Ten Years Since the Financial Crisis: Some Lessons for Reducing Risks to Households

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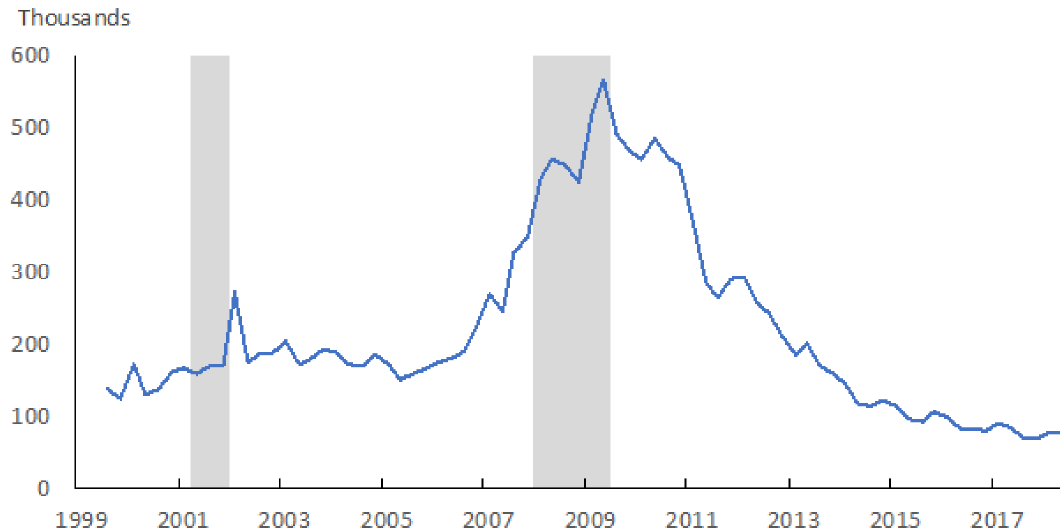
* The views expressed in this presentation do not represent those of the Federal Reserve Bank of Chicago or the Federal Reserve Board.

Whither mortgage market reform?

- We highlight three goals for mortgage market reform that would mitigate risks to households
  - Make households more resilient to shocks
  - Reduce taxpayer exposure to losses
  - Avoid periods with “unduly limited access” to mortgage credit
- Reducing hardships and disruptions for households would also lessen risks for financial institutions and dampen propagation of macroeconomic shocks
- In contrast, many proposals for mortgage market reform make specific recommendations on institutional design of new system
  - E.g. Johnson-Crapo, Bright-DeMarco, MBA, etc.

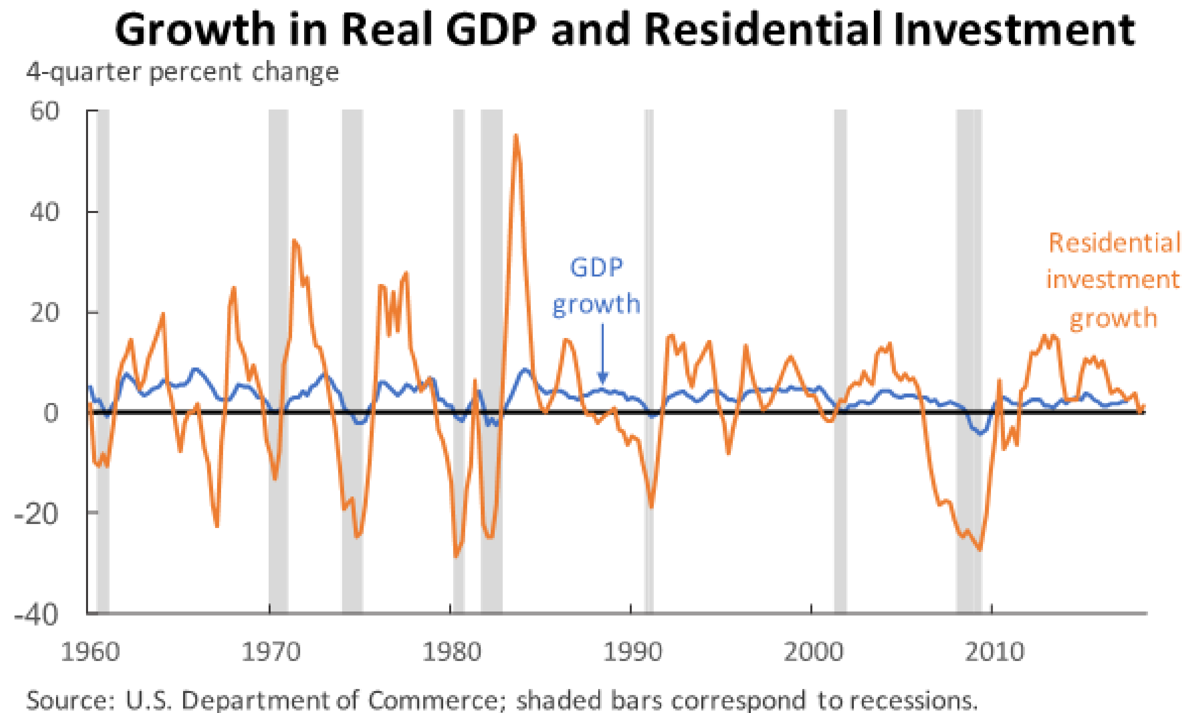
Many Sources of Risk



- Idiosyncratic economic risks
- Aggregate economic risks
- Institutional factors related to mortgage markets
- Bad actors and abuses

Financial crisis revealed aspects of mortgage market that need to be preserved and vulnerabilities where reforms are necessary.

Lesson #1: Procyclicality of Mortgage Credit Drives and Amplifies Business Cycles

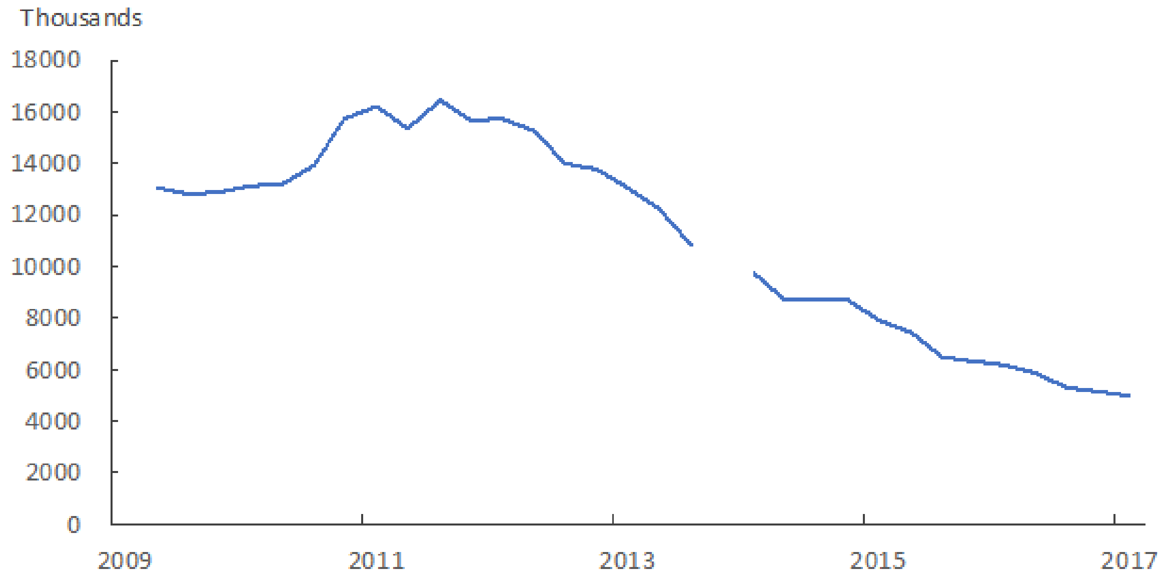


- Provides rationale for government intervention in mortgage market
- During Great Recession, government involvement helped support flow of credit
  - Implicit/explicit guarantees
  - Low DP loans available through FHA
- Reform should feature policies that:
  - Support lending in bad times
  - Weigh against excessive risk-taking in good times

Lesson #2: Design of Mortgage Market Affects Monetary Policy Transmission to HHs

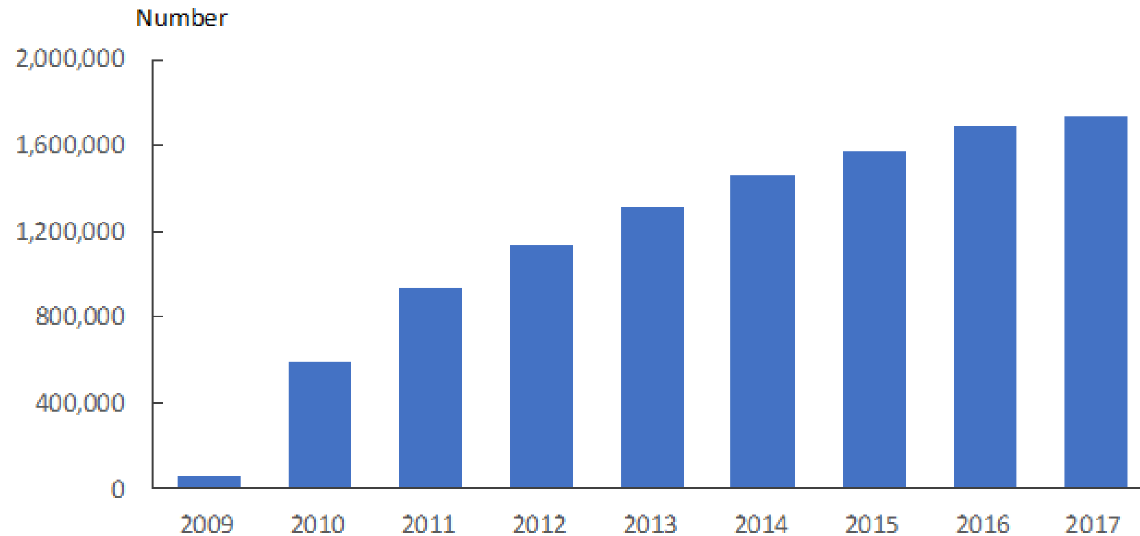
- During downturns, monetary policy stimulus reaches households via lower rates on ARMs and FRM refi's (Dudley 2012)
  - Support higher consumption (Di Maggio et al. 2017)
  - Help households avoid delinquency and foreclosure (Fuster and Willen 2017)
- Major obstructions to monetary policy stimulus during Great Recession
  - Credit standards tightened
  - Negative equity impeded refi's
  - Few borrowers have ARMs
  - Lender capacity constraints
  - Lender concentration
- Reforms that ease frictions would make monetary policy stimulus more effective
  - Such as through auto refi's of underwater borrowers, countercyclical adjustments to mortgage payments

Lesson #3: Negative Equity Is Costly & Leads to Delays in Deploying Assistance



- "Double trigger" view of negative equity (Foote et al. 2008)
- Politics of negative equity are complicated and slow the deployment of borrower assistance
- Policy should aim to make negative equity less consequential during downturns
  - For example, innovation in mortgage contract design could help

Lesson #4: Assistance Delayed for Other Reasons



- Design mistakes
- Regulatory uncertainty
- "Put back risk"
- Servicer capacity constraints and incentives
- Reforms should allow for assistance to be deployed quickly and at scale

Lesson #5: Not Just "Housing" Policy

- Countercyclical monetary and fiscal policies support housing market during downturns
- Social insurance programs play important role in lessening impact of income disruptions
  - Unemployment insurance extensions prevented more than 1.3 million foreclosures
  - ACA's Medicaid expansions have lowered likelihood of financial distress
- Are we prepared for the next recession?
  - ZLB & limited fiscal capacity provide pessimistic view
  - But policymakers will need to strengthen social safety net in next downturn

Lesson #6: Ongoing Conservatorship Keeps Taxpayers at Risk

- In 2008, taxpayers "bailed out" GSEs with $187.5 billion
- Currently, taxpayers provide $254.1 billion backstop
- If another large downturn were to occur, taxpayers would need to provide tens of billions of dollars to cover GSE losses
- Taxpayers are likely not compensated for the risks they bear
- Reforms that reduce these risks – or allow for compensation – would benefit all taxpayers

Do Economic Objectives Help Achieve Goals?

- Taming the credit cycle is an economic objective that helps achieve goals but there are tradeoffs and risks
  - Policy tools provide benefits
  - But also costs – e.g. macroprudential regulation and consumer protection entail risks for access to credit, e.g. limiting innovation, raising compliance burdens, and uncertainty in "how much"
- Streamlining the ex post renegotiation of mortgage contracts or limiting costs of negative equity may come at the expense of more complexity
- Reforms that would mitigate taxpayer exposure to mortgage market risks are worthy but politically challenging
- Policymakers will need to weigh tradeoffs and understand risks but our view is that goals will not be met unless economic objectives achieved