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

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October 12, 2018

* 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