An Open Letter to Ben Stein
By Don Solomon – January 10, 2008

Dear Mr. Stein,

I find your articles and TV appearances enlightening, but I felt impelled to write in response to your Sunday article on subprime loans. I'm not an economist (although I majored in it) or a particularly successful investor, but I am a real estate lawyer and know something about these transactions at the micro level.

You are right that some borrowers lie or come close to it in their mortgage applications, and you are right to look at the micro side of these loans (which few commentators do). I believe, however, that the source of the problem is elsewhere.

I have seen plenty of transactions in which immigrants with low-wage jobs and virtually no English language skills went to shady mortgage brokers who tried to put them into zero-down loans, often with success. These folks enjoyed the American dream of homeownership only until housing prices took a dive. Since my old-fashioned view is that "ownership" includes the ability to sell the property, I think they ceased to be property owners at that point; instead they became prisoners unable to move or refinance without going bankrupt. They would have been better off renting.

It should be pointed out that most home buyers see a lawyer, if at all, only after they have applied for a loan and committed to that lender. By the time they have signed a purchase agreement, the only way to get out of the loan is to give up the purchase, and psychologically that is unlikely to occur. No one wants to hear bad news in legalese when they have already picked out the new wallpaper.

I don't think any of these transactions would have occurred under the ancien regime you and I remember, when mortgage applications were taken by neighborhood bankers who knew the local market and usually held the loans in their portfolio. Those banks still exist and are generally doing quite well. The bank typically lent no more than 80% of appraised value, so the security was practically airtight. The bank regulators looked at their loan portfolios and cash reserves, and were happy.

With the advent of national lenders funneling money through unregulated mortgage brokers (who have practically no capitalization of their own), the lying began. Although the lenders require documentation, it's harder to verify every piece of paper that comes in. In a rising housing market, the default rate is low even when the loan shouldn't have been made in the first place.

This is exacerbated by zero-down loans, by variable interest rates and by negative-amortization balloon notes, which make no economic sense unless the borrower is still employed after 5 years and sells or refinances — otherwise the loan balance may exceed the value of the home.

Then we saw the advent of mortgage-backed securities. This meant that the lender packaged a large number of loans, vouched for the documentation, and sold them in shares to big investors — first domestic, then foreign. Whatever expertise Countrywide or Wells Fargo has in evaluating mortgages is entirely lacking at the investment desk of Goldman Sachs or Deutsche Bank. These mortgages have turned into securities and are evaluated by securities standards. Technically, the investors have recourse against the original lender if the underwriting was bad, but I doubt that happens often; proving it would cost more than it is worth.

I think we've made a big mistake in allowing the risk of mortgage lending to be displaced so far from the source. Home mortgages issued by tiny brokers are being traded as though they were bonds issued by SEC-regulated corporations. Essentially, Joe Homeowner is issuing a bond to Deutsche Bank without providing the audited financials that Moody's would require of any other issuer.

We've also made a mistake in letting dubious loan products into the marketplace. This turns the home from a place of security into collateral exchanged for casino chips. The homeowner bets the house, literally, on rising home prices.

It's true that homeowners go along with this in the sense that most of them consciously understand most of the essential terms. But in practice they are relying on the lender and on the real estate brokers to validate the transaction by telling them the house is worth what they are paying and is a good investment. The off-the-record assurances they often get from these sources would not be tolerated in an SEC-regulated investment broker. Some of the big real estate firms now have affiliated mortgage operations which have an incentive not to upset the sale by declining a mortgage. To me, this looks awfully similar to a stockbroker encouraging his clients to borrow on margin, and we know how that turned out in 1929.

The other mistake we have made is in writing the ideal of homeownership into the tax code. Allowing an unlimited deduction for mortgage interest makes homeowners seem like winners and renters seem like losers. Historically, this has been a good social policy — if you like social policy in the tax code — but it is becoming less so. People move more often because the job market moves, because they have children, and because they retire. The transaction cost of each move is substantial — more so for homeowners because they pay sales commissions, attorney's fees, settlement costs and sometimes prepayment penalties.

The tax code also encourages frequent turnover by limiting the capital gain exclusion to $250,000 or $500,000. Once the home has appreciated by more than that amount, the homeowner must sell and move somewhere else or lose the tax break.

I can't prove it, but I'd guess that these frequent sales contributed to the enormous rise in home prices over the past few decades. In the 1930s, despite increases in personal net worth, home prices stayed about the same and many small homes were bought for cash. Eventually, prices reach a level that working people with decent jobs can't afford —

perhaps that time has come, perhaps not, but it will. At that point the tax code serves to reward the older generation and punish the younger.

My long-term solution, which will not be embraced by anyone in Washington, is to limit the mortgage interest deduction to approximately the amount needed to service a loan of, say, $300,000. I'd say the capital gain exclusion should be replaced by a provision allowing the fortunate homeowner to report the gain over the same period in which the gain was accrued, or by adjusting the cost basis of the home for inflation before taxing the gain.

Sad to say, I cannot help thinking that the risk to homeowners of bad loan products should be mitigated by government regulation forbidding their use. Borrowers just aren't savvy enough to know what they are getting into, any more than the small investors of 1928 knew what margin calls could do to them. Our social policy should go from homeownership for all to homeownership for those who have saved enough for a decent down payment.

For low-income subprime borrowers who are caught between declining home prices and the increasingly strict rules of the Bankruptcy Code, I think the government should become the lender of last resort — on carefully defined terms. There are now small subsidy programs in existence whereby first-time buyers can qualify for lower-interest loans on a shared-equity basis — if they sell the home within 5 or 10 years, 20% of the appreciation goes back to the local agency that provided the loan. The same principle can be applied to subprime borrowers caught in a squeeze; in exchange for refinancing, they can be asked to make the government-funded lender a 20% partner in the property.

I'm sure these proposals appeal more to me as a social liberal than to you, but for me the bottom line is that foreign investors can absorb the risks inherent in the products they bought and sold, but people with no assets other than their homes cannot. And as a nation we cannot afford an epidemic of mortgage defaults with millions of people banging on the door of the Bankruptcy Court — even if they were a little overoptimistic in buying their homes. We need to start getting serious about the savings rate, and doing so in a way that does not shock the system by changing the rules all at once.