You Can't Repeal the Laws of Physics*

Raymond Natter

February, 2011

Congress, the Administration, and the regulatory agencies have stated various priorities for the financial services sector. At times the emphasis is on enhanced safety and soundness, and the desire to prevent any institution from being "too big to fail." Alternatively, the desire to provide financial services and affordable housing to underserved communities and neighborhoods takes center stage. Another theme that is expressed is enhanced consumer protection, and, in particular, the mandate to make sure that loans are only provided to suitable customers. In addition to all of these goals, Congress and the Administration express concern that financial companies are not lending to small business. What is not acknowledged is that these goals are, to a large extent, inconsistent.

Safety and soundness is a wonderful goal, but the tools that are used to enhance the safety of financial institutions — higher capital and liquidity requirements — will reduce the availability of, or increase the cost of, credit. Providing consumer protection through suitability requirements and limiting the use of adjustable rate loans will result in fewer loans being made to lower income families. All of these goals are worthy, but they must be balanced. Congress or the regulators could insist on a failsafe bank, but it would not make any loans. Likewise, you could remove all safety and soundness constraints, but bank failure would multiply causing harm to our economy and insurance funds. The problem arises when Government leaders ignore these fundamental economic precepts, and instead legislate outcomes that are impossible to achieve. Congress or the regulators can raise safety and soundness standards, and at the same time declare that banks must increase lending to small businesses and individuals, but those actions cannot change the reality that it is impossible to simultaneously comply with both demands. Just as Congress and the Administration cannot repeal the laws of physics, they cannot alter the fundamental economic principles that govern the cost and availability of credit.

*The information contained in this newsletter does not constitute legal advice. This newsletter is intended for educational and informational purposes only.

This conundrum can easily be illustrated by the recently released Administration's paper on the reform of the housing finance system. On one hand the paper states that the Government is too heavily involved in housing finance, that the Government Sponsored Enterprises need to be wound down, and that higher fees should be charged to guarantee mortgage-backed securities. The paper also recommends that the Federal Housing Authority insurance program should be limited and that the FHA should also charge higher fees and require higher cash down payments to reduce the risk to the Treasury. Stronger underwriting standards for all mortgage loans are promoted. At the same time, the paper states that the Nation must adopt measures to ensure that capital is available to creditworthy borrowers in all communities, including economically distressed regions and low-income communities. Going further, the report states that the Administration will "make sure" that borrowers that have incomes below the median level for their area have access to mortgage loans through the FHA. Finally, the paper recommends the creation of a Government fund to provide down payment assistance to needy families.

Raising underwriting standards, reducing Government involvement, and raising fees to reflect the actual risk involved in mortgage lending is a worthy goal. Making mortgages available to underserved families and low-income communities, and providing Government assistance to needy families is also a worthy goal. But you can't have it both ways. The basic principles of economics, just like the laws of physics, cannot be willed away. We, as a Nation, must make a fundamental decision regarding two conflicting policies, and we should not think that we can have both widespread home ownership and little or no Government support for housing finance.

Raymond Natter is a partner with the law firm of Barnett Sivon & Natter, P.C.

©2011 Barnett Sivon & Natter, P.C.