VIII. Potential Solutions to the Housing Crisis

A. Introduction

Prior to 2008, many factors, including low interest rates and high availability of credit, created a housing bubble.[1] The bubble was filled with trillions of dollars of risky mortgages, and as housing prices decreased and people began to default on their mortgages, a crisis developed.[2] There is much debate surrounding the specific cause of this crisis, and that, in turn, creates debate on the proper way to deal with the crisis.[3] The debate aside, there were many causes to the housing crisis, and potential solutions must be fashioned from different angles to properly tackle the problem. Lax government regulation may have facilitated an increase in irresponsible lending practices and may have allowed the subprime mortgage market to operate less transparently than would be ideal.[4] Another probable cause of the housing crisis was the government's policy decision to push for increased homeownership.[5] Government policies forced lenders to take on more risk and many of these riskier loans resulted in default and foreclosure.[6] In addition to regulations to stop predatory lending and to increase transparency in the mortgage market, a comprehensive set of solutions must also address this governmental distortion of the market.[7]

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[1] THE FIN. CRISIS INQUIRY COMM'N, THE FIN. CRISIS INQUIRY REPORT at xvi (2011).
[2] *Id.*
[3] *Compare id.* at xvii (arguing that a lack of regulation and government oversight were major causes of the real estate crisis), *with* PETER J. WALLISON, THE FIN. CRISIS INQUIRY COMM'N, DISSENT FROM THE MAJORITY REPORT OF THE FIN. CRISIS INQUIRY COMM'N 2 (2011) (arguing that community lending programs were responsible for the real estate crisis).
[4] THE FIN. CRISIS INQUIRY COMM'N, *supra* note 1, at xxi.
[5] PETER J. WALLISON, THE FIN. CRISIS INQUIRY COMM'N, DISSENT FROM THE MAJORITY REPORT OF THE FIN. CRISIS INQUIRY COMM'N 2 (2011).
[6] *Id.*
[7] *Id.*

B. Causes of the Housing Crisis

One of the contributing causes of the housing crisis was the increase in subprime mortgages.[8] Subprime mortgages are high risk loans given to people with less than ideal credit histories.[9] The tremendous increase in these risky mortgages combined with falling house prices led to many foreclosures and widespread problems in the financial markets.[10] Congress put together the Financial Crisis Inquiry Commission to examine the housing and subsequent financial crisis.[11] The reports issued from this commission about the causes of the housing and financial crisis seem to pit two views against each other with only two possible solutions: more or less government regulation.[12] In the view of the majority's report, lax government regulation was the cause of the problem and the solution is a stringent set of regulations.[13] In the view of one of the dissenters, governmental policies and regulation caused the explosion in subprime mortgage lending, which led to the housing crisis and the appropriate solution is to reduce government involvement in the residential mortgage market.[14] Both sides point out legitimate causes and potential solutions to the crisis. Lax government regulation probably led to many of the problems associated with the housing crisis.[15] The lack of regulation opened the door for irresponsible and predatory lending practices.[16] These practices increased the number of risky mortgages that were likely to default.[17] Weak regulation was also responsible for the lack of transparency in the market.[18] This lack of transparency impedes the government's ability to respond when a crisis emerges.[19]

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[8] THE FIN. CRISIS INQUIRY COMM'N, *supra* note 1, at xvi.
[9] Todd J. Zywicki & Joseph D. Adamson, *The Law and Economics of Subprime Lending*, 80 U. COLO. L. REV. 1, 55 (2009).
[10] THE FIN. CRISIS INQUIRY COMM'N, *supra* note 1, at xvi.
[11] *Id.*
[12] *Compare id.* at xvii, *with* WALLISON, *supra* note 5, at 2.
[13] THE FIN. CRISIS INQUIRY COMM'N, *supra* note 1, at xviii.
[14] WALLISON, *supra* note 5, at 29.
[15] THE FIN. CRISIS INQUIRY COMM'N, *supra* note 1, at xvi.
[16] *Id.* at xxii.
[17] *See id.*
[18] THE FIN. CRISIS INQUIRY COMM'N, *supra* note 1, at xx ("Within the financial system, the dangers of this debt were magnified because transparency was not required or desired.").
[19] *Id.* at xii.

Government policy also had a part in causing the housing crisis.[20] The government's housing policy decision to increase home ownership in the United States caused lenders to relax their underwriting standards and lend to poorly-qualified borrowers.[21] This policy-induced change to the mortgage market was another cause of the housing crisis.[22]

C. Predatory Lending and Potential Solutions

One definition of predatory lending is creating a loan "where there is no reasonable anticipated financial benefit to the borrower as a result of the loan."[23] In potential predatory lending situations, the lender may have more information about the borrower's default potential than the borrower does.[24] A borrower may not understand how changing economic conditions could affect his or her ability to make payments.[25] The lender is in a better position to understand how interest rate changes or falling house prices, for example, will burden the borrower.[26] In some cases, lenders purposely made loans they knew borrowers could not afford.[27] Lenders were sometimes incentivized to make these loans because they received higher commissions for higher interest rate loans.[28] It is this type of mortgage practice that potential solutions to the housing crisis should address.

House Bill 2108, known as the "Predatory Mortgage Lending Practices Reduction Act," proposed a special certification process for persons who provide mortgage loans secured by a government-sponsored enterprise.[29] The certification process would

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[20] WALLISON, *supra* note 5, at 2.
[21] *Id.* at 2.
[22] *See* WALLISON, *supra* note 5 at 2; Zywicki & Adamson, *supra* note 9, at 37.
[23] Zywicki & Adamson, *supra* note 9, at 12.
[24] *Victimizing the Borrowers: Predatory Lending's Role in the Subprime Mortgage Crisis*, KNOWLEDGE@WHARTON (Feb. 20, 2008), http://knowledge.wharton.upenn.edu/article.cfm?articleid=1901.
[25] *Id.*
[26] *Id.*
[27] THE FIN. CRISIS INQUIRY COMM'N, *supra* note 1, at xxii.
[28] *Victimizing the Borrowers: Predatory Lending's Role in the Subprime Mortgage Crisis*, *supra* note 25.
[29] Predatory Mortgage Lending Practices Reduction Act, H.R. 2108, 111th Cong. §13a (2009).

require such persons to receive training in subprime lending practices.[30] The bill also would make grants available to nonprofit community development corporations to train and educate borrowers and community groups on predatory lending.[31] These training and educational efforts could be useful measures to help prevent predatory lending. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act" or "Act") also details some other methods to curb predatory lending, such as limits on compensation practices that incentivize lenders to create high-risk loans that are likely to default.[32]

Many regulations in this area seem appropriate, but to properly address the crisis and allow for significant results in the future, the best solutions will not overly regulate the subprime mortgage market.[33] The subprime mortgage market has many positive aspects that should be preserved.[34] Before the expansion of the subprime mortgage market, borrowers unable to obtain prime rate financing were not able to acquire any mortgage financing.[35] This market brought in many new, previously excluded, borrowers and allowed them to become homeowners.[36] It allowed others to access accumulated home equity for other consumption, such as education, home improvements or starting a small business.[37] Increased homeownership is also "correlated with a substantial increase in one's propensity to vote, dramatic improvements in children's life outcomes, and improvements in labor market outcomes; home-ownership also creates incentives to improve property, generally increases life satisfaction, and is correlated with a reduction in crime

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[30] *Id.*
[31] H.R. 2108 §122.
[32] Bradley K. Sabel, *Mortgage Lending Practice after the Dodd-Frank Act*, HARV. L. SCH. F. ON CORP. GOVERNANCE AND FIN. REG. (Nov. 16, 2010, 10:03AM), http://blogs.law.harvard.edu/corpgov/2010/11/16/mortgage-lending-practice-after-the-dodd-frank-act/.
[33] *See* Zywicki & Adamson, *supra* note 9, at 4 ("Because of the benefits that the subprime market creates for millions of marginal homeowners, lawmakers should carefully consider ways to maintain the legitimate subprime market while restricting the ability of predatory lenders to originate high-cost loans that impose a net harm on borrowers.")
[34] *Id.*
[35] *Id* at 20.
[36] *Id.*
[37] *Id.*

rates."[38] Methods advanced by proposed bills such as H.R. 2108 and provisions of the Dodd-Frank Act to curb predatory lending are potentially effective solutions to the housing crisis; however, it is important that solutions advanced do not have the effect of curtailing the subprime mortgage market.[39]

The Dodd-Frank Act extends further than the regulations intended to prevent predatory lending.[40] Some regulations contemplated by the Act impose specific minimum standards for certain loans.[41] Depending on how those regulations are implemented they could hurt the housing market by making it harder for potential buyers to obtain loans.[42] Overinclusive regulations could also restrict legitimate practices that seem predatory when used incorrectly.[43] Solutions to curb predatory lending should be carefully constructed to stop predatory lenders while maintaining the legitimate subprime market.[44] Proposals that increase awareness and education, as well as regulations that curb incentives for lenders to make unsafe loans, may achieve this end. Regulations that seek to control rates and terms of mortgages, however, may be unhelpful in solving the housing crisis.

D. Lack of Transparency and Potential Solutions

Regulators of the financial system were not prepared to deal with the housing crisis because of the lack of transparency in the markets.[45] Many government officials thought the risks in the financial markets had been diversified, but they had actually been concentrated over the period leading up to the crisis.[46] The government's ignorance meant it did not have a comprehensive plan to attack the problem.[47] Government Sponsored Enterprises

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[38] *Id.* at 23
[39] *See id.* at 2-4.
[40] Sabel, *supra* note 32.
[41] *Id.*
[42] Donna Robinson, *Residential Real Estate Industry Cringes As Dodd-Frank Era Begins*, REALTY BIZ NEWS, Sep. 4, 2011, http://realtybiznews.com/residential-real-estate-industry-cringes-as-dodd-frank-era-begins/9875363/.
[43] Zywicki & Adamson, *supra* note 9, at 12.
[44] *See id.* at 3.
[45] THE FIN. CRISIS INQUIRY COMM'N, *supra* note 1, at xxi.
[46] *Id.*
[47] *Id.*

("GSEs"), such as Fannie Mae and Freddie Mac, were large contributors to the transparency problem.[48] The risk exposure of these enterprises was and still is unknown.[49] Further complicating the situation, the government's implicit guarantee of the GSEs gave them an incentive to take on more risk.[50] It was very difficult for government officials to measure and control the GSEs' risks.[51] Because these GSEs are the dominant entities in the mortgage market,[52] this uncertainty is particularly troubling. Disclosure requirements and regulations that increase the quantity and quality of information provided on mortgage loans seem to be the best solutions to the transparency problem.

Fannie Mae and Freddie Mac purchase mortgages from originators and pool them into mortgage-backed securities, which they sell to investors.[53] During the time of the housing crisis, investors were making judgments about risk based on generalized information about these pools because more accurate data was not available.[54] Increasing the quantity and quality of the data available to investors could mitigate the transparency problem. Some disclosure rules proposed by the SEC would require issuers to disclose information on loans that are modified and provide more detailed information on an individual borrower's ability to pay.[55] As more loan-level information is disclosed, the pool of loans will be more transparent.[56]

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[48] *See Transparency, Transition and Taxpayer Protection: More Steps to End the GSE Bailout: H. Fin. Servs. Subcomm. on Capital Mkts. and Gov't Sponsored Enterprises Hearing*, 112th Cong. (May 25, 2011), 2011 WLNR 10498128.

[49] *Id.*

[50] CONG. BUDGET OFFICE, FANNIE MAE, FREDDIE MAC, AND THE FEDERAL ROLE IN THE SECONDARY MORTGAGE MARKET, at X (2010), *available at* http://www.cbo.gov/ftpdocs/120xx/doc12032/12-23-FannieFreddie.pdf.

[51] *Id.*

[52] WALLISON, *supra* note 5, at 15.

[53] CONG. BUDGET OFFICE, *supra* note 50, at VII.

[54] *Transparency as an Alternative To Risk Reduction: H. Oversight and Gov't Reform Subcomm. on Fin. Servs. and Bailouts of Pub. and Private Programs Hearing*, 112th Cong. (May 11, 2011), 2011 WLNR 9562598.

[55] *Id.*

[56] *See id.*

E. Government Housing Policies and Potential Solutions

The subprime mortgage market expanded beyond its capacity because of government policies aimed at increasing homeownership.[57] Through legislation such as the Government-Sponsored Enterprise Act and the Community Reinvestment Act ("CRA"), banks were forced to loosen underwriting standards to expand loan access to riskier borrowers.[58] As a result many borrowers that were approved for loans now face default and foreclosure.[59] For example, in October of 2008 Bank of America reported that "CRA lending comprised only 7% of its lending volume, but 29% of its losses on mortgage products."[60] The government also pushed Fannie Mae and Freddie Mac to take on greater risk.[61] In 2005, the Department of Housing and Urban Development instructed Fannie Mae and Freddie Mac that 52% of their mortgage financing had to go to borrowers with lower than median income.[62] To meet these goals, they had to pressure lenders to issue riskier and riskier loans.[63] Moving forward, government policies should allow lenders, borrowers and the markets to decide which loans should be made and at what price.[64] With other protections in place, risk-based pricing should foster beneficial competition and a workable subprime mortgage market.

F. Conclusion

The housing crisis had many different causes and a comprehensive set of solutions will have to attack the problem from different angles. Regulations to help eliminate predatory lending and to increase transparency in the market will be necessary, but it is

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[57] *See* WALLISON, *supra* note 5, at 15-16.
[58] *Id.* at 14; Zywicki & Adamson, *supra* note 9, at 36.
[59] Zywicki & Adamson, *supra* note 9, at 36.
[60] *Id.*
[61] *Id* at 37.
[62] *Id.*
[63] *Id.*
[64] *See* WALLISON, *supra* note 5, at 29 ("The appropriate policy choice was to reduce or eliminate the government's involvement in the residential mortgage markets, not to impose significant new regulation on the financial system.").

important that these regulations do not distort the mortgage market. Since government pressure on actors in the lending market contributed to the crisis, an important part of the solution will be to allow the actors in the market to control their own participation.

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