Are countries prepared for the next recession?

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By

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Introduction

'Act now on world turmoil', says the International Monetary Fund in a recent speech by David Lipton[1], the watchdog's second in command. The global economy is 'clearly at a delicate juncture' and the 'risk of economic derailment has grown'. 'A sharp retrenchment in trade is taking place' as economies around the world have slowed down.

'Credit boom shows signs of bursting'[2] warns the Bank for International Settlements. Global debts now stand at over 200% of GDP, exceeding levels seen before the financial crisis of 2007.

With warnings from these global institutions, it may be appropriate to raise the questions: 'Are countries prepared for the next recession?' 'Are central banks equipped to deal with such recessions or have central banks used all their ammunition?'

The IMF was set up with a primary purpose to ensure stability in the system of exchange rates and international payments. It advises governments through its surveillance reports for its 188 member states and it has at its disposal about $1.2 trillion to help countries in financial difficulties. It is a government-to-government organization, acting as lender of last resort to governments, when needed.

The main objectives of central banks are external and internal. An external aim is to maintain stability of the currency against other currencies. The internal aim is to ensure that the value of the currency is maintained in purchasing power terms. Another internal aim is to supervise banks and act as lender of last resort for the banking sector, sometimes including non-banks operating in the financial sector, like pension funds. Finally some central banks have domestic economic objectives, like the aim to achieve a high level of employment.

In this institutional set up, there appears to be a missing link. Which institution has been or should be designated as lender of last resort to individual households? Privately owned banks cannot fulfill such role as their aim is to recover all money due when a loan facility is no longer serviced on time. Central banks cannot do it either, as their role is to supervise the banking sector. The U.S. experience as described by Dr. Bernanke in his book: 'The Courage to Act' was that no consensus could be reached over the manner of how to deal with foreclosure proceedings and home repossessions. In the U.S. over the period 2006-2013 21.3 million households, who faced foreclosure procedures, were left

[1] http://www.imf.org/external/np/speeches/2016/030816.htm
[2] http://www.telegraph.co.uk/business/2016/03/04/debtor-days-are-over-as-bis-calls-time-on-world-credit-binge/

to their own devices and 5.8 million households paid the ultimate price in having their homes repossessed.

This paper will set out the case for establishing a new tool of economic policy: a National Mortgage Bank (NMB), to be used only as and when the collective of individual households acting as long-term borrowers see their financial position weakened due to the threats of a recession. The tool can both be used as a preventive instrument as well as a corrective one. Without its existence such actions cannot be taken. It will be the households' equivalent of lender of last resort.

1. Why a National Mortgage Bank may be needed

1.1. Different patterns of a financial crisis for a government, the banking sector, companies, investors and individual households.

One may wonder if the nature of a financial crisis is the same for a government, for companies, for banks and investors and for individual households acting as borrowers. A government ends up in trouble when it cannot or does not raise sufficient taxes to service its government debt. It might need outside help to survive or it might have to depreciate the value of its currency towards other currencies. Companies may get into financial trouble for all kind of reasons: low demand for their goods or services; a wrong type of financing a company's debt compared to its equity base; international competition based on lower overseas product costs and changes in commodity and other input prices for instance. Banks may also get into financial difficulties if the quality of their loan book deteriorates dramatically or if depositors take fright about a bank's stability and start a run on a bank. Investors may panic when obligations on payments due to them are not fulfilled or when expectations about future economic developments take a turn for the worse. Individual households may get into financial trouble through losing their jobs, through increases in the cost of funding their mortgage loans or through inflation levels of goods and services or tax increases exceeding their increase in income levels.

This summary of possible causes of a financial crisis for a government, for companies, banks, investors and individual households is not exhaustive, but it shows that the concept of a financial crisis is different for different households in a society.

In Ben Bernanke's book: "The Courage to Act"[3] the start of the financial crisis was evidenced by BNP Paribas' decision on August 9, 2007 to bar investors from withdrawing money from three investment funds that held securities backed by U.S. sub-prime mortgages. The bank indicated that it could not determine the value of its funds because of the "complete evaporation of liquidity". No investors were willing to invest in these funds any longer.

What caused the investor crisis in 2007 was the result of a financial crisis for individual households that had started in 2006 already. In the U.S. in 2006 545,000 foreclosures were completed. By 2007 this level had more than doubled to 1,260,000. Home repossessions did grow from 268,532 in 2006 to 489,000 in 2007.[4] Foreclosures and repossessions are a consequence of the mortgage-

[3] Ben S. Bernanke: "The courage to act" 2015, W.W. Norton & Company Ltd, ISBN 978-0-393-24721-3

[4] http://www.statisticbrain.com/home-foreclosure-statistics/

lending pattern to the collective of individual households during previous periods. The individual households' financial crisis had its origin in the change in outstanding mortgage levels. In 1997 the increase in outstanding mortgage levels was $180 billion; by 2005 it had increased nearly six-fold to $1.053 trillion.[5] Only from 2004 did sub-prime mortgages started to play a significant role. By 2008, sub-prime mortgages did not exceed more than 13%[6] of the total outstanding mortgage portfolio of just over $10 trillion. It was not just the sub-prime mortgage crisis, but the excessive home mortgage lending pattern over the period 1997-2005 that ultimately caused the collective individual households' financial crisis.

The investor crisis of 2007 led to the banking crisis of 2008. J.P Morgan rescued Bear Stearns in April 2008, but only with the help of a $30 billion non-recourse loan by the Fed. Worse was to come for other financial institutions, like Lehman Brothers and AIG for instance.

By 2008 consumer confidence had dropped considerably, house prices had shown a sharp drop and unemployment levels were up substantially.

The U.S. individual households' financial crisis had led to a full-blown economic and financial crisis for the U.S. and ultimately other countries' banking sectors, for worldwide investors and for the U.S. and other governments.

1.2 Consumer protection

In Ben Bernanke's book: "The Courage to Act", the issue of consumer protection is extensively dealt with (pages 98-106). Within the Fed a Division of Consumer and Community Affairs existed since 1998. According to the book, this Division had a relatively low status within the Board and lacked the resources of supervisors focused on safety and soundness. Not only that, but the Fed only supervised a relatively small number of banks, while State and other regulators supervised the majority of banks. In 1994 Congress with the support of the Fed passed the Home Ownership and Equity Protection Act (HOEPA), to outlaw abusive mortgage lending practices. The Act concentrated on predatory lending practices which included 'bait and switch' (borrowers receive a different type of loan than they were told to expect); 'equity stripping' (lending to borrowers without enough income to repay, with the intent of ultimately seizing their homes); 'loan flipping' (racking up loans and fees by encouraging repeated refinances) and 'packing' (charging borrowers at mortgage origination for unnecessary services). The HOEPA legislation aimed to prevent predatory lending practices, but not to impede 'legitimate' subprime access to the mortgage markets.

[5] http://www.federalreserve.gov/releases/z1/current/z1r-5.pdf and previous releases

[6] http://business.cch.com/images/banner/subprime.pdf

As the book describes, there were weaknesses in oversight in the run up to the financial crisis. The Fed was given the responsibility for implementing the law, but in many cases State and other supervisors had to execute it. Responsibility and oversight were often not in the same hands. In the meantime greedy and unethical lenders had made hundreds of thousands of bad mortgage loans. They were not stopped.

The conclusion out of the above is that, in the U.S., consumer protection was focused on stamping out bad practices in the mortgage-lending sector; in other words it focused strongly on actions of the lenders rather than on the impact to the borrowers. The HOEPA act has in its title "Equity Protection". When actions failed to stop the lenders, very little was done to protect the equity position of the borrowers.

There is a second, more relevant, conclusion. The impact of a national mortgage portfolio does not only depend on the quality of the mortgages granted, but also on the annual increase in mortgage lending volumes. As the U.S. experience showed, in 1997 the volume increase in outstanding mortgage levels was $180 billion. By 2005, this level had reached $1.053 trillion or a nearly six-fold increase. In this author's view, the influence of the volume effect has often been overlooked, while bad market practices have gotten most of the attention. Support for this statement can be drawn from the statistics of foreclosure proceedings and home repossessions. Over the period 2006-2013 21.3 million U.S. households were confronted with foreclosure proceedings. This number represented nearly 45% of all mortgagors. Compare this to the market share of subprime mortgages of 13% in 2008. Over the same period 5.8 million homes were repossessed; 1 out of every 8 households with a mortgage lost their home. They certainly were not all subprime mortgagors!

The Home Ownership and Equity Protection Act did not address the volume of lending aspect. Consumer protection at the macro economic level did not enter into the thought process in drafting the Act. The Act was aimed at eliminating bad lending practices rather than managing the effects of a mortgage-lending boom. Collective equity protection or in simple terms helping the 21.3 million U.S. households in financial difficulties was and has not been practiced in the U.S.

2. How setting up a National Mortgage Bank may serve as a macro-economic tool.

2.1 The creation of a lender of last resort for individual households

A National Mortgage Bank (NMB) would not be a mortgage lender or originator in the normal sense. One could not visit its office to obtain a mortgage. It is also not a Fannie Mae or Freddy Mac, organizations that facilitate long-term fixed rate mortgages. What it would be, is an instrument of economic policy, only to be called into action as and when the number of foreclosure proceedings start to grow substantially.

An increase in foreclosure proceedings has a detrimental effect on economic growth. In the case of the U.S. for instance, the pressure on households to repay outstanding mortgages along the agreed repayment schedules forced many households to forego expenditure on other goods and services. From 2008 two effects occurred: the first one was that collectively nearly all the 45 million households that had a mortgage started reducing their mortgage levels. The net effect was that over the period 2008 Quarter 3-2015 Quarter 1 the total level of outstanding mortgages dropped from $10.658 trillion to $9.372 trillion, reflecting a drop of just over 12% over this period. The second effect was that annual housing starts dropped from 1.8 million units in 2006 to 554 thousand in 2009 and continued to increase slowly to reach 1.178 million on an annualized basis by February 2016. With a growing population neither a reduction in the total outstanding mortgage portfolio and/or a reduction in new housing starts bodes well for economic growth levels.

In preparation for countering the next recession, countries could take the step to legislate for and subsequently set up a National Mortgage Bank.

2.2 How an NMB could operate

As the mortgage crisis originated in the U.S., it is probably appropriate to take this country as an example of how an NMB could work.

- Legal framework law: A law could be formulated which sets out the operating structure for an NMB, its legal rights and obligations, its funding structure and its first management set up;

- Ownership: Due to its character as a tool of economic policy, the NMB needs to be a 100% owned U.S. government entity;

- Start and closure of the operating period: A designated team from the U.S. government charged with economic policy decisions could instruct the NMB to start operating. The basis for such decision is a rapid increase in the level of foreclosure proceedings. The same team would decide when to close the operating period when the level of foreclosures drops off rapidly;

- Tools: The tools handed to the NMB will be to provide cash to individual households confronted with foreclosure proceedings. The quantum of cash received could vary from income class to income class, with for instance the lowest income class to receive up to 60% of monthly payments, the second group 50%, etc. These payments vary per mortgagor, but include an interest and a principal element. The duration of such payments could be decided by above designated team on basis of the status of the recovery. Company owned or other buy-to-let mortgagors may not qualify. During the economic recovery period the funds provided could be granted at 0% interest rate. During the designated 'economic recovery period' and thereafter a sub-ordinated mortgage would be granted to the NMB as security over the accumulated principal amount lent. Such sub-ordination would be to the existing level of an outstanding mortgage only. After the closure of the economic recovery period all amounts granted to households would increase their mortgage debt to the NMB. The NMB could fund itself with funds from the Federal Reserve, based on a U.S. government guarantee. In the period after recovery, the payments could be gradually lowered to zero, and the interest rate of the loan set at the ten-year government bond rate plus a small margin. After the official end of the recovery period mortgagors could be asked to gradually fully service their interest payments. The ultimate repayment of the outstanding principal amount could take place as and when the borrower wishes and is alive. Upon death the full amount outstanding becomes payable;

- Referral process: As soon as banks or financial institutions declare that a individual mortgagor has been informed about foreclosure, the case should be transferred to the NMB;

- Beneficiaries: Significant beneficiaries of the risk sharing approach would be the lending banks and mortgage bondholders. The NMB should be placed in a position to charge the fund providers for the reduced risks over their mortgage related portfolios.

2.3 Economic benefits of having an NMB

There will be a number of main benefits from having an NMB in operation. A first one is related to the spending power of individual households. The cash injection will help mortgagors to fulfill their mortgage obligations, but equally it enables them to continue to spend on other goods and services. Had the NMB been in place in 2007, such increased levels of economic activity would have increased government tax revenues. As a consequence, the NMB's operation would have markedly slowed down the U.S. government debt increase. The actual level of government debt increased from $9 trillion in 2007 to $19 trillion now (March 2016).

A second benefit is related to house prices. When the majority of foreclosure proceedings no longer lead to home repossessions, house prices will drop less forcefully and be more stable. Such stability will encourage potential homeowners to come to the housing market. This may also lead to a more stable level of new housing starts.

Introducing the NMB system makes individual households less reliant on extremely low interest rates. The aim of the NMB is not to attract more households to the housing market. Commercial banks do that. The NMB's aim is to help existing homeowners to fulfill their mortgage obligations. For these homeowners, it will turn a long-term borrowing position into a temporary favorable cash flow position, independent of the current prevailing interest rate.
When consumer demand levels fluctuate less, there is less need for an interest rate stimulus.

With the existence of an NMB, the Fed's interest rate setting policy will become slightly easier.

Quantitative easing injections reflect an indirect method of encouraging borrowings. Setting up an NMB helps households in need to fulfill their existing mortgage obligations in a direct manner, rather than involve them in more borrowings. It re-aligns outstanding debt with future earnings levels. An NMB creates a direct link between maintaining consumption levels and existing household debt levels. An economy will be made less dependent on QE injections.

In a previous paper: "Why borrowers rather than banks should have been rescued"[7], the author did calculate that the total NMB lending level during the operating period 2006-2013 would have been about $1.2 trillion. This amount consists partly of the zero interest rate subsidy during the period classified as the recovery period; for the remainder it covers principal amount payments as advanced by the NMB to the borrower. The combined amount is still $500 billion less than the Fed –as a result of its quantitative easing operations-has currently in mortgage-backed securities on its books. Without knowing the exact composition of the U.S. mortgage portfolio at any given time, it is difficult to be precise which share of the $1.2 trillion would have been disbursed by the NMB as a gift to the mortgagors. The key cash transfer element would have been a very welcome rearrangement of an individual household's cash flows. Improvements in short-term liquidity will help long-term solvency for households.

3. The moral hazard question

If banks knew in advance that arrangements would be in place which would rescue them from the consequences of excessive risk taking, they might be tempted to take on even more risks: moral hazard. As was the case in 2006-2008, nearly all-large banks had gambled on a government bailout, as they were perceived to be "too big to fail". The economic consequences of a major bank failure were regarded as unacceptable as many more households and other banks would have seen their assets become worthless.

[7] https://mpra.ub.uni-muenchen.de/68990/

If individual mortgage borrowers would know that in case times turn tough, they would be helped, they might also be tempted to borrow more than they could afford, or claim more quickly in stating that they could not afford the debt servicing.

Executing a borrowers' support program should therefore be accompanied by rules that impact both the banking sector and the Collective of Individual Households.

On the banking side the rescue of mortgage borrowers should be predicated on there being an environment of excessive lending. Banks make excessive profits during such a period until the levels of doubtful debtors go up. If a government decides to implement a borrowers' rescue program with the help of an NMB, banks will stand to generate even more profits, thanks to the improved risk environment. Therefore it is logical that banks pay a risk premium to the NMB in line with such excess profits, both during the excessive levels of lending as well as during the borrowers rescue program. In a way, the heavy fines regulators have imposed on a number of banks already demonstrate this logic albeit applied in a retrospective fashion.

On the mortgage borrowers side, the fact that they need to be helped should not be a scot-free process. It was therefore included in the NMB proposal that there need to be a clear distinction between a grant element and a repayment obligation. During the period designated by the authorities as the recovery period, the grant element was defined as a zero interest rate applied to the part payments provided by the NMB. This element represents the macro economic cash injection to help households to –at least partly- continue to spend money on other goods and services, rather than be forced to allocate income flows in a substantial manner to repay outstanding mortgage levels. This subsidy also helps to prevent large-scale home repossessions. The repayment obligations to the NMB will start the moment that the NMB grants a subordinated mortgage loan to the individual household. However as the aim of this whole process is to help shorten the economic recovery period, no specific repayment schedule is enforced other than repayment at the end of life or any sooner if the mortgagor wishes so. The applied interest rate suggested, could be the equivalent of a ten-year government bond rate plus a small margin. In case economic growth rates recover more quickly and income growth would allow a shorter repayment period, the NMB could enforce a ruling that principal repayments should start to be made over the subordinated mortgages. Once the rescue operation is declared to have started, it might be foreseen that some borrowers may be unduly quick to turn to the government for support.

The adoption of a few constraining factors should be considered. The first one is that the rescue program should not provide more than a fixed percentage of the monthly mortgage obligations. The percentage may differ from income class to income class, but it should not eliminate the responsibility of the borrowers to share in the monthly mortgage debt servicing. Secondly, in the event of excessive applications, an administrative brake may be used, so as to slow the number of loans being granted (which is the type of action which should have been applied to mortgage lending practices especially from 2002-2007).

4 Possible application of an NMB type of action

The case of the U.S. does indicate that it would be a suitable candidate to have an NMB system set up. There are more countries that could potentially follow in its footsteps: Canada for instance. In Europe, the U.K. has a high level of mortgagors, most of who are individual households, rather than landlords or company owners. It would therefore be a potential candidate. Sweden could be another country with its own currency and a high level of mortgagors. Interesting to consider would also be some Eurozone countries. The Netherlands, for instance, which has a high level of mortgage debt, could be a candidate, as could Ireland, Spain, Portugal and Finland. For the Eurozone countries it would imply a national solution to a national problem, rather than a Euro wide application of an interest rate policy or quantitative easing solution.

In the Far East countries like Japan, South Korea, China, Hong Kong might be potential candidates to establish an NMB, while further south Australia and New Zealand could also be candidates.

The more countries that set up an NMB type structure will help the world economy to avoid at least one on the threats to economic growth that may occur: the threat that illiquidity among individual households will be turned to wide spread insolvency with all the negative effects on employment levels and economic growth.

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