

The Wrong Path to Sub-Prime Reform

By Desmond Lachman
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Barney Frank's recently introduced mortgage reform bill demonstrates yet again Congress' penchant for indulging in regulatory over-reaction to crises without addressing their underlying causes. Sadly, it also underlines how little Congress seems to have learned about the costs of past excessive market regulation. This is particularly disappointing coming as soon as it does after the Sarbanes-Oxley fiasco, which was Congress' costly knee jerk reaction to the WorldCom and Enron crises.

One can hardly take issue with the stated motivation of Mr. Frank's mortgage reform proposal. After all, who could seriously object to legislation that purportedly aims "to combat abuses in the mortgage lending market and to provide basic protection to mortgage consumers and investors"? This is especially the case against the backdrop of US foreclosures now set to top a staggering 2 million homes in 2008. It is also the case considering that global financial markets are still reeling as a result of ever-mounting losses on a mountain of ill-advised sub-prime lending.

One must take issue, however, with Congressman Frank's fundamental approach to averting any recurrence of the sub-prime mortgage debacle. For rather than seeking to harness market forces and correct market failures, he chooses to rely exclusively on a regulatory approach to the problem. He does so seemingly disregarding the dismal record of past efforts down this well trodden path.

Mr. Frank plans to rely on regulation in three distinct areas. First, he proposes the establishment of a federal duty of care aimed at prohibiting steering and at requiring the registration and licensing of all mortgage originators, including brokers and bank loan officers. Second, he advocates the setting of a minimum standard for all mortgages, which would require that borrowers must have a reasonable ability to repay. And third, he seeks to attach limited liability to secondary market securitizers, who package and sell interest in home mortgage loans outside of these standards.

The proposed heavy reliance on regulation to prevent any future recurrence of the sub-prime problem is curious to say the least. Was not a principal cause of today's sub-prime lending crisis precisely the fact that the regulators in general, and the Federal Reserve in particular, were fast asleep at the wheel as no less than US\$1.3 trillion in sub-prime loans were made between 2004 and 2006. Does it now really make sense to put one's faith in the same regulators who, for whatever reason, chose to ignore blatantly abusive lending practices and the creation of a ticking time bomb for the financial system of grossly sub-standard loans that had little chance of being repaid?

It might well be recalled that under the Home Ownership and Equity Protection Act, the Federal Reserve already had the authority to reign in the non-bank mortgage originators, who were the most culpable of bad lending practices. Yet, under Mr. Greenspan's leadership, the Federal

Reserve chose not to exercise that authority as mortgage lending standards progressively deteriorated. Can we have any assurance that regulators will be any better at implementing Mr. Frank's proposed reforms?

Reliance on regulation to address the sub-prime problem would seem to be particularly misguided when a more effective and market based remedy is readily at hand. Might not a more straightforward approach to mortgage reform be to harness market forces by aligning the incentives of mortgage originators with the promotion of the public good? One could do so by requiring that all mortgage originators be adequately capitalized and be forced to hold until maturity a significant portion of all mortgages that they originate.

In recent years, poorly capitalized non-bank institutions originated almost 50 percent of U.S. home mortgages. Typically they sold in short order their full stake in the mortgages they originated for securitisation purposes. In this originate--to distribute model, they had little incentive to determine whether the loans they originated might perform well over the life of the loan. Rather, their sole concern was to be sure that the loan would not default during the short period that they held the loan before distribution and before they were paid their fees.

By requiring mortgage originators to hold at least part of the mortgages they originate, one would be establishing powerful incentives for all originators to exercise better due diligence in making loans and to refrain from making loans to those borrowers who are most unlikely to meet the loan's terms. Such an approach would have the distinct advantage of obviating the need for the Mr. Frank's cumbersome regulatory approach to the problem. It would also be very much more transparent and very much less likely to interfere with the proper functioning of the US mortgage market than would Mr. Frank's proposed remedy.

Desmond Lachman is a resident fellow at AEI.