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The Mortgage of the Future

Easy-to-get, overly complicated home loans inflated a bubble that popped disastrously. Though we're still in the middle of the crisis, it's time to devise a safer housing finance system so this won't happen again

By [Peter Coy](#)

Samuel Perez has a steady job running trains for the New York City subway system on the No. 4 line. His wife, Rosemarie, earns a reliable paycheck as a unionized school bus driver in the Bronx. In 2003 they bought a semi-attached, two-story house in unfashionable western Staten Island for \$246,000—as cheap as New York City real estate gets. With two children and a foster child at home, they're not big spenders. "We haven't taken a vacation in years," Rosemarie says.

If you've paid any attention to the U.S. housing market over the past four years, you probably know where this is headed.

One financial hiccup—in 2009, Rosemarie lost her previous job as a real estate agent—and the Perezes fell behind on their payments. They say they've since tried to get current on the mortgage, but the bank that services it, Wachovia Mortgage, has refused to accept any payment, trying instead to get them to sell the house and move out. The bank filed a foreclosure notice in 2010, which it has since tried to withdraw without explanation. The Perezes think they have a better shot at getting a fair deal if their case stays in court, so they're opposing the bank's effort to withdraw the notice. They don't know where they'll be living in a year.

The Perezes' mortgage is typical of the boom era's excesses, a Pick-a-Payment loan that allowed borrowers to pay less than the full interest due. It came from World Savings Bank, which was later acquired by Wachovia Mortgage, now part of Wells Fargo Bank ([WFC](#)). The couple mistakenly believed that because they were making 26 payments a year rather than 24, they were paying off the loan on an accelerated schedule. Instead, unpaid interest was getting added to the principal; they were getting deeper in debt. (Wachovia Mortgage's lawyer on the Perezes' foreclosure case did not respond to a request for comment.)

"What's sad is that I didn't educate myself," Rosemarie says on a rainy Thursday evening at the dinner table, having just made the long commute home from her bus route. "I was so naive. I just thought, 'Everybody does it. It has to be right.'" She adds: "We thought we were going to be happy here. I feel like we really failed."

Every foreclosure story is someone's tragedy; when there are hundreds of thousands, they're a macroeconomic

disaster. There's widespread agreement that what's happening to families like the Perezes mustn't happen again—and heated disagreement over how exactly to prevent its happening. The White House, Congress, bankers, and assorted policy wonks are at odds on how to build a safer mortgage system. Low-income Americans don't want lending standards so tough that they're locked out of owning a home. Bankers fear restrictions that would kill their profits. Conservatives want government out of the mortgage market altogether, while liberals say that would spell the demise of affordable long-term fixed-rate loans.

The sooner America figures out a new mortgage finance system, the sooner lenders and borrowers alike will have the confidence to go ahead and make long-term commitments. So although housing is still deep in the hole, it's time to take a page from Franklin D. Roosevelt's playbook and plan for the peace while the war is still on.

Because the pain of the housing mess is still throbbing—foreclosures have pushed neighborhoods into dereliction; pension and mutual funds have taken big losses on mortgage-backed securities; taxpayers have pumped more than \$150 billion into Fannie Mae ([FNMA](#)) and Freddie Mac ([FMCC](#))—it's easy to forget that this isn't the first time toxic mortgages have poisoned the economy. The housing bubble of the 1920s that gave way to the Great Depression of the 1930s was inflated with toxic air, too.

Mortgages were interest-only “balloon” loans, in which all or nearly all the principal was due in a single payment at the loan's maturity. The loans were for just one- to five-year terms. Borrowers could lose their homes when the loan came due if they lost their jobs, or if home prices fell, making them ineligible to refinance. Sound familiar?

Up until the 1920s, loans typically were for half the value of homes or less, which was good and bad: Lenders had a thick safety cushion, but creditworthy people were cut off from homeownership. Starting in the 1920s, building and loan associations started offering loans up to two-thirds of the home value as well as second mortgages that raised total lending to 80 percent of home value; by 1929 those institutions dominated the mortgage market.

It was, like the 2000s, a decade of innovation and overleverage. Private mortgage insurers grew rapidly. There was even an early stab at securitization: Collateral trust certificates of participation, as they were called, passed through to investors the cash flows on underlying mortgages. Housing finance was entirely private; there were no government guarantees.

The system came crashing down in the 1930s, destroyed by the bust in home prices and record unemployment that left homeowners unable to keep up payments. Private mortgage insurers failed, building and loans stopped making loans, and participation certificates lost most of their value. “When such a delicate structure is once disorganized, it is a tremendous task to get it into a position where it can again function normally,” Henry Hoagland, a member of the Federal Home Loan Bank Board, observed a few years later.

That's when things got interesting. FDR concluded that fixing housing was not only merciful but essential to

getting the U.S. economy back on its feet. On Apr. 13, 1933, he asked Congress for legislation to protect homeowners from foreclosures and to reduce the burden of mortgage debt.

Congress responded with a speed that modern lawmakers could scarcely imagine. "Senate hearings were started after a week's delay but were terminated after two days to speed action," C. Lowell Harriss of Columbia University wrote in a 1951 study of the episode. In pushing ahead, Congress turned aside objections from the New York State League of Savings and Loan Associations, which said "every reasonable consideration" was already being extended to worthy homeowners.

Legislation establishing a Home Owners' Loan Corp. passed the House 383 to 4 and sailed through the Senate in June 1933 on a voice vote. The new agency bought defaulted mortgages from lenders, generally at 100¢ on the dollar, and replaced them with healthier ones—fully amortizing loans with long terms (originally 20 years) and fixed rates of interest. Down payments were a conservative 15 percent. By 1936, when the Home Owners' Loan Corp. stopped restructuring loans, it held mortgages on 1 in 10 owner-occupied homes in the U.S.

But to make safer loans possible, the federal government thrust itself into what had always been a private matter—borrowing to buy a house. Lenders were unwilling to make long-term fixed-rate loans without a safety net. So, through new agencies such as the Federal Housing Administration (1936), the government promised it would make lenders whole if borrowers defaulted. That opened the spigot of private credit.

The seat-of-the-pants experiments of the New Deal changed American housing finance forever, mostly for the better. Even today, the U.S. and Denmark are the only countries in the world in which borrowers can pay off their mortgage over a period of as long as 30 years and at an interest rate that never changes. "The new long-term mortgage was of course no panacea for U.S. banking problems... but it helped," economists Susan M. Wachter of the University of Pennsylvania's Wharton School and Richard K. Green of George Washington University wrote in a research paper in 2005.

The New Deal structure worked well for decades. Homeownership increased from 44 percent in 1940 to 66 percent in 2000; foreclosure rates were low; and home prices rose roughly in line with the overall rate of inflation.

The first crack appeared in the 1960s, when inflation increased because of heavy spending on the Vietnam War and loose monetary policy. Banks' income on their long-term loans didn't budge even as their borrowing costs rose. The same problem occurred in spades in the 1980s, when thousands of savings and loans were wiped out by high short-term interest rates. Bankers gradually concluded that the safe money was not in holding loans, but in getting paid to originate and service them.

The solution, beginning in the 1970s, was securitization. Government-owned Ginnie Mae started the trend in 1970, but Wall Street accelerated it. Lewis Ranieri, a Brooklyn native, had set out to be an Italian chef until asthma ruled out work in smoky kitchens. A part-time job in Salomon Brothers' mailroom started him on the ladder to becoming the head of Salomon's mortgage desk. From there he pioneered the slicing and dicing of mortgages into bonds, which came to influence the price and availability of mortgages like a tail wagging a dog.

Banks sold their loans to investors, raising cash to make more loans. Packaging mortgage loans into investor-friendly securities became the job of a refocused Fannie Mae (founded in 1938 to buy FHA loans, privatized in 1968) and Freddie Mac (chartered by Congress as a private corporation in 1970). Securitization, though held in suspicion now, did what it was meant to do: transfer mortgage risk from banks to deep-pocketed investors who were better able and more willing to take it on.

Before the housing crisis that began in 2007, the American mortgage system was widely admired. Representatives of Fannie Mae “went all over the globe trying to get other countries to set up little Fannies,” recalls Marja Hoek-Smit, director of Wharton’s international housing finance program. Few countries managed to duplicate the U.S.’s success.

The missionary work ended with the bust. “The U.S. mortgage finance system has gone from the envy of the world to a case study of failure in two short years,” San Diego State University economist Michael Lea wrote in a 2010 paper.

Visit any Washington think tank and you can fall into a lively discussion about blame. Was the fault with Barney Frank and the Community Reinvestment Act for forcing mortgage bankers to make imprudent loans to achieve affordable-housing goals? Or was it a case of greedy bankers finding a way to privatize their gains and then socialize their losses?

As entertaining as the recriminations are, what matters is where housing finance goes from here. The U.S. system has been at least temporarily socialized as private capital has fled the market. More than 90 percent of new mortgage loans are guaranteed by Fannie Mae and Freddie Mac, which are wards of the state, or by the Federal Housing Administration, Veterans Affairs Dept., and Rural Housing Service, which are straight-up arms of the government. The only fully private lending is loans for properties too expensive to qualify for a government guarantee. Because there’s no backstop, 30-year “jumbo” loans’ interest rates are higher than conforming loan rates—by 0.6 percentage point now and 1.7 percentage points at the worst of the financial crisis.

There’s agreement across the political spectrum that housing finance is overdependent on government and that it’s important to put more private capital back to work. You don’t have to be a member of the Tea Party to feel outrage that Fannie Mae and Freddie Mac, which insisted for years that they had their risks under control, could cost taxpayers \$121 billion to \$193 billion by the end of 2014, net of dividends paid to the government, according to the Federal Housing Finance Agency.

The hard part is fixing the balance between the public and private sectors. Representative Scott Garrett (R-N.J.), who chairs the House subcommittee that oversees the mortgage-buying giants, this year introduced a series of bills to wind Fannie and Freddie down over the long term and vowed in March to “return our housing finance system to the private marketplace.”

The free-market purist position would, for better or worse, dramatically change American housing finance.

Investors would require considerably higher yields to buy mortgage-backed securities that lacked a government guarantee, which would mean higher mortgage rates or much tighter underwriting standards, says Kenneth Snowden of the University of North Carolina at Greensboro.

Without government loan guarantees, the U.S. would probably come to look more like Britain, where only adjustable-rate loans are available. British homeownership rates are nearly 70 percent. But British borrowers bear all the risk of fluctuating interest rates—"a risk that they are not particularly well-suited to bear and cannot easily hedge," economists Wachter and Green wrote.

Some conservatives such as Alex J. Pollock of the American Enterprise Institute say the 30-year fixed-rate loan would survive just fine without a government guarantee, albeit perhaps with a higher interest rate. They argue that the benefits from the guarantee are tiny compared with the predictable cost—Pollock promises "yet another massive bailout in the future." The 30-year loan should be at most a niche product because "it imposes costs on borrowers, on the mortgage distribution system, and on investors," argues Lea, the San Diego State University economist.

The counterargument: There's nothing like a 30-year fixed-rate loan for predictable household budgeting and peace of mind. The loan "worked for more than 40 years" and still can, Ranieri, who now invests on his own as head of Ranieri Partners Management, wrote in a white paper earlier this year called "Plan B."

Even if the 30-year fixed loan dies, turning the clock back to the 1920s and fully reprivatizing housing is an unrealistic objective for one simple reason: The American people won't stand for it. Americans want to be able to borrow on good terms even when private capital flees, as it has in the current bust. When push comes to shove, the government will never let the entire lending business fail, so the feds might as well make their support explicit and demand some accountability in return. "As distasteful as bailouts are, we as a society are simply too scared of the potential consequences of not bailing out the system to find out what would happen," Adam J. Levitin, a Georgetown University Law Center professor, wrote in congressional testimony in September.

The most innovative ideas for housing finance can't be categorized as left or right. Figures as diverse as liberal investor George Soros and the GOP's Scott Garrett suggest that the U.S. adopt some variant of European covered bonds, which are safer than U.S. mortgage-backed securities. The Danish mortgage system dates back to the reconstruction of Copenhagen after the Great Fire of 1795. Unlike American banks that securitize their loans, Danish mortgage lenders retain the full risk of default, giving them an incentive to underwrite cautiously. The loans are packaged into covered bonds. In more than 200 years, there has never been a default on one of these bonds. And though Denmark's housing bubble was even bigger than the U.S.'s, its foreclosure rate has remained low. One downside is that the system is best suited to long-term mortgages. The system is under strain now that 44 percent of Danish loans are adjustable-rate mortgages.

Want more ideas? Andrew Whinston, a University of Texas at Austin professor of management science and information systems, says securitization could be fixed by making contracts "dynamic" instead of "static." To make sure lenders have skin in the game, they wouldn't get paid all at once. Ralph Y. Liu, a Wharton MBA who is managing director of the PeoplesAlly Foundation, promotes a hybrid form of homeownership in which a renter

contributes 10 percent of the purchase price in return for a tenth of any appreciation (or depreciation) in the property's value.

You'd think the moment for radical thinking would be upon us. But despite daily reminders of the current cataclysm—new home sales are running at the lowest rate since the 1950s—there's a good chance that the future of mortgages will be just a slightly modified version of the present. "The mortgage market in general is very averse to change. We don't like new structures. We don't like new acronyms," says Matthew Jozoff, a managing director and head of mortgage strategy at JPMorgan Chase ([JPM](#)).

That's about where mortgage bankers stand, too. David H. Stevens, who stepped down as commissioner of the Federal Housing Administration in May to become chief executive of the Mortgage Bankers Assn., says: "If you eliminate 1998 to 2006, we had the best housing system for decades. Coming out of this market, it may be easiest just to keep a more limited Fannie and Freddie operating, almost as they are today."

Even if you favor extreme action, changing the system doesn't need to be as abrupt as flipping a switch. It can be like adjusting stereo knobs, says Phillip L. Swagel, an economist at the University of Maryland School of Public Policy who served as an assistant secretary to Treasury Secretary Henry D. Paulson during the George W. Bush Administration.

Swagel's knob-twisting metaphor makes the tradeoffs clear. One knob raises the fee that Fannie Mae and Freddie Mac charge to guarantee loans. The higher it gets, the more room there is for the private sector to enter the market and the smaller a role Fannie and Freddie will play. (Though the FHA presumably would pick up some of the slack as well.) A second knob controls how much private capital must be put at risk. The thicker the private capital buffer, the lower the risk to taxpayers. And a third knob regulates how safe loans need to be before the government will guarantee them. In each case, twisting the knob reduces the government's role in housing but makes mortgages less affordable and harder to get. The hope is that each action leads to harmonic convergence.

Even the man in the White House thinks the knobs need to be twisted somewhat, although not while the housing market is under intensive care. In a report to Congress in February, the Obama Administration wrote that the government should focus on regulation, helping low- and moderate-income homeowners and renters and preserving market stability.

Amid the disgust over what went wrong with housing finance over the past decade, it's easy to forget that the underlying structure is reasonably sound. For the benefit of the Perez family and millions like them, the challenge is to use this housing crisis to achieve change as effectively as FDR used the last one.

With Jody Shenn and Lorraine Woellert

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