Chapter 1

The Rise and Fall of U.S. Housing Prices

Contrary to popular perceptions, residential housing prices in the United States rose by only 10 percent above the rate of inflation from 1949–1997—going from an index of 100 to an index of 110, as demonstrated by Figure 1.1. Next, housing prices rose sharply by 21 percent above inflation between 1997 and 2001 (from an index of 110 to an index of 133), and then suddenly took off like a rocket between 2001 and 2006—rising 53 percent higher than the inflation rate (from an index of 133 to 203). But this meteoric rise was unsustainable; at the end of 2008, U.S. residential housing prices had plunged by 33 percent from their 2006 high (from an index of 203 to 137), and have declined further during 2009.[3]

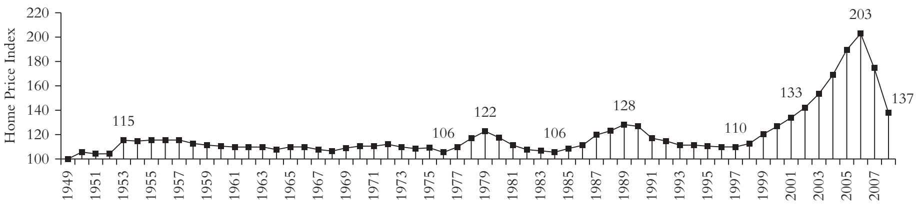

Figure 1.1 Inflation Adjusted Home Price Index: 1949–2008
SOURCE: Robert Shiller irrationalexuberance.com.

Many factors contributed to this rise and fall of housing prices. In this chapter, we will focus on three key factors: abnormally low interest rates, unscrupulous sales practices of certain mortgage lenders, and incentives for certain house purchasers to avoid personal responsibility. (We will discuss additional important factors in other chapters, for instance, Chapter 5 on short selling by hedge funds and Chapter 6 on excessive leverage of financial institutions.)

The Fed Kept Interest Rates Too Low

Low interest rates in the United States were a key factor driving domestic housing prices sky high between 2001 and 2006. Because mortgages were so cheap, some purchasers were willing to pay more for homes that they were going to buy and other purchasers were able to afford homes for the first time. United States interest rates were pushed lower during this period by a combination of the savings glut in the emerging markets and the Federal Reserve's extended response to the 2001–2002 recession.

Between 2000 and 2007, the foreign exchange reserves of central banks in emerging markets ballooned from less than $800 billion to over $4 trillion.[4] In part, this sharp increase resulted from the rising prices of oil and gas in countries with natural resources, such as Saudi Arabia, Brazil, and Russia. In part, this sharp increase resulted from the rapid growth in trade surpluses of China and other Asian countries with the United States, where American consumers gobbled up imports.

In turn, the central banks in the commodity-producing countries and Asian exporters invested much of their rising foreign currency reserves in U.S. Treasuries. Such investments boosted the value of the

U.S. dollar, which supported the price of oil (denominated in U.S. dollars) and encouraged Americans to buy relatively cheap imports from Asia. Between 2000 and 2007, U.S. Treasuries owned by foreign investors rose from $1 trillion to $2.4 trillion. China alone increased its holdings of U.S. Treasuries from $60 billion in 2000 to $478 billion in 2007.[5]

In other words, there was an implicit agreement on a global recycling process. By consuming massive amounts of imported goods and oil, the U.S. ran huge trade deficits, which resulted in large trade surpluses with oil producers and Asian exporters. These two groups of countries then recycled most of these surpluses back to the United States by investing in U.S. Treasury securities. This global recycling process kept the rates on long-term Treasury bonds approximately 1 percent lower than they otherwise would have been.[6]

The role of the Federal Reserve in elevating U.S. housing prices is more complex. In response to the 2001 recession resulting from the burst of the dot-com bubble and the September 11, 2001 terrorist attacks on the World Trade Center, the Fed aggressively lowered the interest rate on short-term U.S. Treasuries (e.g., one week to three months), which declined to almost 1 percent at the end of 2002. The Fed then held the short-term rate close to 1 percent until the middle of 2004. Concerned about the fragility of the economic recovery, the Fed held interest rates too low for too long. Only toward the very end of 2006 did the Fed bring the short-term interest rate back to normal levels.[7] To see how far the Federal Reserve suppressed interest rates during this period, consider Figure 1.2.[8] The chart compares the actual low level of interest rates set by the Federal Reserve to the level determined by the Taylor rule—a well-recognized method of setting central bank rates developed by Stanford University professor and former Treasury official John Taylor. As the chart shows, actual rates were dramatically below those suggested by the Taylor rule from 2001 through 2005.

Low Interest Rates Stimulated Appetite for High-Yield Mortgages

The decline in interest rates on U.S. Treasury bonds stimulated the appetite among foreign investors for higher yields from other types of debt securities. Between 2001 and 2006, foreign ownership of MBS increased from 6 percent to over 18 percent.[9] Similarly, U.S. investors

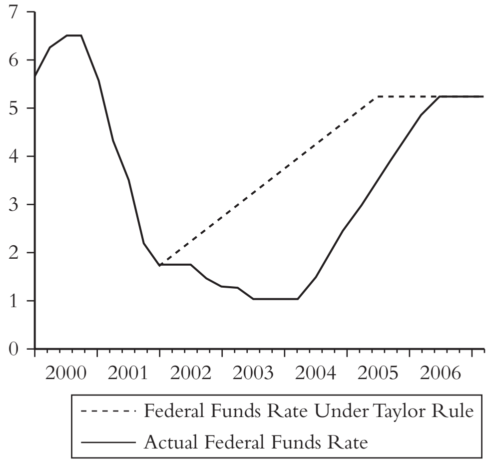

Figure 1.2 Taylor Rule
SOURCE: John Taylor for Federal Reserve Bank of Kansas City (September 2007).

had been burned by the crash in Internet stocks and were not receiving satisfactory yields on their bond portfolios. The mantra of U.S. investors became, "Give me yield, give me leverage, give me return."[10]

In order to offer higher yields, sponsors of MBS shifted toward pools with larger portions of subprime mortgages, which paid higher interest rates than prime mortgages. A prime mortgage is a loan meeting normal credit standards with proper documentation. A subprime mortgage is a loan to a home buyer who cannot meet the credit standards normally required to obtain a prime mortgage.

Interest rates on fixed-rate mortgages are mainly influenced by the rate on long-term Treasuries, which did not drop along with short-term rates. However, the interest rate on adjustable rate mortgages (ARMs) generally moves together with the rate on short-term Treasuries. With ARMs, the interest rate on the mortgages resets periodically (e.g., every year) in line with movements in short-term rates. From the fall of 2002 to the fall of 2004, the volume of new ARMs exceeded the volume of new fixed-rate mortgages as the interest rate on one-year ARMs fell to 4 percent or lower. This increased volume of ARMs contributed to the general surge in U.S. housing prices up to 2006.

In particular, the very low rates set by the Fed on short-term Treasuries and consequently ARMs encouraged the growth of subprime mortgages. Figure 1.3 shows how the volume of subprime mortgages rose from \$120 billion in 2001 (under 6 percent of all mortgages originated) to \$600 billion in 2006 (over 20 percent of all mortgages originated).[11] As former Federal Reserve Governor Edward Gramlich explained, "This whole subprime experience has demonstrated that taking rates down could have some real costs, in terms of encouraging excessive subprime borrowing."[12] While recognizing that subprime loans had helped promote home ownership among minority groups, Gramlich was alarmed by the hidden fees and prepayment penalties in most subprime loans, as well as their very low teaser rates that ratcheted up later. "Why are the most risky loan products sold to the least sophisticated borrowers?" Gramlich asked. "The question answers itself—the least sophisticated borrowers are probably duped into taking these products."[13]

Because of Gramlich's concerns about subprime loans, he urged Fed Chairman Alan Greenspan, as early as 2000, to send federal examiners into the mortgage affiliates of banks. But he was rebuffed by Greenspan, who feared that federal examiners would not spot deceptive practices and would inadvertently give a government seal of approval to dubious loans. In 2004, Gramlich reiterated his concerns about abusive lending practices, which were echoed by housing activists to Greenspan.

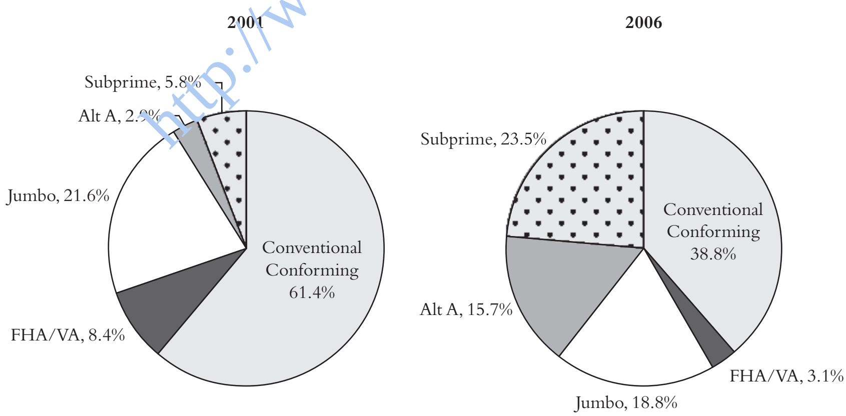

Figure 1.3 Mortgage Originations by Loan Type: 2001 and 2006
SOURCE: Inside Mortgage Finance Data in Major D. Coleman IV, Michael LaCour-Little, and Kerry D. Vandell, "Subprime Lending and the Housing Bubble: Tail Wags Dog?" (2008), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1262365.

But Greenspan again refused to utilize the Federal Reserve's authority to restrict mortgage lending practices.[14]

Lending Rules: Too Little, Too Late

Gramlich's concerns turned out to be well-founded. The default rate on subprime mortgages began to climb—from 10.8 percent in 2005 to 15.6 percent by 2007. In comparison, the default rate on prime mortgages went from 2.3 percent to 2.9 percent for the same period,[15] as shown by Figure 1.4. By the second half of 2007, investor concerns about this trend "led to a virtual collapse of the primary and secondary markets for subprime and nontraditional mortgages and contributed to disruptions in broader financial markets."[16] In 2006 and 2007, the federal banking agencies issued joint statements to depository institutions on how they should manage the risks associated with subprime lending and other nontraditional mortgage products. However, responding to comments from the mortgage industry, the final versions of the statements did not restrict or prohibit specific types of mortgage products or practices.

As the default rate on subprime mortgages continued to rise to 18.7 percent, the Fed in 2008 under its new Chairman, Ben Bernanke, finally adopted significant amendments (effective in 2009) to its rules on mortgage disclosures and unsafe lending practices for substandard mortgages. The new rules prohibit lenders from making a loan without

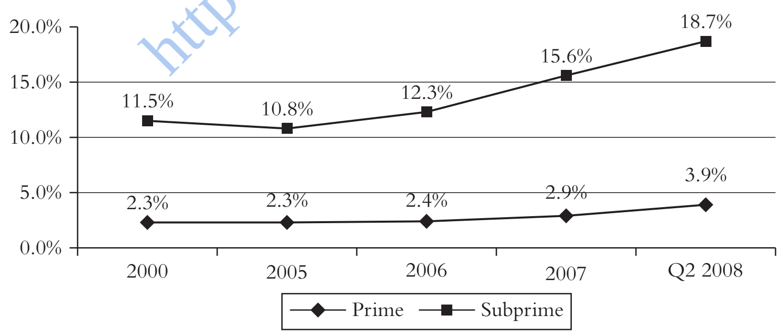

Figure 1.4 U.S. Mortgage Delinquency Rates (Total Past Due) 2000–2008
SOURCE: HUD Historical Data www.huduser.org/DATASETS/pdrdatas.html.

considering the ability of the borrower to repay out of income and assets other than the home's value. They require lenders to ensure that subprime borrowers establish escrow accounts or other arrangements to pay for property taxes and homeowners insurance on first-lien mortgage loans. The rules also ban any prepayment penalties if the terms of these penalties can change within the initial four years of the mortgage. Furthermore, they establish stricter advertising standards for mortgages and require certain mortgage disclosures to be provided to the borrower earlier in the transaction.[17]

Although these new rules go in the right direction, they are deficient in several major respects. Most critically, the Fed rejected a proposal that brokers disclose bonuses paid to them by lenders for steering customers to higher interest loans. These steering bonuses, often worth thousands of dollars, are typically paid to brokers for arranging more costly mortgages to borrowers with weak credit histories. For instance, Kimberly Marumoto of Hermosa Beach, California, said she used a broker to obtain a mortgage for her home and learned later, from her accountant, that she could have qualified for a lower interest rate. "It's almost like if you went to the store, and the store didn't tell you could actually get this item for 20 percent off," said Marumoto, who sells bedding and table linens. "This whole home loan business thing is very daunting to a first-time buyer."[18] As this example illustrates, steering bonuses can provide brokers with a significant incentive to originate mortgages with higher interest rates than those for which the borrower would have been eligible. **Therefore, steering bonuses should be banned or fully disclosed to the borrower.**[19]

Second, on disclosure generally, many subprime borrowers did not understand significant terms in their mortgages, for instance, the reset of the interest rate or the imposition of prepayment penalties. In part, this lack of understanding was caused by the dense pile of documents involved with mortgage applications. In response, Alex Pollock, former president of the Federal Home Loan Bank of Chicago, has made an excellent suggestion: **All applicants for home loans should be provided with a one-page summary form a few days prior to closing.**[20] **That form should outline the essential features of the mortgage, such as its monthly cost, principal amount, prepayment penalties and criteria for resetting interest rates if applicable.** This one-pager would drive home to borrowers the obligations they are assuming in signing the mortgage.

Third, the new rules fail to restrict the use of negative amortization loans. Such loans allow borrowers to pay back less than even the interest due on the loan each month. The shortfall is added each month to the loan's principal—the negative amortization—leading to larger monthly payments at the end of a specified period or at the maturity of the mortgage. Many home owners could not afford these larger monthly payments. **Negative amortization loans should be allowed only in special circumstances, such as restructuring a mortgage on the brink of foreclosure.**

Finally, and more broadly, most of the new rules apply only to subprime and Alt A mortgages. An Alt A mortgage is a loan to a home buyer who may be creditworthy, but does not meet the standards for a conforming mortgage–in many cases, the borrower cannot provide the normally required documentation. (Alt A stands for alternative documentation.) **But the new rules codify sound practices for advertising, underwriting, and servicing mortgages, so they should generally be extended to all first-lien mortgages on primary residences.**

In May, 2009, the House of Representatives approved the Mortgage Reform and Anti-Predatory Lending Act,[21] which imposes more restrictions than the Fed's new rules in several key areas. For example, it prohibits steering bonuses to encourage brokers to sell higher-priced home mortgages. It outlaws mandatory arbitration clauses in any residential mortgage and credit insurance with one advance premium. It bans mortgages with negative amortization (with certain exceptions), and outlaws prepayment penalties in ARMs. It also provides borrowers with a defense of rescinding the loan in a foreclosure proceeding. The House bill has not yet been voted on by the Senate as of September 1, 2009.

Many Mortgage Lenders Were Unregulated

The growth of subprime lending, especially mortgages with low teaser rates that later ratchet up, has been the main driver of mortgage losses. The growth of subprime lending was, in turn, driven by the willingness of mortgage sponsors to include subprime loans as part of mortgage pools underlying the issuance of MBS. As the demand for MBS increased, mortgage originators were able to sell all of their subprime loans quickly to the sponsors of the MBS. Therefore, mortgage originators had strong financial incentives to increase their volume of mortgages at the expense of loan quality and due diligence on borrowers.

Under substantial pressure to produce, mortgage lenders in many cases duped borrowers into taking out loans they could not afford to repay. In many Mexican-American communities of California, such a loan is called "la droga"—Spanish for drug and Mexican slang for a crippling debt. One of the highest concentrations of subprime loans in Orange County, California, was on Camile Street in Santa Ana. A 2007 story in the *Orange County Register* read, "On Camile Street every variety of la droga is on display: adjustable-rate loans with low teaser payments that quickly escalate; prepayment penalties so large that home owners cannot refinance; 'piggyback loans' so low-income buyers can own a house with no money down. All are described in long, complex documents that many Spanish-speaking buyers cannot read."[22]

Overzealous mortgage lenders used pressure tactics to close as many subprime loans as possible. For example, a mortgage broker named Troy Musick was so desperate to close a deal that he followed Ruth DeWitt into the waiting room of an Indiana hospital while Ms. DeWitt's husband was having quadruple heart bypass surgery. She recalls him saying: "It's now or never." The result was a $143,400 loan that the couple was not able to afford.[23] Similarly, New Century Mortgage provided Mr. Ramirez, a strawberry picker from Benito, California, who earned $15,000 per year, with a $720,000 loan to purchase a new home. The Ramirez family members say that they were told by their broker that they could refinance the monthly payments down to $3,000 per month. But this never happened and the actual $5,378 monthly payment was more than the Ramirez family could handle.[24]

The majority of the originators of subprime mortgages were independent mortgage lenders or brokers, called nonbank lenders. In 2005, for example, brokers represented around 60 percent of subprime originations, but only 25 percent of prime originations. As summarized in Figure 1.5, 14 of the top 25 originators of subprime and Alt-A loans in 2006 were nonbank lenders.[25]

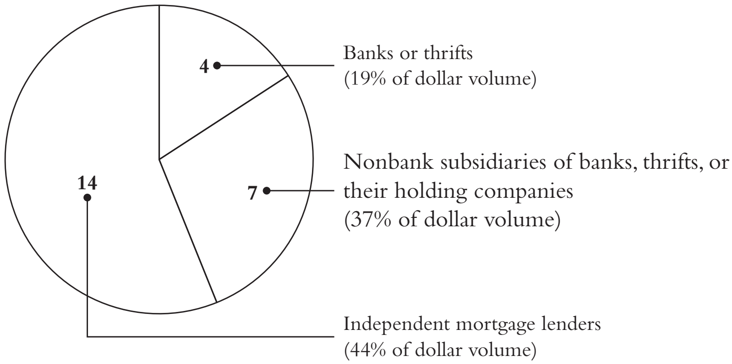

Figure 1.5 Top 25 Originators of Subprime and Alt-A Loans in 2006
SOURCE: Government Accountability Office: Westley Presentation using Inside Mortgage Finance and Federal Reserve Data.

The joint statements of the banking agencies on subprime loans and nontraditional mortgage practices, mentioned earlier, did *not* apply to nonbank lenders; these statements applied only to FDIC-insured banks, thrifts, and their affiliates. The 2008 amendments to the Fed's mortgage rules finally applied to all nonbank lenders. Similarly, until 2008, nonbank lenders were not required to be registered or regulated by any federal agency. Instead, licensing of nonbank lenders was left to the states, which often engaged in little or no supervision of nonbank lenders.[26] In other words, a majority of the mortgage lenders in the United States were essentially unregulated until quite recently.

Not SAFE Enough

In the summer of 2008, Congress finally passed the SAFE Mortgage Licensing Act (SAFE = Secure and Fair Enforcement). This Act establishes minimum standards for state licensing and registration of local mortgage lenders, and requires federal banking agencies to establish a joint registry of loan originators at federally regulated banks, thrifts, and their affiliates. The Act also requires the Department of Housing and Urban Development (HUD) to establish a backup licensing and registry system for loan originators in any state that fails to set up its own system within one or two years.[27]

The enforcement of the new Act is likely to be uneven. Some states will not only register nonbank lenders but also will institute other reforms. For example, California now prohibits lenders from initiating foreclosure proceedings until 30 days after contacting the borrower or making due diligence efforts to do so. This common sense requirement should apply in all states. Yet there is virtually nothing HUD can do if other states establish a registry and licensing system for nonbank lenders, and then do little to supervise them.

In addition, SAFE requires HUD to make recommendations to Congress on appropriate legislative reforms to the Real Estate Settlement and Procedures Act (RESPA) to promote transparency and comparative shopping on mortgage loans. In late 2008, HUD announced revisions of the RESPA requirements so that lenders would provide borrowers, in advance of a closing, with a "good faith estimate" of interest rates, other fees, and prepayment penalties as well as the possibility of later increases in monthly payments. These revisions were needed, according to HUD Secretary Steve Preston, because "many people made uninformed decisions" in taking out loans and these decisions contributed to a surge in mortgage defaults.[28] According to Preston, however, HUD does not have the authority or resources to enforce these RESPA revisions.

In the Stimulus Act of 2009, Congress authorized the Federal Trade Commission (FTC) to ban deceptive lending practices, which is a high priority for the FTC.[29] The FTC will be getting help from the Justice Department, which enforces federal criminal laws against fraud in connection with obtaining mortgages. These laws have long applied to prospective borrowers. In 2009, Congress extended these federal criminal laws to fraud by mortgage lenders.[30]

There are too many federal agencies involved in the regulation of mortgage lending, which also involves the 50 states under SAFE. **Therefore, Congress should create a new agency oriented toward consumer protection, such as the one proposed by the Obama Administration,[31] to police all the federal laws on mortgage lenders and provide that agency with additional enforcement resources in this area. To consolidate jurisdiction over this area, Congress should also transfer the authority to issue mortgage disclosure rules from the Federal Reserve Board to this new**

agency. The Fed should be focused primarily on macro economics and systemic risk, not consumer protection.

Lenders Need Skin in the Game

As long as lenders can sell 100 percent of any mortgage they originate and retain no material risk of loss on that mortgage, lenders will have little incentive to do proper diligence on the borrower and structure the mortgage in a manner that it is highly likely to be repaid. Academic studies confirm the common sense intuition that mortgage lenders usually perform more rigorous due diligence when they are retaining the risk of a subprime mortgage's default, than when they are originating to distribute, that is, issuing subprime mortgages so they can be sold quickly to the secondary market.[32] In other words, lenders need to retain some skin in the game as an incentive to make and document sound loans.

On the other hand, many mortgage lenders do not have much capital. A high retention requirement would put them out of business and dramatically decrease competition in the mortgage lending sector. Balancing these considerations, the U.S. Congress is giving serious consideration to a bill requiring mortgage lenders to retain at least 5 percent of the face value of any mortgage they originate and sell.[33] The European Commission has proposed a directive requiring Member States to implement a similar 5 percent retention requirement for all new securitizations starting in 2011.[34]

Some House Purchasers Were Gaming the System

While some home purchasers were rushed or confused by mortgage lenders, others willingly participated in deceptive practices involving their mortgages. Consider the case of the Mottos, a family with four children, who, in 2005, agreed to pay $540,000 for a new three-bedroom house in Clarksburg, Maryland. The builder offered to supply them with a mortgage, but became concerned that the Mottos might not qualify for the loan. So the builder inflated the couple's income by incorrectly stating that they would be collecting rental income from leasing their old house. Although the Mottos claim they were uncomfortable with misrepresenting their income, they nonetheless signed the loan documents and bought the new house. Like the Bartons in the parable at the start of this book, the Mottos could not sell or lease their old home and were struggling to meet the mortgages on both dwellings.[35]

An Oakland woman candidly told a similar story to the *San Francisco Chronicle* about exaggerating her income in response to suggestions by her mortgage broker: "He said, 'If you made $60,000, we could get you into the lowest interest level of this loan; did you make that much?' I said, 'Um, yes, about that much.' He went clickety clack on his computer and said, 'Are you sure you don't remember any more income, like alimony or consultancies, because if you made $80,000, we could get you into a better loan with a lower interest rate and no prepayment penalty.' It was such a big differential that I felt like I had to lie, I'm lying already so what the heck, I said, 'Come to think of it, you're right, I did have another job that I forgot about.'"[36]

Stories like that of the Mottos and the Oakland woman were repeated many times. The top types of mortgage fraud include the following:[37]

- Misrepresentation of income, assets or other debt
- Forged or fraudulent documents such as tax returns or rent verifications
- Misrepresentation of the borrower's intent to occupy the house as his or her primary residence
- Identity fraud through the unauthorized use of another person's Social Security number
- Straw buyers (someone who is not the actual buyer) used to help family or friends obtain a house

Of course, mortgage lenders and federal authorities should try to prevent these practices by borrowers and take legal actions when these practices are discovered. At the same time, the United States should address three structural incentives that encourage home purchasers to overextend themselves: mortgage loans with no down payments, state exemptions from foreclosure liabilities, and unduly broad tax deductions for mortgage interest.

The FHA Allowed No Down Payment Loans

During the 1990s, the Federal Housing Administration (FHA) participated in several new programs offering no down payment loans to first-time home purchasers through gifts from nonprofit organizations. These programs were analyzed by FHA's Inspector General, who found that the default rate in 2001 was almost 20 percent on a large sample of such no-down-payment loans.[38] Nevertheless, the FHA continued until the middle of 2008 to allow the purchaser to meet its normal requirement for a 3 percent down payment by a gift from a nonprofit group, which, in practice, was often affiliated with the developer or builder of the home. In 2005 and 2006, for example, 40 percent of all first-time buyers took out mortgages with no down payments, according to the National Association of Realtors.[39]

Many no-down-payment loans were facilitated by allegedly charitable organizations that were "being used to funnel down payment assistance from sellers to buyers through self-serving, circular financing arrangements."[40] The program works like this: A seller makes a charitable donation to a nonprofit organization, which in turn gives a down payment gift to the house buyer. The source of the seller's donation is the sale proceeds of the house. Howard Glaser, a former HUD official, said, "It's a well-intentioned program that's turned into little more than a federally financed mortgage scam. The victim is often the borrower, who is lured into a home they can't afford by a federal program."[41] In 2006, the IRS began to investigate nonprofit groups funded by home builders and other sellers. **Although the IRS has revoked the nonprofit status of many front organizations for housing developers, a few continue to operate and should be closed down.**

As of October, 2008, the FHA required a purchaser to make a down payment of at least 3.5 percent of a home's purchase price to obtain a FHA mortgage. However, FHA materials stress that this down payment requirement can be fully satisfied by tax credits for first-time home purchasers, as described later. This use of tax credits is just another way for the FHA to make loans to home buyers with no skin in the game.

Moreover, home purchasers have already found that the U.S. Department of Agriculture will still help guarantee no-down-payment loans in rural areas, generously defined to include some outer suburbs of cities. In fact, the General Accounting Office (GAO) found 1,300 instances of areas qualifying as rural that were closely integrated with urban areas. For example, Belpre, Ohio was designated "rural" by GAO standards in 2005. That same year the Census Bureau reported that Belpre was "densely settled," with an average population density of 1,000 residents per square mile, and also that it was contiguous with the urban community of Parkersburg, West Virginia, which had a population of around 33,000 at the time.[42] **The Department of Agriculture should require at least a 3.5 percent down payment for all home mortgages in its programs and should more accurately define rural areas.**

Limit Tax Credits for First-Time Home Purchasers

In order to provide an additional incentive for home ownership, Congress enacted a tax credit in late 2008 for first-time home buyers with joint annual income of $150,000 or less. This credit applied to home purchases in 2008 and the first half of 2009, but must be repaid by the home purchaser in $500 annual installments over 15 years. The Stimulus Act of 2009 expanded this tax credit to $8,000, and included all buyers of principal residences who have not owned a home in the last three years and whose joint annual adjusted income does not exceed $170,000. The credit can be applied to any principal residence purchased through November 30, 2009, and it will *not* have to be repaid if the residence is held for at least 36 months.[43]

If Congress wants to help first-time home purchasers below a certain income, it should offer them tax credits instead of mortgages with no down payments. But the tax credits should be designed to ensure that these home purchasers have skin in the game. Specifically, the amount of the tax credit should not cover more than half of the down payment for the house.

With the rise of no-down-payment loans and the fall of housing prices, the national average of home owners whose mortgage debt exceeds the current value of their homes (underwater mortgages) was 18 percent as of September 30, 2008, rising to 22 percent by March 31, 2009.[44] Figure 1.6 shows the four states with the highest such percentage (other than Michigan with its auto problems).

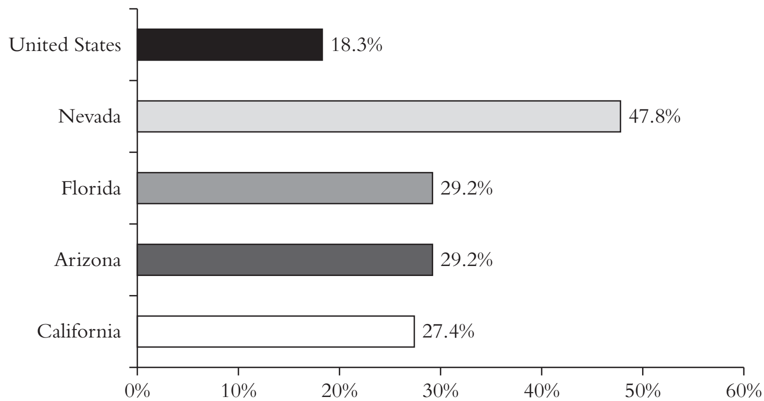

Figure 1.6 Percentage of Underwater Home Owners in Four States as of Sept. 30, 2008

SOURCE: First American CoreLogic published in "State Has Highest Percentage of 'Under Water' Households," *Wall Street Journal* (Oct. 31, 2008).

States Should Restrict Their Antideficiency Laws

California and Arizona both have laws that usually protect borrowers if they default on their home mortgages and the proceeds from the home sale are less than the amount of their mortgages. If a lender sells the home underlying a mortgage, it generally may not collect any deficiency from the borrower in these two states. **California and Arizona should narrow or eliminate their antideficiency statutes, because they encourage purchasers to buy as expensive a house as they can and obtain close to 100 percent financing, with little concern about personal liability if they default on their mortgage.**

In California and Arizona, the mortgage holder can elect one of two remedies when a borrower defaults on a home mortgage. First, the mortgage holder can sell the home subject to the mortgage in order to recover as much as possible of the loan. In that case, the borrower is not liable for any deficiency from the home sale, that is, the difference between the mortgage amount and the sale proceeds. Second, the mortgage holder can sue the borrower personally for the amount of the mortgage. In that case, the mortgage holder cannot attempt to sell the home subject to the mortgage. This second alternative is unattractive to most mortgage holders since the defaulting borrowers rarely have personal assets worth more than their homes.

Both Nevada and Florida have homestead exemptions, which protect a person's primary home from creditors in many circumstances. In Nevada, the homestead exemption protects the owner of a primary residence from most creditors up to $550,000 of equity in their home.[45] In Florida, this homestead exemption essentially has no upper limit, leading people like O.J. Simpson with massive debts to purchase multimillion dollar homes there. However, both states allow lenders to foreclose and collect on a mortgage that is specifically secured by all the owners of a home.

Congress Should Narrow Tax Deductions for Mortgage Interest

Other incentives for home owners to overextend themselves are found in the U.S. tax code. Most Americans agree that mortgage interest on their primary residence should be tax deductible. However, the United States goes much further than other countries in tax deductions for mortgage interest. Interest deductions are available for mortgages on second homes, as well as for mortgages on any number of homes acquired by speculators hoping to sell or flip them quickly for a profit. House purchases by speculators were a significant factor behind the surge in housing prices and subsequent rise in mortgage defaults. In 2005, according to a real estate trade group, investors purchased almost one out of every three homes in the United States.[46]

Although the United States does not allow tax deductions for interest on credit cards or consumer purchases, interest on home equity loans is tax deductible. Yet the purpose of both types of loans is often the same. This tax policy on home equity loans is inconsistent and unwise. Home equity loan balances have ballooned from $1 billion to more than $1 trillion since the early 1980s.[47] During the surge in housing prices, many owners took out home equity loans not to improve their homes but to buy consumer goods. Similarly, cash-outs from refinancing home mortgages amounted to $327 billion dollars in 2006 alone.[48] From 2001 to 2007, $350 billion was shifted from credit card balances to home equity loans or refinanced mortgages.[49] As a result, U.S. household debt relative to personal disposable income rose from 77 percent in 1990, to just over 90 percent in 2000, to over 130 percent in 2007.[50]

Congress should give serious consideration to limiting the interest deduction to one mortgage for the primary residence of each family. In addition, Congress should seriously consider the elimination or restriction of the interest deduction for home equity loans and mortgage refinancings, unless the remaining equity in the home exceeds 20 to 25 percent of its current market value. This limit would allow home owners to realize some of the built-up equity in their home without jeopardizing the ability of the first mortgage holder to protect its interest.

Summary

The recent crash in U.S. housing prices was caused by multiple factors. A leading factor was the abnormally low rate of interest from late 2001 through mid-2005, which was driven by the global glut of savings and the Federal Reserve's policy decisions. This low interest rate made housing much cheaper for many Americans and created a huge demand among global investors for mortgage-backed securities (MBS) with higher yields and higher risks. The result: a huge increase in the volume of high-yield, subprime loans originated by mortgage lenders and sold to Wall Street firms, which packaged and sold them as MBS throughout the world. Unfortunately, these subprime loans were often made to borrowers who could not afford the monthly payments, and who soon began to default at an alarming rate. These high defaults contributed to a sharp decline in U.S. housing prices and an abrupt halt to the mortgage securitization process.

The origination of subprime loans was heavily concentrated in mortgage lenders, which were not required to be licensed until 2009. Although these mortgage lenders will now be licensed by each state, Congress should promote adequate and uniform supervision of the mortgage origination process by creating a federal mortgage agency. More fundamentally, to incent mortgage lenders to underwrite sound loans, they should be required to retain at least 5 percent of the default risk of the mortgages they sell in the secondary market.

Although the Federal Reserve has finally toughened the rules on mortgage disclosures and lending practices, it should go further by requiring disclosure of bonus payments to brokers for originating high-yield loans, and limiting the use of mortgages with negative amortization. Further restrictions on the practices of mortgage lenders may be adopted through legislation, or new Fed rules in response to possible legislation. In the future, the job of setting rules on mortgage practices, as well as the resources for enforcing these rules, should be transferred to a new federal mortgage agency with more of a focus on consumer protection than the Fed.

States like Arizona and California should limit their statutes that encourage home owners to avoid personal responsibility on their mortgages. If home owners default on their mortgages, the holders of those mortgages should have the ability to bring suit against these owners for at least some portion of the difference between the outstanding balance on the mortgages and the proceeds from the home sale. In 2008, the Federal Housing Administration (FHA) finally stopped insuring mortgages with no down payments. However, FHA should also stop allowing home owners to satisfy the agency's requirement for a 3.5 percent down payment entirely with tax credits. Similarly, the Department of Agriculture should eliminate or severely restrict the use of no-down-payment loans in its home ownership programs and narrowly define rural areas.

Tax credits are a sensible way to encourage first-time home buyers if the down payment on the home substantially exceeds the value of the tax credit given to the homebuyer. However, if the United States is to avoid another speculative bubble from overinvestment in housing, Congress should reconsider the scope of the tax subsidies for home ownership. Congress should continue to allow the deduction of interest on first mortgages securing the primary residence of the taxpayer. But Congress should consider repealing or limiting the interest deduction on home equity loans or mortgage refinancings, unless the remaining home equity exceeds 20 to 25 percent of the fair market value of the home. Similarly, Congress should consider repealing or limiting the interest deduction on mortgages used to buy vacation houses or other types of second homes.