

# THE NEXT BANKING CRISIS

*Will the latest round of reform bring an end to subsidizing risky mortgages?*

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**I**s America's housing finance crisis finally behind us? After two years of collapse and three years of stagnation, home prices finally rallied in 2013.

In order to prevent banks from issuing a new round of mortgages that borrowers cannot actually afford, the Consumer Financial Protection Bureau recently issued rules governing "Qualifying Mortgages" (QM). QM loans are protected from legal challenges by borrowers against the mortgage originator should the borrower be unable to make payments. Banks therefore have an incentive to generate loans that get the QM seal of approval.

To prevent banks from using depositors' savings (insured by the Federal Deposit Insurance Corporation) to make risky investments in securities and their derivatives, the Volcker Rule, a provision of the 2010 Dodd-Frank Act, was finally implemented last December by the alphabet soup of regulatory agencies that oversee America's banks. Many of the other regulatory reforms of Dodd-Frank have been in place since 2010, including the designation of the country's largest banks as Systemically Important Financial Institutions (SIFIs). SIFIs can be subjected to tighter regulation, higher capital requirements, and more rapid liquidation than smaller banks. Dodd-Frank also created a Financial Stability Oversight Council (FSOC), headed by the secretary of the treasury, that can designate any financial institution, including insurance companies and hedge funds, as a SIFI, thereby putting it at risk of potential liquidation by the FDIC. Finally, last summer, the House Financial Services Committee approved the Protect American Taxpayers and Homeowners (PATH) Act. If enacted into law, the legislation would wind down Fannie Mae

and Freddie Mac, thereby removing the threat that taxpayers might once again have to bail out the privileged mortgage giants.

## NEW REGIME, SAME WEAKNESSES

It is usually the case that "the devil is in the details," and the state of America's housing finance system is not an exception. The sad truth is that reforms that have been implemented are either irrelevant or have been lobbied to the point that they have been made irrelevant. The main source of potential trouble—risky investments in residential mortgages, undertaken by over-leveraged government-sponsored enterprises (GSEs) and banks—has not been addressed.

Consider the rules governing QMs. As initially proposed, home loans could only obtain QM status if they met quite strict underwriting standards, such as a 20 percent downpayment and a housing-cost-to-income ratio limit of 28 percent. By the time the rules were finally put into place, however, the 20 percent downpayment was gone and the 28 percent ratio was replaced by a total-debt-to-income ratio limit of 43 percent. More striking still, mortgages that can be repurchased or securitized by Fannie Mae or Freddie Mac while they are under government conservatorship or until 2021—whichever comes first—are exempt from QM standards. That is, they automatically count as QM loans provided they do not contain certain high-risk features such as negative amortization, balloon payments, or loan amortizations of more than 30 years. Similar exemptions are made for mortgages guaranteed by the Veterans Administration, the Federal Housing Administration (FHA), and the Department of Agriculture, as well as loans made by small community banks and credit unions. In short, unless Fannie Mae and Freddie Mac are removed from government conservatorship, QM standards are a dead letter.

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**Volcker Rule** / The Volcker Rule, which limits bank proprietary trading, has even less bite. In the first place, proprietary trading



by banks was not a fundamental cause of the recent subprime crisis, and thus banning it will not prevent future subprime crises. As we show in our new book, *Fragile by Design: The Political Origins of Banking Crises and Scarce Credit*, the subprime crisis was caused by a political deal that gave banks and GSEs incentives to reduce mortgage underwriting standards to the point that virtually anyone and everyone could obtain a home loan, in exchange for which the banks and GSEs were allowed to back those risky loan portfolios with paper-thin levels of capital. The Volcker Rule is meant to partially roll back the unification of banks' commercial and investment banking operations (permitted since the 1999 repeal of the Glass-Steagall Act), but the fact is the unification of investment and commercial banking had nothing to do with the origination of mortgages without downpayments, granted to borrowers who were not required to document their incomes or assets.

Even if one believes—as we do—that proprietary trading in GSE- or bank-issued mortgage-backed securities (MBSs) and their derivatives allowed banks to reduce the amount of capital they had to deploy to back their mortgage portfolios, the Volcker Rule will do nothing to constrain that activity. Paul Volcker's initial goal in formulating the rule was to ban all proprietary trading,

The final version of the Volcker Rule, however, specifically exempts real estate-related securities. Goldman Sachs recently announced its intention to take advantage of this exemption to invest aggressively in proprietary trading in real estate through an investment fund it will be sponsoring. Others are sure to follow. Yes, the long-awaited Volcker Rule, which was supposed to reduce bank investments in risky trades, has a loophole as big as—well—a house.

Will reckless risk-taking in real estate by large banks be constrained by Dodd-Frank's abolition of too-big-to-fail bailouts? Unfortunately, the legislation did not actually end such bailouts; in fact, it institutionalized them. Under Title II of Dodd-Frank, when a bank or other intermediary that has been declared a SIFI becomes distressed, the treasury secretary, as head of the FSOC, must decide whether to offer it assistance or liquidate it. If assistance is offered, and if government losses result from the assistance, then a special tax will be levied on surviving institutions to pay for those losses. While the stated intent of Title II is to avoid future bailouts, this new authority establishes explicit procedures for bailing out too-big-to-fail institutions and for levying fees to fund the bailouts. The likely path of least resistance, if a large bank becomes insolvent, will be for the FSOC to declare it a SIFI, and for the Treasury, Federal Reserve, and FDIC to take steps to bail it

out. Troubled financial institutions will argue that anything less will bring the world to an end, and it is difficult to imagine that any treasury secretary—who, after all, is a political appointee—will want to bear the personal risks of standing in the way and endangering the political future of the president that put him in his job.

**No PATH/** One might take some comfort in the House of Representatives' proposed PATH Act, which phases out taxpayer subsidization of mortgage risk by winding down Fannie Mae and Freddie Mac. Alas, the bill has about as much chance of being enacted as we have of winning the doubles championship at Wimbledon. Even if it passes the House, it will be dead on arrival in the Senate. The alternative Senate version of the bill also phases out Fannie Mae and Freddie Mac, but then replaces them with government credit guarantees that would offer permanent, explicit subsidization for excessive mortgage risk-taking. The good news is that the Senate version has little chance of clearing the House.

The bad news is that the absence of agreement will mean the continuance of the government conservatorship of Fannie and Freddie by the Federal Housing Finance Agency (FHFA), whose recently appointed director, former congressman Mel Watt, is a longtime political supporter of taxpayer-supported subsidies of mortgage risk. (President Obama had to use the new filibuster-proof confirmation process to get Watt appointed.)

One of Watt's first acts as FHFA incoming director was to announce that he will delay the implementation of increases in Fannie and Freddie guarantee fees (what they charge lenders for bundling, servicing, and selling MBSs, the main component of which guarantees the MBSs against a "credit-related loss"). This all sounds well and good until you remember that there are no free lunches. Providing favored treatment to one class of households or business enterprises inevitably taxes other households or business enterprises. Watt's decision to delay guarantee fee increases is a prime example of this principle at work. If Fannie Mae and Freddie Mac charge lower guarantee fees than they would otherwise, it implies a subsidy from the taxpayers who invested \$187 billion in the two GSEs when they failed in 2008 and who now receive a return on that investment via dividends paid by Fannie and Freddie to the Treasury.

Some of the senators who pushed though the Watt appointment are already urging him to return Fannie and Freddie to the good old days when they were used as vehicles for income redistribution via affordable housing initiatives. Last January, 33 U.S. senators signed a letter to Watt encouraging him to direct Fannie and Freddie to resume payments to a trust fund designed to create subsidized rental housing. Ironically, that fund was created in 2008, right before Fannie and Freddie had to be rescued at taxpayer expense.

Many analysts also expect that Watt will favor debt forgiveness in the form of reductions in mortgage principal balances for underwater borrowers whose loans are now owned by Fannie or Freddie—a step that his predecessor at FHFA, career civil servant

Edward DeMarco, staunchly resisted. One might be tempted to think of DeMarco as Ebenezer Scrooge and Watt as the ghost of Christmas Past—until you again remember that there are no free lunches. Write-downs of principal balances by Fannie and Freddie have to be paid for by their stockholders, which is to say by taxpayers.

Furthermore, during the mortgage crisis, the FHA, which guarantees low- and moderate-income mortgages, substantially increased its share of the market to a historically unprecedented degree. Like other mortgage lenders, it substantially relaxed its underwriting standards in the years prior to the subprime crisis. The FHA has been experiencing historically unprecedented default rates on its mortgage guarantees and there is no plan on the table for reining in its activities.

We could go on and on, but we hope that by now readers get the point: the United States is very far from anything that resembles a real reform agenda that would constrain the taxpayer subsidization of risk-taking in the mortgage market and prevent a repeat performance of the subprime crisis.

#### FRAGILE BY DESIGN

It would be easy to blame this state of affairs on lobbying by Wall Street "fat cats," but that would be only partially true. Bankers acting alone are not powerful enough to engineer the fleecing of taxpayers on this massive scale. American banking regulation since the 1810s has produced two centuries of politicized and unstable banking practices, which was the result of bankers' successful alliances with populist groups to form highly successful political partnerships. Those partnerships use regulation as the means to benefit bankers and populist groups at the expense of everyone else. The subsidization of real estate debt—in residential and agricultural mortgage markets—has been a predictable consequence of those partnerships.

As our book documents at length, from the 1810s until the 1970s, local bankers, who were opposed to the creation of large, branching banks that would put them out of business, allied with farmers, who disliked and distrusted big corporations of any type and who wanted to constrain banks to serving their local, agrarian borrowing needs. Their legislative agenda gave rise to an extremely peculiar banking system unlike that of any other country. Circa 1970, it was illegal for banks to branch across state lines, and the vast majority of states (38 out of 50, to be exact) limited the ability of banks to open branches even within the state. Some states, such as Texas, outlawed branches entirely: all banks were single-office "unit banks." The absence of branching meant that the U.S. banking system was fragile by design: banks could not regionally diversify their risks and poorly operated banks faced little competitive pressure.

Little wonder that, from the 1840s to the 1980s, the United States had no less than 11 systemic banking crises. In contrast, the Canadian banking system, which was built on the basis of large banks that branched across provincial lines, had none. America's

peculiar banking system also came at a large cost to social and economic mobility. Because banks were risky and did not compete very hard against one another in loan markets, the cost of credit to small and medium-size business enterprises and households was artificially inflated. As bankers in the 1970s joked, banking was a “3-3-3” business: borrow at 3 percent, lend at 3 percent more, and be on the golf course by 3 P.M.

**Megabanks and urban activists**/ The alliance of local bankers and agrarian populists finally died with the wave of bank and savings and loan failures in the 1980s—a collapse that, like many prior banking crises, reflected the subsidization of undiversified risks in residential and agricultural real estate lending. In the late 1980s, many reformers called for ending regulatory policies that subsidized real estate risks, including the winding down of the housing GSEs (Fannie Mae and Freddie Mac) and the farm credit GSEs that comprise the Farm Credit System. But in its wake of those calls, the GSEs remained and grew.

Indeed, the banking collapse of the 1980s was prologue to a new unlikely partnership formed to increase the subsidization of

megabanks had made to their populist partners. In other words, high-risk loans that banks had made in order to get the support of activist groups at Fed merger hearings were quietly transformed into a public subsidy by virtue of Fannie and Freddie’s mandates combined with their special status as GSEs (which meant that taxpayers would back their debts, an eventuality made more likely by the thin capital requirements that the GSEs faced).

The heavily taxpayer-subsidized GSEs found it in their interest to go along with the fiction that the subsidized home loans that were being generated by megabanks and populists were no more risky than other home loans. The result was the new normal of zero or near-zero downpayments and undocumented mortgages, which were applied to everyone, not just the urban poor.

#### WILL THIS TIME BE DIFFERENT?

The megabank–urban activist–GSE coalition was certainly dealt a blow by the subprime crisis and dramatic slowdown in bank mergers since the crisis. Nevertheless, the coalition has not yet gone the way of the local banker–agrarian populist coalition. Will regula-

tory reform this time ultimately bring an end to the subsidization of risky mortgages or just pretend to address the problem? As we described at length above, so far there is little indication that Congress or the Obama administration is serious about rolling back mortgage risk subsidies.

It is certainly possible to imagine effective reforms. For example, the elimination of mortgage risk subsidization by Fannie Mae, Freddie Mac, and the FHA would not require abandoning an effective affordable

housing policy. It is possible to craft government policies to promote affordable housing on a sustainable basis without placing the financial system at risk. A means-tested downpayment matching funds program would be one obvious approach; it would make it easier for low-income households to qualify for mortgages while encouraging saving by would-be homeowners. It would also stabilize housing finance by lowering the loan-to-value ratios of mortgages.

Such a program would, however, require the government to budget for the cost of downpayment assistance. There’s the rub: Congress much prefers off-budget, invisible credit subsidies to politically powerful coalitions. The public costs of those arrangements are only borne after a financial collapse, and even then are not visible to taxpayers because they are channeled through highly opaque mechanisms such as GSE lending, lending to troubled banks, or lending to troubled homeowners. Until average Americans decide to punish political leaders for acquiescing to the subsidization of mortgage risk, effective reform will remain elusive, although reform likely will be promised again—right after the next banking crisis. R

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residential mortgage risk. This was an alliance between bankers building new nationwide megabanks through aggressive mergers and acquisitions, and urban populists who sought to garner a share of the economic benefits generated by the mergers. Urban populist groups did so through regulations designed to boost affordable housing. Some of those regulations required banks engaging in mergers to demonstrate their good citizenship (as defined under the Community Reinvestment Act) at Federal Reserve Board hearings. To do so, bankers enlisted the assistance of urban activist groups like the Association of Community Organizations for Reform Now (ACORN) and the Neighborhood Assistance Corporation of America (NACA) to testify on their behalf. ACORN, NACA, and similar organizations had every incentive to do so because they received over \$850 billion dollars in contractual commitments by merging banks to channel lending or grants to those organizations.

Other regulations forced the GSEs to invest in the loans generated by the megabank–urban activist partnerships. In 1992, Congress passed the GSE Act, which required Fannie Mae and Freddie Mac to repurchase the affordable housing loans that