# Booms and Busts: The Case of Subprime Mortgages

*By Edward M. Gramlich*

We have all learned about productivity as a smooth trend process. There is this rate of productivity change, it produces this rate of capital augmentation, and this rate of economic growth.

But even a cursory examination of American economic history, and probably the history of other countries as well, suggests that the process may not really work that way. Booms and busts play a prominent role as well. In the 19th century, the United States benefited from the canal boom, the railroad boom, the minerals boom, and a financial boom. The 20th century saw another financial boom, a stock market boom, a postwar boom, and a dot-com boom.

The details differ, but each of these cases feature initial discoveries or breakthroughs, widespread adoption, widespread investment, and then a collapse where prices cannot keep up and many investors lose a lot of money. When the dust clears, there is financial carnage, many investors learning to be more careful next time, but there are often the fruits of the boom still around to benefit productivity. The canals and railroads are still there and functional, the minerals are discovered and in use, the financing

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innovations stay, and we still have the Internet and all its capabilities. A deeper understanding of productivity change should seem to focus not only on trend growth, but on how these booms and busts work in.

Well, we've just seen the process work itself out again, with subprime mortgages. Back in the early 1990s there were no subprime mortgages, but then a number of forces combined to lead to incredible growth. From essentially zero in 1993, subprime mortgage originations grew to $625 billion by 2005, one-fifth of total mortgage originations in that year, a whopping 26 percent annual rate of increase over the whole period. These were subprime mortgages, and the growth was largely focused on racial and ethnic minorities and lower-income households who could not get prime mortgage credit. Something like 12 million new homeowners were created over this period, largely first-time homebuyers, largely racial and ethnic minorities, largely lower-income households. America's overall homeownership rate rose from 64 percent to 69 percent, putting the United States in the top tier of countries in the world in terms of ownership rates. This new boom in homeownership was also the subject of intense cheerleading from the White House, both Presidents Clinton and Bush.

There were many causes for this explosive growth, which I will term a boom. The earlier decline of usury laws following the Depository Institutions Deregulatory and Monetary Control Act of 1980 certainly played a role. Now it was no longer illegal for lenders to make higher-priced mortgages—if the borrowers' credit history was not strong, the lender could just charge higher interest rates. Mortgage denial rates fell noticeably following this innovation. Automatic underwriting played a role, as did securitization, which enabled lenders to spread risks more efficiently. And there were changes on what might be called the supportive side of the market too—one of the biggest was the Community Reinvestment Act (CRA), which gave banks an incentive to make low- and moderate-income mortgages. To their surprise, most banks found that CRA lending was pretty good business.

But back to the boom-and-bust story, we all know that that happened too. Unlike the conservative, staid prime mortgage market featuring fixed-rate, long-term mortgages made under tight supervisory conditions, the subprime market was the Wild West. Over half the mortgage loans were made by independent lenders without any federal supervision. A large share were placed by independent mortgage brokers without any skin in the game—they would just place a mortgage, collect their fee, and move on. A very large share were adjustable-rate, often with very low teaser rates in the first few years. Economists studying the issue report that borrowers seem to understand very poorly that if their adjustable rate is low today, it may not be so low tomorrow. Unlike the prime market, lenders would often not escrow taxes and interest, and there was widespread use of prepayment penalties, which made it hard to get out of these mortgage deals.

The predictable result was carnage. The subprime foreclosure rate was about 7 percent when subprime mortgages were not much of a factor, but it is likely to be closer to 20 percent on the new vintage subprime mortgages. Foreclosures are found to be strongly neighborhood-dependent, and many urban neighborhoods have been devastated by widespread foreclosures. Lenders have not done much better, with about 30 going broke, including New Century Financial, the third- largest subprime lender back in 2005. And while some of these mortgage risks have been successfully securitized, some have ended up in hedge funds as well, and two Bear Stearns subprime hedge funds have recently gone under, losing investors something like $3 billion. Many press commentators have suggested that we throw out the whole market and go back to the constricted situation of the early 1990s.

But again going back to the boom-and-bust story, that seems exactly the wrong message to take from the experience. The subprime mortgage market was a valid innovation, and it did enable 12 million households to become homeowners, a large majority of these who would have been denied mortgage credit in the early 1990s. The recent foreclosure rate is 20 percent, but the average across all subprime mortgages is 12 percent, according to the Federal Reserve. This, of course, means that about 88 percent of these new homeowners are making their payments and retaining their houses. Some have excruciating debt burdens and are highly vulnerable to loss, it is true, but according to the Fed's Survey of Consumer Finances, a large share of these subprime borrowers are actually increasing their net worth through capital gains, the standard American way for building wealth. Structurally, also, it would be very strange to bring back usury laws, and get rid of securitization and automatic underwriting.

So, I have been claiming that we ought to treat all these events as the positive residue of the usual productivity-enhancing boom-and-bust cycle. I've got lots of ideas about how we could make technical changes to make the whole process work better, but our mindset should be to take what is valuable in the subprime boom and build on it, not tear it down.

Before getting to reform issues, let me discuss one monetary issue. The Fed, as we repeat all the time in our speeches, tries to stabilize the economy by taking rates up when things get hot and down when things cool (I realize that we attribute primary importance to price stability, but here I am just talking about the output side). Taking rates up is no particular economic problem, though it could become a political problem. But this whole subprime experience has demonstrated that taking rates down could have some real costs, in terms of encouraging excessive subprime borrowing. I'm not sure what the exact share is, but a lot of the so-called stimulatory impact we got in the early 2000s when rates were low was due to subprime borrowing and housing spending.

Now, if we promptly enact all the safeguards I'm going to mention shortly, we should have no problem in behaving in this standard way. Rates go down, but there should not be the serious carnage that accompanied this particular fall in rates. But if we do not fix the problems, we could well get a repetition of the ugly recent experience with subprime mortgages.

What should we do about this—is it a dilemma? I really do not think so, and I assume that opinion is shared around the room. Again, our standard mantra is that the Fed should worry about overall spending, not the problems facing any particular sector. Fine, but assuming we do that, it would seem incumbent on us to make sure the subprime structural problems are fixed before we repeat the low interest rate cycle. I'm not sure how much time this gives us, or politicians. But it is not forever.

What then are the fixes? I recently wrote a book called *Subprime Mortgages: America's Latest Boom and Bust* that lists many. Here, I will hit the high points.

### *The Hole in the Supervisory Safety Net*

According to 2005 data from the Home Mortgage Disclosure Act (HMDA), approximately 20 percent of all subprime mortgages are made by banks and thrifts, which undergo arduous supervisory regimes. Federal supervisors visit every three years, and they check carefully into the banks' routines for making loans, validating repayment abilities, and compliance with the numerous consumer protections and laws—HMDA, the Equal Credit Opportunity Act, the Truth in Lending Act, the Real Estate Settlement Procedures Act, and the Home Ownership and Equity Protection Act (HOEPA). Most observers feel that if there are problems in the subprime sector, predatory lending or whatever, these problems do not emanate from this tightly supervised part of the market.

Another 30 percent of subprime loans are made by affiliates of banks, holding companies, or thrifts. These affiliates are in a hybrid status—they typically are not supervised on a three-year basis by federal supervisors, though the supervisors do check into the head office's routines for keeping affiliates in compliance. They are also subject to specific examination if problems are noted, through complaints, suits, or whatever.

Then 50 percent of subprime loans are made by state-chartered but not federally supervised independent mortgage companies. Typically the states bring a lot less resources to the supervisory process, and most reports of abusive or predatory lending do emanate from this sector. This is in contrast to the prime mortgage market, where virtually all loans are made by federally supervised banks or thrifts, or affiliates, with only a trivial share made by independent mortgage companies.

This all sets up what I will call a giant hole in the supervisory safety net. In the prime market, where we need supervision less, we have lots of it. In the subprime market, where we badly need supervision, a majority of loans are made with very little supervision. It is like a city with a murder law, but no cops on the beat.

In my book, I recommended attacking this problem forthwith, but I did not give a lot of suggestions on how to attack it. The simplest idea seemed to require all subprime (and prime) mortgage lenders to sign up with a federal supervisor, a change that would require federal legislation and might antagonize the states. I do think these difficulties could be circumvented, though it may be difficult to pass the relevant legislation.

But I am pleased and proud to note that I think the Fed may have come up with a better way. On July 17, they announced a joint program under which the Board and the Office of Thrift Supervision (OTS) would select a sample of affiliates under their supervision and begin supervising them. The Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency have different structures, and this supervisory plan would not be relevant to them. But what is unique about the program is that the consortium of agencies includes state agencies represented by the Conference of State Bank Supervisors. These state agencies would begin supervision as well, in parallel with the federal supervisors. The change brings state-chartered institutions into the program without federal legislation.

Whether we simply require all subprime mortgage lenders to sign up with a federal supervisory, or focus on the Board's July 17 approach, it is important to emphasize the word "all." The subprime market is pretty competitive, and there will always be an incentive to cheat—to ignore this law or that regulation. Bringing all lenders into the tent means that all are playing by the same rules, which hopefully are effective rules. A long list of subprime mortgage abuses could be easily eliminated by expanding the lending supervision—from inadequate efforts to document borrowers' ability to repay the loan, failure to escrow taxes and insurance, or some of the common predatory lending practices.

### *ARMS, Exotic Products, and the Subprime Market*

One subprime mortgage anomaly is that we have more supervision in the sector where we need less, and less in the sector where we need more. Another is that the prime mortgage market consists largely of long-term fixed-rate mortgages while the subprime market contains all kinds of exotic instruments—interest-only loans; negative amortization mortgages; and, the real menace, 2/28 loans. Under these, the interest rate is fixed for two years and then becomes adjustable for 28 years. Often lenders offer teaser rates in the first two years, and borrowers suffer what are known as serious payment shocks after that. But these loans also contain prepayment penalties that last longer than two years.

Why are the most risky loan products sold to the least sophisticated borrowers? The question answers itself—the least sophisticated borrowers are probably duped into taking these products. Should we ban all exotic loan products? The thought is tempting, but the Fed's normal approach is to make it more difficult to sell exotic products in the subprime market.

Exactly how this can be done is tricky. The key, it seems to me, is HOEPA, a predatory lending statute administered by the Fed. HOEPA already bans long-term prepayment penalties and balloon payments on mortgages. But it does not ban large payment shocks due to the interest rate, and it seems logical to extend the law in that direction. Lenders would not be so quick with their teasers if they could not get their rates back up again.

HOEPA contains triggers—a loan is considered a HOEPA loan (high-cost loan) if its APR is a certain threshold (now eight percentage points) above the Treasury rate for a comparable maturity bond. The eight points is now limited by statute. If Congress were to relax this threshold, say making it Treasury plus five, the Fed could use the law pretty aggressively. For example, it could leave the threshold at eight points for fixed-rate loans and cut it to five for adjustable-rate loans. Such a twist might spread the use of fixed-rate loans in the subprime market, which to me seems like a very good outcome.

## *Rental Housing*

One of the things I tried to do in my book was to give an integrated treatment of the subprime market and rental housing. This is the choice for most households in this segment of the housing market, and the usual treatment simply ignores rental housing.

In a word, things are not that great on the rental side either. There is a massive shortage of rental housing in many urban communities, and low-income service workers (gardeners, nannies, etc.) are often forced to spend an inordinate share of their income on rents and live many, many miles from their place of employment. Before the subprime market broke, this paucity of rental housing was getting to be a major problem.

It still may be a major problem, but there is a new element. The subprime foreclosure problem has meant a very large price break in many of these same urban communities. As foreclosures have spread through urban markets, properties have become available. It strikes me an ideal opportunity for local rental housing groups, called Metropolitian Planning Organizations, to borrow some money, buy up foreclosed properties, turn them into high-quality rental properties, and in effect use the opportunity to deal with some long-standing issues with rental housing. In all this talk about the subprime mortgage issue, I have not heard any suggestion like this, and I cannot understand why not. In any case, that suggestion is now made.

### *Community Groups*

One unique element in the low-income housing picture is the importance of community groups. NeighborWorks America has organized about 250 community development corporations into an effective national operation, and the Opportunity Finance Network has done likewise with about 200 Community Development Financial Institutions. (It can be hard for an outsider to tell a communitiy development corporation from a community development financial institution, but we can ignore this distinction in a luncheon speech). These community organizations have traditionally focused on what might be called the offense of housing development—getting properties, getting responsible purchasers or renters, working out the financing, and so forth. But lately, with the rise of predatory lending claims and the massive foreclosure problems, the community organizations have gone defensive as well—many have organized significant and highly effective foreclosure prevention programs.

Without going into details, which are again in my book, these foreclosure prevention programs usually work on a call-in basis. The borrower starts missing payments and calls for help. Sometimes the foreclosure prevention groups can sell the property and wind up the loan, sometimes they can restructure the loan, sometimes they can get alternative financing, and sometimes they cannot do anything—the loan is just massively unsuited to the borrower. These programs do seem to be successful, often averting up to two-thirds of potential foreclosures, and they would be even more successful if given added funds to help with the workouts. If Congress does appropriate any funds for the subprime issue, or if it requires Fannie Mae or Freddie Mac to kick in new funds, the community-based organizations are ideally set up to deal with the issue.

These are a few ideas—there are many others. But let me return to some main points. The subprime market, for all its warts, is a promising development, permitting low-income and minority borrowers to participate in credit markets. It does have to be cleaned up, but that cleanup should not be so hard. It would take a few simple changes in supervision and regulation to right many of the wrongs. Let's get cracking on fixing the problems, and in particular let's get it done before the Fed has to lower interest rates again. These are soluble problems.