Mortgage Lending and Borrowers' Welfare

Homeownership

- US public policy strongly favors homeownership
  - Tax incentives – many billions per year in normal times, more in 2009-2010
  - GSEs – keep mortgages liquid and cheap; “implicit” guarantee
  - FHA/VA – guarantee of certain loans
  - Recent Fed MBS purchases (support ownership/prices)
  - Rhetoric (bipartisan)
- What are the benefits?
  - Public: more stable communities, incentives to participate in public affairs
  - Private: building wealth

Mortgage policy (1)

- Risks
  - Home purchase is a huge and complex commitment
  - Done only a few times in a lifetime
  - Asset purchased is illiquid with volatile value
  - Default results in huge private and social costs
- Relatively simple, affordable mechanism for purchasing homes can make process easier for borrowers
- 30-year FR mortgage contracts
  - Interest rate (inflation) risk: borne entirely by lender/investor
    - Need a mechanism to entice lenders
  - Still complex: borrowers own the refinance option
    - When to exercise?
    - Temptation for equity withdrawal at refinance
      - Reduces borrower wealth if spent on consumption
      - Generates big risks to lenders if prices fall

Mortgage policy (2)

- Consumer financial regulation can mitigate some of these risks
  - Discourage lending likely to result in foreclosures
    - High social costs when defaults occur
  - Promote standard mortgages – easily understood
    - Discourage innovation? ARMs can offer some advantages
  - Standardize and regulate origination and closing process
    - Borrowers especially vulnerable at moment of closing
  - Facilitate borrower calculation of costs and risks
    - Simple metrics for diverse products

Mortgage policy (3)

- Regulation can take many forms
  - Prohibit/require certain practices
    - Eg, racial discrimination
  - Encourage certain practices
    - Eg, 30-year FRMs encouraged by GSEs
  - Require full information and allow market to function
    - Mandatory disclosures
  - Rely on market completely
    - No regulations

Mortgage policy (4)

- Complexity of even basic regulation: the case of subprime 2-28s
- Hybrid ARMs, 2-year fixed period, 28 years of adjustable rates
  - 6-month LIBOR + “margin”
  - Rates can adjust every 6 months
  - Complex periodic and lifetime ceilings and floors vary by lender
  - Many defaults in 2007-2009
- What information do borrowers have to make their decision?
- How to APR calculate on this product?
  - Assume:
    - LIBOR stays fixed
    - Loan pays for 30 years
- Closing costs get amortized over 30 years
  - For loans that have short expected durations, calculation understates the true cost of upfront points and fees

Points & fees, and APR Subprime 2-28s, August 2005 Originations

- Overall mean points and fees 3.3% of origination balance
  - High costs for loans naturally designed to be short duration
- Relative to white borrowers
  - APR premium paid by black borrowers: -.014% (0)
  - Points and fees paid by black borrowers $250 higher, significant
- Big difference in upfront costs “disappears” in 30-year calculation
- Could report APR if loans last various durations
  - APR = X if you stay in loan for 2 years,
  - Apr = Y(<X) if 30 years
- Requires borrower to understand refinance option

Conclusions

- Promotion of homeownership presents challenges to policymakers/regulators
- Can we make buying a home a safe investment?
  - For borrowers
  - For society
- A very basic step is to ensure borrowers have meaningful information about alternatives
  - Even this is difficult
  - Simple metrics not always useful
  - More sophisticated may be too complicated
- Potential solutions
  - More stringent regulation: forbid some contracts
  - Financial education
  - Counseling