Building the Dream:

A History of Federal Policy Intervention in Home Mortgage Finance

by

Tamar Greenspan, BA

Report

Presented to the Faculty of the Graduate School of

The University of Texas at Austin

in Partial Fulfillment

of the Requirements

for the Degree of

Masters of Science in Community and Regional Planning

The University of Texas at Austin

May 2009

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Approved by
Supervising Committee:

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For My Family

Acknowledgements

This project would not have been possible without the encouragement and inspiration of many people. I would like to start by thanking my readers, Terry Kahn and Elizabeth Mueller. From the drawing board to the final draft, your input and guidance helped me to get myself in gear, choose a topic, and, ultimately, take it much farther than I initially intended. I'd also like to thank the many members of my family who listened to endless updates about the flavor-of-the-week new direction I had decided to take. It couldn't have been easy, but you listened anyway. And finally, I'd like to thank my brother Yoni for agreeing to be my final reader. When I first asked you to do it, I was prepared to beg, to bribe, and, if necessary, both, but you immediately agreed to do it. Though I'm sure this will come back to haunt me later, I sincerely appreciate your generosity now, and won't be surprised when you cash in on the bribes later.

May 8, 2009

Abstract

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Tamar Greenspan, MSCRP

The University of Texas at Austin, 2009

Supervisor: Terry Kahn

This paper traces the effects which federal policy has had on home mortgage finance in the United States. In the past, the phases of intervention have been described as 1) the New Deal responses to the Great Depression, 2) the creation of the Government-Sponsored Enterprises and promotion of the secondary market, and 3) the deregulation of the banking industry. This paper uses the historical backdrop to examine the current era of intervention, including the Making Home Affordable initiative. The paper concludes with policy recommendations that tie past experience with current problems and explores shared equity homeownership as a sustainable model for the future.

Table of Contents

CHAPTER 1: INTRODUCTION **9**

Why Housing? 9

The Role of Housing Finance 11

Toward a Taxonomy of Housing Policy 13

CHAPTER 2: THE GREAT DEPRESSION AND THE ORIGINS OF FEDERAL INTERVENTION IN MORTGAGE FINANCE **15**

The Early Years 15

The Great Depression 16

Federal Home Loan Bank Board 17

Home Owners Loan Corporation 18

Federal Housing Administration 21

Federal National Mortgage Association 23

Conclusions 24

CHAPTER 3: GOVERNMENT SPONSORED ENTERPRISES AND THE SECONDARY MARKET **27**

Reauthorization of Fannie Mae 28

Regulation Q and Interest Rate Fluctuations 29

Civil Unrest 30

Restructuring the Secondary Market 31

Fannie Mae and Ginnie Mae 31

Freddie Mac 32

Conclusions 32

CHAPTER 4: DEREGULATION AND THE CHANGING INSTITUTIONAL LANDSCAPE **34**

Financial Deregulation 34

Depository Institutions Deregulation and Monetary Control Act 34

Garn-St. Germain Depository Institutions Act 35

FIRREA 36

Resolution Trust Corporation 37

Politics of Deregulation 38
Growth of the Secondary Market.....39
Conclusions.....42

CHAPTER 5: SUBPRIME CRISIS AND THE RETURN TO REGULATION **44**

The Foreclosure Crisis.....44
Subprime Crisis.....44
Predatory Lending.....45
Changes in the Underwriting Process.....46
Housing Prices Decline.....47
Causes of the Foreclosure Crisis.....47

CHAPTER 6: MAKING HOME AFFORDABLE AND THE FUTURE OF US HOUSING FINANCE **50**

Making Home Affordable.....50
Learning from the Past.....52
Future of Fannie Mae and Freddie Mac.....53
Overinvestment in Housing.....54
Changing the Conversation.....55
Shared-Equity Homeownership.....58
Conclusions.....60

BIBLIOGRAPHY **62**

VITA **65**

Chapter 1: Introduction

This paper aims to trace and contextualize federal policy interventions in US mortgage finance. It will examine the circumstances surrounding each era of intervention and the policy tools and approaches that were employed. Since the 1930s, the United States housing finance system has evolved dramatically over time, shaped largely by increasing levels of government intervention and regulation. The history starts with the Great Depression and New Deal Era, focusing on the Home Owner's Loan Corporation (HOLC), Federal Home Loan Banks (FHLB), and the Federal Housing Administration (FHA). The late 1940s and 50s were a period of relative stability, in which the savings and loan industry was the major player in the housing finance arena. In the late 1960s, liquidity problems threatened the housing finance system and federal legislation again intervened to free up credit and increase liquidity in the market through the secondary market institutions of Fannie Mae and Freddie Mac, also known as the GSEs. Beginning in the early 1980s, several major pieces of legislation were passed which significantly deregulated the financial industry. With these changes, the housing finance landscape changed dramatically, leading to the decline of the thrifts, the growth of the secondary market and the entrance of new players into the market. The final section of this analysis will address the current situation using the historical background of past interventions. It will also review the Making Home Affordable initiative and present a recommendation for shared equity homeownership as a sustainable model for the future.

Why Housing?

According to former Secretary of Housing and Urban Development Andrew Cuomo, "Housing is more than just bricks and mortar; it is the building block of community, it is powerfully tied to civic behavior—to working together with neighbors on shared concerns, to literally making us a part of a block, a neighborhood, a town, a county, a nation. Homeownership makes us stakeholders in something grander than ourselves."[1] In the United States, housing is many things; much more than simply a source of shelter, it is also a shaper of urban form, a marker of citizenship, and a major investment device. Owning a home is one of the most pervasive and meaningful symbols in the United States and is widely regarded as the "American Dream," a symbol of success and belonging in American culture. The house is also a center of family life, and its location is a major determinant of access to transportation, employment, and social and educational opportunities. Finally, housing is a major sector of the US economy, accounting for over a fifth of the nation's gross domestic product.[2] For all of these reasons, both individuals and the federal government have a vested interest in the housing sector.

This paper does not seek to address the question of whether homeownership should be a preferential tenure choice to renting but, rather, builds on the fundamental assumption that homeownership is beneficial to at least some households at some points in time. Among the well-documented effects of homeownership are longer tenure in a unit, more work and assets invested in maintaining and improving the unit, and a broad range of social behaviors linked to good citizenship. Because the house represents such a large portion of most homeowners' wealth, they have a large economic incentive to improve the quality of the neighborhood. Homeowners have decreased mobility, and therefore have a greater stake in their neighborhoods than do renters.[3] Homeownership

[1] Coulson, *Housing Policy and the Social Benefits of Homeownership*, 6
[2] Schwartz, *Housing Policy in the United States: An Introduction*, 3
[3] Glaeser and Sacerdote, "The Social Consequences of Housing," 3

has also been linked to positive outcomes for children, including higher educational achievement and lower incidence of behavioral problems.[4]

In addition to social benefits, homeownership is widely promoted on the basis of its economic benefits. One of the major benefits which homeownership provides is wealth accumulation in the form of home equity. In the United States, home equity makes up more than half of household wealth for half of the homeowner population.[5] Low-income homeowners under age 65 have about twelve times greater wealth than their renting counterparts, showing how important homeownership is for wealth accumulation for low-income families.[6]

The Role of Housing Finance

Because housing has so many functions, "housing policy" has taken many forms. Housing policy has traditionally taken three major approaches. Most policy has been undertaken through the tax code, the authorization and supervision of the credit market, and via direct subsidy. Housing is one of the lumpiest and most expensive goods purchased by most households, and it is typically purchased through a combination of debt and equity. Because most home purchases in the United States are dependent on the availability of financing to complete the transaction, housing finance has become a major point of policy intervention in the housing markets. The availability of credit is not only significant to a household's ability to purchase a house, but also to its wealth-building potential, as leverage has historically increased the returns on housing well beyond those

[4] Coulson, *Housing Policy and the Social Benefits of Homeownership*, 6
[5] Siniavskaia, *Homeownership, Financial Flexibility, and Wealth*
[6] Collins, Retsinas, and Belsky, *Towards a Targeted Homeownership Tax Credit*, 2

of the stock market, making it a preferential investment.[7] This preferential treatment of housing relative to other investments will be further discussed at the end of this analysis.

Beginning with the National Housing Act of 1934, the federal government played a major role in the evolution of the housing finance system in the United States. Through a variety of means, federal policies have helped to make credit accessible and affordable to a continuously expanding population, pushing up the homeownership rate. In 1965, just over 63 percent of Americans were homeowners. This figure continued to rise until it peaked at 69.2 percent in 2004, before falling back to 67.5 percent in 2008.[8] Obscured within these figures is the disparity in homeownership levels based on demographics, especially race and wealth.

Along with an increase in the number of households owning their own home, there has also been an increase in the number of households who use credit to purchase their home. This increase has come from two directions. The first is expanded access to credit, as underwriting requirements have been loosened, allowing buyers who did not fit the traditional profile to qualify for loans. The second is the liberalization of the terms under which credit is issued, which has brought borrowing within reach of more households. This was initially done by lowering interest rates and other fees associated with borrowing, but in recent years has shifted towards more exotic terms that lower downpayments, reduce or eliminate monthly principal payments, and provide additional flexibility in loan repayment options. Various federal policies have been aimed primarily at either expanding access to credit or liberalization of underwriting standards.

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[7] Schwartz, *Housing Policy in the United States: An Introduction*, 255

[8] US Bureau of the Census, *Housing and Vacancy Survey*

Toward a Taxonomy of Housing Policy

Allen Hays divides housing policy into three categories. The first, social welfare is "any program which utilizes public resources…to alleviate problems confronted by individuals and families which are considered beyond their capacity to deal with on their own."[9] These policies include public housing and many of the other programs intended to subsidize housing costs for low- and middle-income households. The second category, community development policy, is "the process by which a geographic or political entity improves the quality of its physical structures, its economic life, and its social relationships."[10] These policies include neighborhood-level approaches to housing, including the removal of blight and infrastructure improvements such as transportation and parks that increase the location value of housing. The final type of policy is macroeconomic policy, which deals with the economy as a whole. It is under this category that interventions in mortgage finance primarily fall. These interventions have been intended to boost the economy through increased employment and liquidity in the market.

Through an analysis of historic policies, this paper will argue that the treatment of these objectives as distinct entities rather than as a larger, interconnected whole has led to socially and economically suboptimal outcomes. By maintaining the distinctions between each of these interests, federal policy has placed them in competition, and often even in opposition, with one another, rather than approaching them with holistic policies that actively promote multiple goals simultaneously. Macroeconomic policies have not only received greater attention than social welfare and community development goals, but have also been enacted to the detriment of these other interests.

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[9] Hays, *The Federal Government and Urban Housing: Ideology and Change in Public Policy*, 25
[10] Ibid., 35

Federal interventions in housing finance have been almost entirely directed at macroeconomic objectives. In this way, much of the policy that affects housing is not typically considered to be "housing policy." While policies that fall into this category often have secondary effects that fulfill the goals of social welfare and community development, that is not their primary purpose. The most commonly cited example is the authorization of the Federal Housing Administration under the New Deal, which was intended primarily to spur activity in the building sector, a major piece of the economy at the time. Though it is certainly true that many households were able to become homeowners as a result of this program, this was not the primary intent. Over time, macroeconomic policy affecting housing has become increasingly distanced from policies focused on social and community development goals. The current foreclosure crisis is an opportunity to reverse this trend and realign issues of social welfare and community development with macroeconomic policies.

Chapter 2: The Great Depression and the Origins of Federal Intervention in Mortgage Finance

The Early Years

Formal mortgage finance in the United States began with "Terminating" Building Societies, in which members pooled funds in order to make loans to one another for home construction. Lending terms and credit risks were controlled by the group, and once everyone had received a loan the organization was dissolved. In the 1850s, these societies became "Permanent" Building Societies, and eventually evolved into what today are known as savings and loans.[11] Under these arrangements, loans were typically not self-amortizing, and were made for an average period of 6-10 years, after which time the borrower would be forced to refinance. In addition, these loans had variable interest rates and maximum loan-to-value (LTV) ratios of about 50 percent, requiring that borrowers provide significant cash down payments and have income levels high enough to absorb interest rate fluctuations. Combined, these characteristics placed large capital requirements on borrowers, while also saddling them with most of the commensurate risk.

During the economic boom of the 1920s, the US housing finance system expanded dramatically, and new sources of capital, including insurance companies, entered the market. Though mortgage capital had become much more readily available, the terms of the loans were highly troublesome for borrowers. Loans were typically still made for very short terms, forcing homeowners to refinance frequently. Additionally, the loans did not amortize, leaving owners to make a "bullet" payment of the entire principal

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[11] Office of Policy Development and Research, "Evolution of the U.S. Housing Finance System: A Historical Survey and Lessons for Emerging Mortgage Markets," 3

at the end of the term. Most loans also carried variable interest rates, creating an additional source of uncertainty for borrowers.[12]

The Great Depression

The end of the 1920s and the beginning of the Great Depression sent major shocks through the housing market. As unemployment rose, borrowers struggled to make their loan payments. Between 1931 and 1935, there was an average of 250,000 foreclosures per year.[13] At the worst point, 10 percent of homes were in foreclosure. At the same time, economic deflation caused 50 percent declines in home values, making it difficult to recover the outstanding loan balance from the sale of the home. Further deflating home values was the overabundance of supply on the market; between 1929 and 1932, 2.5 million new housing units were created, far outpacing the population increase of 1 million households.[14] Together, these factors created serious liquidity problems for the entire housing finance system.[15]

As effective demand for housing dwindled, so, too, did the construction industries. From their peak in 1925, new home starts had dropped 90 percent by 1933.[16] In testimony before Congress, the Roosevelt administration argued that the loss of jobs from construction related industries made up one third of the nation's unemployment. Stimulating housing demand was, therefore, seen as integral to stimulating the larger

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[12] Green and Wachter, "The American Mortgage in Historical and International Context," 94
[13] Ibid., 94
[14] Colton, *Housing Finance in the United States: The Transformation of the U.S. Housing Finance System*, 2
[15] Office of Policy Development and Research, "Evolution of the U.S. Housing Finance System: A Historical Survey and Lessons for Emerging Mortgage Markets," 5
[16] Weiss, "Marketing and Financing Home Ownership: Mortgage Lending and Public Policy in the United States, 1918-1989," 112

economy as a whole.[17] The largest constraint to effective housing demand, however, was the inability of households to secure financing. Savings and loans, the primary source of mortgage financing, had pulled back their lending, leaving the market for mortgage credit dry.

In the early days, the savings and loans had restricted their business largely to investments in mortgage loans. Because of their singular focus, they had become closely allied with the building and construction industries, as their needs were inextricably linked. Just as the thrifts enabled demand for the products of the construction industry, the construction industry created lending opportunities for the savings and loans. These alliances came into play any time political issues were raised, with the construction industry firmly supporting thrifts.[18] However, this relationship did not continue unchallenged for long. Thrifts argued that, since mortgage lending was their primary business, they should be the target of government assistance. Although the construction industry supported assistance for the thrifts, they also supported measures aimed at assisting other mortgage lenders, causing the first cracks in this relationship.[19]

Federal Home Loan Bank Board

To deal with the crisis, President Hoover called for a system of Home Loan Discount Banks to rescue the beleaguered financial institutions, jumpstart the construction industry and the larger economy, and "create a structure for the promotion of homeownership."[20] The first of the initiatives meant to achieve these goals was the

[17] Carliner, "Development of Federal Homeownership "Policy"," 305
[18] Weiss, "Marketing and Financing Home Ownership: Mortgage Lending and Public Policy in the United States, 1918-1989," 111
[19] Ibid., 112
[20] Carliner, "Development of Federal Homeownership "Policy"," 305

creation of the Federal Home Loan Banks (FHLB), which were chartered to provide additional liquidity to savings and loan institutions. Under the Federal Home Loan Bank Act of 1932, thrift institutions came under federal regulation for the first time. The twelve regional FHLBs were initially capitalized with government funds. Savings and loans which borrowed from the FHLBs were required to purchase stock, and the FHLBs eventually bought back the government-owned stock to become fully membership-owned cooperative institutions. In addition, the FHLBs chartered federal savings and loans and placed restrictions on their assets and liabilities.

The FHLB system decreased investor risk by diversifying the portfolio and reducing the liquidity constraints created by previous prohibitions against nationwide banking.[21] As a result, S&Ls were able to make 10-12 year mortgages, predominantly within a 50-mile radius of their home office.[22] Although the FHLB system was successful in extending access to credit, it was only later that it would become a major player in the housing finance system.

Home Owners Loan Corporation

The era of substantial government intervention began in response to the challenges created by the Great Depression. As unemployment skyrocketed and home values plunged, increasing numbers of homeowners found themselves unable to meet their mortgage obligations. As the predominantly short-term, non-amortizing mortgages matured, many homeowners were unable to refinance their homes, as they owed more than their homes were worth. Lenders, however, were weary to pursue foreclosure, as

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[21] Lea, "Innovation and the Cost of Mortgage Credit: A Historical Perspective," 161

[22] Office of Policy Development and Research, "Evolution of the U.S. Housing Finance System: A Historical Survey and Lessons for Emerging Mortgage Markets," 6

declining house values meant that they would not be able to recoup their investment. With borrowers and lenders trapped in this situation, the already scarce credit market dried up, intensifying the problem.

To deal with this crisis, Congress passed the Home Owners Loan Act in 1933, establishing the Home Owner's Loan Corporation (HOLC) to deal with the immediate foreclosure crisis. The HOLC was to be a lender of last resort, and operated under the regulation of the Federal Home Loan Bank Board. In order to help struggling financial institutions remain solvent and keep families in their homes, the HOLC purchased and restructured defaulting loans, reinstating them as fixed-rate, long-term (typically 20 years), self-amortizing loans.[23] By refinancing mortgages that were distressed or already in default, the HOLC aimed to prevent a large shakeup in the financial sector. The HOLC was initially capitalized with $200 million in treasury funds, and was given the authority to raise up to $2 billion by issuing government-backed bonds.[24]

Under the HOLC guidelines, one- to four-unit properties valued at up to $20,000 were eligible to receive loans for up to 80 percent of their value, with maximum interest rates of 5 percent and fifteen-year repayment periods.[25] There was extraordinary demand for the program; between 1933 and 1935, the HOLC received 1.9 million applications for assistance. Though many applications were not accepted, the need for such a program was clear, and by 1935, the HOLC held about 12 percent of the outstanding residential mortgage debt in the United States.[26] It is estimated that over 60 percent of the mortgages refinanced by the HOLC were for homes that had lost more than 15 percent of

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[23] Green and Wachter, "The American Mortgage in Historical and International Context," 95
[24] Ibid., 95
[25] Colton, *Housing Finance in the United States: The Transformation of the U.S. Housing Finance System*, 4
[26] Ibid., 4

their value.[27] In total, the HOLC refinanced nearly one million loans across the country, totaling about $3.1 billion. A large portion of this lending was done in 1934 and 1935.[28] By the end of the 1930s, the HOLC had refinanced 20 percent of all mortgaged properties, staving off an enormous wave of foreclosures.[29] With the financial crisis over, the HOLC was liquidated in 1951, creating a small profit.

In general, the HOLC is regarded as a successful program. About 20 percent of borrowers defaulted on their loans, but this was not unexpected since only troubled borrowers were eligible for the program.[30] Although this requirement did result in incidences of moral hazard, with some borrowers intentionally defaulting on loans in order to take advantage of the bailout, there is overwhelming evidence that there was a true need for the program.[31] To its credit, the HOLC was able to prevent the foreclosure of 750,000 homes and shore up a struggling financial system and the badly damaged institutions within it. The most lasting legacy of the HOLC, however, is in the precedents that it set: 1) the introduction of the long-term, fixed-rate, self-amortizing mortgage to the marketplace, 2) the structure of the mortgage lending industry, and 3) the federal government's role in the support and regulation of housing finance.[32]

Unlike many of the programs that would follow it, the HOLC had explicit goals of assisting both the troubled financial industry and imperiled homeowners. While many subsequent programs did, in fact, aid both lenders and borrowers, the HOLC's dual stated

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27 Ely, "The Resolution Trust Corporation in Historical Perspective," 54
28 Fishback, Horrace, and Kantor, "The Origins of Modern Housing Finance: The Impact of Federal Housing Programs During the Great Depression," 4
29 Ibid., 7
30 Colton, *Housing Finance in the United States: The Transformation of the U.S. Housing Finance System*, 4
31 Office of Policy Development and Research, "Evolution of the U.S. Housing Finance System: A Historical Survey and Lessons for Emerging Mortgage Markets," 5
32 Colton, *Housing Finance in the United States: The Transformation of the U.S. Housing Finance System*, 32.

goals make it stand apart. At the same time, however, the program created a federal incentive to homeownership, furthering the roles that homeownership and housing finance would play in the future of the US economy.[33]

Federal Housing Administration

The Roosevelt Administration came into power at a time when the entire nation was struggling with the economic crisis. Under the New Deal's economic recovery efforts, Congress passed the National Housing Act of 1934. Included in the Act were provisions intended to stimulate home building activities, a large portion of the economy. Title I was a temporary measure which provided unsecured loans of up to $2,000 for remodeling, a direct attempt to create jobs in this sector. The most important element in the new legislation, however, was Title II, which charged the Federal Housing Administration (FHA) with the task of providing mortgage insurance for new homes and for purchasing/financing existing homes.

Mortgage insurance was intended to lower the risk which financial institutions faced when underwriting mortgages, allowing them to increase the amount and extend the length of their financing commitments. Up to this point, only private mortgage insurance had been available, but firms offering this insurance were largely unsuccessful. These firms were significantly undercapitalized, and most went out of business during the crisis of the 1930s.[34] One primary advantage that allowed for the success of the FHA model was its nationwide scope, which allowed it to diversify risk across local mortgage markets.[35]

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[33] Green and Wachter, "The American Mortgage in Historical and International Context," 95
[34] Ibid., 95
[35] Lea, "Innovation and the Cost of Mortgage Credit: A Historical Perspective," 162

In order to minimize direct outlays, the FHA was backed by a mutual mortgage insurance fund, capitalized with premiums equivalent to .5 percent of the insured outstanding loan balance, which were paid by the borrower. Policies were written for mortgages following the precedents set by the HOLC, allowing LTVs up to 80 percent on properties appraised under $20,000 at 5 percent interest amortizing over twenty years.[36] Rather than liberalizing standards to expand the base of homeownership, however, the FHA introduced stricter standards, intended to reduce their risk exposure and minimize the number of claims filed.

As a result, in the early years of the program, FHA insurance went predominantly to middle- and upper-income households. In the 1930s, most of the insurance policies were written for families earning between $2,000 and $2,500, much more than the average full-time wage of $1,500.[37] Higher income households were also given more favorable terms, with lower down payments and longer repayment periods. Overall, this allowed them to purchase more expensive homes, providing an additional stimulus to the building trades.

The underwriting standards put in place by the FHA also placed limitations on the types of properties that could be insured. For each policy written, the FHA required strict appraisals, high construction standards, and escrow of tax and insurance payments. Only homes in “homogenous” neighborhoods were eligible, and the underwriting standards encouraged the use of racially restrictive covenants to maintain neighborhood segregation.[38] Residential segregation was widely pursued, and over 30 percent of the

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[36] Colton, *Housing Finance in the United States: The Transformation of the U.S. Housing Finance System*, 5

[37] Fishback, Horrace, and Kantor, “The Origins of Modern Housing Finance: The Impact of Federal Housing Programs During the Great Depression,” 3

[38] Carliner, “Development of Federal Homeownership "Policy",” 306

new homes built during the 1930s had FHA insurance.[39] It was not until the 1960s that the FHA reversed its official racially biased lending practices.

For nearly 30 years, FHA policies had been based on macroeconomic considerations, focusing on risk and the bottom line needed to maintain profitability. The FHA was not intended to broaden the reach of credit, but rather to reduce the risk of losses faced by lenders. While promoting homeownership for a sector of the population, the FHA further excluded low-income and minority borrowers by tightening underwriting standards against borrowers and neighborhoods deemed to be risky. It is clear that social welfare and community development goals were not actively pursued under the auspices of the FHA at its inception.

Federal National Mortgage Association

Also contained in the National Housing Act of 1934 was Title III, which authorized nationally chartered mortgage associations. These organizations were intended to purchase FHA-insured mortgages for sale in a secondary market. Although it was not as significant as Title II at the time, Title III paved the way for the creation in 1938 of the Federal National Mortgage Association (FNMA), later to be known as Fannie Mae. Fannie Mae was originally intended to buy FHA- and VA-backed loans by borrowing funds in areas where financial institutions had significant deposits and redistributing this capital by buying mortgages in areas where savings were low.[40] It was not until the 1970s and 80s, however, that FNMA and the secondary market came to be major players in the US housing finance system.

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[39] Colton, *Housing Finance in the United States: The Transformation of the U.S. Housing Finance System*, 7

[40] Ibid., 6

Conclusions

The federal government interventions in the housing market in the 1930s forever changed the nature of the housing market and the housing finance system in the United States. Before that time, federal policy had not played a significant role in the housing sector. Through the creation of the FHLB, HOLC, and FHA, however, the federal government inserted itself into the system, creating a precedent for future involvement in difficult financial circumstances. The HOLC and FHA fundamentally changed the form of standard mortgages, extending their length, lowering down payment requirements, and lowering their interest rates. Between the 1920s and the late 1930s, average mortgage maturity terms increased by 55 percent while loan to value ratios increased 16 percent and interest rates fell by about 15 percent.[41]

The FHA has been credited with restoring confidence, and, thereby, liquidity to the housing finance system after the Great Depression. Though the economy as a whole benefited from these programs, not everyone benefited equally. It was mostly higher income households that received the direct benefits of the programs. FHA insurance policies were written only for low-risk loans, allowing it to maintain a low rate of default. These strict underwriting criteria would later be the source of significant controversy as they created and propagated economic inequalities. In addition to these critiques, there is also evidence that the FHA did not have a statistically significant effect on homeownership rates in its early years. Only upper-income households were able to access FHA insurance, and many of them would have been able to purchase houses even without the program. Therefore, the base of households who were able to purchase their

[41] Fishback, Horrace, and Kantor, "The Origins of Modern Housing Finance: The Impact of Federal Housing Programs During the Great Depression," 7

homes was not significantly expanded by the program in the 1930s, and social welfare and community development ideals were left by the wayside.[42]

Expanding the base of homeownership, however, was not the primary purpose of the 1930s legislation. The federal government had not previously played a role in housing finance. In response to the unprecedented challenges created by the Great Depression and the general economic collapse, however, the federal government was forced to intervene. Acting in response to the financial pressures of the time, the government sought to restore liquidity to the financial sector and boost demand for the construction industry. These policies were crafted through a macroeconomic lens, not as social welfare programs or efforts to further community development. Together, all of the efforts of the 1930s sought to broaden the institutional basis for mortgage finance, bringing new players into the market to increase and stabilize the supply of capital available to fund residential mortgages. New Deal policies did not seek to determine who would benefit from the increased liquidity or how it would be used.

This involvement came at a time when the federal government was expanding in many sectors. Under the auspices of New Deal programs, the federal government took on a larger role in many social and economic initiatives. The HOLC is a textbook example of a “big government” program, by which the public sector invested directly to meet its aims, rather than using incentives and regulation to encourage the private sector to achieve these outcomes. As a result of the Great Depression and the complete chaos gripping the private sector at the time, there was ideological acceptance of such a strategy in the 1930s. The shift towards big government was already waning, however, by the time the FHA was created. Though the FHA was created as a public agency, its purpose

[42] Ibid., 24

was to encourage confidence in the private financial sector, which would in turn engender demand for the construction and building trades.

The landscape of the housing finance system which would stay in place for several decades to come was established in this period. Savings and loans would play a major role, partially due to restrictions on their portfolios which precluded them from holding corporate loans, bonds, and equity issues. They also received incentives through the tax code to maintain a majority of their portfolio in residential mortgages. Meanwhile, commercial banks, life insurance companies, and the secondary market also began to contribute capital towards funding mortgages, and outstanding mortgage debt ballooned.[43]

[43] Green and Wachter, "The American Mortgage in Historical and International Context," 97

Chapter 3: Government Sponsored Enterprises and the Secondary Market

Through the 1940s and 1950s, the US housing finance system remained largely unchanged. The efforts of the 1930s had been successful in broadening the mortgage finance marketplace, and, in 1950, savings and loans held 36 percent of outstanding residential mortgage debt, while life insurance companies and commercial banks each held about 20 percent.[44] During this period, savings and loans paid an average of 3.9 percent on deposits, higher than the 2.8 percent offered by commercial banks and only slightly lower than the 4.1 percent average return on 20-year bonds.[45] FHA insurance remained an important element, encouraging lenders to continue making long-term, self-amortizing mortgages. By the late 1950s, however, private firms began to enter the mortgage insurance market, undercutting prices and ending the monopoly of the FHA. Between 1957 and 1973, enabling statutes for private insurance were passed in every state, creating competition and leading to the decline of the FHA's market share over the next two decades.[46] As a result, the FHA share of the mortgage insurance marketplace dropped from 29.4 percent in 1970 to less than 10 percent in the 1990s.[47]

As the mortgage marketplace changed and expanded, it became increasingly apparent that local deposits, the traditional source of mortgage funds, were insufficient to meet the growing demand. To increase the flow of credit to the mortgage marketplace, Congress chartered several organizations, intended to link mortgage markets with world-wide capital markets. These agencies, called government-sponsored entities (GSEs),

[44] Colton, *Housing Finance in the United States: The Transformation of the U.S. Housing Finance System*, 9
[45] Doan, *American Housing Production, 1880-2000: A Concise History*, 75
[46] Office of Policy Development and Research, "Evolution of the U.S. Housing Finance System: A Historical Survey and Lessons for Emerging Mortgage Markets," 6
[47] Green and Wachter, "The American Mortgage in Historical and International Context," 97

bridged the gap between the public and private sectors, and served as an additional source of subsidy from the federal government to the housing sector.

Reauthorization of Fannie Mae

From its inception in 1938 through the 1950s, the Federal National Mortgage Association was not a major player in the US housing finance system. The Housing Act of 1934 had allowed for the creation of private mortgage associations to create a secondary market for home loans, but none had formed. In 1938, the Roosevelt Administration created the Federal National Mortgage Association (FNMA) as a government agency to fulfill this role. In its original form, FNMA issued bonds for purchasing mortgages at par, which expanded the geographic basis of mortgage funding, allowing investors to buy mortgages in areas where investment capital was scarce.[48] In the postwar era, it also sought to increase the availability of credit by acting as a portfolio lender, putting it in direct competition with the S&Ls.

The Housing Act of 1954, in response to the economic recession, renewed the charter of Fannie Mae, as it had become known, and charged it with "retarding or stopping a decline in mortgage lending and home building activities which threatens materially the stability of a high level economy."[49] In that same year, the FNMA Charter Act ended Fannie Mae's direct lending activities, leaving it only as a buyer and seller of mortgages on the secondary market. Its public purpose was renewed, with special requirements that the company buy certain mortgages, especially to support low-income housing. The 1958 Emergency Housing Act and the Housing Act of 1961 again relied on

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48 Ibid., 95

49 Carliner, "Development of Federal Homeownership "Policy"," 308

the agency, increasing its funding in order to put more money into its special assistance functions.[50]

Regulation Q and Interest Rate Fluctuations

Up until this point, most mortgages had been funded through commercial banks and savings and loans. Because these institutions were insured by the Federal Deposit Insurance Corporation or the Federal Savings and Loan Insurance Corporation, which carried the guarantee of the full faith and credit of the federal government, they were able to access inexpensive funds. At this time, the yield on Treasury bills never rose above 4 percent, and 30-year fixed mortgages typically paid between 5 and 6 percent, providing investors with a safe investment while still earning higher yields than those of Treasury bills. Even during this time, however, there was concern that the industry was exposed to significant interest rate risk. Starting in the 1950s, there were several attempts to shield S&Ls from interest rate risk through the introduction of adjustable-rate mortgages, but federal and state governments repeatedly blocked these attempts, arguing that individual households were not able to bear such substantial risk.[51]

In 1966, however, the industry's fears were realized as the yield on short-term Treasury notes rose above four percent, and investors rapidly shifted their funds away from savings and loans and into Treasury bills. This shift resulted in a severe shortage of funds available for funding mortgages.[52] In addition, the savings and loans had "borrowed short" and "lent long," adding to the crunch. While their cost of funds increased, they were only able to charge higher rates on new mortgages, further

[50] Ibid., 309
[51] Lea, "Innovation and the Cost of Mortgage Credit: A Historical Perspective," 165
[52] Green and Wachter, "The American Mortgage in Historical and International Context," 97

squeezing the spread between current deposits and existing mortgages. As a result of the finance crunch, new housing starts dropped 18 percent in 1966.[53] Another attempt to maintain the solvency of the thrifts was the introduction of Regulation Q in 1966, which placed caps on the interest rates that thrifts were allowed to pay on deposits. Although this addressed competition between thrifts, it also created significant cash flow problems when market rates rose beyond the cap and thrifts were no longer able to compete against other investments.

In the late 1960s, it became increasingly clear that the regulatory structures put in place during the New Deal were no longer appropriate. The inflationary environment of the era severely threatened the thrift institutions, which had been encouraged to specialize in long-term, fixed-rate lending. In 1970, to aid the thrifts, the President's Commission on Financial Structure and Regulation (also known as the Hunt Commission) recommended the removal of interest rate ceilings on deposits and the expansion of their investment powers. Although these recommendations were not immediately adopted, they set off a debate in Congress that would last for several years.[54]

Civil Unrest

Along with the financial crisis, the late 1960s were a time of social unrest. Under President Johnson, the National Advisory Commission on Civil Disorders (also known as the Kerner Commission) was appointed to study the problems facing America's cities. In their report, released in 1968, they identified housing as one of the most significant problems, saying that "Homeownership…would provide many low-income households

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[53] Doan, *American Housing Production, 1880-2000: A Concise History,* 91.
[54] Ibid., 92

with a tangible stake in society for the first time."[55] Along with recommendations for subsidized housing for low-income households, the Commission placed a strong emphasis on increasing housing production, reflecting the slowdown in new construction starts that took place earlier in the decade.

Restructuring the Secondary Market

Fannie Mae and Ginnie Mae

In response to the dual social and financial crises, Congress passed the Housing and Urban Development Act of 1968, restructuring the Federal National Mortgage Association. Out of Fannie Mae, they created two separate entities: the Government National Mortgage Association (GNMA), Ginnie Mae, and a new Fannie Mae. Ginnie Mae was created as a government agency to perform the "special assistance" functions of the former Fannie Mae. In addition, Ginnie Mae was authorized to guarantee mortgage-backed securities issued by private lenders. The new Fannie Mae, however, was spun off as a private entity. It was given the designation of a "government-sponsored enterprise" and was authorized to purchase FHA and VA loans, as well as to act as a portfolio lender.[56] By making Fannie Mae a private entity, the federal government was able to remove Fannie Mae's debt from its own balance sheet. In 1970, Congress granted Fannie Mae approval to purchase conventional mortgages. In that same year, Ginnie Mae began issuing securities backed by pools of FHA and VA loans, upon which it guaranteed interest and principal payments. It was not until 1981 that Fannie Mae issued its first mortgage-backed securities.

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[55] Carliner, "Development of Federal Homeownership "Policy"," 311
[56] Ibid., 309

Freddie Mac

In 1970, Congress chartered the Federal Home Loan Mortgage Corporation, Freddie Mac, to create a secondary market for conventional mortgages originated by savings and loan institutions. The main purpose of Freddie Mac was to prevent Fannie Mae from operating as a monopoly. In 1971, Freddie Mac began issuing Mortgage Participation Certificates, securities created from bundled conventional loans, which paid monthly principal and interest payments to investors.

By 1977, savings and loans had nearly doubled their market share of outstanding residential mortgage debt to 65 percent, while life insurance companies' share decreased to below 5 percent.[57] This shift is largely due to the emergence of the secondary market and the rising demand for mortgage-backed securities. Federal regulations had also provided assistance for new small lenders, such as mortgage brokers. In contrast, as interest rates rose in the 1970s, Regulation Q became a serious impediment to the thrifts, with deposits flowing towards newly created money market accounts that offered higher yields than those which the thrifts could offer.

Conclusions

After the Great Depression and before the late 1960s, US housing policy was shaped almost entirely by financial policy. Macroeconomic concerns guided federal intervention in banking, with an emphasis on maintaining the liquidity of the credit markets and the competitiveness of the savings and loans. When interest rate fluctuations

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[57] Colton, *Housing Finance in the United States: The Transformation of the U.S. Housing Finance System*, 9

threatened the solvency of the S&Ls, Congress turned to the secondary market. The GSEs were chartered in order to create a secondary market for home loans and to prevent the liquidity problems of 1966 from recurring.

By the late 1960s, social concerns were clearly at the forefront of political debates as urban riots tore cities apart. While increasing housing supplies was a motivating factor in the creation of the GSEs, the resulting policy was not social welfare or community development policy. Rather, it was macroeconomic policy, aimed at the security of the private financial sector. These programs were not targeted directly to address living conditions or segregation.

It is important to note that two other major pieces of legislation were passed following this period. The Home Mortgage Disclosure Act was passed in 1975, requiring lenders to report the quantity and size of loans they made. In 1989, an amendment to the Act required lenders to also disclose the income, racial characteristics, and sex of borrowers whose applications were rejected.[58] The Community Reinvestment Act was passed in 1977, requiring lenders to meet the credit needs of the entire communities in which they were located. Unlike previous policies, these were aimed at social welfare and community development goals, extending credit to underserved areas and requiring banks to report on their activities in order to effectively monitor lending patterns.

[58] Doan, *American Housing Production, 1880-2000: A Concise History*, 108

Chapter 4: Deregulation and the Changing Institutional Landscape

Along with limitations on what kind of investments they could make, thrifts had long received significant tax incentives to deal heavily in residential mortgages. In exchange for investing primarily in housing, they were allowed to calculate loan loss projections at a much higher rate than would ordinarily be regarded as reasonable. By doing so, they were able to transfer much of their pre-tax income into loan loss reserves, reducing their tax liability. This provision was whittled away over time, with transfers of up to 60 percent of taxable income allowed between 1962 and 1969, 40 percent for the following decade, and then, as part of the 1986 Tax Reform Act, down to 8 percent.[59]

As thrifts lost much of their incentives to focus on mortgage lending, the secondary market gained ground. In 1977, only 4 percent of the fixed-rate mortgages eligible for securitization were actually securitized by Fannie Mae or Freddie Mac. By 1982, this share had increased to nearly 25 percent, and increased further to over 50 percent in 1986 and 69 percent in 1989.[60]

Financial Deregulation

Depository Institutions Deregulation and Monetary Control Act

In response to the fluctuations in interest rate, Congress passed the Depository Institutions Deregulation and Monetary Control Act of 1980. As part of this legislation, Regulation Q, which had placed a limit on the returns which thrifts were allowed to pay on deposits, was phased out over a four-year period. In addition, the Act broadened the investment powers of thrifts and raised the cap on individual insured depository accounts

[59] Hendershott, *An Altered U.S. Housing Finance System: Implications for Housing*, 4
[60] Ibid., 5

to $100,000. In 1981, federally chartered thrifts were finally authorized to issue adjustable-rate mortgages (ARMs), although this change came too late for many of the thrifts, which had already become insolvent. This new authority made a dramatic impact on the remaining thrifts, and, between 1982 and 1989, 40 percent of the new mortgages written had adjustable rates.[61] By 1989, adjustable-rate mortgages made up 48 percent of the thrifts' single-family loan portfolios. The use of ARMs by all types of lenders grew, making up 43 percent of all conventional single-family loans issued between 1984 and 1989.[62] At the time, there was speculation as to whether adjustable-rate mortgages would become the norm once again, as they had been before the 1930s.[63]

In 1982, the President's Commission on Housing concluded that the "nation can no longer rely so completely on a system of highly regulated and specialized mortgage investors and a single type of mortgage instrument if the strong underlying demand for housing credit is to be met."[64] This report not only set the stage for further deregulation of the financial industry, but also paved the way for the growing role that the secondary market would play in housing finance.

Garn-St. Germain Depository Institutions Act

That same year, Congress passed the Garn-St. Germain Depository Institutions Act, which increased government authority to assist the thrifts and once again broadened their investment powers. Together, these provisions were intended to help the thrifts to compete for deposits. Under the Garn-St. Germain Act, the Federal Deposit Insurance Corporation (FDIC) and Federal Savings and Loan Insurance Corporation (FSLIC) were

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[61] Ibid., 1
[62] Ibid., 7
[63] Green and Wachter, "The American Mortgage in Historical and International Context," 99
[64] Colton, *Housing Finance in the United States: The Transformation of the U.S. Housing Finance System,* 11

authorized to issue government-backed promissory notes to those thrifts that were not in danger of collapse, temporarily increasing their net assets. Acting under this new authority, the FDIC and FSLIC invested over $175 million into fifteen S&Ls by January of 1983.[65] In addition, the Act loosened restrictions on the types of investments which thrifts were authorized to make, allowing them to diversify away from their traditional emphasis on mortgage lending. Thrifts were given the power to invest up to 10 percent of their assets in corporate, commercial, and agricultural loans, up to 30 percent in consumer loans, and up to 40 percent in nonresidential mortgage loans.[66]

These changes had significant political ramifications, breaking down the traditional alliances between the construction and building industries with the thrifts. As thrifts began to divert significant portions of their investments into non-residential assets, these partnerships lost strength, weakening the overall housing lobby. Along with this breakdown, there was a movement to diversify the investment portfolio of the United States, moving capital away from housing and towards other sectors of the economy which were thought to be more effective levers of economic stimulation.[67]

FIRREA

Over the short term, the Garn-St. Germain legislation was extremely effective, dramatically reversing the negative net new deposits of 1981 and 1982, and bringing in $63 billion in net new deposits in 1983.[68] The period of reinvestment was short-lived, however, and from 1987 to 1990, the S&L industry lost billions of dollars each year. With the Federal Savings and Loan Insurance Fund bankrupt and the industry on the verge of collapse, Congress and the first Bush Administration intervened with the

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65 Meyerson, "Deregulation and the Restructuring of the Housing Finance System," 72
66 Ibid., 73
67 Ibid., 75
68 Doan, *American Housing Production, 1880-2000: A Concise History*, 115

Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). Under FIRREA, the federal government sought to close the insolvent institutions while putting in place stricter standards for the remaining ones. Large outlays of direct funds and bond issuances were authorized to close the failed institutions, and higher capital requirements were required of all remaining institutions. In addition, new limits were set on the types of investments thrifts were allowed to make, as well as requirements for uniform accounting practices and increased penalties for fraud.

Large organizational changes were made, replacing the discredited regulators with new structures; the Federal Home Loan Bank Board was replaced with the Office of Thrift Supervision, and the Federal Housing Finance Board was created to oversee the twelve Federal Home Loan Banks. With increasing deregulation and the declining importance of S&Ls in mortgage finance, mortgage bankers and the secondary markets became significantly more important. With these changes, however, housing finance lost its pool of cheap funds, its local orientation, and its reliance on long-term, fixed-rate mortgages.[69]

Resolution Trust Corporation

The Resolution Trust Corporation (RTC) was created under the FDIC to handle the assets and liabilities of those thrifts that had become insolvent before 1992. This role had been previously played twice by other organizations, the Home Owners Loan Corporation and the Federal Asset Disposition Association (FADA), which had been formed to liquidate the assets of the bankrupt Federal Savings and Loan Insurance

[69] Meyerson, "Deregulation and the Restructuring of the Housing Finance System," 70

Corporation.[70] FADA had been liquidated by FIRREA in 1985. Under FADA, 296 thrifts, with total assets of $125 billion, were closed or sold.[71] This number would be dwarfed, however, by the RTC.

Though it had originally been authorized for only three years, the RTC was extended twice as authorities quickly realized that "the problem was far worse than anyone in government had envisioned."[72] Charged with disposing of assets from thrifts that became insolvent between 1989 and 1995, the RTC resolved 747 thrifts with $394 billion in assets.[73] By 1999, it was estimated that RTC losses amounted to $82.7 billion, of which $75.6 billion, or 91 percent, accrued to the public sector. In all, direct losses from the savings and loan crisis between 1986 and 1995 totaled $145.7 billion, of which $124 billion was paid by taxpayers required to back up the Federal Savings and Loan Insurance Corporation's commitment to depositors.[74]

Politics of Deregulation

With the deregulation of the financial sector, housing finance lost the "protected" status it had enjoyed since the New Deal.[75] Though the construction lobby had supported the inclusion of other types of financial institutions in the housing finance market, they also supported the legislation intended to rescue the remaining thrifts after the savings and loan crisis. The National Association of Home Builders legislative

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70 Ely, "The Resolution Trust Corporation in Historical Perspective," 53
71 Curry and Shibut, "The Cost of the Savings and Loan Crisis: Truth and Consequences," 26
72 Ibid., 29
73 Ibid., 26
74 Ibid., 33
75 Meyerson, "Deregulation and the Restructuring of the Housing Finance System," 74

council explained their support of aid to the thrifts, saying that "We felt that half a thrift was better than no thrift at all."[76]

In both the 1930s and the 1980s, the federal government provided significant aid to the financial industry. It is striking to note in both instances that "the government's overriding aim seemed to be to support the interests of the nation's private financial institutions," not to meet public objectives.[77] In a poignant remark by Lane Kirkland, then secretary-treasurer of the AFL-CIO, he said "I am persuaded that the basic thrust of these recommendations is designed to promote the interests of private financial institutions without any genuine regard for the most urgent problems and needs of the nation."[78]

Growth of the Secondary Market

In 1982, the President's Commission on Housing was convened to assess the crisis. They concluded that "Inflation and unprecedented interest rate movements have fundamentally damaged the system of financial intermediation that so successfully supported American housing for more than forty years, and therefore a broader-based and more resilient system will be needed to supply the funds a strengthened housing finance industry will require."[79] Additionally, the report included recommendations that would increase the efficiency of the secondary market for residential mortgages, such as offering a guarantee for the securities from a government agency and changing the tax and legal treatment of these products. It also suggested that Fannie Mae and Freddie Mac

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[76] Ibid., 75
[77] Ibid., 76
[78] Ibid., 76
[79] Colton, *Housing Finance in the United States: The Transformation of the U.S. Housing Finance System,* 10

should be key players in the expansion of the secondary market, though it did not resolve the question about the appropriate level of public intervention in this area.

Congress passed the Secondary Mortgage Market Enhancement Act of 1984, implementing many of the recommendations of the President's Commission on Housing. This legislation greatly increased the availability of mortgage credit, drawing attention away from the long-time questions of how to increase the supply of credit and towards questions regarding the terms at which this credit would be offered. By closely connecting the US housing finance system with capital markets around the world, the secondary market filled the gap in credit left by the declining thrifts. In addition, the increased supply of credit benefited customers by lowering interest rates by an average of half a percent on those loans that could be sold in the secondary market.[80] Although the secondary market has increased the supply of credit to the market and lowered the rates at which it is available, it may also have negatively affected some households who do not fit easily into the standardized underwriting guidelines required.[81]

The growth in the secondary market, starting in the mid-80s, was explosive. In 1984, some $62 billion of mortgage-backed securities were issued. By 2001, this number had grown to $1.2 trillion.[82] As it became one of the primary sources of credit, the secondary market also helped maintain the liquidity of the market, smoothing the ups and downs that would have been experienced under the earlier systems. It also broadened the investor base of housing by attracting mutual funds, pension funds, and foreign entities whose capital had previously not been invested in housing and further tying the housing market to the economy at large.

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80 Ibid., 15

81 Lea, "Innovation and the Cost of Mortgage Credit: A Historical Perspective," 167

82 Colton, *Housing Finance in the United States: The Transformation of the U.S. Housing Finance System,* 15

The secondary market may have also extended the life of the 30-year fixed-rate mortgage. In the early 1980s, the 11th District Federal Home Loan Bank proposed an adjustable-rate mortgage indexed to their cost of funds. In order to make this product successful, savings and loan executives from the 11th District asked Freddie Mac to agree to buy these loans, creating a secondary market and greater liquidity. They also requested that Freddie Mac cease purchasing 30-year fixed-rate mortgages, as they saw these as direct competitors to the ARMs. Although Freddie Mac did agree to purchase the new loans, they did not agree to the second request, preserving the market for both types of loans. Because of this secondary market intervention, the United States is one of the only countries in the world which offers a mortgage product that is as advantageous to the consumer as the long-term, fixed-rate mortgage.[83]

Since the introduction of a robust secondary market, many different kinds of loan products have been introduced. Adjustable rate mortgages have allowed for the shifting of interest rate risk, with no-cost refinancing intended as the safety valve.[84] Other exotic loan products have proliferated such as payment-option loans and interest-only loans, with so-called "affordable features." In addition, low regulatory requirements allowed for stated loans, by which the borrower's income does not need to be documented or verified. Many of these exotic products, allowed under the loose regulations, would ultimately prove dangerous, as discussed in the final chapter.

Federal regulation gave the secondary market an additional advantage in 1989 with the spread of risk-based capital requirements. Under these rules from the Board of Governors of the Federal Reserve System, mortgage backed securities were treated preferentially to mortgage whole loans, with GSE securities weighted at 20 percent,

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[83] Ibid., 26-27
[84] Ibid., 16

GNMA securities weighted at 0 percent, and whole loans weighted at 50 percent, making it more favorable for institutions to hold these securities relative to other types of investments.[85]

Conclusions

During the 1980s, the pendulum of federal financial regulation in the United States swung sharply towards deregulation. As limitations were relaxed on the types of investments that banks and savings and loans could make, investment decisions changed dramatically, and capital was redirected in new ways. Though the capital requirements of the housing sector were never forgotten, they were not the focus of the changes in policy affecting the banks during this period. In fact, distancing the savings and loans from their original focus on the needs of housing finance was at the core of the new policies. The nature of their business, short-term demand deposits, had originally been the cause of their vulnerability to interest rate risk on long-term mortgages. This mismatch had caused 1,043 thrifts to fail between 1986 and 1995, creating a huge drag on the economy as a whole and on the federal budget in particular.[86] The new regulations were intended to allow the surviving thrifts to diversify their portfolios.

Meanwhile, the secondary market expanded to fill the funding gap left by declining thrift investment in housing finance. By linking mortgage markets with international capital markets, the GSEs successfully addressed the credit shortages that had long plagued the housing finance system. With credit plentiful, the terms of credit took on increased importance, increasing affordability for more borrowers.

[85] Lea, “Innovation and the Cost of Mortgage Credit: A Historical Perspective,” 168
[86] Curry and Shibut, “The Cost of the Savings and Loan Crisis: Truth and Consequences,” 33

Deregulation policies were aimed at the macroeconomy. As housing markets and other pieces of the financial sector have become increasingly linked, the federal government has used macroeconomic tools to address problems in the housing market. In doing so, they have addressed concerns related to the availability of financing, but have not addressed social welfare concerns such as ensuring that the financial industry lend responsibly and protect the interests of consumers who are less able to protect their own interests. In addition, these policies do not address community development concerns such as ensuring that credit is provided in ways that will further community goals and build stable and secure neighborhoods. Rather, these policies tend to support the freedom of the private markets to pursue profit-oriented activities.

Chapter 5: Subprime Crisis and the Return to Regulation

The Foreclosure Crisis

From 2000 to 2005, homeowners across the country saw major increases in their home values. Median house prices peaked in October of 2005, and then lost 18 percent of their real value over the following thirty months, the sharpest decline in fifty years.[87] At the end of this period, a sharp downward spiral began, and home prices went into freefall. The earlier part of the decade also saw a very large number of refinances and home equity loans, as homeowners withdrew equity from their homes for a number of other purposes. As long as housing prices continued to increase, more and more equity was withdrawn from houses. Meanwhile, other borrowers took on exotic loans with unusual features, assuming that they would be able to refinance into more traditional loan products later. Still others accepted these loans without fully understanding the terms, whether as the result of predatory behaviors on the part of lenders or as the result of personal negligence. As a result, as house values have come crashing down, many owners have negative equity left in their homes. These owners cannot afford to sell or refinance, as they owe more than their house is worth, and increasing numbers are being pushed into default and, eventually, foreclosure.

Subprime Crisis

The foreclosure crisis has not affected all loans equally. The first wave of foreclosures was heavily concentrated in subprime mortgages, loans made to “riskier” borrowers that carried higher, and often adjustable, interest rates. The percentage of subprime or high cost loans originated increased dramatically in recent years, going from

[87] Joint Center for Housing Studies, “The State of the Nation's Housing 2008,” 10

about 10 percent in 2003 to almost 33 percent in 2006.[88] While subprime loans were a way of making mortgage credit available to households who would not otherwise have qualified for credit, their use has been widely questioned, and they are commonly associated with predatory practices. Many subprime loans carried adjustable interest rates, which often started with a discounted "teaser rate" to attract borrowers, but would then reset to a higher rate. At the beginning of 2006, these initial rates were, on average, about 2.3 percentage points lower than the comparable rate for fixed-rate loans, but, as a result of the rapid deterioration of subprime loan performance through the year, began 2007 at an average discount of only .5 percent.[89]

Predatory Lending

High cost loans were concentrated in low-income and minority areas; in 2006, more than 40 percent of loans made on properties in low-income communities were high-cost, and over 45 percent of loans made on properties in low-income, minority neighborhoods were high-cost. These numbers stand in stark contrast to the 23 percent of loans made in middle-income, white communities, and 15 percent of loans made in high-income, white communities that were high-cost.[90] In addition, the incidence of loans with "affordable features" was much higher in the most expensive markets, where borrowers were already stretched to afford homes.[91] In order to continue attracting new borrowers, lenders continued to lower down payment requirements, increase LTV ratios, and provided loans to borrowers without verification of income. It was assumed that rising house values would serve as the safety valve, and that even if borrowers could not

[88] Quercia and Ratcliffe, "The Preventable Foreclosure Crisis," 778
[89] Joint Center for Housing Studies, "The State of the Nation's Housing 2008," 18
[90] Ibid., 18
[91] Ibid., 19

make their payments, the banks would be able to recoup their investment from the sale of the asset.

Changes in the Underwriting Process

Another major change that occurred during this period was the separation of the underwriting, servicing, and holding of loans. Increasing numbers of loans were processed by mortgage brokers, who were compensated on a commission basis. These brokers had no long-term financial stake in the performance of the loans, and were therefore incentivized to sell products with the highest commission, not necessarily those which were best suited to the borrower's needs. Originating banks, too, lost their financial incentives to maintain the integrity of their underwriting, since a large percentage of their loans would be quickly sold on the secondary market rather than held in portfolio. Because the secondary market processes of packaging and securitization pooled large numbers of loans together, it became virtually impossible to assess the true value of the underlying mortgages. As a result, mortgage originators lost their incentive to maintain the quality of their underwriting. And finally, the incentives of the credit rating agencies, who were supposed to provide investors with information about the quality of the securities, were also misaligned. They were paid directly by the institutions issuing the securities, and therefore were incentivized to give higher ratings in order to attract future business. From beginning to end, the lending process became fraught with economic disincentives to maintaining high underwriting standards.

These changes shifted emphasis from loan quality to loan volume, increasing the total volume of outstanding mortgage debt. However, many of these new loans did not last long. Defaults and foreclosures skyrocketed to their highest levels since record keeping began in 1974; the 2002-2006 annual average of 455,000 foreclosures nearly doubled to 940,000 by the end of 2007, a number which has only continued to rise.[92] Moreover, the subprime share of these defaulted loans rose from 4.6 in 2006 to 8.7 by the end of 2007. Even more alarming is the share of subprime loans with adjustable interest rates, which made up 13.4 of defaulted loans in 2007.[93]

Housing Prices Decline

US Housing prices had increased steadily through the first half of the decade, but peaked in October of 2005.[94] Between mid-2007 and the end of 2008, home values in the United States were estimated to have fallen by over $700 billion. Despite this decline, home equity still makes up the largest segment of household wealth.[95] Along with the value of the underlying assets, the value of securities has also dropped precipitously. Investors lost confidence in the underlying value of the securities, and demand for these investments dried up. With little to no new capital coming in and investors demanding repayment, many funds collapsed and mortgage companies found themselves unable to pay back their obligations.[96]

Causes of the Foreclosure Crisis

As the foreclosure crisis unfolds, fingers have been pointed in many directions. It is clear that federal regulators acted too slowly to curtail some of the most abusive practices. Regulators did not issue guidelines for negative amortization and interest-only loans, two of the most troublesome of the exotic products, until 2006. It was not until mid-2008 that they amended the Truth in Lending Act (also known as Regulation Z) to

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[92] Ibid., 20
[93] Ibid., 20
[94] Ibid., 18
[95] Quercia and Ratcliffe, “The Preventable Foreclosure Crisis,” 777
[96] Joint Center for Housing Studies, “The State of the Nation's Housing 2008,” 20

require lenders to verify incomes and assets of borrowers and curtail practices which Federal Reserve Chairman Ben Bernanke characterized as “unfair or deceptive acts and practices by lenders [which] resulted in the extension of many loans, particularly, high-cost loans, that were inappropriate for or misled the borrower.”[97]

Two of the most commonly cited culprits are the Community Reinvestment Act (CRA) and the Affordable Housing Goals which Congress sets for the GSEs. These two federal initiatives were intended to “democratize credit” and bring homeownership within reach of a larger swath of the population. The Community Reinvestment Act was passed in 1977 to encourage federally-insured depository institutions “to help meet the credit needs of the local communities in which they are chartered, consistent with the safe and sound operation of such institutions.”[98] Critics have argued that this legislation has forced a particular allocation of credit by lenders. The data, drawn mostly from the Home Mortgage Disclosure Act (HMDA), show that only about nine percent of the high-cost loans to lower-income borrowers or neighborhoods were covered by the CRA. Evidence shows that a large portion of these loans were originated by institutions not subject to the CRA, and that while banks did underwrite some high-priced loans within their CRA assessment districts, they did so at a significantly lower rate relative to the overall market.[99] In addition, research has shown that, in general, CRA lending, when adhering to “safety and soundness” principles, has been “overwhelmingly profitable” to banks.[100]

There is also significant evidence against the claim that the Affordable Housing Goals of the GSEs are the main culprit. Beginning in 1992 with the Federal Housing

97 Quercia and Ratcliffe, “The Preventable Foreclosure Crisis,” 776
98 Park, *Subprime Lending and the Community Reinvestment Act*, 2
99 Ibid., 3
100 Quercia and Ratcliffe, “The Preventable Foreclosure Crisis,” 778

Enterprises Financial Safety and Soundness Act, Congress began setting targets for the GSEs, encouraging them to fund loans to low-income households and to underserved neighborhoods, and to "lead the industry in affordable lending."[101] In response, the GSEs created special affordable programs, which allowed for reduced down payments, increased flexibility in credit and employment history, and higher debt-to-income-ratios.

It is clear that the first wave of troublesome loans was not originated or securitized by Fannie Mae and Freddie Mac, as subprime loans were not a major part of their business until 2005, several years after these loans had been made. Though they were not the original cause of the problem, the GSEs did join the market for products with low credit ratings, and may have "followed the market down."[102] These investments made up more than half of each company's credit losses in the second quarter of 2008, but only 11 percent of Fannie Mae's and 10 percent of Freddie Mac's portfolios. The average loan amount was about $170,000 and the average loan-to-value ratio was below 75 percent, excluding them from the affordable housing programs.[103] Taken together, this evidence suggests that Fannie Mae and Freddie Mac did add to the overall troubles of the housing and financial markets, but not primarily as a result of their affordable housing programs.

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101 Ambrose, Thibodeau, and Temkin, *An Analysis of the Effects of the GSE Affordable Goals on Low- and Moderate-Income Families,* 8
102 Quercia and Ratcliffe, "The Preventable Foreclosure Crisis," 779
103 Ibid., 779

Chapter 6: Making Home Affordable and the Future of US Housing Finance

Making Home Affordable

In March of 2009, Congress and the Obama administration introduced the Making Home Affordable program, a three-prong plan meant to address the foreclosure crisis and assist between 7 and 9 million households. The first of the initiatives is a refinancing program intended to help borrowers with high-interest loans refinance into fixed-rate mortgages and take advantage of historically low interest rates. The second is a $75 billion program to encourage loan modifications for 3 to 4 million homeowners. Finally, the third initiative seeks to maintain low mortgage rates by encouraging confidence in Fannie Mae and Freddie Mac.

The home refinance program seeks to assist 4 to 5 million borrowers who cannot refinance because their house value has declined with the overall market, leaving them without the requisite owners' equity to secure a new loan. Through this program, borrowers with loans that are owned or guaranteed by Freddie Mac and Fannie Mae will be able to refinance into lower-rate mortgages through these institutions. This provision will only assist homeowners who are current on their payments, and does not offer assistance to already distressed borrowers.

The second prong of the program will provide loan modifications to borrowers who are "at risk" as well as those who have already fallen behind on their payments. Through modifications of existing loans, the program seeks to lower households' monthly payments so as to make them affordable to the individual households' current circumstances. This program is only available for loans below the Federal Housing Finance Agency (FHFA) conforming limit of $729,750.

The loan modifications will be subject to specific guidelines issued by the Treasury, and will first require lenders to lower monthly payments to no more than 38 percent of the household's income. From there, the program will provide a dollar-for-dollar match until the debt-to-income ratio is reduced to 31 percent. After five years, lenders may raise the interest rate by one percent annually until it reaches the conforming loan survey rate in place at the time of the modification. Loan modifications will begin with interest rate reductions down to two percent, after which point lenders may extend the amortization period to forty years. If this is still insufficient to bring monthly payments within 31% of borrowers' income, then lenders may forebear principal at zero percent interest. Alternatively, lenders may elect to reduce the principal balance until the 31 percent target is reached.

To incentivize successful loan modifications, the program offers an up-front cash payment of $1,000 to the servicer of any eligible loan modified under the approved terms. In addition, servicers will receive a payment of $1,000 per year for the first three years if the borrower remains current. Finally, servicers will receive an additional $500 (and mortgage holders will receive $1,500) for loans modified for "at risk" borrowers who are still current on payments, as these loans have the highest probability of success. Borrowers are also eligible to receive up to $1,000 per year for five years as long as they remain current on their modified payments. An additional $10 billion has been allocated for "Home Price Decline Payments" to encourage servicers to modify currently viable loans rather than pursuing foreclosure out of fear that home values will continue to decline. These funds will be used to offset losses should values continue to decline.

Finally, the Making Home Affordable program seeks to encourage confidence in Fannie Mae and Freddie Mac. To do so, the Treasury has increased its support of the GSEs through funds appropriated in 2008. Additionally, the Treasury will continue to buy securities issued by the agency in order to maintain liquidity in the secondary market. The GSEs will also be authorized to hold an additional $50 billion of loans in portfolio, increasing their total to $900 billion each.

The program aims to strike a political balance, but in doing so falls short on many points. The "common sense" provision limiting mortgages eligible for modification to the FHFA conforming limit of $729,750 is hardly common sense, as it makes no distinction between price differentials in local markets; while this may be a reasonable limit for high-priced markets, it is an exorbitant limit in other places, and thus fails to adequately target federal support. Though it is successful in aligning the previously unaligned incentives for lenders, servicers, and borrowers, it uses large amounts of public money to encourage lenders and servicers to solve the problems which they are largely responsible for causing. The program includes several provisions meant to discourage moral hazard on the part of borrowers, but does nothing to hold those who created the current situation accountable for past actions. The other major shortcoming of the program is its relatively short focus. By loosening the restrictions on the affordability of loan modifications after only five years, it is not creating a permanent solution, but rather expending enormous subsidies that will simply forestall the problem without fully addressing it.

Learning from the Past

The Home Owners Loan Corporation was the federal government's first attempt to intervene in mortgage markets as a holder of mortgages. Amidst the turmoil of the Great Depression, the HOLC was instituted to act as a lender of last resort. As such, it was able to set its own terms, creating its own system for appraisals, limiting its exposure to 80% of assessed value, and refinancing only those mortgages which were deemed viable. Under the HOLC terms, lenders were often forced to accept a portion of the loss through a reduction in outstanding principal. Despite losing some of the value, which in an economic sense had already been lost to the declining value of the asset, they gained liquidity, as non-performing loans were replaced by salable bonds.

A similar model would be appropriate under the current context, using an arm of the federal government to purchase and refinance loans. Rather than providing incentives to financial institutions to modify loan terms, this could be done more efficiently by simply purchasing the loans and refinancing them, taking advantage of historically low interest rates and the federal government's low cost of capital to refinance viable mortgages, thus preventing foreclosure, maintaining the value of the homes, and providing liquidity to the financial sector. It would also better align incentives, penalizing financial institutions for underwriting loans that were not sustainable from origination. Although the housing finance landscape today is much more complicated than that of the 1930s, the form of the crisis is similar. Fannie Mae and Freddie Mac can be used as government agents, paralleling the functions of the HOLC.

Future of Fannie Mae and Freddie Mac

In July of 2008, the Bush Administration seized control of Fannie Mae and Freddie Mac and placed them into conservatorship of their new regulator, the Federal Housing Finance Agency. Both companies had reported tremendous losses, with Fannie Mae reporting negative income of $58.7 billion in 2008, greater than their total net profits since 1992.[104] By placing them into a conservatorship, the federal government made

104 Duhigg, "U.S. Likely to Keep the Reins on Fannie and Freddie."

explicit the guarantee of federal backing that had formerly been only implicit. In announcing the takeover, Treasury Secretary Harry Paulson said, “these enterprises pose a systemic risk and they cannot continue in their current form. Government support needs to be either explicit or nonexistent, and structured to resolve the conflict between public and private purposes.”[105] Since July of 2008, plans to restore confidence in the mortgage markets and to stave off further declines in the housing market have increasingly relied on Fannie Mae and Freddie Mac as key participants.

Though they currently remain in limbo between public and private ownership, it is unlikely that Fannie Mae or Freddie Mac will ever return to public ownership, at least not in their current forms. As Congress and the Obama Administration continue to draw the companies into the economic recovery strategies, the companies increasingly lose decision-making power and autonomy, jeopardizing their future independence. Additionally, even if the companies could return to profitability, current estimates say that it could take as many as 100 years for them to pay off their government debt.[106] Finally, in an era of increased government control and regulation, it is unlikely that legislators will be eager to cede control of these powerful entities. At this time, however, the question of what to do with the GSEs is not being officially discussed.

Overinvestment in Housing

Research shows that about one third of the US owner-occupied housing stock constructed before 1976 would not have been built if not for the lowered after-tax costs of homeownership relative to other investments.[107] Because of all of the incentives

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[105] Labaton and Andrews, “In Rescue to Stabilize Lending, U.S. Takes Over Mortgage Finance Titans.”
[106] Duhigg, “U.S. Likely to Keep the Reins on Fannie and Freddie.”
[107] Applebaum and Gilderbloom, “Supply-Side Economics and Rents: Are Rental Housing Markets Truly Competitive?,” 171

provided to homeownership through direct subsidy, the GSEs, and the tax code, households have been incentivized to concentrate their investments in housing rather than other assets that might be more productive were it not for policy interventions. By allocating a large portion of their investments to a single asset, they also decrease the diversity within their individual portfolios. Giving housing an advantage over other consumer interests creates greater investment in housing, detracting from investment in vehicles such as stocks, bonds, and mutual funds. Housing that would otherwise not have been built drives out other investments that would have been more profitable before taxes, lowering the GDP by an estimated $200 billion in 1998.[108] For this reason, households have come to view their house largely as a financial investment and not just as a home.

The incentives given to homeownership are largely the results of macroeconomic policies, with little attention paid to the social and community outcomes they create. These incentives primarily benefit higher-income households, and do not address overall community health or stability. In fact, they draw investment away from many lower-income communities which are dominated by renters. Finally, these policies do not address the chronic underinvestment in housing for low-income households. By focusing on macroeconomic objectives, these policies measure only financial benefits, ignoring all other facets of housing.

Changing the Conversation

Over the years, homeownership has been touted both for its social and economic benefits. These benefits have served as the justification for a long line of government

[108] Coulson, *Housing Policy and the Social Benefits of Homeownership*, 2

programs and initiatives which have promoted and subsidized homeownership. The emphasis on homeownership as a wealth-building investment has increased, and, as house prices rose sharply in the late 1990s and early 2000s, has come to overshadow many of the other services that come from a house. Households invested beyond their means in homeownership, and often used their home as a source of equity. In fact, the majority of subprime loans were made to owners seeking to refinance, not to purchase new property.[109] For a large number of these borrowers, refinancing was a means for tapping into the investment value of their home.

As Donald Degollado, a housing counselor said, "it's time to change the value statement of homeownership." It no longer suffices to treat housing primarily as an economic investment, as doing so has brought the entire housing finance system to its knees. Instead, housing must be addressed through a combination of macroeconomic, social, and community development policies. By ignoring these other outcomes, past macroeconomic policies have actually lowered the economic value of homeownership, as demonstrated by the current crisis. Policies must focus on the social and neighborhood values of homeownership, not simply the wealth-building potential of the investment. The recent crisis has shown that homeownership can be a risky way of amassing wealth, if not least so because it discourages many households from adequately diversifying their portfolios across different investment types.

The idea of homeownership as the predominant form of wealth accumulation is also problematic from the perspective of federal policy. There is a pervasive gap between the homeownership rates of whites, of whom roughly three quarters are homeowners, and minorities. The gap is most dramatic between white and black

[109] Quercia and Ratcliffe, "The Preventable Foreclosure Crisis," 777

homeownership, with only about half of black households owning their own homes. Moreover, research shows that this gap grew between 1985 and 2005, even after controlling for income, education, and immigration status.[110] Other research shows that parental wealth and ownership are significant indicators of a household's ownership status.

Discriminatory practices, both public and private, have been institutionalized through federal policy's emphasis on the promotion of homeownership. Not only do renters have lower wealth and fewer opportunities to build wealth than their homeowner counterparts, but their children are likely to face the same fate. Many minority households were excluded from neighborhoods by FHA redlining and private restrictive covenants in the 1950s and 60s, but the effect of this exclusion is still felt today. These policies encouraged racial segregation, and even today "residential segregation costs African American homeowners enormous amounts of money by suppressing their home equity in comparison to White homeowners," decreasing the investment value of homeownership for African Americans.[111] Therefore, federal policies that subsidize homeownership and promote it relative to other investments perpetuate and increase current wealth gaps and societal inequalities.

As a policy for the promotion of wealth building, homeownership has failed many people. Due to the lumpy nature of housing and the significant obstacles to first-time homeownership, many people are excluded. Recent experience, however, shows that even those who have been able to purchase a home are not always better off for having done so. Subprime loans were underwritten disproportionately for low-income and

[110] Hilber and Liu, "Explaining the Black-White Homeownership Gap: The Role of Own Wealth, Parental Externalities and Locational Preferences," 153

[111] Schwartz, *Housing Policy in the United States: An Introduction*, 255

minority households, and these loans have faced the most problems with the housing downturn and economic slowdown. Many of these borrowers are now finding themselves worse off than they were before becoming homeowners. A shift away from the promotion of homeownership relative to other investments is necessary, and homeownership should be valued for the social benefits it offers rather than the economic ones.

Shared-Equity Homeownership

One way of doing this is through the promotion of shared equity homeownership, which preserves the social value of housing but lowers both its investment value and the associated risk. In many ways, shared equity homeownership falls between traditional ownership and rental, creating a spectrum of tenure alternatives rather than two discrete tenure choices. Shared equity homeownership encompasses a range of models which seek to make homeownership safer and more accessible to individual households while creating long-term affordable housing and preserving the value of public subsidies. In this way, macroeconomic policies are being used for the purpose of creating positive social welfare and community development outcomes. Included in this category are community land trusts and various programs which use deed restrictions to maintain affordability. Although there is great variation in the specific terms that each program uses, the basic models are quite simple.

Community land trusts (CLTs) are organizations which own the land upon which housing is built. Homeowners purchase a ground lease from the CLT, giving them the right to use the land, though they fully own the improvements. Traditionally, increases in housing prices are largely due to land appreciation, so by separating the value of the house from the value of the land, long term affordability can be more readily preserved. The terms of each agreement vary, but ground leases typically include provisions limiting the future sale price and the division of any equity appreciation between the owner and the CLT. The ground lease may also restrict the eligibility of buyers based on such criteria as income and residency, making sure that future owners who benefit from the program come from the target population.

The second major paradigm for shared equity homeownership is that of deed restricted programs. Deed restrictions work similarly to ground leases in that they restrict the terms of resale. Deed restrictions are more flexible than community land trusts in that they do not require an entity that owns the underlying land, but rather need only an agency to oversee the enforcement of the restrictions. Like CLTs, they can employ a wide range of formulas to calculate the way in which equity appreciation will be split between the homeowner and the sponsor.

The current crisis is an ideal opportunity for the development of large-scale shared equity homeownership programs. The public sector is currently making enormous investments to restore the vitality of the housing market. However, without some kind of shared equity approach, these expenditures will be one-time subsidies. The major advantages that shared equity models offer are their ability to target assistance and preserve the value of public subsidy. They offer a tradeoff to buyers, allowing them the benefit of the subsidy so long as they live in their home and the opportunity to share in any upside potential, but also protecting the long-term value of the subsidy so that it can be recycled for the benefit of future households. There is currently a glut of homes on the market, many of them owned by lenders and other investors as foreclosed assets. A shared equity program would not only help many households to purchase homes, but would also help to dispose of these assets, restore the health of the market, and create a permanent stock of affordable housing.

Shared equity homeownership offers a range of benefits to local municipalities. By bringing properties back into use, they can increase their property tax revenues, the principal source of funding for most local governments. A shared equity homeownership program would also require local control as the mechanisms must be tailored to local circumstances. Unlike the majority of federal macroeconomic policies, funding for shared equity programs would allow local governments to meet their specific community development goals, which are largely overlooked by federal policies.

While these programs are far from revolutionary, they have not received sufficient attention as potential solutions to current problems. The Making Home Affordable Plan does not have any provisions for subsidy preservation or recapture. It aims only to solve the current crisis, but lacks the foresight to create a lasting public resource. In addition, because a large portion of the expenditure has been allocated to loan modification through private banks, this subsidy will be going to lenders rather than into sustainable public resources. Conversely, shared-equity homeownership programs offer an opportunity to create sound economic policies while achieving the social goals of affordable housing and the community development goals of neighborhood stability.

Conclusions

The United States is currently in the midst of the worst downturn in housing markets since the Great Depression. For years, homeownership has been considered the "American Dream," with substantial federal resources poured into its preservation and expansion. After years of home price appreciation and expanded homeownership, there is now a significant contraction which has affected not only house prices, but the availability of credit and the health of the economy as a whole. While the crisis is certainly the source of significant challenges, it also provides opportunities for rethinking the role of housing and homeownership in federal policy and in American society as a whole. The time is ripe for marrying macroeconomic, social welfare, and community development policies, replacing these distinct spheres with sound, sustainable policies that create better outcomes for individuals, communities, and the economy as a whole.

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Vita

Tamar Greenspan was born in Kfar Sava, Israel on March 13, 1984, the daughter of Rivka and Ezra Greenspan. After graduating from the South Carolina Governor's School for Science and Mathematics in 2002, she entered Wesleyan University in Middletown, Connecticut. She received the degree of Bachelor of Arts in Poverty Studies in May, 2006 and moved to Washington, DC where she worked for the Local Initiatives Support Corporation. In September 2007, she entered the Graduate School at the University of Texas at Austin.

Permanent Address: 10819 Meadowcliff Ln.
Dallas, TX 75238

This report was typed by the author.