress and his position as Chair of the House Financial Services Committee, was the most influential proponent of this view in recent years. His Financial Choice Act passed the House in 2017 but did not gain traction in the Senate. Neil Haggerty, *An Uncompromising Jeb Hensarling Is Not Sorry*, American Banker (Oct . 14, 2018), https://www.americanbanker.com/news/an-uncompromising-jeb-hensarling-is-not-sorry. The Financial Choice Act reflected his free-market approach to housing finance and those of the other Republicans who supported it. Id. Others, including many in government and in policy circles, believe that the housing market is too important to leave to market forces and profit-maximizing private actors. The Obama Administration acknowledged that a number of experts and advocates argued for nationalization in the years after the financial crisis, though the administration itself did not agree with that approach. Department of Treasury, *Reforming America's Housing Finance Market: A Report to Congress* 26 (Feb. 2011). Indeed, a surprising array of people support nationalizing more of the housing finance market. For instance, former Treasury Secretary Paulson, a George W. Bush appointee, raised the idea after Fannie and Freddie entered conservatorship. James R. Hagerty, *Paulson: Redo Fannie, Freddie*, Wall St. J., Jan. 8, 2009, at A11. They believe that the government should continue playing the dominant role.

Within this polarized debate, there is a middle ground: Free markets should be allowed to work in the absence of market failures, but the government should intervene to correct any market failures that emerge. The government also could subsidize entry into the housing market for those who would otherwise not have access.

Three Housing Principles

A framework for a discussion of the future of American housing finance policy should consider the three main housing policy principles that have informed federal housing policy: allowing all Americans to live in a safe, well-maintained, and affordable housing unit; providing a specialized form of income redistribution that ensures that the income transferred is consumed in increased housing; and incentivizing Americans to take on the key attributes of the Jeffersonian yeoman farmer, economic self-sufficiency as well as a jealous regard for one's liberty. A policy guided by the first principle would emphasize housing for very low-income households that would not be able to pay market rates for safe, well-maintained, and affordable housing. A policy guided by the second principle would likely contemplate some kind of progressive housing subsidy for a broader range of low and moderate-income households. Finally, a policy guided by the third principle would seek to maximize the homeownership rate for the nation as a whole.

We can reinvent the housing finance system to meet the needs of twenty-first-century Americans by focusing on these housing policy principles and goals—regardless of whether they were met in the past. Having identified these legitimate principles of housing policy, we can then evaluate housing programs to see whether they achieve goals consistent with some or all of those principles or whether they work at cross-purposes. This process should help to clarify debates surrounding American housing policy and set the stage for the development of future policies that will prevent the stack of wooden blocks from again crashing down. If we succeed, most Americans will have a good feeling about their homes and will not notice the massive regulatory infrastructure that makes it all possible. If we fail, our children and grandchildren may have difficulty enjoying the financial and emotional benefits of homeownership, finding themselves living in the wretched Pottersville that threatens to replace Bedford Falls when George Bailey gives up hope in himself and his community.

Homeownership Policy in The Trump Era

The divisive nature of contemporary politics affects federal homeownership policy along with just about every other area of social policy. But there are still some areas of bipartisan agreement. Many believe in some version of the three housing principles. There is a longstanding commitment to the idea that the federal government should help Americans to live in safe, well-maintained, and affordable housing. Moreover, a broad array of Democrats and many Republicans favor policies that increase the homeownership rate. Republicans in particular believe that homeownership is fundamental to the American notion of citizenship. The question is whether our currently divided government can come up with a compromise that outlines a coherent role for the government in the housing market to act on those principles. So far, Congress has not been able to do that.

There have, however, been big changes on the administrative front. The Executive Branch can have an effect on housing policy without input from Congress. During its first two years, the Trump Administration has taken actions that are inconsistent with longstanding, bipartisan commitments to broadening access to homeownership opportunities. See, e.g., David Reiss, *The Trump Administration and Residential Real Estate Finance*, Westlaw Journal, Derivatives 3 (Jan. 25, 2018). Housing and Urban Development Secretary Benjamin Carson has dramatically curtailed fair housing enforcement. Tracy Jan, *HUD Secretary Ben Carson Doubles Down on Dismantling Obama-Era Fair-Housing Policies,* Wash. Post, May 19, 2018. Carson has had a big assist from Treasury Secretary Steven Mnuchin and Comptroller of the Currency Joseph Otting, who have been working to scale back fair lending enforcement and the Community Reinvestment Act. Evan Weinberger, *Banks Look to Narrow Exams Under Community Reinvestment Act*, Bloomberg Law Banking (Dec. 3, 2018).

Consumer Financial Protection Bureau Acting Director Mick Mulvaney defanged consumer protection in the mortgage market over the course of 2018. Patricia A. McCoy, *Inside Job: The Assault on the Structure of the Consumer Financial Protection Bureau* (Dec. 9, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3285589. The jury is out on what recently-appointed CFPB Director Kathy Kraninger plans to do, but it is reasonable to assume that her agenda aligns with Mulvaney's, as he put her forward for the job. From the perspective of an advocate of affordable and sustainable housing, there is a lot to dislike in the Trump agenda.

Things are somewhat more textured when it comes to housing finance reform though. With the start of the new year, the Federal Housing Finance Agency (FHFA), Fannie Mae and Freddie Mac's regulator, has gone from Democratic to Republican control. The five-year term of President Obama's appointee as FHFA Director, Melvin Watt, ended at the start of the year. President Trump has nominated Vice-President Pence's Chief Economist, Mark Calabria, to be the permanent director. Calabria is a housing finance expert and is likely to be confirmed. This means that the Trump administration will be fully in charge of the FHFA for the first time later this year.

Given his previous statements, Calabria's FHFA will likely reduce the footprint of Fannie and Freddie in the mortgage market. Hannah Lang, *What Calabria at FHFA Would Mean for GSE Reform*, Am. Banker, Dec. 10, 2018. This will likely modestly increase the interest rates charged on mortgages but will also reduce the likelihood of taxpayer bailouts. This change in control will also likely mean fewer low-down payment loan options will be offered by Fannie Mae and Freddie Mac, which will put downward pressure on the homeownership rate.

Calabria would be right to seek to redistribute credit risk in the mortgage market from the government to the private sector. This is a good thing because it would put the housing finance system on a stronger footing for the first time in a long time—since the financial crisis, it has been too dependent on the government.

Some believe that the government's current high level of involvement in the mortgage market is a positive development because of the predatory behavior of private actors in the years leading up to the crisis. The author has argued elsewhere that a properly regulated mortgage market would allow the private sector to do what it does better than the government—evaluate and hold credit risk —while leaving the federal government to focus on implementing strong consumer protection; safety and soundness; and system risk regulation. David J. Reiss, *Fannie Mae and Freddie Mac and the Future of Federal Housing Finance Policy: A Study of Regulatory Privilege,* 61 Ala. L. Rev. 907 (2010).

Conclusion

Those who believe that government plays a positive role in the housing market by supporting affordable and sustainable homeownership have a fight ahead of them to move their agenda forward. The move to redistribute credit risk in the mortgage market from the government to the private sector should be seen as a step in the direction of creating a healthy market for mortgages that appropriately balances the role of the federal government with that of the private sector. But the jury is still out on whether the right type of regulation will be in place as the private sector gains market share under Calabria's free market initiatives. Although this is not a hopeful conclusion for advocates of affordable and sustainable housing, it is the best we can hope for until Congress returns to bipartisan ground to build a strong and resilient housing finance system for a broad swath of 21st century Americans. n