HOME MORTGAGE LENDING: PAST, PRESENT, AND FUTURE

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THE 2011 DONALD F. CLIFFORD, JR. DISTINGUISHED LECTURE

Dean Boger, Professor Wegner, Professor Broome, Mrs. Clifford, my friends and colleagues. It is always a pleasure to participate in the Festival of Legal Learning. It is a particular pleasure and a profound honor this year to have been asked to give the lecture named for one of the Festival's founders, Professor Donald F. Clifford, Jr.

Don Clifford was a talented legal scholar and an exemplary human being. Karl Llewellyn once wrote: "Technique without ideals may be a menace, but ideals without technique are a mess; and to turn ideals into effective vision, in matters of law, calls for passing those ideals through a hard-headed screen of effective legal technique."[1] Don possessed both ideals and technique in abundance and devoted himself to the development of a commercial law that facilitates the provision of consumer credit in a fair and equitable way. To honor him, I would like to discuss with you the interplay of ideals and technique with regard to home mortgage lending.

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[*] Joseph A. Smith, Jr. is the North Carolina Commissioner of Banks. The following is a reprint of the 2011 Donald F. Clifford, Jr. Distinguished Lecture given by Comissioner Smith on February 11, 2011. This lecture was held at the UNC School of Law Festival of Legal Learning and was given in memory of a long-time UNC School of Law faculty member and member of the Board of Advisor for the Center of Banking and Finance, Donald F. Clifford, Jr. Professor Clifford's career is described in Lissa L. Broome, *In Remembrance: Donald F. Clifford, Jr.*, 13 N.C. BANKING INST. 1 (2009). This address expresses the personal views of the Commissioner and is not a statement of policy of the Office of the North Carolina Commissioner of Banks or the State of North Carolina.

1. *Committee on Curriculum*, 1944 ASSN. AM. L. SCHS. HANDBOOK 159, 161 (1944), *reprinted* in Comm. on Curriculum, Assn. Am. L. Schs., *The Place of Skills in Legal Education*, 45 COLUM. L. REV. 345,346 (1945)).

As everyone in this room is aware, we are still working through the aftermath of a financial crisis brought on in substantial part by improvident home mortgage lending, magnified through structured finance and derivatives.[2] This catastrophe is the result of the co-option of the ideal of widespread home ownership in service of breathtaking and ultimately self-destructive greed. We are left with a great deal of cleaning up to do and a number of practical and policy issues to resolve. I would like to take a few steps back to review how we got here and then propose a few steps forward on some of these issues.

There was a time, not so long ago, when home mortgage lending was generally done by banks and thrifts and was governed by prudence and the underwriting standards of the Fannie Mae and Freddie Mac (the Enterprises). Having learned the lessons of the thrift crisis, banks and thrifts originated mortgage loans and sold them into the secondary market, particularly if they were fixed rate instruments.

In those halcyon days, the tension between technique and ideals was over access to credit, particularly in low and moderate income and minority communities. Allegations of an unnecessary denial of credit to such communities, in some cases outright red lining, led to the enactment of the Community Reinvestment Act (CRA) and the Home Mortgage Disclosure Act. Under those statutes, banks, particularly those that wished to grow by mergers and acquisitions, developed affordable housing programs to increase mortgage lending in underserved markets.[3] The major policy issue arising from bank originated affordable housing loans was whether the CRA was mandating "credit rationing," the pricing of loans in a way that did not reflect cost and risk. Progress on the access front was slow and steady and there was a growing body of

2. *See generally* FIN. CRISIS INQUIRY COMMISSION, THE FINANCIAL CRISIS INQUIRY REPORT, THE FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES (2011), *available at* http://www.fcic.gov/report.

3. The Community Reinvestment Act, 12 U.S.C. §§ 2901-2908 (2006); s*ee* The Home Mortgage Disclosure Act, 12 U.S.C. §§ 2801-2810 (2006).

evidence that affordable housing loans performed reasonably well, at least relative to other subprime loans.[4]

Then things changed. Advances in information and communications technology, deregulation, and private capital looking for yield converged, creating an alternative system of housing finance that was market-driven and outside the traditional institutional framework. During the mid-2000s, this private market took a substantial share of mortgage lending, leaving the government-sponsored entities (GSEs) (Fannie Mae, Freddie Mac and Ginnie Mae) in relative decline. From an eighty percent share of the mortgage backed securities market in 2001, the aggregate share of the mortgage-backed market of the GSEs fell to fifty-four percent in 2004, forty-five percent in 2005, and forty-four in 2006.[5] The exponential growth of private label mortgage-backed securities issued by Wall Street took a substantial share of the market, based on a fee and volume driven origination and funding system that, we now know, ignored the niceties of underwriting and prudence, not to say honesty.

A number of states responded to the negative aspects of the new subprime mortgage market with protective legislation—North Carolina's anti-predatory lending statute being first and foremost.[6] For their trouble these states had to endure not only the aggressive assertion of federal pre-emption by the regulators of national banks and federal thrifts, but the argument that, although well intended, their actions denied deserving low and moderate income folks their chance at the American dream of home ownership. As if that weren't enough, aggressive (for which read, effective) statutes that dared to hold purchasers liable for non-compliant

4. Lei Ding et al., *Risky Borrowers or Risky Mortgages: Disaggregating Effects Using Propensity Score Models* 34, (Univ. of N.C. Ctr. for Cmty. Capital, Working Paper, 2010), *available at* http://www.ccc.unc.edu/documents/Risky.Disaggreg.5.17.10.pdf.

5. FEDERAL HOUSING FINANCE AGENCY, REPORT ON THE ENTERPRISES' FINANCIAL PERFORMANCE 5 (2010), *available at* http://www.fhfa.gov/webfiles/16591/ConservatorsRpt82610.pdf [hereinafter FHFA CONSERVATOR'S REPORT].

6. N.C. GEN. STAT. § 24-1.1A-10.2 (2009).

loans originated by others were subjected to the ultimate sanction: censure by the rating agencies. This meant that investors would not purchase the unrated mortgage-backed securities containing such loans and, accordingly, capital markets would no longer fund them, or would do so at prohibitive cost. In this "through the looking glass world" both idealism and technique were turned against those who stood against the march of the market. Access to credit ceased to be a policy issue; fraud, flipping and foreclosure came to the fore.

What followed has been well chronicled. The private issue mortgage-backed securities market collapsed, taking with it Bear Stearns, Lehman Brothers, Countrywide, WAMU, Wachovia and others, and leaving behind assets of questionable quality on the balance sheets of major financial institutions that survived the meltdown, including the GSEs and the Federal Home Loan Banks.

As if this were not bad enough, the damage extended to the Enterprises. Not to be outdone by Wall Street, Fannie Mae and Freddie Mac ramped up their activities in the subprime and Alt-A[7] markets in 2006 and 2007.[8] Having emulated Wall Street, the Enterprises got similar results, but with taxpayers on the hook for losses. Fannie Mae and Freddie Mac were put into conservatorship in 2008 and are currently on life support, notwithstanding which fact the GSEs now account for over ninety percent of the mortgage market.[9] The foreclosure tide continues to run at a rapid pace and the current and prospective inventory of unsold homes is huge. Home mortgage credit is tight.

In a way, we are back where we started: home mortgage lending tightly confined and institutionalized. Once again, the policy issue is access to credit and it is a serious one.

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7. Alt-A loans fall between the subprime and prime mortgage loans in terms of their risk. What is an ALT A Loan? MORTGAGE REFERENCE LIBR., http://www.brokeroutpost.com/reference/149510.htm (last visited Feb. 12, 2011). Alt-A loans include loans to borrowers with prime or close to prime credit scores but lacking full (or any) documentation. *Id.*

8. *See* FHFA CONSERVATOR'S REPORT *supra* note 6, at 5-6.

9. *See* FHFA CONSERVATOR'S REPORT *supra* note 6, at 5.

Given our current circumstances, what are we to do? Restructure our system of home mortgage finance to be fair, strong and efficient. Legislation to achieve this objective will be taken up by Congress in its current session. It will be hotly debated in no small part because it involves a clash of ideals and of techniques needed to achieve them. While I am chastened by recent personal experience in our nation's capital, I persist in the belief that common ground can be found to reform home mortgage finance. In my view, a necessary first step is a reassessment of the nature of home ownership and its place in our scheme of values.

Home ownership has a dual nature that has been a source of confusion and harm. Not to be too obvious about it, home ownership provides you with a place to live, what some experts call "housing services."[10] If you don't own a home, you obtain housing services by renting from someone else.

Home ownership is also commonly referred to as an investment, and it is here that the confusion and harm begin. One view of the return on a homeownership investment is related to the provision of housing services. In this view, the financial return of homeownership is the value of rent you don't have to pay, less borrowing costs, taxes and maintenance. The investment value of a home resembles that of an annuity: early payments in and return obtained later, when the mortgage has been paid down or off and you get the benefit of imputed rent.

Another view of the investment return of home ownership, probably the more common one, is the price appreciation of a house or, assuming it is mortgaged, the increase in home equity after deducting applicable debt. This view equates home ownership with an equity investment and treats the equity in a

10. Eric S. Belsky et al., *Identifying, Managing and Mitigating Risks to Borrowers in Changing Mortgage and Consumer Credit Markets* 35, (Harv. Univ. Joint Ctr. for Hous. Studies, Working Paper, 2008), *available at* http://www.jchs.harvard.edu/publications/finance/understanding_consumer_credit/papers/ucc08-14_belsky_case_smith.pdf [hereinafter Belsky et al.].

home as a financial asset. Home equity viewed in this way underpins a substantial number of personal financial statements and the tax bases of most of our communities.

While neither of these views necessarily excludes the other, I believe it is fair to say that our housing market has gone from an emphasis on housing services to one where the idea of a house as a financial asset predominates.[11] This change mirrors changes in our society. Our parents grew up in a world where it could reasonably be expected that homeowners would live in a house for thirty years, have a mortgage burning party, and retire with cash income from a defined benefit pension plan and Social Security and imputed income from the house. Our children and the younger members of this audience live in a different world, where multiple jobs in multiple locations are the norm, the duration of mortgages averages about seven years, the defined benefit plan has become a 401(k) plan or nothing, and Social Security is less than a certainty. In this brave new world, home equity has become the principal financial asset of many households and, all too often, the source of a crippling debt burden.[12] I believe that consumer welfare is best served by reversing this trend and returning the home to its traditional function as a place to live and a store of long-term value. Getting there from where we are now will take some doing.

One way to address the problems of the housing finance market is to separate the housing services component of home ownership from the risks associated with fluctuations in house prices and home equity.[13] Such a separation can be accomplished by a transfer of ownership risk from borrower to lender or through risk mitigation strategies that transfer such risks to the lender or a third party. This is not as avant-garde as it sounds: there are a number of examples of ownership transfer in the market today and risk

11. *Id*. at 3.
12. *Id*.
13. *Id*. at 35 (discussing use of the derivatives market to separate the cost of housing services (H*s*) from the cost of housing as an investment vehicle (H*i*)).

mitigation for consumers is growing more likely as a housing-related derivatives market develops.[14]

Ownership transfer is present in a spectrum of currently available housing finance products. At one end of the spectrum is leasing, where all ownership is in the landlord; however, the idea of "lease to own" is under discussion as a possible tool to either keep families in their homes after foreclosure or find new occupants for such homes. "Soft second" mortgages, generally offered in connection with affordable housing programs, have been a feature of the mortgage market for a number of years. Shared appreciation mortgages are being discussed as tools for restructuring distressed loans and instruments to give first-time homebuyers needed financing.[15] Reverse mortgages are at the other end of the spectrum; transferring ownership risk to the lender and allowing the borrower/occupant to remain in the home for little or no consideration until it is sold or the borrower dies. In each of these instances, in varying degrees, consumers transfer ownership risk and reward to their financiers in order to obtain or continue to enjoy housing services.

A second and developing approach is to use derivatives – which by their nature are intended to separate investment return from physical ownership of goods – to hedge a homeowner's exposure to the risks of the housing market or to separate physical ownership from price fluctuations. In a 2008 paper for the Harvard Joint Center for Housing Studies, Eric Belsky of the Joint Center, Karl Case of Wellesley, and Susan Smith of Durham University discussed how such an approach can reduce the vulnerability of homeowners to a variety of risks.[16] Among the specific proposals contained in this paper were: (i) housing price-linked savings products that enable home buyers to save for home ownership in a way that protects them from being shut out of the market through house price inflation; (ii) purchases of only the

14. *See, e.g.*, *id.* at 35.

15. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 406, 124 Stat. 1376 (2010) (amending 15 U.S.C. § 80b-11 (1940)).

16. *See* Belsky et al., *supra* note 11, at 35.

housing services component of a home, "selling off" the investment component and reducing the cost of purchase; (iii) a house-price linked mortgage the repayments of which fall when and if house prices falls; and (iv) SwapRent (SM), which separates legal and economic ownership of housing in a way that allows a sale of all or a portion of future appreciation of a house for a current lump sum payment or income stream.[17] Each of these concepts is based on the use of housing linked derivatives. While they are somewhat speculative, trading of such derivatives has begun on the Chicago Board of Options Exchange, is developing rapidly and makes them possible.[18]

I do not believe that any of the approaches just mentioned is a "silver bullet" for our housing woes; nor are any of the proposals soon to be debated in Washington over the structure of the housing finance system. Frankly, I don't believe any single solution exists. Rather, the current problems of foreclosures, shadow inventory, and tight credit, and the longer-term issues regarding home ownership as a feature of the American social contract have to be addressed one at a time, in light of the needs of our citizens and communities. Starting now, we should seek to apply all of the techniques available to us to make home ownership available to those who choose it on a fair and sustainable basis. Such a result is possible if all of us focus on the ideals to be served by our application of technique: community, stability, prudence, and thrift.

Success also requires that we stop viewing a house as a highly leveraged bet on the real estate market or a status symbol. We should put aside our house-proud ways and quit trying to borrow our way to happiness, individually and collectively. At the very least, we should stop subsidizing this kind of conduct.

The crisis through which we are now living has done substantial damage to our financial system. It has also undermined public

17. *See* Belsky et al., *supra* note 11, at 35-36.
18. *Id.*

confidence in our institutions and, worst of all, our ideals. The concept of the American Dream, in which freedom and the opportunity for self-fulfillment is widely available and expanding, has been corrupted by cynical public relations and marketing to limit it to the acquisition of material possessions with cheap and illusory credit. Recovery and renewal of our nation require that we address the fallout from the financial crisis, but technical fixes will not suffice. Technique must serve renewed ideals based on the inherent worth of each of us and the pursuit of genuine freedom and community. By seeking to restore and refresh our values, we will honor Don Clifford and people like him, who coupled technical brilliance with a profound commitment to others. I am strengthened by his memory and know you are too.