Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

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The Need for Trust in the Mortgage Market*

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Francis Fukuyama presented a thesis a few years ago that the countries that had the best chance for economic success were those that adopted the capitalist system and that had the ability to trust not only those within their nuclear family but persons outside of that narrow group.[1] To the extent that the ability to trust was replaced with an over reliance on entrepreneurial culture, then the prospects dimmed. While not his best known work, its thesis still is provocative and can be used as a guide toward economic success.

Trust is the basis of economic life in the United States. Absent the ability of strangers to enter into a contract and expect the counterparty to honor that contract, either willingly or through mandate from the judicial system, what we think of as normal economic activity would be difficult to imagine. Even absent a contract, parties expect others to follow the rules and to do what they say they will do. On that basis, it is trust that permits collections of individuals to aggregate and to create larger corporate bodies that can efficiently provide services and goods to consumers, the government and other corporate bodies. All of that is basically tautological.

But occasionally it is worthwhile to step back and see how well we are following that principle. For example, the revelation that parties contributing to LIBOR were not following the rules and were reporting rates different from those that they knew were required by the LIBOR rules is a glaring example of failure of trust. It may turn out that it was a compounded failure of trust if, in fact, more than one firm was engaged in erroneous reporting.

The inevitable results of failure of trust is written in bold face type in the present condition of our mortgage market. Systematic failure of administration was alleged by government in persuading firms to sign consent agreements relating to the methods by which they administered loan files of

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[1] Trust: The Social Virtues and the Creation of Prosperity

borrowers that were delinquent on residential mortgage payments. Brokers and other originators were alleged and, in many cases, found responsible for misleading consumers into borrowing money for mortgages of other purchases under terms and conditions more severe than the customer deserved. Appraisers and home builders were found guilty of illegally flipping houses to the detriment of communities and individual consumers.

Similarly, many consumers misrepresented their income, whether they planned to live in the home, their debts, and other key elements of what was necessary for a lender to decide whether or not they could repay the loans they sought. Rating agencies represented that their opinion was that certain securities were AAA securities, recognizing that many buyers assumed they had done appropriate due diligence and that such a rating was equivalent to saying the loans were really AAA, when in fact that wasn't the case. Senior officials in institutions cooked their books to assure themselves bonuses under company compensation plans, or if not that, pushed bad products out the door to get the same result.

When those practices in the residential mortgage area were combined with a greedy pair of privately owned but highly subsidized GSEs, and the Federal Reserve maintained an easy money policy that permitted heavy leveraging in the commercial, consumer and government sectors, then certain economic results were inevitable. In the recent economic collapse, those policies and those results coincided with foreign countries adopting similar policies creating a slush fund of money around the world that looked to find the politically safest and best returns. U.S. single family mortgage securities was the haven they found. All became tainted.

There are, of course, many other examples in many other fields (be they political, economic, athletic, or others) of just such abandonment of the need to be trustworthy. Would we have been better off as individuals or as a county had we remained trustworthy?[2]

Well, many individuals became very rich during the run up in the housing cycle, and did so even though they engaged in what anyone would call nefarious practices. The fines they have been assessed, in those cases in which fines have been assessed, do not equate with the money they accumulated,

[2]Trust and a group belief in the need for a rule of law are a matched pair in many respects. But there are occasions when the law is ambiguous; actions that will generate and maintain trust never are.

so for them, not being trustworthy paid off. That is too bad.

Similarly, many consumers that lied on their applications, including those who were obtaining loans for a number of home purchases and calling each a home in which they planned to live, may be in the process of benefitting from government programs that encourage lack of trust in the future. For example, even though they had failed to honor their contracts, they are receiving payments because a servicer failed on certain administrative tasks, such as failing to have a notary stamp a document appropriately. Meanwhile, homeowners with the same disposable income that have been extremely prudent and responsible are not sharing in the government supported bounty; they have struggled to make their payments, and chosen not to buy the new car, the new cell phone, the new cable movies. Others not so responsible simply stopped making mortgage payments knowing that new government laws or programs would effectively let them live rent and payment free in a house beyond their means for years.

What are the results of all of that? Did everyone benefit like those few just mentioned? Economies are complex, of course, and it is foolish to make a direct causal connection between isolated examples. Nevertheless, the programs that have been adopted to favor delinquent or foreclosed borrowers may well leave an impression in the minds of many consumers that mortgage payments no longer need be the first payment to be made each month, and as a result, the mortgage loan may contain an element of risk (voluntary slow or deferred payments) that did not earlier exist. If so, that will have to be priced into all mortgage loans going forward, making all mortgages more expensive for consumers.[3]

Not unreasonably, legislatures have fought the previous battle, and passed laws that will tighten credit severely. They have managed to impose not trust but authoritative discipline on the market, and as a result, thousands of persons that history has shown could own a home will not own one; after all, most of even the subprime loans were repaid. Regulators are following the lead of the legislatures, and in the case of state officials, all levels of government have seen housing as a good one to pile on — it's an electable sound bite. The vibrant housing secondary market has effectively shut down except for the government supported GSEs, now in conservatorship. The GSEs, forced into conservatorship with the collapse of the sector and their

[3] See "***Caution: Mortgage Payments May be Losing Their Priority***," Our Perspectives, June, 2012.

poor management, have changed the rules of the game on put backs and have forced losses onto institutions that had no advance notice that the GSEs would change those rules. To get a mortgage loan now requires excellent credit and a large down payment — many prospective borrowers are left out, and once the regulations are adopted that are currently being debated on ability to repay and retention of risk, those tight conditions will be written in the books. Our economy has stagnated, with the anemic housing sector being one of the principal causes, while the economy of many European nations has cratered, in great part because of the housing tailspin.

These are not desirable results. They would not have happened had there been more adherence to Fukuyama's first principles.

For example, if with respect to the mortgages that ultimately became delinquent, the borrowers had entered full and accurate data on their applications, and had brokers not changed those entries to ensure that the application would be accepted (because the application no longer expressed facts), and had the lenders not compensated originators in a way that encouraged them to place borrowers in more severe terms and conditions than some of them warranted, and if appraisers had insisted upon accurate appraisals at all times, and had securitizers packaged mortgages only after real due diligence, and had rating agencies truly rated the securities without concern for the reaction of the securitizers, and had bonuses on these products and services been withheld until there was proof the mortgages were being repaid — had all of this and similar straight forward actions been done — we would not have had the same housing crisis that tainted the world's economies.

Yet, there is nothing complicated about any of these actions. They simply required an understanding that taking actions that cause people to trust you both in the short and long run are the right actions to take.

This does not suggest that had everyone been acting "properly" there would have been no housing cycle. Unemployment numbers have been very high, and it is doubtful that they are that high simply because brokers fudged applications for residential mortgages. There are other factors at play, and higher unemployment will lead to more mortgage delinquencies. We would have had a housing cycle — we always have had housing cycles and always will have.

We would not, however, had had a cycle that has plowed under long held assumptions and practices about residential mortgage lending, and replaced them with what is moving toward the paternalistic housing supervision and regulation of the now defunct Federal Home Loan Bank Board, exacerbated by alert AGs and banking regulators that previously were content to let the Federal Government handle most of these issues. We would not have collapsed the GSEs and changed them into institutions that have turned their back on their own long-held practices on what should be put back. We would not have blown up the credibility of the rating agencies, or basically eliminated the mortgage broker industry and mortgage lending to borrowers without prime credit, or smacked the secondary market in the solar plexus.

Fukuyama is right in concluding that a society in which trust is an integral part of the economy will have the greatest long term success. One proof can be found in the present condition of the residential mortgage market and its regulation and supervision.

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