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COMMENTARY

Mortgage Madness

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The current troubles in the housing and mortgage markets virtually guarantee that some restructuring of the home-finance industry will occur under the next president. Already there are a number of legislative proposals on the table, with important implications for the ability of young men and women to purchase homes and existing homebuyers to sell. Oddly, in the various presidential debates, the candidates have not been asked about these plans, leaving both homeowners and financial markets in the dark.

One leading proposal is a bill called S. 1299, offered by Sen. Chuck Schumer of New York. Mr. Schumer is a senior Democrat on the Banking Committee and the third-ranking member of his party in the entire Senate, so any proposal he makes should be taken seriously. His proposal represents a regulatory and litigious approach to mortgage-market reform.

The bill requires that each mortgage originator act with "reasonable skill, care, and diligence" and in "good faith and fair dealing." It also requires that all loans are "reasonably advantageous to the consumer." Surely these are noble sentiments. But they are also vague and ill-defined legal requirements that open up the mortgage industry to endless litigation in an environment where juries comprised of homeowners must decide between families in the process of losing their homes and mortgage brokers, investment bankers and other financial intermediaries.

Mr. Schumer's bill makes the ultimate lenders legally responsible for "acts, omissions, and representations made by the mortgage broker." Remember that in the modern mortgage market, the mortgage broker is unlikely to be under the employ or control of the lender. The mortgage may be "owned" by someone who has never seen the borrower or the originator. So, anyone supplying money to the mortgage market may well be taking on uncontrollable and unquantifiable risk in the process.

The legislation also prescribes some regulatory tightening that will block access to mortgages for some key segments of the population, or at least make those mortgages more expensive and less appropriate. The bill would require that all borrowers qualify for a mortgage at the fully indexed long-term rate that would apply when a variable-rate mortgage converts to its long-term level.

Many borrowers choose to take out loans that have a lower rate for the first two to 10 years, which then rises to a higher rate for the duration of the loan's 30-year life. Sen. Schumer would require everyone to qualify at the higher rate, arguing that it is wrong for mortgage lenders to put people into mortgages that they "cannot repay."

Yet former Federal Reserve Chairman Alan Greenspan publicly recommended that people take out variable rate mortgages that may ultimately lead to higher rates. Why? Because they are cheaper.

Locking in a long-term fixed rate is risky for the lender, and so he must charge more. Borrowers can obtain a mortgage with a lower monthly payment or qualify for a larger home if they choose a variable-rate loan. Equally important, in a country where the average household moves every seven years, it seems foolish for everyone to pay for "interest rate protection" they may not need. The Schumer bill requires that they do.

One other factor needs be considered: Incomes rise over time, particularly for people in the prime home buying ages of 25 to 40. The typical family will see its income rise in excess of 5% a year as inflation, promotions and real wage gains take effect. Why should a family be forced to qualify for a monthly mortgage payment today that it won't have to face for another two to five years, when its income is likely to be substantially higher?

Whatever the merits of the idea in the long run, this is precisely the wrong time to add this requirement. Three-quarters of the subprime mortgages issued in 2006, along with other variable rate mortgages, will reset in 2008. Borrowers who had planned on refinancing then may be stopped by the requirements in S. 1299. Unable to pay the new reset rate and barred by law and regulation from easy access to refinancing, many or most of these borrowers could have little choice but to give up their homes. This in turn would put further downward pressure on all home prices.

The home mortgage industry has certainly been guilty of excesses in the past few years. It may be that Sen. Schumer's approach of restrictive regulation and turning the trial bar loose on the industry is the only way to reverse these excesses. But the cost of his approach to every existing homeowner and would-be homeowner is potentially staggering.

We already have an excess supply of homes on the market, and credit standards have been toughened. Reductions in demand already have pushed total home sales -- existing and new -- down 15% in the last year. The Schumer bill would depress demand still further.

Forty percent of all the loans issued last year by dollar volume were either subprime or Alt-A. If these two categories of loans reverted to their more traditional levels, one-third of the 2006 level of home demand would disappear (some already has). The Schumer bill would exacerbate this problem. The current inventory of unsold homes would jump further from its current record of five million homes. The effect on home prices would be disastrous.

Populist legislation has its appeals, but it also has its costs. Not too long ago, Sen. Schumer was a supporter of the original Sarbanes proposal on corporate responsibility and thought the more moderate Bush administration approach was too soft. Today, Sen. Schumer recognizes that even the compromise plan, Sarbanes-Oxley, had the effect of sending much financial business from New York to London. America's homeowners will not be able to relocate as easily.

The key to getting America out of its current housing and mortgage market mess is to do everything possible to maximize the availability of credit. Credit is crucial to making sure there are buyers. Buyers maintain home prices. Sustainable home prices are key to minimizing foreclosures.

There are alternatives to regulation and trial lawyers. Fannie Mae and Freddie Mac, which have been enjoying implicit government subsidies for years (and making the requisite campaign contributions to maintain them), should be asked to step up to the plate. In particular, they can play a role in creating refinancing options for people who may be in distress. The private marketplace is coming up with numerous innovations designed to help keep people in their homes -- ideas that will be stopped in their tracks by the fear of litigation and excessive regulation. Both the IRS and the SEC should change some of their regulations to facilitate the process.

Nearly 10 million more households own their own homes today than a decade ago. Most of this increase was due to financial-market innovation that made access to home mortgages more available. Excesses occurred -- but a choice must be made about whether to sustain the progress of the last decade, or revert to the pre-innovation days of the early 1990s. It is not only home buyers who will be affected by the choice we make. The values of every existing home in America are at stake.

Legislative proposals like the Schumer bill, which has a credible chance of becoming law, will have their effect long before they are enacted. They are setting the backdrop for decisions in the capital market on whether or not to supply loans for mortgage financing. The politicians responsible for making these choices need to be put on record. In particular, Sen. Schumer's fellow New Yorker, who according to the polls has a good chance of being the next president, needs to be asked whether a Hillary Clinton administration would take the regulatory and litigious route that Sen. Schumer is suggesting.

In fact, all presidential candidates in both parties should be asked that same question. The financial markets and America's homeowners deserve to know the risks they face.

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