Contemporary Readings in Law and Social Justice
Volume 4(1), 2012, pp. 168–173, ISSN 1948-9137

THE NEED FOR LAW THROUGHOUT THE SECONDARY HOUSING-FINANCE MARKET

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ABSTRACT. The analysis presented in this article contributes to research on the macroeconomic significance of the shadow banks, the housing bubble and the ensuing near-collapse of the international banking system, the continued increase in housing prices after mortgage interest rates rose, and the bubble-making effect of short-term rates. The key contribution of this paper is to articulate and give expression to aspects of the management of the business cycle, the failure of risk management in the crisis, the role of poor underwriting standards in helping inflate the bubble, the restructuring of the housing-finance market, and regulation of the housing-finance market.

Keywords: housing bubble, mortgage interest rates, economic crisis

1. Introduction

This study is grounded in the considerable body of scholarship examining the economics of the business cycle, the speculative borrowing in the housing market, the uncertainty of the economic environment, and the causes of the economic crisis. This research makes conceptual and methodological contributions to the study of the role of subprime mortgages in fueling the housing crisis, the causes of the housing bubble collapse, changes in the mortgage market, and multiple contributing factors to the housing bubble.

2. The Significance of the Bursting of the Housing Bubble

Levitin and Wachter say that the market shift from a regulated to an unregulated financing market was the leading cause of the bubble. Real estate is uniquely prone to bubbles because of the lack of short pressure. Asset bubbles are built on the shoulders of leverage (a bubble is marked by a rise and subsequent collapse in an asset price). Secondary-market standardization is critical to *preventing future real-estate bubbles and ensuring a stable and sustainable housing-finance system*. The supply-side glut was driven foremost by information failures resulting from the proliferation of PLS). The supply grew faster than the demand (this supply growth was fueled by the change in the financing channel). The movement in PLS spreads and volume points to a supply-side explanation of the housing bubble. The housing bubble was marked by nontraditional mortgages and PLS (PLS provided the funding for nontraditional mortgages), being fueled by mispriced mortgage finance. The bubble was primarily a *supply-side* phenomenon (it was caused by excessive supply of housing finance). "The supply glut was the result of a fundamental shift in the structure of the mortgage-finance market from regulated to unregulated securitization. […] The primary cause of the housing bubble was the shift from regulated, government-sponsored securitization to unregulated, private securitization as the principal method of funding mortgage loans."[1]

The important point here is that PLS are idiosyncratic property forms, and made the expansion in the nontraditional mortgage market possible. The structure of PLS allowed investors to underestimate the risks involved. Levitin and Wachter note that the underlying mortgages in a PLS would count for affordable-housing goal credit. PLS investors assumed both credit and interest-rate risk on the MBS (investors in PLS were familiar with interest-rate risk on mortgages). The PLS market initially developed with low credit-risk products. In the PLS market, the normal market constraints on declining mortgage quality and MBS underwriting quality all failed. Standardization of MBS would mean that financial institutions could not sell nontraditional mortgages into capital markets. Correcting the informational failures in housing finance requires better disclosure about the mortgage loans backing MBS and substantive regulation in order to make disclosures effective. The GSEs sell the mortgages to legally separate, specially created trusts, which pay for the mortgages by issuing MBS (the GSEs' financial strength was heavily dependent upon the performance of the mortgages). Levitin and Wachter write that the GSEs bore the credit risk on the mortgages, and were subject to regulatory oversight and statutory constraints on underwriting. The competition for market share was primarily between GSEs. The GSEs would only purchase loans that conformed to their underwriting guidelines. The growth in ARMs reflected their role as an affordability product that enabled market expansion. The shift to ARMs was driven by their use as initial affordability for market expansion.

It is worth noting that housing finance was permitted to shift from a regulated to an unregulated space. Greater disclosure cannot reveal the character of credit in the housing-finance market. Levitin and Wachter argue that housing prices were bid up due to an oversupply of underpriced mortgage finance. Securitization provides the financing for the vast majority of mortgages in the United States. The financial institutions that originate and securitize loans serve as economic agents for the end borrowers and lenders (they hold a temporary interest in the mortgages they facilitate, so they have incentives different from borrowers and investors). Financial institutions boosted mortgage-origination and securitization volume (their profits are derived from fees taken at every stage of the origination and securitization process), and were incentivized to make and securitize as many mortgages as possible. Levitin and Wachter put it that markets and regulators must be able to observe the credit risks in financing. The price of mortgage finance decreased while the quantity was increasing. The oversupply of mispriced mortgage finance was the result of the shift to unregulated private-label securitization. Lack of regulation makes the study of the lack of regulation squarely within the purview of legal analysis. The rating agencies were objective commentators on structured-finance products, and were intimately involved in the structuring of individual deals (they were heavily dependent on fees from structured finance).

3. The Housing Bubble and the Ensuing Near-collapse of the International Banking System

Hardaway observes that *foreclosure actions have degenerated into nightmarish legal tangles in the aftermath of securitization*. The BLS camouflaged the dangerous expansion of the nation's housing bubble and deceived investors as to the country's real inflation rate. Policy makers should adopt policies that would prevent a future bubble from occurring. "A litigation explosion occurred in the aftermath of the collapse triggered by losses in virtually every nook and cranny of the economy."[2]

Mayer stresses that the housing bubble was global in nature and included commercial real estate. Subprime lending contributed to the housing bubbles. Dysfunctional lending markets helped inflate the bubble. Speculative bubbles appear in markets that have gone decades without any such excesses. Speculation and unrealistic expectations of future house price appreciation by lenders and buyers played a decisive role in the housing bubble. Poor underwriting and unrealistic expectations of future house price appreciation contributed trenchantly to the sharp rise in defaults and foreclosures. Conflicts of interest between parties to securitization contributed substantially to the financial crisis. Securitization creates conflicts of interest and less efficient management of assets. Flaws associated with incentives in securitization played an important role in the failures associated with the crisis.

This suggests that flaws in the securitization system contributed to the broader financial crisis (flaws were prevalent in many parts of the securitization process). Mayer insists that mortgage securitization led to the origination of lower quality mortgages. Originators used their special position to take advantage of loan or securities purchasers. Rating models were sensitive to small errors in economic projections. Excesses in subprime lending contributed to the crash of the housing market. The lending excesses developed into a full-blown crisis. Servicers foreclosed on borrowers more quickly than did portfolio lenders. Mayer holds that *the growth in subprime loans that provided credit to the riskiest borrowers is correlated with the subsequent growth in defaults and foreclosures, non-traditional mortgage terms did not disproportionately contribute to the foreclosure crisis, investors and underwriters were aware that originators had incentives that were potentially at odds with investors, whereas the reduced leverage is a function of the reliance on the issuers credit and capital to make the securitization function properly*.[3]

4. The Responsiveness of Housing Prices to Interest Rates

Posner emphasizes that an asset-price bubble can form and burst, triggering a recession that can feed on itself until it grows into a depression: there *was* asset-price inflation (inflation in the price of houses and of common stock). The inflation in housing prices caused a bubble (an unsustainable rise in asset prices as a result of a misestimation of asset values). An increase in the price of an asset creates a belief that the asset is a good value. Posner reports that buying into a suspected bubble is not necessarily irrational, a nationwide housing bubble bursts and mortgages may be a significant component of the asset portfolios of most banks, and low interest rates caused housing, stock market, and credit bubbles (the bubble was the product of loose monetary policy): *raising interest rates is a costly way of stopping a bubble before it reaches a point at which it bursts with catastrophic effect, short-run profits in a bubble tend to be very high because prices are rising rapidly, whereas when the housing bubble burst, mortgagors who could no longer afford their monthly mortgage payments could not sell their house at a profit*.

From this, it is evident that the low interest rates of the early 2000s pushed up housing prices directly by reducing the cost of housing debt and indirectly by pushing up the value of common stocks. Posner claims that housing prices continued rising after interest rates started to rise (*all that was sustaining housing prices was the expectation of continued price increases*). Cheap credit and soaring house values were the immediate causes of the housing bubble. Housing prices were falling so fast that prime mortgages were endangered as well as subprime ones. The fall in housing prices undermined prime mortgages as well as subprime ones. The fall in the stock market and in housing prices has reduced household wealth dramatically (a fall in the market value of a house reduces the owner's home equity).

> Housing prices rose first on low interest rates, then on momentum, and the inevitable though unforeseen collapse of those

> prices inaugurated a chain of events that triggered a widespread economic collapse which had an adverse feedback effect on housing prices. […] Housing prices fell so far because they had soared so high, and they had soared so high in part because the availability of subprime mortgages had drawn to the demand side of the housing market many people who could not have qualified for a conventional mortgage.[4]

As Posner puts it, *securitization enabled firms that would not have wanted to deal directly with a mortgagor to invest in the mortgage market, and facilitated a lowering of credit standards (the demand for new mortgage-backed securities composed of subprime mortgages dried up).* The credit boom induced consumers to take on more mortgage and other debt. Adjustable-rate mortgages shift the risk of interest-rate fluctuations from lender to borrower. Mortgages that provide prepayment penalties carry a lower interest rate. The depression has caused both banks and individuals to hoard cash (*high interest rates discourage the hoarding of cash by increasing the opportunity cost of such hoarding*). The downward spiral that marks an economic depression increases the uncertainty of the business environment. Institutional hoarding is illustrated by the immense excess reserves of the banks. American banks are hoarding most of the cash they have received from the government's bailouts. Bailing out an insolvent firm creates moral hazard and inflation (inflation and moral hazard resulting from bailing out insolvent banks are costs of trying to avert a financial collapse). The bankers and the home buyers should not be blamed for the banking collapse.

One thing that is clear is that the banking industry can collapse without careful macroeconomic management by government (even a fully regulated insurance market can collapse). Credit easing did not strengthen the balance sheets of the banking industry (increasing the cost of credit causes economic activity to decrease). Posner holds that *the shadow banks and their hedge-fund customers were heavily engaged in speculative lending and investing*. The reason for the banks' constrained lending is the riskiness of lending in the present troubled economic environment. The government's flooding of the banks with cash enabled commercial banks to continue lending at approximately their normal level throughout the economic crisis. A modest increase in short-term interest rates can destabilize banking by increasing the banks' cost of capital. Banks cannot avoid taking on a great deal of short-term debt. Banking (financial intermediation) is both inherently risky *and* critical to economic stability. On Posner's view, banks engaged in highly risky lending because such lending was vastly profitable. There is no free lunch in a program of reducing systemic risk by restricting risk taking by bankers (the willingness to take financial risks is essential to economic progress). Commercial banks supply less than a quarter of the total amount of credit in the United States, providing essential financing for small and medium-sized businesses. The lending of borrowed capital is the essence of banking. Borrowing short holds down the interest rate by minimizing the lender's risk.

This strongly suggests that the study of business cycles is a part of modern economics. *Anything that increases the uncertainty of an uncertain economic environment reduces investment and consumption further*. High interest rates increase the opportunity cost of holding cash. Posner maintains that in depressions the amount of cash that people hold increases even though the number of transactions is falling. Reducing the purchasing power of money, inflation is a tax on cash balances. Flooding the economy with money is a response to a financial crisis. "Relationship lending has declined during the current depression not only because of fear of default and a falloff in demand for loans but also because the relationships that sustain relationship banking had withered in banks that had embraced the new model of originating and purchasing securitized debt."[5]

5. Conclusions

Considerable research attention has focused on the cause of the housing bubble, the changes in the structure of the housing-finance market, the problem of risk in banks' capital structures, and the regulatory failures that underlie the current depression. The material gathered in this study provides a rich and diverse context for understanding the government's failure to prevent the crisis, the global scope of the crisis, the significance of the bursting of the housing bubble, and the responsiveness of housing prices to interest rates. The implications of the developments outlined in the preceding sections of this paper suggest a growing need for a research agenda on inherent difficulties of business-cycle economics, the importance of relationship banking in reducing credit risk, the role of credit in accelerating consumption, the bursting of the housing and stock bubbles, and contributing factors to the mortgage and financial crisis.

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