

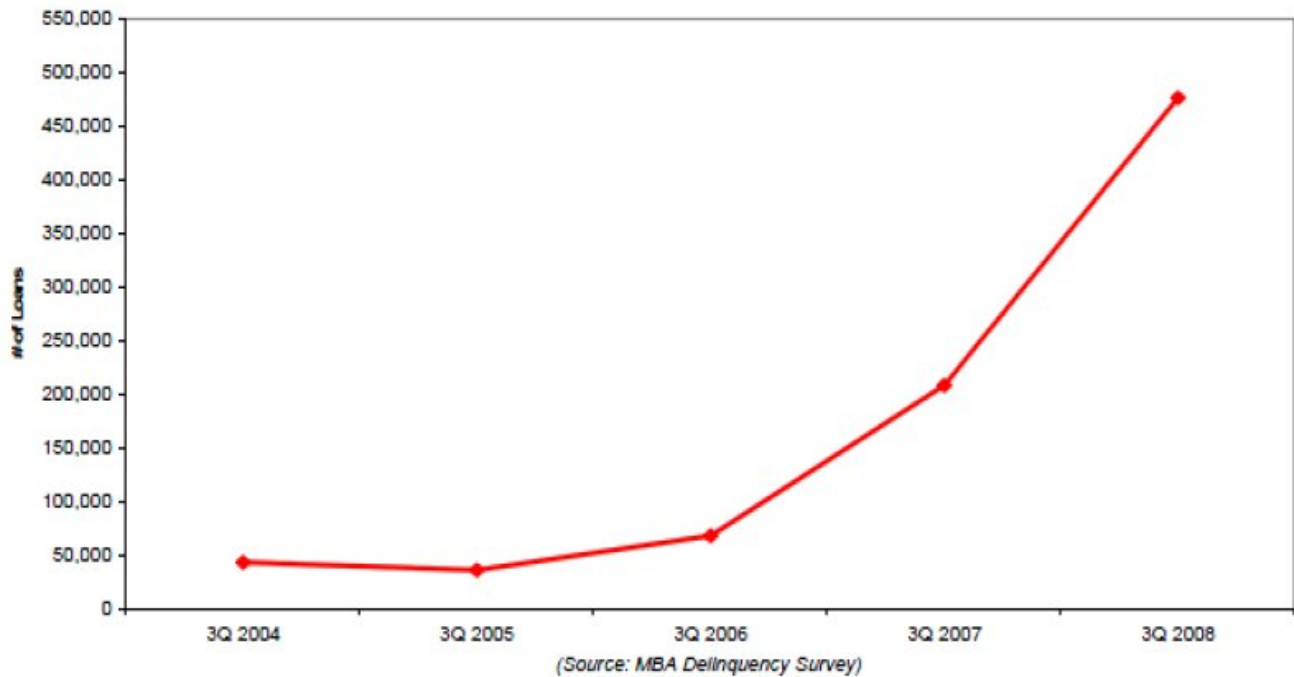
**NATIONALIZING THE PRIMARY MORTGAGE MARKET:
ELIMINATING THE RAVAGES OF COMPETITION
WHILE RESTORING MARKET STABILITY**

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Housing market stability is the foundation for sustainable, equitable, and accessible communities and households. The current economic crisis offers the opportunity to redesign housing market mechanisms in a way that promotes transparency, restores faith in government, and empowers communities. A confluence of circumstances has led to irresponsible home value speculation, which in turn has thrown global financial markets into calamitous instability through artificial asset inflation. Spurred by the mandate of federal policy to make credit more widely available, mortgage lenders enticed borrowers into unsustainable mortgages, luring them with low introductory interest rates. Then-president George Bush pushed for increased homeownership in accordance with his grander vision of an “ownership society,” in which responsibility for many services would be shifted to the private sector. His homeownership strategy had the twin benefits of broadening his political support base among minorities and stimulating business activity for loan corporations (many of which had been his campaign contributors; the brokerage industry contributed \$847,000 to Bush’s 2004 campaign.¹) Mortgaging future macroeconomic stability to purchase immediate political capital, the administration endorsed a “push-marketing” strategy for credit while concurrently allowing unsustainable, unregulated practices in the lending market to perpetuate.²

Loans With Two or More Payments Past Due in California



Given the charge to underwrite more loans, mortgage lenders were deployed into a population of eager, naïve borrowers, many of whom were uninformed of the financially troublesome terms they were offered. Brokers were compensated according to the volume and size of underwritten mortgages, not according to the long-term stability of loans and borrowers' ability to pay. Through shoddy due diligence and overstatement of borrower income,³ brokers ushered borrowers into loans that were beyond their means. Where default risk was determined to be high, borrowers compensated by making loan terms more burdensome, introducing variable interest rates, high prepayment fees, and origination points capitalized into the value of the loan.

However, the most unattractive of these terms, and primary source of the "subprime" mortgage crisis, was the floating interest rate. Often scheduled to take effect several years after the loan was originated, the risk was deemed unimportant in the rush to sell loans. After a grace period of attractive introductory interest rates, borrowers were promised the opportunity to refinance into a fixed rate mortgage, effectively allowing them to escape a skyrocketing interest rate.⁴ However,

when the time to refinance arrived, many homes had lost significant value and brokers were unwilling to underwrite additional loan amounts that covered the original mortgage. Many borrowers resorted to taking out second mortgages at unfavorable rates, in order to stay financially solvent. The accompanying box describes the timeline of a typical mortgage leading to default.

Since borrowers were unable to acquire additional (refinance or second) mortgages due to the oversupply of housing and resultant value collapse, they were faced with payments that fluctuated with mortgage interest rates. By the time the borrower was incapable of making payments and defaulted, the mortgage origination broker was often long out of the picture. Once variable rates began to float, often two or more years after sale, the mortgages had long been sold in the secondary market, and default risk was not the business of larger institutional investors. The brokerage industry had de-levered its downside risk while profiting from marketing practices that were often misleading.

Toxic Mortgages: Sequence of Doom

- Borrower is sold a sub-prime, adjustable rate mortgage with a low, fixed “teaser rate” and a two year grace period. She finances 95% of the \$500,000 home.
- After two years, the borrower seeks to refinance into a fixed-rate mortgage to avoid the imminent post-grace period interest rate rise.
- An overbuilt housing market, in conjunction with macroeconomic instability and job losses, reduces housing demand. The borrower’s house is now worth only \$200,000.
- \$200,000 is the maximum refinance amount a lender is willing to loan the borrower, but after two years of payments the borrower’s original mortgage balance is still \$450,000.*
- The borrower must continue to make payments on a house that is not worth the mortgage balance, or face the prospect of foreclosure or short sale.**
- With the original broker out of the picture, the homeowner is left to negotiate with the loan servicer, who often has little incentive to adjust the original mortgage terms.

*Payments early in a mortgage cycle are applied almost exclusively to interest rather than principle.

** Timiraos, Nick. *Short Sales: A Win-Win? Not Quite*. Wall Street Journal; 14 May 2009.

Mortgage origination firms competed with one other on volume and loan size, knowing that they could sell default uncertainty (responsibility for “toxic” loans) to secondary market institutional investors. Often, these investors were far removed from the origination process, playing no role

in the determination of risk at the origin point of sale. Instead, they relied on risk ratings assigned to mortgage-backed securities by ratings agencies.⁵ With the pricing of mortgage-backed securities an inexact science rife with bad information, subjective adjudication and irrational exuberance,⁶ in addition to biased reporting and general short-run, profit-driven malfeasance, investors were exposed to much more risk than they thought they had bought. Meanwhile, the brokerage industry was aware of the ravages wrought upon the secondary markets by toxic mortgages, but was unwilling to curtail its activities because brokers were not liable for the risk of mortgages after they sold them.

This is the heart of the problem, and the driving force behind this document's policy recommendations. As a profit-centered intermediary between borrowers and the end-buyers of mortgage securities, the brokerage industry has been thriving in the most desired of business circumstances: the opportunity to make a profit without concern for long-term risk. As the brokerage arm of large banking institutions, in-house brokers were profit centers for companies that underwrote, securitized and sold mortgages as bundled assets. As independent operators, private brokers acted as business generators for banking institutions that had no brokerage divisions. In either case, the business model of brokerage allowed participants to maximize profit and virtually eliminate risk. According to capitalist thought, this is a desirable model. However, when one expands the cost to include negative social and economic externalities, to both homeowners and end-investors, the model is not worth the profit it generates.

Among banks and other large lending and investment institutions, there is a tacit acknowledgment that something is wrong in the brokerage industry.⁷ Banks are now taking steps to internalize the loan origination and approval processes. Brokers have been branded as quick-trigger "playground pushers" who turn a fast profit on false promises, cashing out on "toxic" loans and dumping their high risk onto the securities markets. Many of these institutions knowingly assumed the risk but polluted bundled securities with as many toxic mortgages as they could before ratings agencies would drop their "AAA" rating. These were sold to unwitting investors (pension funds, et al.) with the blessing of overzealous ratings agencies like S&P and Moody's.⁸ However, intermediate institutions, such as banks, would probably not have assumed such high risk if they had been the loan originators, for fear of lost investor confidence in their investment products. Also, many of these institutions retain the mortgages they sell instead of

selling them in the secondary market. If not advocating for the total elimination of the brokerage industry itself, banks are at least seeking to raise the bar on the minimum net worth of brokerage firms originating FHA mortgages, from \$63K to \$150K, presumably to lessen the risk of not being paid back for a bad loan.⁹

| Projected Foreclosures | |
|---|---|
| Projected new foreclosures in 2009 ^a | 462,100 |
| Projected homes lost through foreclosure over next four years ^b | 1,538,600 |
| Housing Market Decline to Date | |
| Change in state homeownership rate (2004-3Q 2008) ^c | -1.2% |
| Change in home prices (3Q 2008 vs. 3Q 2007) ^d | Anaheim-Santa Ana: -27.6% Los Angeles-Long Beach-Santa Ana: -10.5% Riverside-San Bernardino-Ontario: -39.4% Sacramento-Roseville: -36.8% San Diego-Carlsbad-San Marcos: -36.0% San Francisco-Oakland-Fremont: -25.3% San Jose-Sunnyvale-Santa Clara: -23.5% |
| Change in home sales (3Q 2008 compared to 3Q 2007) ^e | 58.4% |
| Decline in housing contribution to state economy (gross state product) 2005-2008 ^f | -\$68.7 billion |

Source: Center for Responsible Lending, "California Foreclosures: Impact and Opportunities," January 2009.

Other, more sinister schemes have emerged in the unregulated marketplace of loan securities, even among larger retail banks with internalized brokerage departments. Through a convoluted series of ethically suspicious acts, Countrywide Financial has actually profited from the mortgage crisis, and in retrospect it now appears to be a coldly calculated plot.¹⁰ The scheme started with Countrywide selling loans to borrowers who were unable to afford them (by overstating their incomes, promising attractive introductory rates, etc.). This occurred without regard to default risk. Then, Countrywide bundled these mortgages into securities that were sold in the secondary market, along with said risk. Countrywide, like a selfish broker, captured the value of over-inflated loans but suffered none of the default risk. At this point, the new purchaser endured significant losses once homeowners defaulted, and had to foreclose and liquidate bad mortgages. Predictably, many of these institutions went bankrupt, and the government purchased

their “toxic” mortgages at deep discounts. Finally, the same Countrywide investors who originated the mortgages returned, this time to buy up the newly underpriced loans they had long before originated. Countrywide therefore turned a profit twice in the same process, while homeowners, investors and local governments suffered the burden.¹¹

Therefore, it is evident that malfeasance occurs in the brokerage industry without regard to whether loan originators are independent operators or service arms of larger institutions. Neither the private agent nor the institutionalized brokerage firm can be trusted in the absence of tighter oversight. On one hand, it is easy to understand the ease with which a rogue broker can operate under the radar of scrutiny and turn quick profits. Unfortunately, however, patterns of abuse have proven to be a matter of institutional policy at many national loan origination firms, as has been exhibited with Countrywide Financial. The problem is therefore endemic, and rooting out abuse may prove to be as Herculean a task as prosecuting the mafia.

Previously, mortgage brokers might have been a necessary middleman, having the kind of ground-level contact with their communities that allows for the best due diligence in screening applicants. However, in an increasingly transient society, one in which technology has provided instantaneous access to individuals' financial data regardless of location, the age of quaint broker-community relations has given way to the tide of efficient automation. Therefore, brokerage has proven to be unnecessary at best, and socially and economically disastrous at worse. In fact, research indicates that subprime borrowers who solicited the “services” of loan originators, supposedly a borrower’s advocate in locating loans with the most favorable terms, actually fared worse than those who went to lenders directly.¹² Originators have abused this trust by steering clients towards higher-priced mortgages in exchange for kickbacks. The argument in favor of the industry existing is that brokers “help homebuyers sort through competing loan proposals and make good choices.” However, if there were a standard protocol for the assessment of applications and loan qualification, there would be no competition, as the government would be the provider of all loans.

With the division of the mortgage markets into two, the dynamics of information flow, competition, regulation and notions of "fairness" have some common but also divergent implications. Within the first of the two markets, in which loans are originated, a combination of

lax oversight, aggressive marketing procedures, and lack of long-term accountability for mortgages has created an inflated market for securities in the secondary market, and a crisis of affordability among many borrowers. This document proposes nationalization as the only way to prevent another such brokerage-related crisis. The mortgage loan market must be treated like the student loan market: standardized, non-negotiable protocols for the assessment of applicants that remove any degree of subjective adjudication, coercion and mendacity. The numbers are inputted, and the “black box” calculates a rate, maximum loan amount, and other terms. The ravages of competition are eliminated and banks are forced to compete in other arenas (most loan originators are out of business anyway, so this proposal does not exactly destroy a thriving market). Nationalization eliminates the shenanigans of overzealous credit sharks, and prevents further economic terrorism against society's disenfranchised populations.

There are parallels between the mortgage loan and student loan industries, and the latter can help understand how nationalization will be beneficial. While the approval and distribution process for student loan applicants remains largely nationalized, there has been a market for private lenders. President Barack Obama's new budget calls for the federalization of all student loans, with funds that had previously been used to subsidize private lenders (through the Federal Family Education Loan program) instead going directly to borrowers.¹³ Previously, the student loan industry had been largely nationalized, with all but the largest loans assessed, distributed and managed by the federal government. There exists a private student loan market only where financial need exceeds what is offered by the government; these loans often come with higher interest rates, shorter payback periods, and generally less favorable terms.¹⁴

Examination of objections to further student loan nationalization is useful in evaluating similar objections to nationalization of brokerage. The student loan initiative is being met with opposition from private industry, which claims that the reform will put many people out of work (in a contorted claim that government education subsidies should not only help students but also sustain the macroeconomic environment, a big responsibility for any program).¹⁵ Sallie Mae, the federal institution that guarantees student loans, is proposing that the origination of loans should be the business of private enterprise, which would then sell the loans to SLM. This precisely resembles the current mortgage industry. The alternative is a direct loan program, and this should be proposed for mortgages as well. Opponents of the student program also say that it eliminates

“choice” (as if education dollars are not a commoditized product.) There is currently consumer choice based solely on the terms of loans, and if these are standardized to prevent preferential or discriminatory treatment, the product offered by the government will be the standard issue loan. While “freedom of choice” is the rhapsodic claim of free-markets apologists, most of the options provided are unappealing (as market benchmarking has uniformly worsened terms offered by all providers). Opponents are primarily motivated by the threatened loss of federal subsidies for institutions that would not survive without them; this argument is an appeal to populism, since private institutions actually have no provable claim to functional efficiency when compared to a government-run program.

With the scope of the crisis having been outlined, it is necessary to examine solutions.

Solution 1: Non-nationalization Total nationalization, while appealing for some, may be impractical. However, it is possible to capture some of the benefits of nationalization while continuing to operate within a competitive but partially regulated system. This proposal creates a standardized protocol for the evaluation of applicants and the terms of offer (interest rate, length of repayment, down payment and principal amount). It devises a universally shared calculus that is legally mandated for all loan originators, and applies aggressive oversight in regards to reporting loan terms (an extension of HMDA), demographic patterns, and information availability (made by the issuer to the borrower).

Negatives:

- This would create a bureaucracy whose role it would be to monitor not only every loan made, but also (in the interest of rooting out discriminatory practices) every loan even offered, regardless of whether it were accepted by the applicant. Consistent enforcement would be costly at best, logistically infeasible at worst.
- Loan originators will be resistant to such "draconian" requirements, and given that many originators are separate divisions within national banks, they have the lobbying apparatus to influence whether and to what extent they should be liable to such requirements.

Solution 2: Nationalization This proposal brings all loan origination activities "in-house" by administering them through a government agency, in the same manner as the student loan market, in which application procedures are standardized and disbursement terms are not a matter of competition or subjective adjudication, the latter of which presents an opportunity for discrimination.

Negatives:

- There will be resistance from originators, some of whom (as stated above) have the support of powerful lobbyists
- Some will claim that this plan puts many people out of work (although the honest brokers among them could be rehired as federal mortgage agents).
- Banks will claim they are losing the opportunity to compete, and free-market apologists will claim this is denying the opportunity for the market to create value. A counter argument would be that the free market has failed in this industry by creating negative value, and (to the first point) banks have many other opportunities besides home mortgages as a basis for competition.

Both of these solutions are designed to:

- Eliminate subjectivity in the evaluation of applications, and by extension possible discrimination
- Provide a reliable national database of loan information not polluted by biased or self-serving reporting on the part of originators
- Remove competition, and its ills, from the process
- Level the negotiations playing field, one that had previously favored those with more leverage and obstructed disadvantaged applicants
- Give central control to a system that had previously been subject to varying practices and degrees of honesty

It is important to consider the dynamics of how the mortgage industry is organized. Some will argue that the mortgage loan industry has already been nationalized, citing the recent government

seizure of control over Fannie Mae and Freddie Mac, both “Government Sponsored Enterprises.” However, these firms constitute the secondary loan market and purchase mortgages that are sold on the primary market. Nothing has been done to nationalize the primary brokerage market, except for sporadically adopted professional standards that seem to have done little to stem the tide of “toxic” loans. The only discussion about nationalization in the mortgage market centers around the nationalization of banks and financial institutions. However, the mortgage loan origination market is populated with non-financial institutions, such as independent brokers. Nationalizing the market would entail taking control of all private brokerage activities, along with the activities of loan origination departments within financial institutions. The red herring used by defenders of the brokerage industry is the term “nationalizing the banking industry.” Nationalizing banks is *not* the proposal in this document. There is a separate industry, “brokerage,” that seeks to connect borrowers with capital, and it is not necessarily a part of the banking industry. It seems that anyone who wants (within certain regulatory guidelines) can “hang a shingle” and become a loan originator.¹⁶ It is this industry that should be nationalized.

Other Solutions

National oversight standards are already creeping into the brokerage industry. In Pennsylvania, individual employees of mortgage originators must subscribe to a database that allows consumers and regulators to “check up” on them. Institutions are already subject to reporting requirements through HMDA, with an extensive searchable online database.¹⁷ Strict licensure, earned through the completion of rigorous education and professional standards, is a possible way to address primary mortgage loan vandalism if nationalization is not a politically feasible option. Originally, only companies were required to have such licenses but not the individual agents dealing directly with loan applicants. Extending this to independent brokers is an important step towards a solution.

Other solutions to the brokerage crisis include the permanent attribution of legal liability to the institution that originates the loan, regardless of who ends up owning the loan as a security.¹⁸ This has been suggested as an opportunity to reintroduce honest due diligence and prudence at the earliest stages of the loan process, a critical time when many loans are made without concern for borrowers’ long-term ability to repay. While such regulation would certainly address the

crisis, its feasibility is a concern given the labyrinthine path taken by individual mortgages that are often bought and sold numerous times, or bundled into obscurity and sold as securities. Tracking down bad loans to identify ownership has already proven to be a challenge for regulators,¹⁹ and the same fate may befall those trying to track down loans for regulatory purposes.

On May 8, 2009, the U.S. House of Representatives passed an historic bill that would require mortgage lenders to assume a 5% stake in the loans they underwrite and ultimately sell as securitized investments.²⁰ This initiative is attractive in its specific numerical stipulation. However, other components of the plan are less descriptive. For instance, banks would also have to prove that borrowers are receiving a “net tangible benefit” derived from the loan. Although a quantitative benchmark has not been set for this goal, Massachusetts Representative Barney Frank expects the law to find its meaning through judicial application.²¹ Additional amorphous language includes the mandate that homeowners not be approved for loans they are clearly unable to pay.²² The law also applies tighter oversight to mortgage lenders, and protects renters by mandating the owner to give notice in the event of impending foreclosure. Other laws have been passed to help mollify the effects of the current crisis, such as “cram down” bankruptcy reform legislation that gives judges power to adjust mortgage terms. This law is encouraging in its focus on proactively addressing the crisis at its origin.

Objections

Defenders of the brokerage industry may argue that it is not the only party responsible for the crisis, and they are correct. With the catastrophic crash in the markets, along with 4-year projections of nearly 1.5 million foreclosures in California alone,²³ there is certainly enough blame to “go around.” The mortgage loan process has evolved into a complicated chain of actors, each deriving profit from a certain stage. However, in the absence of any opportunity to nationalize the whole chain (including banks themselves), there are certain advantages to nationalizing brokerage. In identifying and rooting out risky mortgages at the very root of the selling chain, there is no opportunity for toxic assets to pollute the markets at later stages of the process (including securitization and investment by innocent parties such as pension funds). Some argue that stricter regulations would solve this problem, but fewer regulations would

please free-market apologists who seek open, unfettered trading activity. If traders are driving the markets with bad assets, all investors lose, as has already occurred. Nationalizing the entry portal prevents undue regulatory constraint on the secondary markets by heading off the source of the problem before it enters the system.

Others will argue that the existence of the “subprime” markets aids lower income families in attaining credit. However, one must question whether said families have benefited in the long run, or have merely had the opportunity to occupy large homes at prices beyond their means for short periods of time, before having their credit permanently destroyed. Housing and credit services rendered to low-income individuals are not profitable in a free market. If they were, no shortage of affordable housing or favorable credit terms would exist. Since the altruistic notion of equitable access to credit is seemingly incompatible with profit motives, there is an evident market failure. In this case, the government must intervene in the provision of what some call “merit goods,” those products to which universal access is deemed an entitlement regardless of means. Consumer need is the sole determinant in the provision of merit goods, and equal access to credit terms should not be left to the whims of a marketplace driven by personal profit motives.

There will be other objections still. Some claim that brokers provide a valuable service, connecting demand with supply in an intermediate role of loan matchmaker.²⁴ However, if there is a one-stop provider for all mortgages, as there is with student loans, this will not be a problem because loan seekers will have only one place to look. Another objection is that the elimination of the brokerage industry will cost jobs. This is undeniably correct, because the industry accounts for about 418,000 jobs, in 53,000 different organizations.²⁵ However, policymakers must weigh the costs and benefits: how many jobs are worth long-term housing and financial market stability? The investment banking industry collapse cost tens of thousands of jobs, but it was allowed to happen because it was deemed financially beneficial. Additionally, with the creation of a central mortgage loan office, former brokerage industry employees – presumably only the honest among them – will be hired for their experience and expertise in the field.

In conclusion, focus on the brokerage industry is critical for the reestablishment of housing market and financial market stability. Unregulated, irresponsible, free flow of credit created an asset bubble that ultimately destroyed wealth and livelihood. Nationalization addresses these concerns, places a critical market activity under strict governmental control, and allows the securities markets to operate freely without the ravages of “toxic” financial products. Additionally, nationalization achieves important social goals in the provision of fair and equal access to favorable credit terms. In short, this is a solution both progressives and free-market apologists can endorse.

¹ <http://www.nytimes.com/2008/12/21/business/21admin.html?pagewanted=1&hp> 20 Dec, 2008.

² <http://www.nytimes.com/2008/12/21/business/21admin.html?pagewanted=1&hp> 20 Dec, 2008.

³ Allen, Anthony. Personal communication, 3 Mar 2009.

⁴ <http://www.nytimes.com/2008/12/21/business/21admin.html?pagewanted=1&hp> 20 Dec, 2008.

⁵ <http://www.forbes.com/2009/04/21/ratings-agencies-debt-intelligent-investing-funds.html> 8 May 2009.

⁶ Shiller, Robert J. *Irrational Exuberance*. Princeton: Princeton University Press, 2000.

⁷ http://www.nytimes.com/2009/02/01/realstate/01mort.html?_r=1&ref=realstate 8 May 2009.

⁸ Freeman, James. *The Credit Crisis and its Creation*. Wall Street Journal; 13 May, 2009.

⁹ http://www.nytimes.com/2009/02/01/realstate/01mort.html?_r=1&ref=realstate 8 May 2009.

¹⁰ http://www.nytimes.com/2009/03/04/business/04penny.html?pagewanted=1&_r=2&hp 8 May 2009.

¹¹ http://www.nytimes.com/2009/03/04/business/04penny.html?pagewanted=1&_r=2&hp 8 May 2009.

¹² <http://www.nytimes.com/2009/04/10/opinion/10fri1.html?ref=opinion> 8 May 2009.

¹³ <http://www.washingtonpost.com/wp-dyn/content/article/2009/04/13/AR2009041302771.html?hpid=sec-education> 8 May 2009.

¹⁴ <http://www.tuitionbids.com/student-loan-tools-and-advice/private-student-loans-in-depth.aspx> 8 May 2009.

¹⁵ <http://www.washingtonpost.com/wp-dyn/content/article/2009/04/13/AR2009041302771.html?hpid=sec-education> 8 May 2009.

¹⁶ <http://www.mortgagebrokertraining.com/loan-originator-training.html> 8 May 2009.

¹⁷ <http://www.allbusiness.com/banking-finance/banking-lending-credit-services-mortgage/11593423-1.html> 8 May 2009.

¹⁸ Tietz, Dr. Michael. Personal communication, 8 May, 2009.

¹⁹ <http://www.nytimes.com/2009/04/24/business/24mers.html?ref=business> 8 May 2009.

²⁰ <http://www.reuters.com/article/americasRegulatoryNews/idUSN0739878220090507> 8 May, 2009.

²¹ <http://www.reuters.com/article/americasRegulatoryNews/idUSN0739878220090507> 8 May, 2009.

²² <http://features.csmonitor.com/politics/2009/05/08/belatedly-house-votes-to-curb-predatory-lending/> 8 May, 2009.

²³ Center for Responsible Lending, “California Foreclosures: Impact and Opportunities,” January 2009.

²⁴ <http://www.articlesnatch.com/Article/Mortgage-industry-in-Australia/569399> 8 May, 2009.

²⁵ Wholesale Access Mortgage Research and Consulting, Inc., 2004.