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Pernicious Problems of Housing Finance

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A Right to Housing

Foundation for a New Social Agenda

EDITED BY

Rachel G. Bratt, Michael E. Stone and Chester Hartman

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Michael E. Stone

4 Pernicious Problems of Housing Finance

THE SYSTEM OF housing provision and finance erected in the 1930s and fully implemented after World War II was one of the pillars of the postwar prosperity, sustaining and stabilizing the economy as well as transforming the nation's social and physical geography. However, during the 1960s, this postwar stability began to crumble. Inflation took hold, competition for credit increased, interest rates rose and the housing sector suffered disproportionately.

Attempts to deal with these problems have contributed to worsening housing affordability, from both the income side and the housing cost side. On the one hand, responses by business and the government to increasing globalization and the associated squeeze on corporate profitability have generated widening income inequality: Those at the bottom have experienced declining real incomes; those in the middle have, at best, barely kept up with inflation; while those at the top have substantially improved their standard of living (see Chapter 1). Meanwhile, housing costs have been driven to dizzying heights, caused in part by demand for housing from ever richer households at the top of the income distribution, but also by runaway speculation in housing markets in many areas, perverse housing policies and a restructured national mortgage system.

Since the late 1960s, the system of housing finance in the United States has undergone profound transformation. Once a relatively separate, protected and locally based system, housing finance has become integrated into the national and global capital markets, with massive institutions becoming the controlling intermediaries between distant capital markets and local housing markets. Why and how has the residential finance system been transformed, and what have been the consequences? The chapter begins with an examination of the structural changes in the housing finance system and then explores several major areas of impact: first, the shift of housing production toward more expensive houses, associated with widening income inequality as well as with standardization of lending; second, the recent, modest increase in middle-income homeownership, fueled not only by economic growth but also by special programs in response to advocacy and anxiety about discrimination and diminished affordability in the mortgage system; and third, greater risk-taking by households and lenders, leading to greater household debt burdens, an upward trend in residential mortgage foreclosures and instability at the nation's (and the world's) largest mortgage institutions.

While the 1990s and early 2000s have been celebrated as a period of low inflation and low interest rates, the enthusiastic hucksters of the era rarely acknowledge where these conditions came from: draconian cuts in government social spending, diminishing job security and globalization of corporate capitalism. The concentration, centralization and rationalization of housing finance may have been inevitable with the new economic order. But the consequences have been mixed, at best, for housing, households and communities. Understanding the structure and dynamics of the mortgage system is thus essential for understanding the extent, depth and persistence of housing problems—and the need for

new models of housing finance in order to realize a Right to Housing.

HOUSING FINANCE AND THE ECONOMY

While new housing is of course costly to produce, most housing is not new. Yet because housing is a commodity in this society, the market value of well-maintained older housing is typically of the same order of magnitude as similar new housing, and most housing is sold and resold and refinanced repeatedly over its lifetime. For most of these transactions, the bulk of the cost is financed through mortgage loans. The financial burden of repaying these loans with interest constitutes by far the largest component of residents' housing costs for both renters (indirectly) and homeowners. Most rental housing is mortgaged, with exception of public housing and nonprofit elderly/handicapped housing, and over 65 percent of all homeowners have mortgages on their homes (Kennickell, Starr-McCluer and Surette 2000:Table 11B). On average, two-thirds of total monthly housing costs for homeowners with mortgages goes for their mortgage payments; the share of rents going toward mortgage payments is probably at least as great.[1] The institutions and mechanisms of mortgage lending thus have a contradictory role: They have been essential to the functioning of the private housing market but have also been primary sources of persistent and pervasive housing affordability problems.

Historical Background on Institutional Mortgage Lending[2]

During the first three decades of the 20th century, mortgage lending by financial institutions moved to the center of the U.S. housing system, facilitating expansion of residential construction and sales but also imposing a rigidity on housing costs and making the stability of the overall economy vulnerable to the ability of people to afford their housing payments. Thus, when the economy collapsed at the end of the 1920s, the mortgage system was a big part of the debacle. Millions of households lost their homes to foreclosure because they did not have the incomes to pay off their mortgages. Millions lost their savings because the banks had invested in home loans that were not being repaid. With no new funds available for investment, private residential construction practically came to a halt, and the private housing market nearly ceased functioning, adding to the depth and duration of the Great Depression.

When a new framework for housing finance was erected in the 1930s, it was still built around mortgage lending by private financial institutions—reflecting the power of those institutions and the general philosophical commitment to have the government assist rather than replace private investment. The major and most profound and pervasive forms of federal support for housing put into place in the 1930s were therefore designed to stimulate and protect private institutional lending. They consisted of the system of central banking and deposit insurance provided by the Federal Home Loan Bank system (FHLB); the mortgage insurance program of the Federal Housing Administration (FHA) and, a decade later, the mortgage guarantee program of the Veterans Administration (VA); and the secondary mortgage market facilities of the Federal National Mortgage Association (FNMA, known as "Fannie Mae").

Strategically, the rebuilt mortgage system focused on wide promotion of debt-encumbered homeownership through the creation of low down payment, long-term loans to replace the earlier type of large down payment, short-term mortgage loans that had restricted the market to relatively well-off groups in the population. The new type of loan reduced monthly payments for a given size loan and lessened the personal savings needed to purchase a home. But in doing so, it created the illusion of ownership through the reality of debt. Furthermore, by making loans more easily available, the effective demand for houses was expected to increase, thereby contributing to overall economic growth as well as supporting the lending and construction industries in particular.

Of course, it took World War II to restart the economy and generate the savings needed to set the reconstructed mortgage system into operation. Savings that had accumulated

during the war, along with housing needs virtually unmet since the start of the Great Depression, provided the impetus for what became the postwar housing boom, facilitated by federal support for financial institutions to make the new long-term, low down payment loans. The postwar suburban boom produced some 30 million new housing units in two decades, increasing the nation's homeownership from about 40 percent at the end of the war to over 60 percent by the 1960s. Housing construction accounted for one-third of all private investment and nearly one-half of all public and private construction during this period. Housing debt represented the biggest single component of a vast explosion of private borrowing. Yet despite the success of the new mortgage system in dealing with the housing needs of a majority of Americans and contributing to prosperity, the system contained some inherent flaws and weaknesses.

First of all, even though mortgage lending contributed to economic growth, it grew much faster than the overall economy, hence faster than consumers' ability to repay the debt. Between 1946 and 1965, residential mortgage debt grew about three times as fast as gross domestic product (GDP) and disposable personal income. As more and more current income goes to paying past debts, the potential for profitable new lending to support continued economic growth without inflation becomes constrained. The mortgage system has thus been an important factor in the ups and downs of the business cycle.

Second, while the expansion of mortgage credit has contributed immensely to the growth and profitability of the entire housing industry, the increasing dependence on credit made production of new housing and the cost of buying and occupying both new and used housing increasingly sensitive to the supply and cost of mortgage money. No other major industry is as dependent on borrowed funds, and for no other major consumption item is price as sensitive to interest rates.

The third problem with the new mortgage system has arisen from the promotion of (debt-encumbered) homeownership as the essence of "the American Dream." Following World War II, homeownership became more than ever the mark of full citizenship, the essential symbol of status in American society. However, with wider accessibility of homeownership, the insecurity and low social status of renting became sharper: Tenure became an increasingly defining part of the great divide between the haves and have-nots, strongly correlated with race and marital status, and masking—if not truly replacing—class differences (Dean 1945; Perin 1977; Heskin 1983). Even for many who have made it across the divide, the struggle to achieve and sustain mortgaged homeownership can impose heavy costs—including family stress and exclusionary and snobbish attitudes as well as financial hardship and the risk for mortgage foreclosure—without necessarily yielding the promised fulfillment and satisfaction (Rakoff 1977; Stone 1993:Chapter 1).

The fourth major weakness built into the mortgage system created in the 1930s was the financial vulnerability of "thrift institutions"—savings and loan associations (S&Ls) and mutual savings banks—which were the mainstays of residential lending. Since they put nearly all of their funds into long-term mortgage loans, if interest rates on these loans were constant for the term of the loan, these lenders received a fairly stable and predictable rate of return year after year, regardless of what happened to interest rates after the loans were made. On the other hand, thrifts obtained most of the funds they loaned from savings deposits that could be withdrawn with little or no notice. As long as interest rates on savings accounts were competitive with other investments and substantially higher than the rate of inflation, the risk in "borrowing short and lending long" was not great. Thus, for two decades following World War II, thrift institutions were fairly successful at sustaining a steady inflow of funds into savings accounts, which they then used to support their own growth and a large fraction of the expansion of mortgage credit. As the major suppliers of housing funds, the thrifts were relatively insulated from the rest of the capital markets and not dramatically affected by economic fluctuations. In the 1960s, however, conditions changed, exposing

the inherent flaw in the financial structure of thrift institutions, generating two decades of instability and bringing forth another set of transformations in the housing finance system—changes that overcame the weakness in the structure of thrift institutions but not in the housing finance system's other problems.

Problems in the Late 1960s[3]

The onset of sustained inflation and intense competition for credit in the second half of the 1960s had profound implications for the housing finance system. Prior to the 1960s, savings and loan associations (which were the principal suppliers of mortgage credit), mutual savings banks and other mortgage lenders had sufficient funds from savings deposits and mortgage repayments to meet the demand for new mortgage loans. So government-supported capital infusions through the Federal Home Loan Banks and the Federal National Mortgage Association were only a minor part of the total supply of housing credit. In the early 1960s, though, as the economy and housing construction expanded sharply, middle-income households were saving less and spending more. With growing housing demand, but savings accounts not correspondingly expanding, S&Ls turned to borrowing from the Federal Home Loan Banks in order to provide the funds needed for making new mortgage loans. The Federal Home Loan Bank system, in turn, raised the necessary funds by selling securities in the national capital markets.

As credit competition intensified after the mid-1960s, thrift institutions began to suffer from the imbalance caused by "borrowing short and lending long," described above. In order to keep mortgage rates low, savings institutions were limited by federal regulators in the rate of interest that they could pay on savings accounts. As long as there was little inflation and other interest rates were also low, this posed no problem for thrifts. But in the tight-money period of 1966, wealthier households diverted more than $16 billion of their savings into other types of investments paying higher rates of interest; in 1969, they diverted nearly $35 billion from savings accounts (U.S. League of Savings Associations 1979:11). This sudden withdrawal of large amounts of money from savings institutions is termed "disintermediation." In order to raise money to offset deposit withdrawals, S&Ls turned increasingly to the Federal Home Loan Banks for capital advances, while other lenders sold off their FHA-insured and VA-guaranteed mortgages to Fannie Mae. Mortgage interest rates, which had rarely exceeded 6 percent prior to the 1960s, surpassed this level in 1966 and by 1970 reached nearly 8.5 percent (U.S. Savings and Loan League 1972:41).

The weakening of the traditional, locally based housing finance system led mortgage lenders and their supporters in the federal government to launch a two-pronged strategy. The first component, which was largely put into place between 1968 and 1970, involved the reconceptualization and expansion of government-sponsored secondary mortgage market institutions. The second element, which was only fully implemented in the early 1980s, was deregulation of the financial system. With these changes, the housing finance system embarked on a new era of enormous complexity that served to channel more funds and profits into the industry—but at a cost. Higher interest rates for mortgages, stimulation of real estate speculation and house price inflation, and worsening economic instability were among the consequences of these changes in housing finance (McIntyre 1991; MacDonald 1995, 1996).

Government-Sponsored Secondary Mortgage Markets

Under the pressure of the times, lenders and policy makers became increasingly interested in expanding residential financing through secondary mortgage markets, so as not to be as dependent on savings accounts for funds. Secondary mortgage markets provide a way for locally based originators of mortgage loans (primary lenders) to sell off some mortgages instead of holding them in their own portfolios.[4] This provides primary lenders with additional funds to make more loans. The buyers of mortgages in secondary mortgage markets are large institutions that seek the financial benefits of mortgage

lending but do not want to be bothered with investigating the capabilities of borrowers and appraising the values of the properties prior to loans being made, nor with collecting mortgage payments after loans have been made. Secondary market investors traditionally have included insurance companies, large commercial banks, pension funds and government-sponsored entities (GSEs) like Fannie Mae.

In order to stimulate more secondary mortgage market investing, the 1968 Housing Act provided the authority to privatize Fannie Mae over a two-year period. By 1970, Fannie Mae was to become a profit-making corporation, with its own board of directors and the authority to sell stock and issue securities. Fannie Mae was to remain subject to some federal supervision and had financial privileges available only to federal agencies; for example, even though Fannie Mae securities would not be backed explicitly by the federal government, it was assumed that the U.S. Treasury would repay investors if ever Fannie Mae itself could not do so (Tuck 1979:406–408; FNMA 1972).

The 1968 act also created the Government National Mortgage Association (GNMA, "Ginnie Mae"), a government agency within the Department of Housing and Urban Development that retained Fannie Mae's more risky functions, such as financing for subsidized housing. More importantly, though, Ginnie Mae was authorized to provide the federal government's full financial guarantee to mortgage-backed securities (MBSs) issued by private companies holding FHA and VA mortgages. Mortgage-backed securities are like shares in a mutual fund. Groups of mortgages are batched together into "pools." Buyers of securities in a given pool of mortgages are entitled to a share of the aggregated principal and interest payments from all of the borrowers whose mortgages are in the pool. Private investors in these new Ginnie Mae securities would put up money that would be invested in mortgage loans, and they would be guaranteed profitable repayment, first by the FHA/VA protection on the individual mortgages and second by the full faith and credit of the U.S. government on the securities (Tuck 1979:408–409).

The Emergency Home Finance Act of 1970 added the final ingredients in this expanded public-private secondary market framework. Until this point, Fannie Mae had been limited to purchasing government-backed FHA/VA mortgages, which had been a large share of mortgages in the immediate postwar era (Stone 1993:107–108). By the 1960s, however, that proportion had dropped significantly, mainly because the interest-rate ceiling on these loans remained below the market rate for long-term uninsured mortgages. This led to pressure for a secondary mortgage market for conventional mortgages so that lenders could sell off some of their growing number of mortgages lacking FHA or VA backing. The 1970 act authorized Fannie Mae to purchase uninsured mortgages meeting certain standards.

In addition, the 1970 act created another secondary mortgage market agency, the Federal Home Loan Mortgage Corporation (FHLMC, known as "Freddie Mac"), within the Federal Home Loan Bank system to purchase both conventional and insured mortgages from S&Ls and other members of the system (Tuck 1979:415). S&Ls had pushed for creation of their own federally sponsored secondary market institution because historically most of the mortgages purchased by Fannie Mae had been originated not by S&Ls but by mortgage companies. Unlike thrift institutions and commercial banks, mortgage companies have no depositors; they sell into the secondary market every loan they originate and are not part of the Federal Home Loan Bank system.

Despite these major policy changes establishing a greatly expanded framework for secondary mortgage market activity, thrift institutions continued to be the dominant element of the residential mortgage system through the 1970s. At the end of the decade, they still held more than one-half of all outstanding mortgage debt on one- to four-family houses and well over one-third of multifamily mortgage debt—nearly all of it in long-term fixed-rate loans (U.S. League of Savings Associations 1981:26–27). Part of the reason for this was that Freddie Mac got into operation very slowly during the decade, and so it did not yet provide substantial new funds to thrift institutions through buying up older long-term mortgages in thrifts' portfolios.[5]

The Push for Deregulation in the 1970s

As mentioned above, in the period of tight money and rising open-market interest rates during 1966, higher-income households diverted billions of dollars in savings to more lucrative investments, including savings accounts at commercial banks. Commercial banks could attract savings deposits because they made mostly short-term business and construction loans and hence were not locked into long-term fixed-rate sources of income as were the thrifts with their portfolios of low-interest mortgages. Although the interest rates the commercial banks could offer depositors on savings accounts were subject to regulation, the regulators raised the rates with the market, so savings accounts at commercial banks were an attractive (and safe, due to government deposit insurance) alternative to savings accounts at thrifts. As a result of the disintermediation problem that this created for thrift institutions, in 1966, federal regulators put tighter controls on commercial bank interest rates, setting rate ceilings slightly lower for commercial banks than for thrifts, thereby giving thrifts a slight edge in obtaining and retaining deposits. However, in order to keep mortgage interest rates down, the interest rate ceilings on saving accounts were usually set below open-market rates for nonbank investments (Carron 1982:5). Evidence that this new level of regulatory assistance did not solve the thrifts' stability problem is revealed by the large-scale withdrawals of savings deposits during 1969 to 1970, noted above, and a further round of disintermediation during 1973 to 1975. Interest rate ceilings may have protected thrifts from commercial bank competition for the savings of relatively wealthy households but not from the financial alternatives offered by brokerage houses, corporations and the U.S. Treasury.

The intensified competition for savings and competitive disadvantage faced by regulated institutions like thrifts (and to a lesser degree commercial banks) in the new era of inflation accelerated a movement toward financial deregulation that had begun in the late 1950s and received a big boost in the wake of the disintermediation crisis of 1969 to 1970 (Florida 1986: 209–212; Meyerson 1986:471). The argument was that if interest rates on savings accounts were not subject to government regulation, thrifts could offer whatever competitive rates were necessary to attract and retain deposits. But the only way in which thrifts could afford to offer higher rates to savers would be to raise mortgage interest rates because mortgage payments were, of course, their primary source of income. Thus, deregulation had the potential to help depository institutions but could have dire consequences for housing affordability.

Three major deregulation bills were introduced into Congress in the mid-1970s but were not enacted due to successful opposition from small financial institutions—fearing that they would be swallowed up—and real estate interests—fearing greater competition for credit and higher interest rates (Florida 1986:212–213). However, the momentum was clearly toward deregulation—although it took the economic collapse of the early 1980s to bring about enactment of the necessary legislation.

The Triumph of Deregulation in the 1980s

From 1980 until 1983, the United States experienced a recession much deeper and longer than that of the mid-1970s—so severe that even mainstream economists and business people called it a depression. It was in fact a double recession, as the 1980 economic decline was followed by a slight expansion despite rising unemployment in 1981, which was followed by a full across-the-board drop in 1982. It was so severe that all of the institutional changes of the late 1960s and early 1970s were not sufficient to protect the housing finance system from the devastatingly tight money and high interest rates. First, housing production collapsed—largely (but not entirely) because construction interest rates rose to nearly 20 percent, while demand dried up with rising unemployment and falling real incomes. Although the new financial mechanisms were helpful in getting some high-cost money into housing, credit availability was still part of the problem.[6] Furthermore, with lots of old lower-rate mortgages still on their books, the residential finance industry as a whole suffered a severe earnings squeeze in 1980. And in 1981 and 1982, the industry

experienced its first operating losses since the Great Depression (U.S. League of Savings Associations 1989:52). Due to insolvencies and mergers, the number of federally insured S&Ls, which had been nearly constant at about 4,000 from 1975 through 1980, declined 22 percent from 1980 through 1983 (U.S. League of Savings Associations 1989:47; Carron 1986:211ff.).

The crisis of the thrifts, together with depressed earnings of commercial banks and the weak international position of the dollar, overwhelmed remaining resistance to financial deregulation. In 1980, the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) was passed, providing, among other things, for phased decontrol of interest rates on deposits and permission for thrifts to diversify gradually out of mortgages (Florida 1986:217–218; Vartanian 1986:141; Fraser 1986:243ff). The provisions of DIDMCA were too gradual to have much immediate impact on the thrift crisis, however. Also, Federal Home Loan Bank Board advances of nearly $60 billion a year were no more than stopgaps. As well, the Reagan Administration had little inclination to provide special assistance to housing finance (Florida 1986:219–220). The continuing crisis and long-developing deregulation agenda thus led to a second landmark financial deregulation law, the Garn–St. Germain Act of 1982. The law accelerated and expanded the process in the following ways: moving quickly toward eliminating restrictions on the interest rates that institutions could offer depositors; facilitating variable-rate mortgages, with interest rates that go up and down with the rates paid to attract deposits; allowing thrifts to diversify into all sorts of nonhousing investments; permitting conversion of mutually owned (i.e., depositor-owned) thrifts to stock ownership; and providing emergency financial assistance to distressed S&Ls (Meyerson 1986:467–469; Vartanian 1986:147ff).[7]

With deregulation, many thrift institutions moved aggressively into alternative investments. Many others remained active in housing finance, but more as mortgage bankers—for instance, originating loans that were immediately sold to secondary market institutions, buying mortgage-backed securities and swapping old mortgages for mortgage-backed securities. In 1970, 86 percent of the assets of federally insured thrifts were in the form of mortgage loans. In 1979, mortgages were still 82 percent of assets but thereafter dropped below 80 percent and kept declining, reaching 54 percent by 1988. The thrifts' fastest growing class of assets became mortgage-backed securities, growing from less than 4 percent at the end of the 1970s to nearly 16 percent by 1988. Nonmortgage loans and other assets (including direct equity participation in real estate but excluding cash and nonhousing investment securities) grew from about 6 percent at the end of the 1970s to over 16 percent by 1988 (U.S. League of Savings Associations 1989:49). Furthermore, during the 1980s, over 40 percent of mortgage loans for the purchase of single-family homes had adjustable instead of fixed rates, including about 60 percent in 1984 and 1988 (U.S. Office of Thrift Supervision 1989:D-1). That is, by the mid-1980s, the financial imbalance of the thrifts had largely been eliminated, in part because they were diversifying out of primary residential lending, but even more because they were passing many of the risks of lending onto borrowers, other investors and, as we shall see, taxpayers.

Some thrifts responded to the phase-out of ceilings on the rates that they could pay for deposits by competing aggressively for funds; they then put the money into highly speculative projects in order to pay the high rates and make profits. These institutions were quite successful at attracting "hot money" depositors, wealthy investors who sought big returns yet were protected by federal deposit insurance. By and large, these were the thrifts that ended up collapsing in the next and bigger crisis of the late 1980s—at public expense. Most thrifts did not so actively pursue deposits in this way but instead filled the gap between their deposits and their desire to invest by borrowing from the Federal Home Loan Banks. FHLB advances, which had helped to sustain the savings institutions through the tight money periods of 1970, 1974 to 1975 and 1980 to 1982, actually tripled in the 1982 to 1988 period, growing to nearly $300 billion, or 22 percent of thrift liabilities (U.S. League of Savings Associations 1989:50).[8] That is, while deregulation meant that thrifts were no longer required to provide moderate-rate mortgages for

middle-income homeownership, it did not mean that they gave up government protection: They still had the security of federal deposit insurance and Federal Home Loan Bank advances.

Mortgage Lending in the 1980s

In the broad financial explosion that began after 1982, residential mortgage lending managed to hold its own. With savings institutions moving away from their traditional role as originators of residential mortgages for their own portfolios and into mortgage banking and nonmortgage investing, all sorts of other financial and nonfinancial companies got into the business of originating mortgage loans—the so-called primary mortgage market (Guttentag 1984:243–247; Kane 1986:266). As thrifts themselves and these other institutions sought to turn over these loans and obtain new funds for profitable lending, federally sponsored housing credit grew exponentially, and the government-sponsored secondary mortgage market institutions (Fannie Mae, Freddie Mac, Ginnie Mae) became the principal sources of housing finance. In 1986, thrift institutions yielded their century-long role as the dominant providers of home-mortgage credit, when for the first time the residential mortgage debt held by federally supported agencies (directly) and their mortgage pools (indirectly) exceeded the total held by S&Ls and savings banks (U.S. League of Savings Associations 1989:29).

Of the federally sponsored secondary-market institutions, Freddie Mac grew rapidly during the 1980s. Acting as a true secondary-market agency, it retained only a small portion of the mortgages that it bought; it aggregated the rest into pools and issued mortgage-backed securities against these pools, thereby bringing other investors into the world of housing finance. Fannie Mae, by contrast, continued its traditional role as buyer of insured mortgages for its own portfolio during this period while also taking on a new role in the 1980s as an issuer of mortgage-backed securities. Fannie Mae's total contribution to the residential finance system was slightly greater than that of Freddie Mac but grew more slowly and involved somewhat less activity in mortgage-backed securities. Finally, the volume of privately issued securities backed by pools of FHA/VA mortgages and guaranteed by Ginnie Mae grew at the fastest pace of all, since these MBSs had the lowest risk, due to federal guarantees, as explained above.[9]

A vast array of new programs, institutions and techniques were thus created and put into place to tap the national and international capital markets for housing, both directly and indirectly, and to provide thrift institutions with more flexible asset and liability structures. In addition to financial deregulation and expansion of federally sponsored secondary mortgage markets, many state and some local governments also sought to draw funds for housing from the national capital markets by creating housing finance agencies and issuing mortgage revenue bonds.[10] Also, deregulation led many types of financial entities to become involved in housing finance, even outside of the government-sponsored agencies, through the creation of sophisticated mortgage-backed securities sold to wealthy private investors and institutions. Even the commodities markets became involved, setting up mortgage "futures" trading to enable hedging and speculation in mortgage interest rates.

The Savings and Loan Crisis and Bailout

As the 1980s drew to a close, hundreds of thrifts collapsed because they had invested in speculative land development projects and high-risk junk bonds that did not yield their promised high profits, which had been the basis for offering very high interest rates on savings accounts and certificates of deposit. Because these institutions now had on their books large volumes of nonperforming and even worthless assets, not only could they not pay high interest rates, they could not even return the deposits themselves to the unhappy savers who wanted their money back. The institutions were insolvent, and as members of the Federal Home Loan Bank System, they were taken over by the Federal Savings and Loan Insurance Corporation (FSLIC). Because the savings accounts were insured, FSLIC had to pay off the depositors and itself soon ran out of funds. The crisis revealed all too clearly that deregulation had not only failed to provide

much help to the housing industry; it had even failed to save much of the thrift industry.

In 1988, the S&L collapse became a source of daily headlines, but there was little action from the Reagan Administration. Congress also moved gingerly, as it too had enthusiastically backed deregulation, and many members of the banking committees had benefited from financial industry ties and campaign contributions. With FSLIC insolvent and demands being made for general appropriations to pay off depositors, Congress finally began to move (U.S. General Accounting Office 1988a, 1988b), and soon after his inauguration, President Bush (senior) announced his bailout plan (White House 1989).

The S&L bailout legislation was debated for six months, with most attention devoted to questions of who would pay and how. Finally, on August 6, 1989, the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) was signed (Hershey 1989; Barth and Wiest 1989:1). The law's most significant feature was that most of the hundreds of billions of dollars for the bailout of (mostly wealthy) depositors at failed thrifts would be paid for by the public through our taxes. FIRREA also essentially eliminated the 55-year-old Federal Home Loan Bank system through the following changes: FSLIC was dissolved, and deposit insurance for thrifts was placed within the solvent but shaky Federal Deposit Insurance Corporation (FDIC); the independent Federal Home Loan Bank Board was replaced by an Office of Thrift Supervision (OTS) within the Treasury Department; the regional Home Loan Banks, owned by member thrifts, were allowed to continue, but all regulatory functions were placed directly within the federal government. The law established new restrictions on thrift institutions and gave regulators stronger enforcement powers; as well, it mandated some small-scale measures to support slightly below-market housing (Barth and Wiest 1989; Low Income Housing Information Service 1989). It was all, of course, much too little and much too late.

The estimated cost of the S&L bailout continued to rise after FIRREA was passed, doubling by the spring of 1990 to an estimated $325 to $500 billion over a 10-year period (Gosselin 1990a). The S&L scandal generated understandable public anger about the fraud, political payoffs, lax oversight and costs to the taxpayers but too often missed the deeper and longer-term roots of the crisis. As we have seen, the processes of deregulation and resulting chaos represented the response to very real weaknesses in the housing finance system—the contradiction between providing long-term mortgages with relatively low and fixed rates, and the need to offer high rates on savings accounts to attract funds to lend. It was a bad response, but it was to a very real problem rooted ultimately in the inability of U.S. capitalism to solve the problem of housing affordability through a system of profit-driven mortgage-debt financing, which inevitably passes much of the costs and risks of financial instability and insecurity onto housing consumers and the government.

Furthermore, the public bailout itself proved highly inefficient and inequitable (Campen 1991). Considerable attention was focused on the regional redistribution of wealth resulting from the bailout, from the Northeast and Northwest to the Southwest, especially Texas (Bailey 1990). Less attention was focused on the upward redistribution of wealth: This involved, at the first level, the hundreds of billions of dollars lent to developers, speculators and financial manipulators that will never be repaid by them; but at the second level, within the failed institutions, much of the deposit funds were in large "hot-money" accounts, so taxpayers were forced to bail out depositors far wealthier, on average, than themselves (Gosselin 1990b). This massive two-level process of redistribution has only exacerbated widening economic inequality.[11]

The Illusion of Stability in the 1990s

At the end of the 1980s, the economy spiraled into another deep recession. It was the inevitable result of the immense gap that had developed between soaring speculative values and mountains of debt on one side and stagnant household incomes and the underlying weaknesses of the U.S. economy on the other. The official unemployment rate rose to about 7 percent by 1991, but the real impact was far worse, as millions of people gave up looking for work and therefore stopped being counted in the

official unemployment rate. The federal deficit jumped to $220 billion in FY1990, and then to a new high of $270 billion in FY1991, as government tax revenues plummeted with the recession (U.S. Office of Management and Budget 1992). In 1991, assets of failed banks (commercial banks and thrifts) set a record as well—$64 billion—and another record of over $100 billion in 1992, as more big banks collapsed under the weight of nonperforming real estate loans. Continuing bank failures of this magnitude sent the Federal Deposit Insurance Corporation into bankruptcy by late 1991; it was itself bailed out only with new taxpayer-backed borrowing authority (Skidmore 1991).

The recovery from the early 1990s' recession was much slower than in previous cycles, with housing/real estate/banking problems and federal budget deficits as major drags on growth during the first half of the decade. From 1992 through 1994, the economy grew at an average rate of less than 3 percent a year, about one-half the rate of other recoveries over the past half-century. In the second half of the decade, growth did accelerate, averaging 3.7 percent a year from 1995 through 1999, but even this was modest by historical standards (Henwood 1999). Furthermore, economic growth during that decade was associated with the lowest rate of investment in real productive capacity and the highest rate of investment in financial assets—the Wall Street mania and debt-financed housing and consumer spending binge—of the past five decades (Henwood 1999; Moseley 1999).

Yet the economic expansion of the 1990s and early 2000s was the longest on record, facilitated by remarkably low interest rates and low inflation, even though the official unemployment rate fell to 6 percent in the fall of 1994 and below 5 percent in the middle of 1997 through the start of the new millennium. How was this possible? The answer is to be found in increasing economic insecurity that kept wage pressures down and widened income inequality (see Chapter 1; see also Henwood 1999, placing U.S. inequality in an international context). Associated with what was occurring in the labor market, government social spending continued to be cut drastically: On the one hand, budget cuts exacerbated the deterioration of living conditions for those at the bottom; on the other hand, tight spending and rising revenues caused steady reductions in federal budget deficits and by late in the decade turned into surpluses, thereby limiting competition for credit and helping to keep interest rates down. Furthermore, weaknesses in the economies of most other nations meant that imported goods were relatively cheap, facilitating high rates of consumer spending with low inflation in the United States.

Housing finance was deeply enmeshed in the course of the economy during the 1990s. While the mortgage-backed securities (MBSs) market had been fully developed by the end of the 1980s, economic conditions of the 1990s brought the full fruition of MBSs, resulting in even greater integration of housing finance with the global capital markets. In the early 1990s, new computer-based techniques of investment analysis mated with relatively low interest rates and high housing demand to spawn a complex array of attractive mortgage-backed securities. During the period from 1991 through 1993, interest rates on MBSs were higher than corporate and Treasury bonds and seemed virtually risk-free, due to the explicit government guarantee on Ginnie Mae securities and implicit guarantee on Fannie Mae and Freddie Mac securities. In response, many major investment houses bought MBSs issued by these government-sponsored entities and then issued and promoted another type of security, called collateralized mortgage obligations (CMOs), backed by these securities. CMOs, which had first been introduced by Freddie Mac in 1984, divide the expected interest payments and principal repayments from pools of mortgages into slices called "tranches." Each type of CMO, which is very much like a bond, corresponds to a particular tranch; each has a unique combination of interest rate, term to maturity, rate of repayment of principal and risk. Because different kinds of investors have different financial goals, tax situations and tolerance for risk, the diversity of CMOs has opened up housing finance to a whole array of wealthy individual and institutional investors, including pension funds, insurance companies, banks and Wall Street firms themselves (Benson 1996; Lea 1996:167).

The market for these sophisticated mortgage-backed securities is, however, quite complex and unregulated, and even elaborate computer models cannot anticipate all the possible risks. Thus, in the mid-1990s, when the economy and mortgage interest rates did not behave as predicted, there was chaos in the MBS markets. With the economy recovering slowly early in the decade, mortgage rates dropped below 8 percent at the beginning of 1993 and below 7 percent briefly at the end of the year (FHLMC 1999), triggering a rash of mortgage refinancings by homeowners. In turn, this led to a greater rate of prepayments of mortgage-backed securities than had been anticipated. Then, in 1994, economic growth accelerated, leading to concerns about inflation, causing mortgage rates to climb to over 9 percent in late 1994 and early 1995 (FHLMC 1999). While such higher rates would have been attractive to investors buying newly issued MBSs, pessimism regarding inflation and potential reduction in mortgage demand from consumers, as well as declining market values for previously issued MBSs, led the MBS market to dry up. Suddenly, lots of investors were trying to bail out. There was a liquidity crisis in the market when buyers could not be found, and many investors sustained substantial losses. What should have been obvious, but perhaps did not get much attention from promoters and high-flying investors, is that government backing associated with MBSs issued by GSEs only protects investors against losses due to homeowners not paying their mortgages, not fluctuations in the market value of MBSs resulting from interest rate fluctuations in the capital markets. So what had looked like very safe, high-yield investments turned out to be almost like junk bonds in terms of risk (Benson 1996:62–64). Eventually, after several years of lower and relatively stable mortgage rates, the MBS market recovered but was no longer as profitable or as exuberant. This experience reveals how very sensitive to interest rates the housing finance system remains and how unanticipated behavior by consumers can be transmitted to the capital markets.

While the discussion here and in most of the literature has focused on the development of the secondary mortgage market institutions and financing vehicles, the 1990s were also a period of continuing changes at the "retail" primary market where residential mortgages are originated and serviced. By the late 1990s, mortgage banking companies (which, as noted previously, have no depositors and sell into the secondary market every loan they originate) accounted for 56 percent of all residential mortgage originations, an increase from 35 percent of the market in 1990 (Lereah 1997; Avery et al. 1999). This is a highly competitive business that operates on thin profit margins; it depends heavily on information technology to be able to profit from small, short-term fluctuations in interest rates. This shift and the related consolidation of the banking industry has raised questions about the responsiveness of the conventional mortgage industry to the needs of low-income and minority borrowers and neighborhoods.[12]

In addition, the servicing of residential mortgages—collecting and processing the payments of interest and principal as well as property tax and insurance escrows—has evolved into a separate, specialized and highly concentrated business. As of the end of 1998, 25 so-called mega-servicers held 47 percent of the market. Because their portfolios are national in scope, they lack the firsthand knowledge and flexibility to anticipate and respond sensitively to local economic conditions and individual borrower circumstances. This raises questions about their capacity to handle mortgage delinquency and foreclosure problems at a distance and across the country in the event of a sharp economic downturn (Lereah 1999).

SOME IMPLICATIONS OF THE NEW HOUSING FINANCE SYSTEM

Over the entire postwar period, housing has been the largest single user of credit, but since the late 1970s, it has only been through the new financing instruments and institutions that housing has been able to compete effectively and obtain a large share of available credit. This, in turn, has come about only because the U.S. Treasury has provided direct or implicit backing for so much of the net increase in residential mortgage lending. In the 1980s, almost 56 percent of the net increase in residential mortgage

debt was financed through Fannie Mae, Freddie Mac, Ginnie Mae and the Federal Home Loan Banks, and in the 1990s, nearly 72 percent. In terms of potential obligations on the U.S. Treasury, this means that by the end of 2002, federally sponsored housing credit accounted for nearly 50 percent of the federal government's total publicly held liabilities (direct plus sponsored debt) compared with less than 5 percent in 1970, 22 percent in 1980 and 33 percent in 1990 (see Federal Reserve System 2003:Tables L-1, L-126; Stone 1993:Table 5.1).

The changes in mortgage financing that began in the late 1960s had contradictory results. They did give a substantial boost to real growth in the economy before and after the 1973 to 1975, 1980 to 1982 and 1990 to 1992 recessions, but also gave a boost to the unprecedented inflation of the 1970s and the overblown credit bubbles of the past three decades. The new mortgage institutions, especially the federally created and federally backed agencies, have intensified competition for credit, which led to even higher interest rates throughout the system until the 1990s. Therefore, the attempts of mortgage lenders to compete more effectively for funds have been relatively successful but at a real cost. Most directly, for a long time, the higher costs were in the form of higher mortgage interest rates. During the 1990s, nominal mortgage interest rates fell to their lowest levels since the mid-1960s—because of what was happening with the labor market, government spending and the global economy, as discussed previously—contributing to the boom in mortgage borrowing and lending. Taking into account the low rate of inflation throughout most of the decade, inflation-adjusted mortgage interest rates were actually considerably higher in the 1990s than in the 1970s, but nonetheless, they were well below the rates during most of the 1980s.

In short, residential finance is no longer a relatively separate and insulated component of the credit system. Housing finance has become almost fully integrated with the national and international capital markets (see, for example, Hendershott and Van Order 1989; McIntyre 1991; Weicher 1994). But what difference have these changes made for housing affordability and the willingness and ability of the prevailing institutions to meet the housing needs of all Americans? The following sections examine how several major aspects of housing affordability have been impacted by the evolution of the finance system: First, new construction has moved toward larger and more expensive houses, as widening income inequality and mortgage standardization have shifted more of the housing market to higher-income households. Second, for the same reasons, homeownership declined for a while as moderate- and middle-income families found it harder to afford homes but then turned up again due to new, riskier lending programs and changing demographics. Third, the long-term changes and recent measures to support and expand mortgage lending have created financial stress for households, most especially for borrowers of modest income. And fourth, the enormous growth of profit-motivated, government-sponsored secondary mortgage market enterprises (GSEs) has led to institutional arrogance, with great risks for taxpayers and financial markets as well as for the institutions themselves.

The Trend Toward Bigger, More Costly Houses

The abundance of mortgage credit in recent decades has fueled accelerating turnover of houses and increases in house prices. Until the mid-1970s, about three existing single-family houses were sold for every new one sold; since then, the ratio has risen to more than five to one (U.S. Department of Housing and Urban Development 2003). On average, prices of single-family houses have fluctuated with the economy but over the long term have risen considerably more than inflation. Over the 30 years from the high point of the late 1960s through the end of the 1990s, the median price of new single-family houses rose 32 percent more than the Consumer Price Index (CPI), while the median price of existing single-family houses rose 39 percent more than the CPI. But how much of this consists of speculative increases in the market values of the same or similar houses, and how much represents a shift toward bigger, more costly houses?

During the 1970s, there were ups and downs in real (i.e., inflation-adjusted) average construction costs for single-family houses but only

a slight upward trend toward larger houses. By contrast, during the 1980s, there was a dramatic rising trend in the inflation-adjusted construction cost of new single-family housing—indicating a historical shift over the decade toward more extravagant new houses that corresponds to and exacerbates the affordability implications of growing income inequality. From 1990 to 1991, the recession brought a dip of 5 percent in average real construction costs, followed by a climb back to the previous level by mid-decade and then a surge to new heights of about $150,000 a unit in 1997 and 1998.[13] The average real construction cost of a new single-family house in 1998 was about 50 percent higher than it would have been if houses similar to those from the late 1960s through the late 1970s had been built. Since middle-income households have seen little increase in their real incomes, it has not been as profitable for developers to build housing for them. High-income households have experienced substantial increases in their real incomes, so more luxurious and costly housing for them has been a growing share of new single-family housing.

For new multifamily housing, changes in average real per unit construction cost have been more complex. In the recession of the early 1970s, multifamily construction dropped precipitously, and with it, the average construction cost of a new unit fell to about $50,000 (in 1998 dollars), where it remained until the late 1970s. Thereafter, through two cycles of the economy, the inflation-adjusted cost rose over 70 percent, to a peak of nearly $86,000 (1998 dollars) in the early 1990s, before dipping and settling at about $74,000 from the mid-1990s on. As with single-family housing, this trend is indicative of the shift to construction for high-income households—in the form of condominiums and luxury rentals.

The affordability implications of this analysis are fairly apparent. Development of new housing is responding to and reinforcing widening income inequality. As a larger proportion of new housing is produced for higher-income households, people with more modest incomes compete for the available supply of less luxurious older housing. This drives the prices and rents of older houses higher than they likely would be if a broader spectrum of new housing were being produced. The result is that in some locales even relatively modest housing is becoming less affordable and hence is moving up the income distribution in terms of who can buy and rent it.

While these patterns are, to a considerable extent, explained by widening income inequality, the restructuring of mortgage markets is also an important part of the story. In order to minimize risks and transaction costs, secondary mortgage market institutions would buy only highly standardized mortgages free of complexity or potential problems—at least until the 1990s, when some special lending programs were created (discussed below). As MacDonald has put it (1996:1184): "Underwriting guidelines established at the national rather than the local level were aimed at filtering out borrowers and properties that posed higher (or unidentifiable) default risks, in order to support the price MBSs would attract in the capital markets." These policies had impacts on lending for multifamily rental housing as well as single-family owner-occupied houses (MacDonald 1996:1185–1190). Thus, the shift to higher-end housing production is not only due to developers directly pursuing housing consumers with the most money. It also reflects the kinds of projects for which developers could most readily obtain financing from primary lenders who wanted to be able place the mortgages expeditiously and profitably in the secondary mortgage markets.

Housing Finance and Homeownership Trends

The U.S. homeownership rate climbed steadily from the late 1940s until 1980, when it reached a record level of 65.8 percent. Then, in the first half of the 1980s, it declined steadily to 63.8 percent in 1986, the lowest level since the mid-1960s, and for the next decade, through 1994, remained almost unchanged at about 64 percent (U.S. Department of Housing and Urban Development 1999:Table 29). Given the continued ideological and economic bias toward homeownership (see Dean 1945; Rakoff 1977; Weicher 1994; Hughes 1996; Berson and Neely 1997), this was a remarkable historical shift. To a considerable extent, the

decline in homeownership certainly was due to widening income inequality, the shift in housing construction to the higher-income/higher-cost market and high interest rates. It was also due, though, to the changes in the housing finance system. As noted earlier, the standardization required for mortgages to be marketable in the secondary mortgage markets, especially as imposed by the "duopoly" of Fannie Mae and Freddie Mac (Weicher 1994; see also McIntyre 1991), means that local mortgage originators no longer have had flexibility to make allowances for prospective borrowers whose incomes, assets, debts and/or credit histories are less than sterling (see also Chapter 12).

Then, beginning in 1995, after a decade and a half of decline and stagnation, the homeownership rate began climbing again, reaching a new record rate of 68 percent in 2002 (U.S. Department of HUD 2003:Table 27). What happened? Was it just the fruits of low inflation and low unemployment eventually ripening? Not entirely. In large measure, the expansion of homeownership in the 1990s was the result of deliberate reactive and pre-emptive public and private initiatives. First, advocacy groups, using data produced pursuant to the Home Mortgage Disclosure Act (HMDA) and lending requirements of the Community Reinvestment Act (CRA), became increasingly skilled and successful at getting primary lenders to increase mortgage lending to communities and households of color and/or low income (see, for example, Squires 1992; Schwartz 1998; Avery, Bostic and Canner 2000). Second, in the wake of the S&L debacle of the 1980s, as well as in response to community advocacy, the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 directed HUD to establish and monitor annual goals for Fannie Mae and Freddie Mac to purchase low- to moderate-income mortgages (Canner and Passmore 1995; MacDonald 1995, 1996; Eggers and Burke 1996). Third, mortgage activity by lenders providing subprime and manufactured home financing has accounted for a growing share of all home purchase lending, but most especially to low-income and minority borrowers and neighborhoods (see Canner, Passmore and Laderman 1999).[14] Finally, ideological support for expanding homeownership, especially among people of color, and more generally those of lower income, was provided by the Clinton Administration beginning in 1995 (Berson and Neely 1997) and was continued by the administration of George W. Bush, in keeping with both presidents' records of rhetorical declarations of expanding opportunity despite substantive actions in housing and other areas that deepened inequality.

With the conjuncture of these initiatives and favorable macroeconomic conditions, the major demographic components of the increase in the overall homeownership rate since the mid-1990s can be examined in relation to the decreases in the 1980s and early 1990s. Among Black non-Hispanics, the homeownership rate first decreased from 46 percent in the early 1980s to 42 percent in 1989, changed little through 1993 and then increased to 48 percent by 2002. Among other non-Hispanic households of color (mostly Asians, although the data do not separate Asians and Native Americans), the homeownership rate dropped from 53 percent in the early 1980s to under 49 percent in 1987 and remained at around 50 percent through the mid-1990s before rising to 55 percent by 2002. Among Latinos, homeownership declined from a little over 41 percent in the early 1980s to 39 percent in 1991. Thereafter, it rose fairly steadily to 48 percent by 2002. Among white non-Hispanics, homeownership dipped slightly from 69 percent in 1983 to a bit over 68 percent in 1986 and has climbed ever since, even during the early 1990s recession, to 74.5 percent in 2002 (U.S. Department of Housing and Urban Development 2003:Table 29). Clearly, the decline in homeownership was overwhelmingly borne by people of color, not by whites. Yet the more recent increase in homeownership rates has been nearly as great among whites as among people of color. Although the changing homeownership rates for Latinos and Asians include the impacts of high rates of immigration (most recent immigrants being renters), the contrast between Black non-Hispanics and whites is not explicable in this way: The homeownership rate for Blacks had a net increase of little more than two percentage points since the early 1980s, while that of whites rose over five percentage points.

Although lower incomes and discrimination by lenders certainly account for lower rates of homeownership among households of color, these factors do not fully account for the substantial declines in homeownership rates among such households in the 1980s. The standardization of mortgage underwriting imposed by Fannie Mae and Freddie Mac, which eliminated flexibility in dealing with applicants whose income and/or credit histories did not quite meet the standardized criteria, most certainly had the effect of narrowing home-buying opportunities for households of color in that period. By the same token, the increase in homeownership among people of color since the 1990s is disproportionately attributable to the specially targeted mortgage programs and subprime lending of the recent decade, even though lower-income white households have also been among the participants.

The advent of specially targeted lending programs, as a way of offsetting some of the consequences of mortgage standardization, does, however, suggest a disproportionate distribution of risk. These programs generally involve very low down payments, which, studies suggest, is a strong predictor of the likelihood of mortgage default (Weicher 1994:60). Perhaps surprisingly, borrower income is not strongly related to loan performance, although triggering events like job loss certainly are significant (Avery et al. 1996). Some institutions with so-called "affordable" home-lending programs have reported that such programs do involve higher costs of origination and servicing in contrast with conventional lending but not significantly higher default rates if flexible acceptance criteria are applied carefully and if there is counseling and education of borrowers.

On the other hand, early quantitative analyses of "affordable" lending by secondary mortgage market institutions and private mortgage insurers do suggest somewhat higher rates of delinquency and default than those found in conventional lending. For example, a study of delinquency rates where the borrower made a 3 percent down payment and another party paid the remaining 2 percent found rates significantly higher than where the borrower put down the full 5 percent (Avery et al. 1996). The Freddie Mac experience with special programs that have looser underwriting standards has been that the loans show significantly higher default and foreclosure rates, especially on loans that have only 2 percent down and where the bank often pays even this amount (Schnare 1996). Advocacy groups that have negotiated agreements with large banks to channel mortgage loans through them, such as the Neighborhood Assistance Corporation of America (NACA), have had great success at facilitating homeownership for thousands of moderate-income and minority borrowers but are also being criticized for putting some people into untenable financial situations. While most groups refuse to divulge their default rates, mortgage industry officials estimate that the delinquency rate on NACA mortgages through Fleet Bank exceeds 10 percent compared with about 7 percent for other targeted Fleet mortgages and about 2 to 3 percent for conventional mortgages (Browning 1999). Comparing the current programs with the abuses of FHA homeownership programs in the early 1970s that resulted in widespread foreclosures and neighborhood destruction, Ann Schnare, Freddie Mac vice president for Housing Economics, has declared: "In my opinion, it is bad public policy to put individuals into houses they cannot afford to support" (Schnare 1996:177).

Household Debt Burdens and Mortgage Stress

While a great deal of attention has been focused on the inability of young families to buy their first home, the preceding discussion suggests that the more serious problem of homeowner affordability is with the people who have bought homes but are finding it harder and harder to keep up their mortgage payments. This is a problem exacerbated by home equity borrowing and, to some extent, by refinancing that results in higher debt burdens (see, for example, Cannner, Durkin and Luckett 1999; Brady et al. 2000; Bradford 2002; Canner, Dynan and Passmore 2002).

Aggregate statistics on mortgage and consumer debt in relation to disposable income are suggestive of potential debt stress but do not in themselves reveal the burden of debt *payments*,

which depend on interest rates and loan terms, not just amount of debt; and aggregate statistics do not reveal the *distribution* of debt burdens among different households. Estimates of actual debt payments in relation to disposable personal income show a cyclical variation, rising during periods of economic expansion and declining during recessions. In the early 1990s, debt payments rose little, on average, despite rising debt:income ratios, because of falling interest rates (Canner, Kennickell and Luckett 1995:324–325). Behind the cyclical pattern, however, there has been an upward trend in payments as households have increased their debt in relation to income (Edelberg and Fisher 1997).

Disaggregated data from the Surveys of Consumer Finances conducted by the Federal Reserve Board reveal significant differences among income groups in the burdens and risks of debt overload. High-income households owe most of the debt, but such households (those with annual incomes of $100,000 or more) have a median ratio of debt payments to income (for mortgage and home equity debt) far lower than for all other income groups. Through the 1980s, payment:income ratios rose for all income groups, but since the late 1980s (according to Canner, Durkin and Luckett 1999) or early 1990s (according to Edelberg and Fisher 1997), the ratio has declined, on average, for higher-income households but continued to rise for lower- and middle-income households. Also, while households with incomes of $50,000 to $100,000 have had the highest median ratio of housing debt payments to income, the biggest *increases* in the ratios since the late 1980s have been among households with incomes under $25,000. Furthermore, in 1998, about one-fourth of all families with incomes of under $50,000 had total debt payments of more than 40 percent of their incomes compared with just 2 percent of those with incomes of $100,000 or more (Kennickell, Starr-McCluer and Surette 2000:Table 14). In 2001, 13.4 percent of families in the lowest quintile of income had debt payments that were 60 days or more past due compared with 10.2 percent of such families in 1995 (Aizcorbe, Kennickell and Moore 2003:Table 14). Many of these families have taken on and been encouraged to assume high debt loads in order to achieve the American Dream of homeownership, but at what risk?

Among those expressing concern about the dangers of rising debt burdens for lower-income households has been the chief economist of the Mortgage Bankers Association, amidst his otherwise broadly bullish comments on the mortgage industry (Lereah 1997, 1998, 1999). Some of his comments are worth quoting (1999:5):

> Bringing attention to these potential problems is the fact that the share of loans with loan-to-value ratios greater than 90 percent has risen substantially during the past five years (to about 25 percent). This places greater burden on the quality of loan portfolios in a period of deteriorating economic performance. And if and when the economy turns down, the first group to be hit with lost jobs and unreliable wages will be the lower-income group. According to recent income and debt data, the debt burden of low-income households relative to higher-income households is rising. If the economy falters, clearly many households that are at the margin in terms of their abilities to meet their monthly mortgage obligations now will bring delinquency and foreclosure problems for mortgage servicers. Thus, it is the low-income families that are experiencing heavy debt burdens, leaving them more vulnerable to recession and meeting their mortgage obligations, while the higher-income groups are actually reducing their debt burdens (via refinancings and higher wages) and lowering their mortgage obligations.

Long before the downturn, however, there already was a long upward trend in mortgage foreclosures since the late 1970s. During most of the 1970s, the rate of foreclosures was less than about 0.5 percent of all mortgages, actually declining steadily after 1973 to a historic low of 0.3 percent in 1978 (see Figure 4:1). The severe double recession of the late 1970s and early 1980s brought a surge in foreclosures, to more than 0.8 percent in 1982, where it leveled off for two years. Remarkably, though, the boom years of the late 1980s brought not a decline but a steady increase in foreclosures, to nearly 1.1 percent in 1988. The next recession brought another increase, to above 1.3 percent in 1989 and 1991 (with a slight dip in between). The rest of the 1990s then recapitulated the pattern of the late

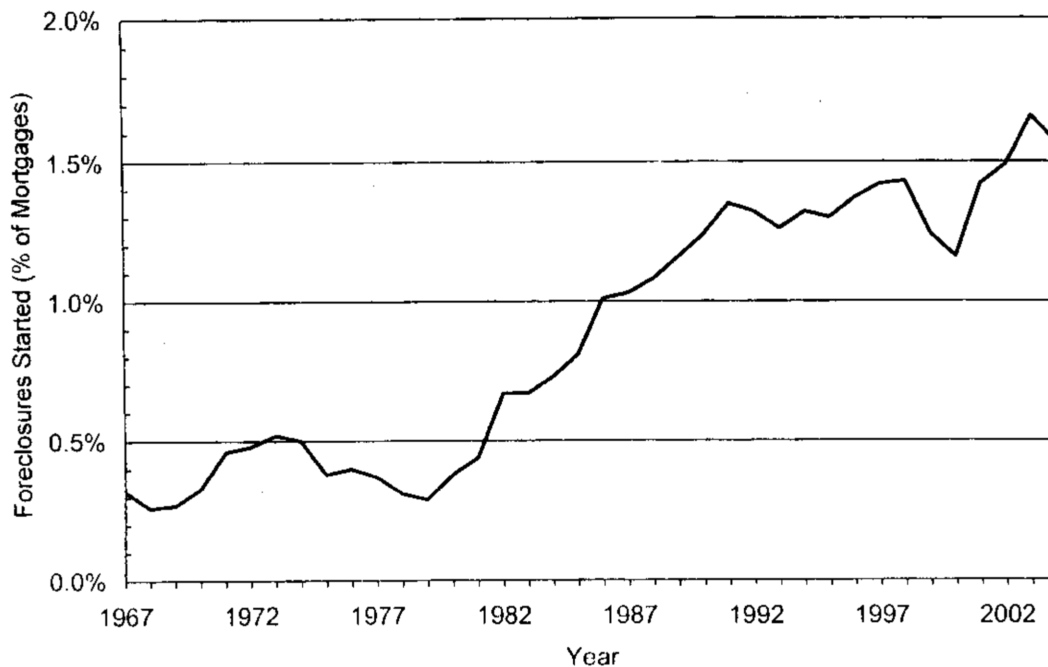

FIGURE 4.1. Residential Mortgage Foreclosure Rate, 1967–2004.
Source: Mortgage Bankers Association.

1980s but at a higher level: Despite steady economic growth and declining unemployment, the rate of foreclosures remained nearly flat at about 1.3 percent from 1992 through 1995 and then began steadily climbing, reaching a new record high of over 1.4 percent in 1998. Over the next two years, as the long boom reached its culmination, there was substantial reduction in the foreclosure rate to less than 1.2 percent. However, the onset of recession brought a sharp reversal, with rate surging to a new high of 1.6 percent in 2003 (Figure 4.1).

The new era of housing finance has ensured a high volume of mortgage money by creating new vehicles and opportunities for profitable investment in housing. But with this abundant supply of capital has come extensive promotion and acceptance of dangerously high levels of debt for buying homes, refinancing existing mortgages and tapping home equity.

Instability in Freddie Mac and Fannie Mae

Freddie Mac and Fannie Mae emerged as the "Pillars of Hercules" in the mortgage system because their private profits are underpinned by public support. On the one hand, as government sponsored enterprises, they have an obligation to provide some mortgage support for lower-income households and underserved geographical areas. On the other hand, and far more significantly, their special status means that their mortgage-backed securities have had the implicit backing of the U.S. Treasury,[15] thus making these securities easy to market and making Freddie and Fannie's stock quite attractive to Wall Street investors. Both entities have thus become Fortune 500 companies, yet they are the only members of this club exempt from regulation by the Securities and Exchange Commission and thus exempt from the disclosure requirements of other corporations with publicly traded stock. As Fred Smith, president of the Competitive Institute in Washington, has put it, Fannie Mae and Freddie Mac are examples of "profit-side capitalism and loss-side socialism" (quoted in Berlau 2003).

Fannie and Freddie's success and special status have led to a certain amount of hubris among their executives. As a result, there was little close scrutiny of their operations until the beginning of 2003, when outside auditors raised issues about some of Freddie Mac's accounting procedures. Then, in June of 2003, Freddie's problems

reached the level of scandal: Possible criminal probes were announced as the board of Freddie Mac forced out its three top executives, claiming they had obstructed a probe into the company's accounting. But a growing number of critics say that this is more than a typical corporate scandal: It is a government-policy scandal for which taxpayers could be left holding the bag. And many were wondering if the controversy over accounting issues at Freddie Mac will spill over to its older sister, Fannie Mae (Berlau 2003).

Indeed, in the wake of the Freddie Mac scandal, it was soon revealed that Fannie Mae might have suffered billions of dollars in losses over the preceding two years that were obscured by the complexity of its accounting procedures. Apparently, investors in Fannie Mae securities were unconcerned because they had thought that the federal government would protect them. Nonetheless, Fannie immediately responded that it would take steps to reduce its risks, but some outside analysts still felt that it was taking too much risk and needed to disclose more about its mortgage operations (Berenson 2003).

Congressional hearings were launched in the fall of 2003, and the Bush Administration recommended regulatory changes that would be the most substantial since the S&L crisis confronted the first Bush Administration a decade and half earlier. It was proposed that there be a new regulatory agency within the Treasury Department that would not only provide oversight but also the authority to set one of the two capital reserve requirements of Fannie and Freddie as well as approval authority for new lines of business. It was not proposed to eliminate implicit government backing for their debt and the indirect subsidies associated with this backing and other protections (Labaton 2003a). However, soon thereafter, the Treasury Department raised the possibility of eliminating its special line of credit to the two companies. But the nervous reaction of the capital markets to this trial balloon (Labaton 2003b) revealed how much the capital markets rely on "loss-side socialism" in the mortgage system.

At the end of 2003, Congress had not yet acted on regulatory reform of the mortgage giants, apparently due to resistance of Freddie Mac and Fannie Mae to some of the reforms being considered (Glater 2003; New York Times Editorial Desk 2003). Adding substance to the debate about the implications of Fannie and Freddie's special status, just before Christmas, a Federal Reserve senior economist released the draft of a study of "The GSE Implicit Subsidy and the Value of Government" (Passmore 2003). The study estimated that the federal government's implicit subsidy amounts to between $119 and $164 billion, with only about one-half of that going to borrowers in the form of lower interest rates, the rest going to shareholders. It also estimated that the reduction in mortgage interest rates due to public subsidy amounts to only seven basis points, and, due to this small impact on rates, the "implicit subsidy does not appear to have substantially increased homeownership or homebuilding" over what they would be if the GSEs operated without government support. Fannie Mae immediately disputed the study, while Freddie Mac did not respond (Andrews 2003).

One final point of significance in the saga of Fannie and Freddie is revealed by the response of a leading housing advocate who was directly involved in helping to establish the so-called "affordable housing goals" of Fannie Mae and Freddie Mac (Fishbein 2003). While fully acknowledging the internal problems at the agencies, he notes that their cost of funds could rise if there were to be reduction in market confidence in the agencies and/or transfer of regulation to a Treasury Department insensitive to the special housing purposes of Fannie and Freddie. He is concerned that an increase in the cost of funds in the capital markets could result in higher mortgage rates, thereby closing off homeownership opportunities for some low- and moderate-income households. His stance is a telling illustration of one of the devil's bargains that is entered into by housing advocates because we do not have a truly social system of housing finance.

CONCLUSION

This chapter has examined the contours of housing finance and the economy since the middle of the 20th century, in order to elucidate some of the limitations, weaknesses and problems of a

housing finance system based on private capital markets, mortgage debt and speculative ownership of housing. It is a system that, to be sure, has facilitated the production of vast amounts of housing and has provided access to homeownership for over two-thirds of all U.S. households. At the same time, though, in idealizing conventional (debt-encumbered) homeownership, it has exacerbated the social stigma of renting, inhibited the exploration and expansion of forms of tenure other than conventional ownership and renting, and imposed enormous affordability burdens and risks on many who have bought (and indeed many who rent). Furthermore, the existing system of housing finance has been the source of considerable institutional and financial instabilities. Yet the problems manifested and generated by this system have been dealt with not through fundamental reform and new approaches to housing finance but rather through public policies that for the most part ensure private profits while socializing investor risk.

Rather than idealizing the market and providing endless subsidies and bailouts to private capital, public policy must transcend the market and truly serve social purposes. Overcoming the extensive and persistent problem of affordability will require substantial and sustained public commitment to new concepts of housing finance as well as alternative approaches to housing ownership and tenure. The most significant and straightforward mechanism for overcoming permanently the affordability burden of mortgage payments is by using direct public capital grants to finance the production and acquisition of social housing. In a complementary way, though, it is also essential to reform the financial system in order to deflate the overblown credit system, reduce speculative uses of credit and assure an adequate supply of low-cost credit—as a supplement to capital grants—for productive investment in social housing and progressive economic development. This, though, will require the imposition of social criteria on private capital market participants and institutions. Chapter 12 explores various existing and potential models of social financing, demonstrating what has been done, what is possible and what is necessary (see also Stone 1993:Chapter 8).

NOTES

1. In 2001, the median monthly total housing payment for homeowners with mortgages was $1,015, while their median monthly mortgage payment was $676 (U.S. Department of Housing and Urban Development and U.S. Bureau of the Census 2002:Table 3-19). The ratio is 67 percent. No comparable data are available for renters. However, the proportion of rents that goes for mortgage payments is probably greater, on average, because interest rates are higher on the commercial loans used to finance commercial properties, and landlords are more likely to use multiple mortgages to cash out equity.

2. For detailed discussion of the development of the housing finance system prior to the 1960s, including the origins of the Federal Home Loan Bank System and the Federal National Mortgage Association as well as full discussion and citation of sources, see Stone 1993:Chapters 3,4.

3. This section and the following sections through the 1980s are based on Stone 1993:Chapters 5,6.

4. After selling a loan in the secondary market, the primary lender usually continues to service the loan, including collecting mortgage payments (and sending them on to the ultimate holder of the mortgage) and ensuring that property taxes and insurance are paid. The primary lender, or other servicer, receives a fee from the ultimate holder of the mortgage for handling these activities.

5. Freddie Mac issued its first mortgage-backed security in 1975 and by the end of the decade had issued about $10 billion of such securities (Berkman 1979:69).

6. The net growth of residential mortgage debt had accounted for 24 percent of the net increase in total debt from 1979 to 1980 but dropped to 15 percent and then 11 percent in 1981 and 1982, respectively, before returning to 20 percent in 1983 (Federal Reserve System 1999:Table 5.1).

7. With deregulation, a frenzy of takeovers, conversions to stock ownership and a push for quick profits overwhelmed much of the thrift industry. Between 1980 and 1989, the number of thrift institutions further declined by one-third, while the share of industry assets held by the 50 largest institutions grew to 40 percent (from 25 percent in 1980). Stock-owned institutions increased to 45 percent of all thrifts in 1989, from less than 20 percent in 1980, but these 45 percent of institutions held 75 percent of the assets of the entire thrift industry compared with 27 percent of assets held

by stockholder institutions in 1980 (Barth and Wiest 1989:15).

8. Outstanding advances had been $10.8 billion in 1970 (6.3 percent of thrift liabilities), $24.6 billion in 1974 (8.5 percent of liabilities), and $98.2 billion in 1982 (14 percent of liabilities); by 1988, they were nearly $299.2 billion (22.1 percent of liabilities) (U.S. League of Savings Associations 1989:50).

9. Freddie Mac's total mortgage portfolio was $338 billion in 1990, having grown from virtually nothing in 1970 to $20 billion in 1980. Its volume of mortgage-backed securities grew from nothing in 1970 to $15 billion in 1980, $100 billion in 1985 and $316 billion in 1990, an average annual compound rate of growth of 35 percent during the 1980s (FHLMC 1989:9, 24; U.S. League of Savings Associations 1989:65; FHLMC 1991:16). By the end of 2001, its total mortgage portfolio was $1.14 trillion, and its volume of mortgage-backed securities was $948 billion (FHLMC 2001:21, 25).

Fannie Mae's mortgage portfolio grew from $15 billion operation in 1970 to $57 billion in 1980 to $113 billion in 1990. Its mortgage-backed securities operation only began in 1981, growing to $55 billion by 1985 and $300 billion by 1990 (FNMA 1989:3–4; U.S. League of Savings Associations 1989: 66; FNMA 1991:17). By 2002, its mortgage portfolio was $798 billion, and its volume of mortgage-backed securities was $1.54 trillion (FNMA 2002:39, 49).

Ginnie Mae securities grew from nothing in 1970 to $94 billion in 1980 to $400 billion by the end of 1990 (U.S. Bureau of the Census 1990:503; GNMA 1991). Between 1970 and 2002, over $2 trillion of Ginnie Mae mortgage-backed securities were issued; net of repayments and refinancings, the outstanding balance was $568 billion at end of 2002 (GNMA 2002).

10. Mortgage revenue bonds are, in some ways, similar to the MBSs issued by secondary mortgage market agencies, but they tend to be much more closely tied to individual mortgages or small groups of mortgages rather than large pools.

11. For further added costs in the late 1990s, see Labaton 1998.

12. See Avery et al. 1999 on the effects of consolidation. See Canner, Durkin and Luckett 1999 on the growth of subprime lending. See Bradford 2002 on racial disparities in the subprime market.

13. Note that this figure does not include the costs of land acquisition, site preparation, construction financing, fees, and overhead and profit. See Stone 1993:376, notes 2 and 3 to Chapter 6, for explanation of the methods used.

14. Between 1993 and 1998, subprime and manufactured home lenders more than tripled their share of applications for conventional (for instance, not FHA and VA) home purchase mortgage loans to about 34 percent and nearly tripled their share of loans made to about 14 percent (Canner, Durkin and Luckett 1999:710).

15. Fannie Mae has claimed that the "US government does not guarantee directly or indirectly Fannie Mae's debt securities or other obligations" (FNMA 2002:25). Yet the Federal Reserve states that the mortgage-backed securities of Fannie Mae, Freddie Mac and Ginnie Mae, as well as securities issued by Federal Home Loan Banks "are classified as US government securities" (Federal Reserve System 2003:78, notes to Tables L-125, L-126). See Passmore 2003 for the value of this ambiguity to the GSEs.

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