Has the Home Loan Bank Board Ghost Returned?*

Bob Barnett

January, 2014

A question that should be asked is whether the extraordinary scope and depth of regulations created by the Dodd-Frank Act will be successful in empowering a more robust and safer residential mortgage finance industry than would have been created without it.

The beauty of the American economy has been that it has promoted innovation and entrepreneurial creativity, while being driven by demands of individuals, industry, pressure groups and the government. This, along with an abundance of natural resources, and the geographic luck of being distant from some of the devastation of wars, has created prosperity for Americans. Even those who are relatively on the lower end of the U.S. economic ladder are still considerably better off than most in most other economies.[1] In other words, our economy has been successful in providing goods and services to its citizens.

The recent backslide in the economy generated significant government intervention into the economy for many reasons (it was needed to restart the economy, it offered an opportunity for planners to get their hands on the wheel again, it seemed like relatively easy money for some recipients, it was seen as a way to get elected to public office, etc.). While nothing like the intervention in the 1930s, it was not limited to the intervention needed to simply fix the existing problems; it included solutions designed to prevent those problems from arising again.

This, of course, seemed reasonable since to do otherwise would be to permit the same problems to develop. So, in residential mortgages, to take one sector effected, Congress passed laws that prevented certain products from being

*The information contained in this newsletter does not constitute legal advice. This newsletter is intended for educational and informational purposes only.

[1]For a discussion of income inequality in the U.S. and what it means, see "***The Hidden Prosperity of the Poor***," Opinionator N.Y.Times.com.

offered in most circumstances (interest only loans; option ARMs in which the borrower could decide how much to pay and when — at least for a while; balloon loans in which the borrower is not required to amortize the loan; etc.). In addition, it required that the lender make a reasonable effort to ensure that the borrower could repay the loan, imposed strict sanctions on violations of that rule, and provided standards which (if met) would give varying degrees of protection against lawsuits or enforcement actions based on violations of the general ability to repay rule.

To some, the establishment of a safe harbor for certain mortgages represents a drift toward the relationship that at one time existed between the savings and loan industry and its then regulator — the Home Loan Bank Board System and its successors. Faced with a moribund housing industry in the 30s, the government created a regulator that had the prosperity of the housing industry as its primary goals. To obtain this prosperity, regulators limited the price that the industry could pay for its supply (deposits), the price it could charge for its products (loans), and to control everything else in between with lengthy manuals and rules. It then created quasi-government entities (the GSEs) to take the inventory off the hands of the S&Ls under strict rules. What the S&Ls could do was rigidly controlled by the government. If the association stayed within the regulators' playbook they stayed out of trouble and so were drawn into doing no more nor no less than what the regulators' rules prescribed.

Most of the time this worked well. The U.S. was the dominant economy for years, what with first most of Europe and Japan recovering from WWII and then with the global economy humming along nicely with only brief liquidity or speculative problems. When the OPEC nations finally got their act together, however, and the resulting upward pressure on oil prices combined with other inflationary features to push interest rates to German-like heights, a portfolio of fixed long-term assets (30-year fixed rate assumable mortgages) coupled with short-term market priced liabilities doomed the savings and loans, particularly when it operated (as it did) on a thin capital structure. The government regulators could not or would not respond quickly to permit them to compete, although with 5 percent assumable mortgage loans in their portfolios and low capital, they were limited in what they could do. They were also hampered because there were conflicting structures within the regulatory bodies (some regulations being at the state level and some at federal), federal examiners reported to a different entity than supervisory personnel, low caps limited pay for examiners vis–vis their regulatory peers, etc. In a scramble to get through the crisis, the regulators created faux capital for the entities (massive amounts of regulatory goodwill), provided regulatory forbearance, publicized the long-term viability of the industry against the short-term liquidity problem, changed stock ownership rules and permitted cowboy-types into the industry, reduced the number of examiners, and in a glorious misuse of deregulation, expanded deposit insurance coverage on thrift accounts. To provide more revenue, Congress and the regulators let them invest in all kinds of crazy ventures such as massive out of territory distant ADC loans, casinos, fast-food franchises, ski resorts, and windmill farms.

Anyone should have been able to see the result of this lopsided and poorly conducted deregulation. Even when the attitude of the regulator changed, Congress resisted tighter controls, the accounting system that had been adopted showed the entities still with capital even though everyone knew they were insolvent, and the insurance fund had insufficient funds to close them anyway. Aggressive managers and owners, playing with house money, made even riskier investments at that point. Collapse was inevitable; the industry that was the primary funding source for mortgage credit went under.[2]

The government fixed that by adopting additional laws and regulations.[3] These were designed to ensure that the housing industry would not have another catastrophic failure in the foreseeable future. They unified regulation, put the S&L insurance fund in the FDIC, and imposed limitations on activities that could be generated by state laws inconsistent with federal laws. FIRREA was passed in 1989, and, once again, things seemed to pick up in the housing industry.

However, slightly more than a decade later, notwithstanding FIRREA and the changes added by FDICIA[4] in 1991, some borrowers had started to receive

[2] For a good review of that industry and its relationship with its regulators, see History of the Eighties — Lessons for the Future, FDIC Division of Research and Statistics, 1997, Volume 1, Chapter 4 — "The Savings and Loan Crisis and its Relationship to Banking."

[3] Financial Institutions Reform, Recovery and Enforcement Act of 1989, Pub. L. No. 101-73; 103 Stat. 529.

[4] Federal Deposit Insurance Corporation Improvement Act of 1991, December 19, 1991

mortgage credit without documenting their income and expenses and without meaningful appraisals; products were introduced that required no down payment and no amortization; credit risks were casually passed on through the chain to the ultimate investor who made the investment based on a rating from rating agencies (whom some claim were compromised); and a host of participants and observers assumed that borrowers could simply refinance their way out of trouble if they couldn't make payments because house prices always increased. When defaults popped up, everyone looked over their shoulder and liquidity in the economy froze.[5]

This created an extraordinarily dangerous situation in the economy, and government leaders worked quickly to create a program to pump funds into the economy. The initial decision by the government was to pump funds into those entities that had the ability to begin to remove the liquidity crisis — namely the banking system, large and small, and a few large non-bank entities whose failure would have systemic effect in the economy. Notwithstanding complaints about that use of taxpayer money (i.e., for a short-term, high interest rate loan to a key sector that could in turn make loans to others), that worked and the economy came out of that nosedive fairly quickly. The bank portion of the TARP program began to earn a profit for the government in 2 1/2 years[6] (most of the major banks repaid their loans in nine months[7]) and has increased its profitability since then. Other parts, the car industry, the GSEs, AIG, etc. were not as quick to produce profits, but in November 2013, the TARP program, as a whole, became profitable, notwithstanding the loans made to various state agencies that were not expected to be repaid, and pending additional revenue still to be received from a few non-banks and a few smaller banks.[8] Collections from the entities still owing debt will increase that profit.

Any objective viewer would see that as a win-win situation, but the con-

Pub. L. 102-242. Prompt corrective action, among other provisions, was adopted by this Act.

[5]To see how this works and has always worked, see Manias, Panics, and Crashes by Charles. P. Kindleberger. He concludes that all cycles have one thing in common — human greed.

[6]See Treasury press releases of October 14, 2008, and March 30, 2011.

[7]See Treasury press release of June 9, 2009.

[8]See Monthly Report to Congress, November 2013, TARP, U.S Treasury.

cept of the program was subjected to violent attack on the grounds of what appears to be misguided conclusions that it favored large institutions and was a taxpayer bailout of those institutions. That led to its firm rejection in the Dodd-Frank Act.[9] Absent congressional intervention at some future time when a similar concept seems like the only good solution to a problem that then exists, such a program as TARP will not be used again.

Instead, the government created a very complicated scheme of mortgage finance regulation (it's not quite completed since the credit risk retention regulation has not been finalized), left the GSEs in conservatorship without adopting a viable replacement (and because they have begun to distribute large profits to the government are becoming more of a threat to continue), has not yet clarified the role of the FHA in markets such as those we have been experiencing for a decade, installed a newly created regulator to assume most of these enhanced responsibilities, imposed stiffer penalties for violations of the new regulations, and directly or indirectly pushed lenders to a specific set of government approved mortgages. Unlike the Home Loan Bank Board situation, however, they also provided increased staff (in fact a whole new agency), provided authority to penalize loan originators, and have moved beyond the RAP accounting system that caused such problems.

The concern is that the creation of such conditions will chill the innovative entrepreneurship of the industry. In fact, one could argue that this is exactly what is intended. It is not clear that this is the correct approach, although few would want to travel again the roller coaster ride that was the early part of the 2000s nor to expose consumers to some of the deceptions that were practiced. There are a variety of alternatives that Congress and the Administration could have taken, but they didn't, so we are stuck with what has been wrought.

What does seem clear is that the paternalistic supervisory approach of the Federal Home Loan Bank worked only in really good times when the savings and loan industry provided major subsidies. Once it was forcefully exposed to conditions that resembled a free market, its supervisors were seen to be inadequate for the job, the statutes under which Congress had them operate were also seen as inadequate, and the entrepreneurship of the participants

[9] Wall Street Reform and Consumer Protection Act, Pub. L. 111-203 (see especially Title II).

exploded in ways that destroyed the industry.

Time will tell whether the Dodd-Frank bill is another example of Congress successfully fighting the last war, but based on the chatter from the industry, it seems clear that a significant portion of the industry will switch to unimaginative operations to stay primarily within the safe harbor that the regulators have provided. Whether that will make more mortgage credit available to a greater proportion of our citizens only time will tell, but at this point, it seems unlikely. Whether it will ensure a safer residential mortgage finance industry does not seem to be the major driving force behind the statute and the regulations. That seems to be grounded in the concept that regulations should remove the risk to the consumer of borrowing money to finance a home, and while a reasonable goal should be to minimize the ability of lenders and third parties to mislead the borrower, the care with which this concept has been articulated threatens to remove the entrepreneurial spirit rather than harness it.

Bob Barnett is a partner with the law firm of ***Barnett Sivon & Natter, P.C.***