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Federal Restructuring of Fannie and Freddie Ignores Underlying Cause of Crisis

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Very shortly, the federal government will release a series of recommendations regarding the restructuring of the government-sponsored entities Fannie Mae and Freddie Mae, which are responsible for guaranteeing 90 percent of mortgages in the country today.

Yet these recommendations will probably ignore the major market-based reason for the collapse of the housing and mortgage industry over the past five years, which sparked the worst economic downturn since the 1930s and remains the major drag keeping the economy from recovery today. If you do not know the cause of the meltdown, how can you know what to fix to avoid it from happening again?

The fundamental cause of the mortgage meltdown was not poor underwriting standards, greed on Wall Street, moral hazard, corruption, and the other "usual suspects" blamed for a financial crisis. These were all important secondary factors, but they were not the fundamental cause.

What caused the meltdown was a *structural* shift in market demand. For two generations we in real estate have been building drivable suburban product—car-accessible, low-density, socially and economically segregated, isolated, single-purpose housing (and, for that matter, commercial) development. It is what the market wanted following World War II, and the real estate and the financial industries geared up to efficiently build it.

Then the market changed. Millennials and empty-nester baby boomers—collectively over half of all households—decided they wanted something different. Millennials in particular do not want to spend countless hours burning fossil fuels while stuck in traffic. They are demanding walkable urban development that offers a variety of transportation options and is mixed use, integrated, complex, and socially and economically integrated. As Patrick Doherty and I outlined in the cover story of the *Washington Monthly* in December, meeting the pent-up demand for walkable urban development will take a generation. It will be a boon to the real estate industry and put a foundation under the American economy for decades, just as the construction of low-density suburbs did during the last half of the 20th century.

The collapse of the mortgage market was primarily confined to the metropolitan fringe with "drive until you qualify" automobile-dominated suburban housing—places that required families to have a fleet of cars in order to participate in society, draining their mortgage carrying capacity.

Housing prices on the fringe tended to drop at twice the metropolitan average while walkable urban housing tended to maintain their values and are coming back nicely in select markets today. As shown in a new economic assessment of real estate, *Growing Wealthier*, households will only spend about 45 percent of their household income on the combination of housing and transportation, and as commuting costs increase, the amount spent on housing drops.

We in real estate thought the car companies were our partner in getting customers to our housing offerings. But with the average drivable suburban household spending about a quarter of its income on cars, we now know the auto industry has been eating our lunch by absorbing a disproportionate amount of household spending.

Besides recognizing the collapse of fringe drivable suburban housing prices as the fundamental cause of the mortgage collapse, the feds need to understand that both housing and transportation costs must be used in underwriting. This type of loan underwriting, known as location efficient mortgages, must be incorporated in federal reform of the mortgage market. Further incentives to locate in transit-oriented developments and other walkable urban places should be put in place in any federal reform.

The market has fundamentally changed in how it wants to live and work. The real estate and financial industries and federal policy have to change as well to allow that pent-up demand to be met—which will put a sustainable foundation under our economy.