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Making Financial Regulation Work: Overseeing Lending

This is part of a series on The Hearing called "Making Financial Regulation Work." This guest post was written by Georgia Tech professor Dan Immergluck.

The **White House** has floated a proposal to replace the somewhat byzantine arrangement of federal banking regulators with one agency, essentially by combining the **Office of the Comptroller of the Currency** and the **Office of Thrift Supervision**. It would leave systemic risk regulation and resolving insolvent institutions to two other agencies that currently supervise banks -- the Federal Reserve and the FDIC. The initiative has already met with stiff resistance from some in Congress, special interest groups and the agencies themselves.

Before getting into the gory details of a new regulatory system and mounting what promises to be a hard-fought restructuring attempt, it is best to begin with a set of key principles. There is certainly more to banking regulation than mortgage markets, but it is important to identify such principles market-by-market. The following six principles will provide for stronger and more resilient federal regulation of mortgage markets.

The first principle is simply a recognition of what has become painfully obvious on Main Street — that the costs of failing to regulate mortgage markets adequately are enormous. Much of the inside-the-Beltway debate over mortgage regulation in the past 30 years has operated within a frame of balancing the protections of consumers against the "burden" of stronger regulations, and those arguing against constraining lenders in any way have usually won the day. In the past 10 years, numerous opponents of regulation suggested that even modest constraints on high-cost loan markets would reduce the welfare of society. Consumer advocates even found themselves arguing that stronger regulation would not reduce subprime lending. Most observers would now agree curtailing subprime activity would probably have been beneficial.

Second, entire communities -- as well as individuals – are hurt by irresponsible lending. Access to sound, responsible mortgage lending is a public good, and breakdowns like those in the mortgage crisis impose great harm on many who have done nothing wrong. While consumer protection is critically important, considering harm to only borrowers and lenders is not sufficient. In this arena, the broader set of consumers are the communities into which mortgage credit flows, which are harmed by plummeting property values and vacant and blighted buildings.

Third, consumer disclosure -- by itself – has proved wholly insufficient at protecting consumers. The basis for relying almost exclusively on this tool lies in a theoretical notion that highly detailed and documented disclosure of loan terms will result in borrowers obtaining the most suitable loans. Unfortunately, this reasoning fundamentally confuses

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information with knowledge. It also requires borrowers to act “rationally” and make intelligent choices in an inherently complex and risky arena. Individuals who face complex financial decisions often simplify them into one or two basic choices. Borrowers also tend to rely on mortgage brokers or lenders to direct them to the most suitable loan product, even when these actors have incentives to do otherwise.

Fourth, regulation must promote lender and investor accountability. Regardless of the path that capital takes while flowing into mortgage markets, lenders and investors must be accountable for the loans they fund. Thinly capitalized originators should not be able to be used as shields against financial or legal liabilities. Financial accountability — so that originators, securities issuers, investors, and other parties have “skin in the game” — is key. Securitized lending was thought to provide some level of accountability, for example, by requiring originators to buy back loans that they sold if they defaulted early. However, when these “kickouts” reached very high levels, thinly capitalized originators could file for bankruptcy. Securitizers and investors in the credit supply chain should also have legal, and not just financial, accountability. In practice, this is implemented through “assignee liability” provisions in regulation, in which those purchasing or investing in loans are held liable for problems in the origination of a loan. Assignee liability would bring transparency to the entire chain of the mortgage funding process.

Fifth, policy goals concerning homeownership should focus on sustainable and beneficial ownership. Much of the political support for not regulating subprime lending essentially employed the argument that any homeownership was good homeownership. Yet, the very high default foreclosure rates of subprime loans, even before 2007 and 2008, had already shown that subprime homeownership was risky for the borrower. Moreover, even when subprime loans do not result in default, their high costs often mean that they reduce the net present value of the buying-vs.-renting decision so much that the odds of ownership being a wise financial decision become quite small. This is not to say that homeownership cannot be beneficial for some modest-income households, but financing costs and default risk are key determinants of whether homeownership makes sense for a family. Given lower probabilities of rapid home price appreciation in most places, high-cost financing will become even more likely to result in negative returns to homeownership.

Finally, a fragmented system of regulation that enables lenders to shop for the friendliest regulator does not promote a sustainable or fair mortgage market. The system that currently exists involves internecine struggles between regulatory fiefdoms. There certainly is a case to be made for overlapping federal and state jurisdiction, especially when federal regulation has proved too lax. There is much less rationale for offering lenders a menu from which they can select their supervisors and rules. All types of lenders should be subject to the same level of federal supervision and the same regulations. In the past, the riskiest lenders tended to receive the least routine scrutiny. Policymakers should also severely limit any federal preemption of state consumer protection or fair-lending policies. If state legislatures wish to enact laws that include stronger laws to protect their citizens, they should have a right to do so. An effective dual federal-state system will put pressure on federal regulators to not be too lax in their own rulemaking and supervision.

For well over a year now, numerous commentators have suggested that stronger regulation of mortgage markets is somehow inevitable. Those who have witnessed mortgage lending regulatory debates over the past two to three decades know better. There are immense bureaucratic and special interest forces that will attempt to block meaningful reform. Unfortunately, minor tweaks will do little to prevent the next mortgage crisis. Given the stakes involved, it is important that any redesign of this regulatory system begin with some basic principles aimed at fundamentally reorienting the nature of the policy debate in this arena.

--**Dan Immergluck** is an associate professor of city and regional planning at **Georgia Tech**. The essay is derived from his recently published book "Foreclosed: High-Risk Lending, Deregulation and the Undermining of America's Mortgage Market."

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