

# Ownership = Equity

CHARLES W. CALOMIRIS AND JOSEPH R. MASON<sup>†</sup>

The “democratization of finance” of the past two decades reflects improvements in the pricing of risk and the deepening of mortgage-backed securities (MBS) markets that will continue to provide greater market access for lower-income people. But some innovations should not persist. One practice that has contributed to the recent spike in subprime market defaults has been permitting mortgagors to own homes without making a significant commitment to accumulate home equity, which in many cases has resulted in home renting in the guise of home ownership.

Does it make sense to allow borrowers with poor credit history and no savings to invest in a home to buy homes with 100% or even up to 125% loan-to-value ratio mortgages? Some lenders and MBS investors did so hoping that home price appreciation would provide the equity cushion for mortgages, which would incentivize borrowers to make payments and maintain their homes and protect MBS investors from the risk of loss. This lending strategy is risky, but it often does result in the eventual accumulation of equity by the borrower.

In reality, however, future equity often did not grow, even with rising home prices. A number of borrowers were unwilling, rather than unable, to allow their rising stakes to remain invested in their homes. They obtained the same 100% to 125% loan-to-value ratio mortgages on cash-out refinancings (CORs), and were able to pocket and consume value appreciation as it occurred. From 1995 to 2005 home equity extraction through CORs increased from under \$14 billion to almost \$245 billion and cash available for extraction through home equity lines of credit increased from \$332 billion to over \$1 trillion.

There is plenty of blame to go around for the experiment in equity-free quasi-homeownership. Rating agencies (the gate-keeping stress testers in the MBS market) employed overly optimistic default scenarios that did not properly take into account important features of the current mortgage market (including the use of interest only mortgages and the understatement of default risk because of the failure to disclose mitigation practices -- more on this below). Mortgage brokers, MBS originators, the appraisal industry, mortgage servicers, and real estate developers, all of whom also gained from the excessive optimism, fed the frenzy

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<sup>†</sup> Charles Calomiris is Henry Kaufman Professor of Financial Institutions at Columbia Business School and a Senior Fellow at the American Enterprise Institute. Joseph R. Mason is Associate Professor of Finance and LeBow Research Fellow, Drexel University LeBow College of Business, Senior Fellow at the Wharton School, and Visiting Scholar, Federal Deposit Insurance Corporation.

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with projections of never-ending price rises. Government-subsidized credit and the mortgage interest deduction stimulated demand.

Of course, risk overreach is par for the course when new products and financing structures are combined with ample market liquidity, as in recent years. Market participants are now adapting, putting hard-headed thinking back into stress tests, and requiring that homeowners have some of their own “skin in the game” in the form of a significant downpayment. Note that, thanks to existing government programs, “significant” remains quite small. The Federal Housing Administration (FHA) permits downpayments on mortgages that it guarantees of as little as 3% on new mortgages and 5% on refinancings.

Politicians, however, don’t always learn from markets, and some would take us even farther into the brave new world of zero- or negative-equity mortgages. Last week, Ohio joined Maryland, Rhode Island, Massachusetts and Virginia by implementing their \$100 million refinancing program to allow borrowers burdened by a “lending product that no longer meets their needs” to further increase their loan-to-value ratios. A recent House bill sponsored by Maxine Waters and Barney Frank would offer zero-downpayment loans through a “revitalized” FHA.

From a public policy perspective, it makes no sense to support zero-equity mortgages. Like renters, such borrowers purposely avoid building the home equity that forms the basis of incentives for borrowers to act like homeowners. A person’s home has historically been their principal savings asset. The primary motivation for government subsidies for mortgagors (the mortgage interest rate deduction, FHA guarantees, and the panoply of other programs designed to make mortgages more affordable for lower-income people) stems from the view that home ownership and saving breed better citizens by ensuring that people are more invested in their communities. But borrowers with nothing to lose from default and no equity built up as savings are not invested in their communities, and should not be supported by government subsidies.

Some mortgagors are at risk of being unable to meet their payments, especially as interest rates rise. But there are ample private and government-subsidized means for mortgagors to refinance or renegotiate their mortgages to avoid the consequences of spikes in mortgage servicing costs. The proper policy response is not to pretend that all mortgages can be repaid, and add leverage as needed, but rather to reinforce market changes that would restore proper risk management.

Illiquid mortgagors that have a reasonable chance of meeting debt service obligations already enjoy access to many refinancing options, including through FHA programs. Beginning in the mid-1990s, Fannie Mae and Freddie Mac adopted new “mitigation” practices. Similar practices were formally adopted by the FHA in 2002. Over the past decade there has been a dramatic change in the treatment of delinquent mortgagors. In 1998, a mortgage that was 90 days delinquent had a 77% chance of being foreclosed as the result of that delinquency. By 2002, that probability was 15%. FHA, Fannie and Freddie now require originators to offer delinquent mortgagors a range of renegotiation

options, including rescheduling or forgiving interest, reducing monthly payments, and extending maturities.

One reform urgently needed is requiring disclosure of mitigation practices so that rating agencies and MBS investors can make accurate assessments of default risk. Current practice hides mitigation information by failing to identify loans that have been mitigated. This has resulted in underassessments of risk in both the subprime and prime mortgage markets, contributing to lax underwriting standards.

Combining realistic credit standards, incentives to save rather than spend home equity, and sensible mitigation standards will deliver the appropriate outcome: borrowers willing to commit wealth to own (build significant equity in) a home will be able to do so, and illiquid but long-term creditworthy borrowers will be able to renegotiate mortgage payments to avoid unwarranted foreclosures.

Charles Calomiris is Henry Kaufman Professor of Financial Institutions at Columbia Business School and a Senior Fellow at the American Enterprise Institute. Joseph Mason is Associate Professor of Finance at Drexel University's LeBow College of Business.