Mortgage Lending and Borrowers’ Welfare

The views expressed here are those of the author, and do not necessarily reflect those of the Federal Reserve Bank of New York or the Federal Reserve System.
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