Boston College Journal of Law & Social Justice

Volume 37
Issue 2 *Has the Mortgage Pendulum Swung Too Far? Reviving Access to Mortgage Credit*

Article 5

May 2017

Discussion of Papers on Cyclicality in Mortgage Markets

Edward J. Kane
Boston College, edward.kane@bc.edu

Follow this and additional works at: https://lawdigitalcommons.bc.edu/jlsj

Part of the Banking and Finance Law Commons, Housing Law Commons, Law and Society Commons, and the Property Law and Real Estate Commons

Recommended Citation

Edward J. Kane, *Discussion of Papers on Cyclicality in Mortgage Markets*, 37 B.C.J.L. & Soc. Just. 295 (2017),
https://lawdigitalcommons.bc.edu/jlsj/vol37/iss2/5

This Symposium Article is brought to you for free and open access by the Law Journals at Digital Commons @ Boston College Law School. It has been accepted for inclusion in Boston College Journal of Law & Social Justice by an authorized editor of Digital Commons @ Boston College Law School. For more information, please contact abraham.bauer@bc.edu.

DISCUSSION OF PAPERS ON CYCLICALITY IN MORTGAGE MARKETS

EDWARD J. KANE*

Abstract: The mortgage market can be portrayed as a complicated machine that processes information and disinformation to help lenders and would-be homeowners to fashion an enforceable and fair set of mutual obligations. The papers in this symposium issue focus on ameliorating cyclical speed-ups and slowdowns in the lender-operated parts of this machine. My discussion focuses on two issues: (1) how transitioning to a gig economy is changing household needs for owner-occupied and rental homes across different age groups; and (2) how to use the legal system to lessen the informational disadvantage that would-be homeowners face in understanding the deals they are offered.

INTRODUCTION

U.S. mortgage markets can be likened to a gigantic machine with many real and financial "moving pieces." These pieces move cyclically and are too many to be covered in a few papers. Table 1 lays out my understanding of the main parts of this machine and sorts out which of these parts have and have not been specifically addressed so far in this session.

I. LAURIE GOODMAN'S PAPER: COMPLICATIONS IN THE LENDING PROCESS

Among the things that make mortgage markets different from other financial markets are the ways borrower information is assembled, verified, and used. Lenders burned by bad information during the housing bubble need to rethink how they generate, double-check, and use measures of household creditworthiness.

Laurie Goodman (Goodman 2017, 239–43, 247–49) produces evidence of a post-crisis slowdown in resetting three parts on the supply side of the machine:

> 1. Lending standards, especially FICO scores: Realtors and lenders are learning more and more about how to inflate scores artificially, so that threshold scores must move up as well, if only to compensate for this bias.

© 2017, Edward J. Kane. All rights reserved.

* Professor of Finance at Boston College and Research Associate at the National Bureau of Economic Research. Email: edward.kane@bc.edu.

2. Regulator and investor resistance to nontraditional mortgage contracts: This reinforces lenders' difficulty in laying off mortgages which reflect low FICO scores.
3. Servicing costs for Federal Housing Administration (FHA) loans.

To complement her presentation, I want to call attention to parallel slowdowns occurring on the *household demand side* of the machine. My main point is to note that homeownership has become more than ever an obstacle to job mobility and to relocation on retirement. Relatedly, the career economy and gig economy differ in ways that affect the age and ownership structure of household demand for mortgage credit:

1. In the career economy, employees had to provide evidence of their loyalty to the employer. In part, owning a home bonded an employee's loyalty to his or her employer and community. Employers responded in ways that encouraged or discouraged particular employees to move up or out.
2. In the gig economy, it makes much more sense to rent, especially at the beginning of one's career. If an employer wants high-value employees to show loyalty to their firm, the employer will selectively bond the career options it has to offer and make sure that benefits improve progressively with length of service.

In my opinion, the changing role of loyalty in employer-employee relations is fueling extra-long delays in reworking and restoring major pieces of housing and mortgage demand today. These delays include:

1. *Delays in launching* the careers, family sizes, and mortgage debt of unemployed and underemployed young people: Increasingly dismal career prospects for those without at least some college education raised the percentage of 18- to 34-year-olds living at home in 2014 to 32%. (Fry 2016, 4–5).
2. *Delays in launching* moves to warmer climates by would-be-empty-nesters who are still housing adult children or in neighborhoods hurt badly by the crash.
3. *Delays in turning over homes* and temporarily lower prices in warm-weather states for homeowners planning to move into assisted-living facilities.
4. *Delays in launching* new ways for Congress to deliver mortgage-related subsidies to lenders, builders, realtors, and landlords. The shape of reform of the government-sponsored enterprises (GSEs) remains unknowable, while post-crisis investment in a

common GSE securitization platform is going to make it all the harder to replace the GSEs with something entirely new.

II. McCoy-Wachter Papers: How to Ameliorate Cyclicality in Trust

The McCoy-Wachter papers (McCoy & Wachter 2017a; McCoy & Wachter 2017b, 377–78) pay special attention to the difficulty of relying on representations and warranties in the distrustful environment the housing crash has produced. Trust is always in short supply and adverse information is hard to surface. These authors explain why trust is particularly lacking today. Their work carefully documents the way that attempts to substitute *assurances* for due diligence expand and deteriorate in quality as a boom goes on.

The exercise of pre-deal and post-deal due diligence goes through a cycle that parallels the boom and bust of housing and mortgage cycles, but in reverse. The loss of trust created by the overexpansion and deterioration of shortcuts for diligence in the boom makes lenders and borrowers in the ensuing bust and recovery more skeptical than they need to be.

III. Different Ways of Restoring Trust

Representations and warranties are not the only class of due-diligence substitutes. Third-party guarantees and opinions about collateral values, credit ratings, and audited accounts show the same kind of overexpansion and deterioration in quality during real-estate bubbles.

Following in the tradition of the literature on financial regulation, McCoy and Wachter study the problem of restoring trust in due-diligence substitutes as a two-party contracting problem. They propose to build a better contract paradigm by making improvements in the dimensions of bilateral negotiating space. To do this, they recommend imposing enhanced supervisory safeguards against over-lending and introducing specific changes in the language of standard contracts. These improvements would expand the civil remedies and rights of redress available to the party buying opinions and bond more effectively the duties of professionals who supply reps and warranties.

But adverse societal losses from fraud can also be reduced by rewriting the laws of fraud as they apply to professional financiers. In my opinion, the burden of proof currently set for complainants by U.S. financial fraud law is so severe that it invites mortgage professionals to lie.

Let me remind you of the five *cumulative* common-law tests for fraud (Bear and Maldonado-Bear 1994, 173–174):

1. A conscious misrepresentation or concealment of the truth;
2. An intent to benefit by causing another party to rely on the untruth to his or her detriment;
3. The misrepresentation was material (i.e., directly related to the harm caused);
4. There was an intent to cause the other party to rely on the misrepresentation to his or her detriment;
5. That the other party did reasonably believe, rely, and suffer provable harm.

With respect to the exchange of expert opinion in financial activities, it would be useful to rewrite the laws of criminal fraud to weaken either or both of its demands for proving intent. I believe that the mortgage securitization bubble demonstrates that society has a special stake in exchanges of information. Collecting fees from customers based on willfully or negligently unfulfilled promises of competence, loyalty, and careful work is a form of *theft*: a scam. Particularly in the gig sector of the knowledge economy, society needs to disincentivize knowingly destructive material misrepresentations by high-paid credentialed professionals. This can be done by replacing the traditional intent tests in the common-law definition of civil and criminal fraud by *presumption of knowledge tests*. When persons supplying falsified information are acting in a professional capacity and paid handsomely for their opinion, it should be enough for complainants and prosecutors to establish that defendants "knew or should have known" the adverse consequences to which they were exposing their customers and society at large.

I believe both that burden of proof in prosecuting violations of trust is too tough and that the punishments that are generally meted out are too light for these laws to have much of a deterrent effect. Demands for proof and available punishments should be in inverse proportion to the damage done to families and society at large. Our prisons today hold numerous individuals who are said to harm society by buying, selling, or possessing forbidden drugs. The task of proving these allegations is made particularly easy by the existence of bright-line tests for establishing the occurrence of these crimes.

In view of the far greater damage done by actions that contribute to financial crises, it is fair to ask why the prosecutorial bar does not rebel against financial fraud and negligent-misrepresentation laws that are plainly overly hard to prosecute. My answer is that these are crimes that are committed by society's elites and the elites and the politically well-connected have rigged the system against the rest of us.

Unlike say, drug laws, these laws are written to protect high-status offenders from exposure to harsh punishment. These offenders are allowed to

arm themselves with the best lawyers in the business. These lawyers are encouraged to paint their clients as "good people who have done one bad thing," albeit repeatedly. Finally, the career ladder for regulators and prosecutors may foster a counterproductive fear of reprisals for challenging a high-status defendant's case too aggressively. Strengthening their obligation and ability to enforce the nation's antifraud law would send a message that would ease that fear of reprisals.

Replacing each of the intent tests in financial fraud laws with a knowledge test would create a much stronger disincentive to exploiting clients, creditors, and taxpayer guarantees and undermine the extent of the impunity conveyed by golden parachutes and corporate settlements that do not document or admit wrongdoing.

Giving hell-or-high-water pension rights to top executives cements the implicit conspiracy between megabank stockholders and managers to take undue advantage of others. It is not healthy for society to allow executives whose passion for exploitive short-term profits led them into forms of deal-making that unduly risked the survival of their firm to mischaracterize and deny their bad behavior by settling complaints against them with corporate monies and retire with an unencumbered stream of handsome future income.

CONCLUSION

Lenders move in and out of the nation's mortgage markets every day. But households do so only several times in a lifetime. This leaves the average borrower at a severe disadvantage in understanding the disinformation buried in the deal conveyed by the daunting pile of papers they find themselves asked to sign. This makes trusting borrowers a boon to fraudsters and a danger both to themselves and to society at large. To my mind, the best substitute for enhanced borrower due diligence is to frame and enforce an easier-to-prosecute set of lender fraud laws.

BIBLIOGRAPHY

Bear, Larry, and Rita Maldonado-Bear, 1994. *Free Markets, Finance, Ethics and Law*. Englewood Cliffs, NJ: Prentice-Hall, 172–208.

Fry, Richard. 2016. For First Time in Modern Era, Living With Parents Edges Out Other Living Arrangements for 18- to 34-Year-Olds. Washington, D.C.: Pew Research Center. Available from http://www.pewsocialtrends.org/files/2016/05/2016-05-24_living-arrangemnet-final.pdf [https://perma.cc/Z6QP-Z5MM].

Goodman, Laurie. 2017. Quantifying the Tightness of Mortgage Credit and Assessing Policy Actions. *Boston College Journal of Law & Social Justice*. XXXVII: 235–66.

McCoy, Patricia A. and Susan Wachter. 2017 (2017a). Representations and Warranties: Why they did not stop the crisis. *Evidence and Innovation in Housing Law and Policy*. Lee Fennell and Benjamin Keys, eds. New York: Cambridge University Press.

McCoy, Patricia A. and Susan Wachter. 2017 (2017b). Why Cyclicality Matters to Access to Mortgage Credit. *Boston College Journal of Law & Social Justice*. XXXVII: 361–94.

Table 1. Taxonomy of Cyclically Moving Parts in U.S. Mortgage Markets

1. Population Structure: Locational distribution* and differences in cultural norms in different age* and ethnic subpopulations
2. Labor Markets:
   a. Mismatch in locations of unfilled jobs and housing vacancies*
   b. Establishment of career prospects *vs*. gig-by-gig contracting*
3. Adaptability of existing housing stock to shifts in demand for apartments, starter houses, upgrades, and retirement facilities*
4. Cycle in the Flow of New Homes: *gestation lags* cause overbuilding due to prices rising above production costs in booms and leave us with excess supply and fire-sale pricing in busts
5. Cycle in the degree of due faith and due diligence embodied in lending standards
   a. Impact of contract law and regulations on the enforceability of contracts
   b. Impact of professional culture and criminal law*
6. Political influence on:
   a. The size of explicit and implicit subsidies flowing to owners, builders, realtors, and financial institutions
   b. The character and enforceability of fraud laws†
   c. The character of mortgage terms and protections

* Not explicitly explored in the presentations under discussion
† Only lightly touched upon in these presentations