Mortgages and the Future of Housing Finance

Federal Reserve System and the Federal Deposit Insurance Corporation

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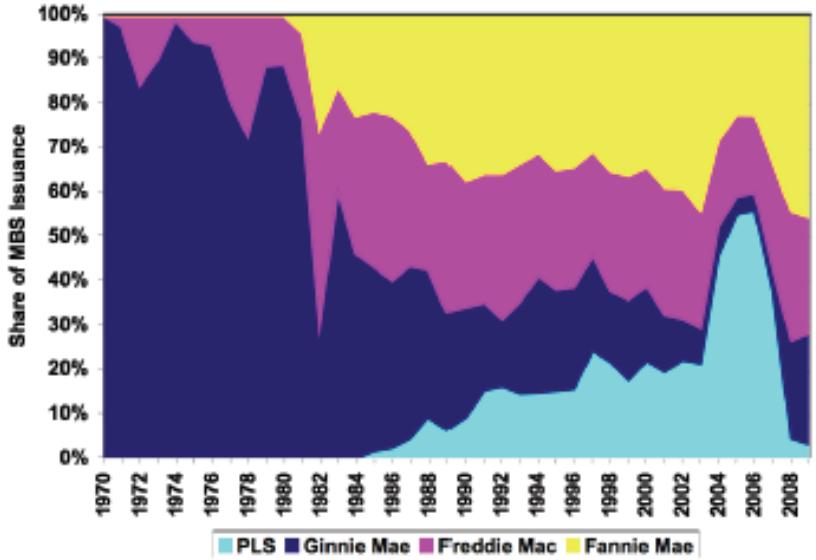
Key Points

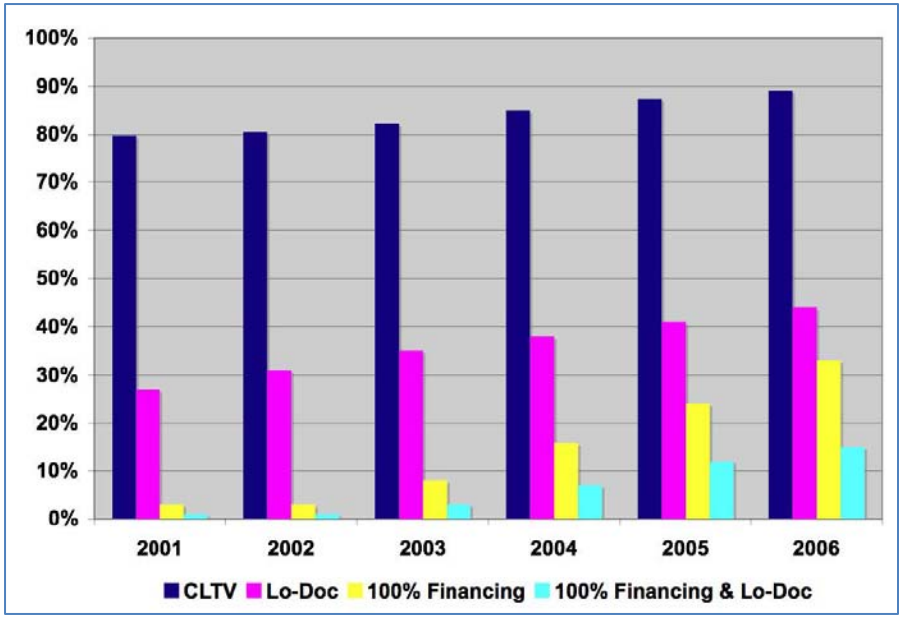
- Origins of the bubble
  - Supply-side phenomenon
  - Mortgage finance spreads declined and volume increased
  - Oversupply of mortgage finance
- Transparency and pricing of risk
- Pro-cyclicality of leverage

The Oversupply of Mortgage Finance

Underwriting standards eroded as complex, heterogeneous mortgages were packaged into MBS.

Figure 4. Share of MBS Issuance by Securitization Type[65]





Source: Inside Mortgage Finance, 2010 Mortgage Market Statistical Annual

The Mispricing of Risk

Financial intermediaries lowered PLS yields,
despite the increasing default risk of the mortgage pools.

Figure 12. PLS Issuance and Weighted Average PLS Spreads, 2003-2007[87]

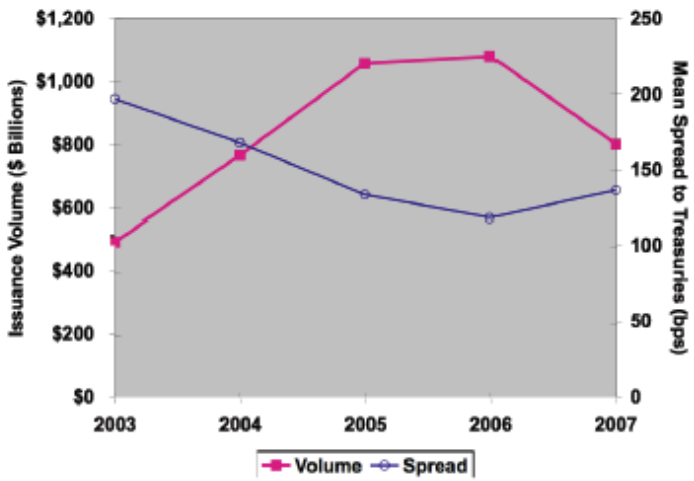
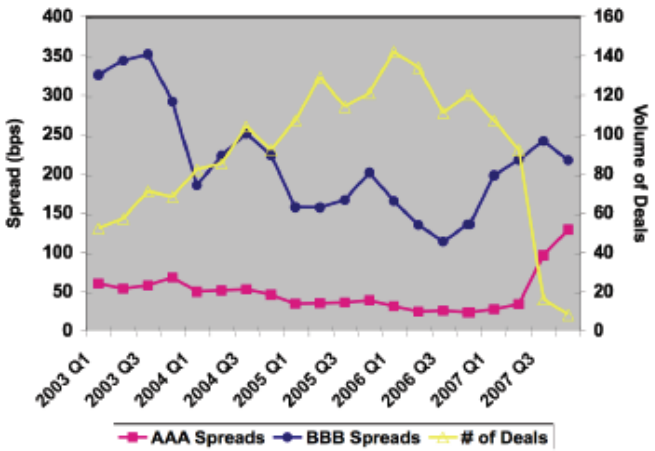


Figure 13. PLS Issuance and Spreads 2003-2007 for AAA and BBB Rated Tranches[88]



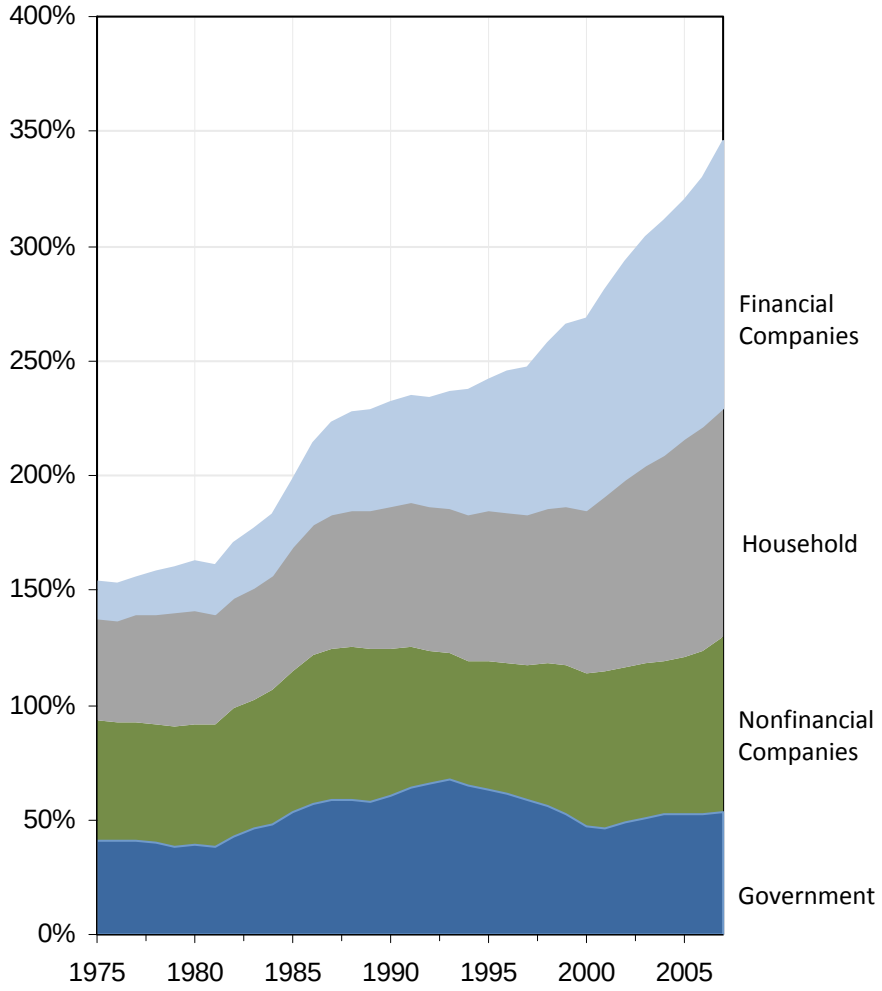
Documentation Problems

- Recent documentation problems for investors are *not new*; they are an aftershock of the oversupply of mortgage finance
  - Financial intermediaries took advantage of an *information asymmetry*
  - What we're seeing now is discipline on the market with a big lag
  - Real problem is *heterogeneity and complexity* that blocks transparency
  - Creates difficulty in tracking characteristics of *individual mortgages, mortgage pools, and correlated market*
- MBS investors looking for banks to repurchase the securities, since the banks may not have actually included the mortgages stated in the contract
- <u>For real-time pricing accuracy, investors must have access to information</u>
- Transparency is not a panacea; <u>complexity and heterogeneity will remain unless standardization becomes a priority for regulators</u>

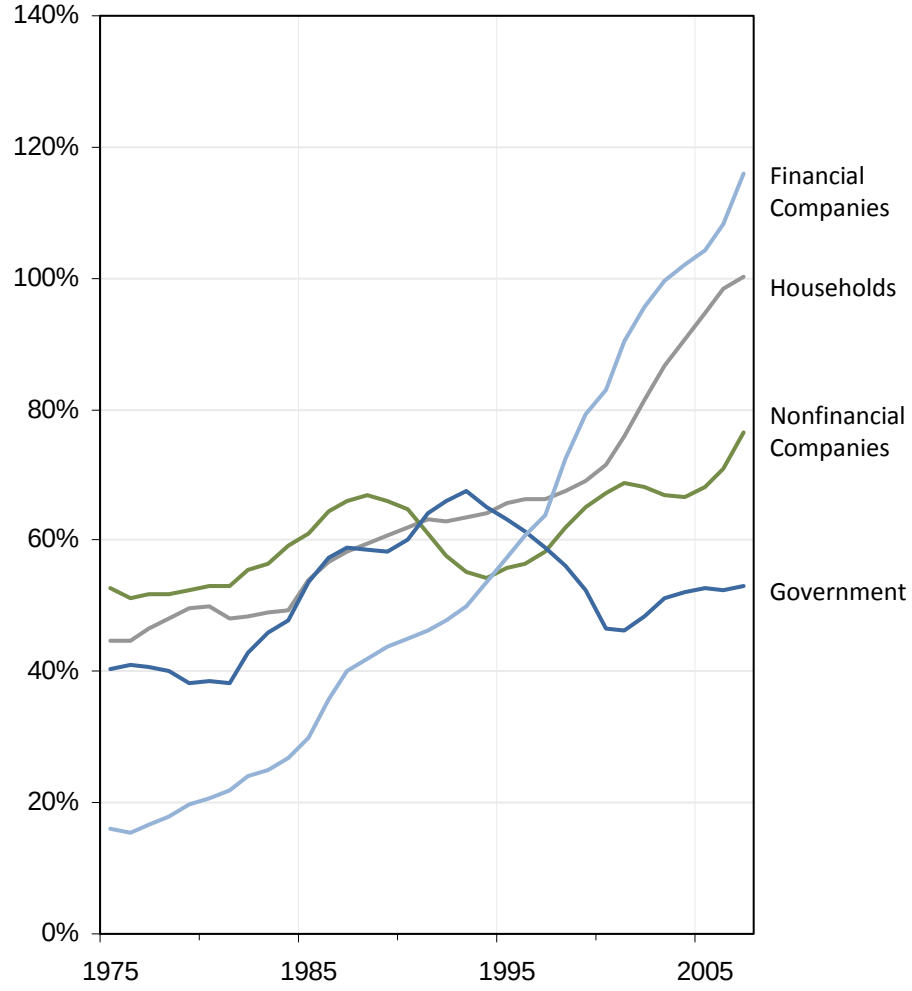
Dramatically Increased Leverage

The credit supply surge was not confined to MBS markets.

Sectoral contribution to U.S. gross debt
Percentage of GDP



Gross debt by U.S. sector
Percentage of GDP



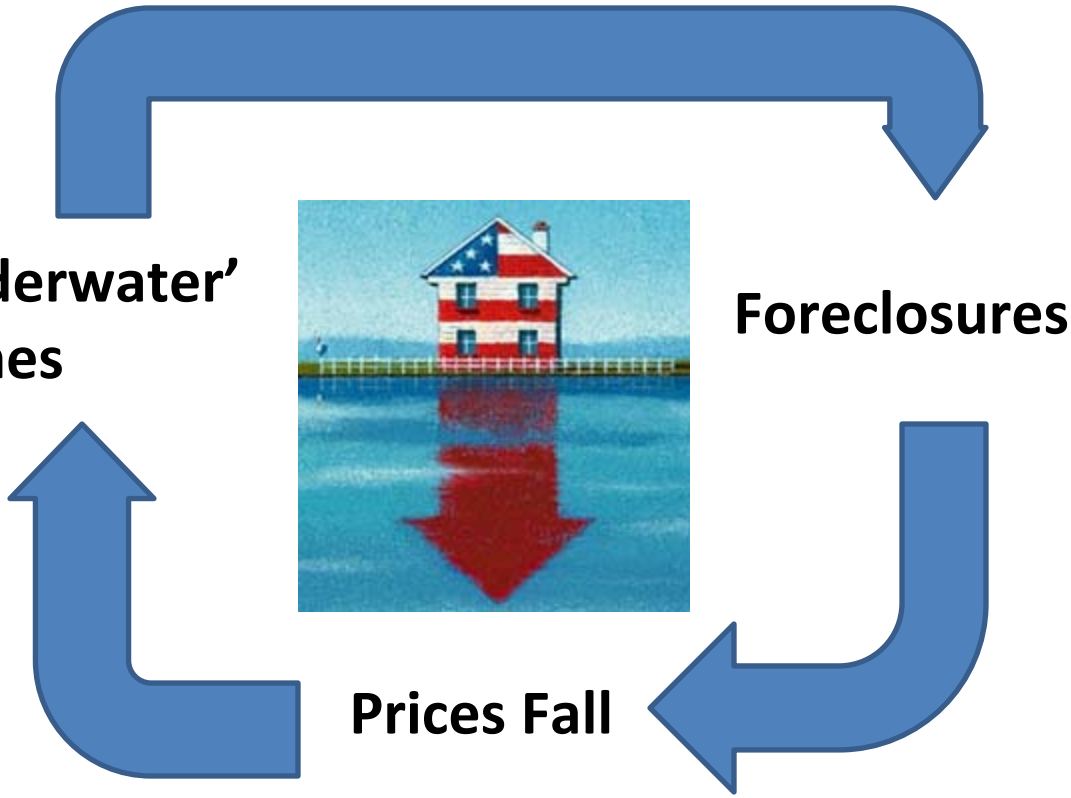
Source: U.S. Federal Reserve, Bureau of Economic Analysis

Pro-Cyclicality of Leverage Is the Deeper Issue

- An increase in credit supply precedes recessions
  - Theorized by Minsky, documented by Kindleberger, and measured by Kydland and Prescott
- Pro-cyclicality of leverage increases volatility in the business cycle and makes the financial system vulnerable to credit crunches
  - Because real estate cannot be shorted, it is particularly vulnerable
  - Financing housing assets through mortgages exposes the banking sector to this risk
- The decrease in regulations, capital requirements, and lending standards magnified this natural fluctuation

Through Adaptive Expectations, Pro-Cyclicality of Leverage Leads to Crisis

A pro-cyclical system will expose housing finance to changing international markets



Live and die by the market

…and the inevitability of bailout

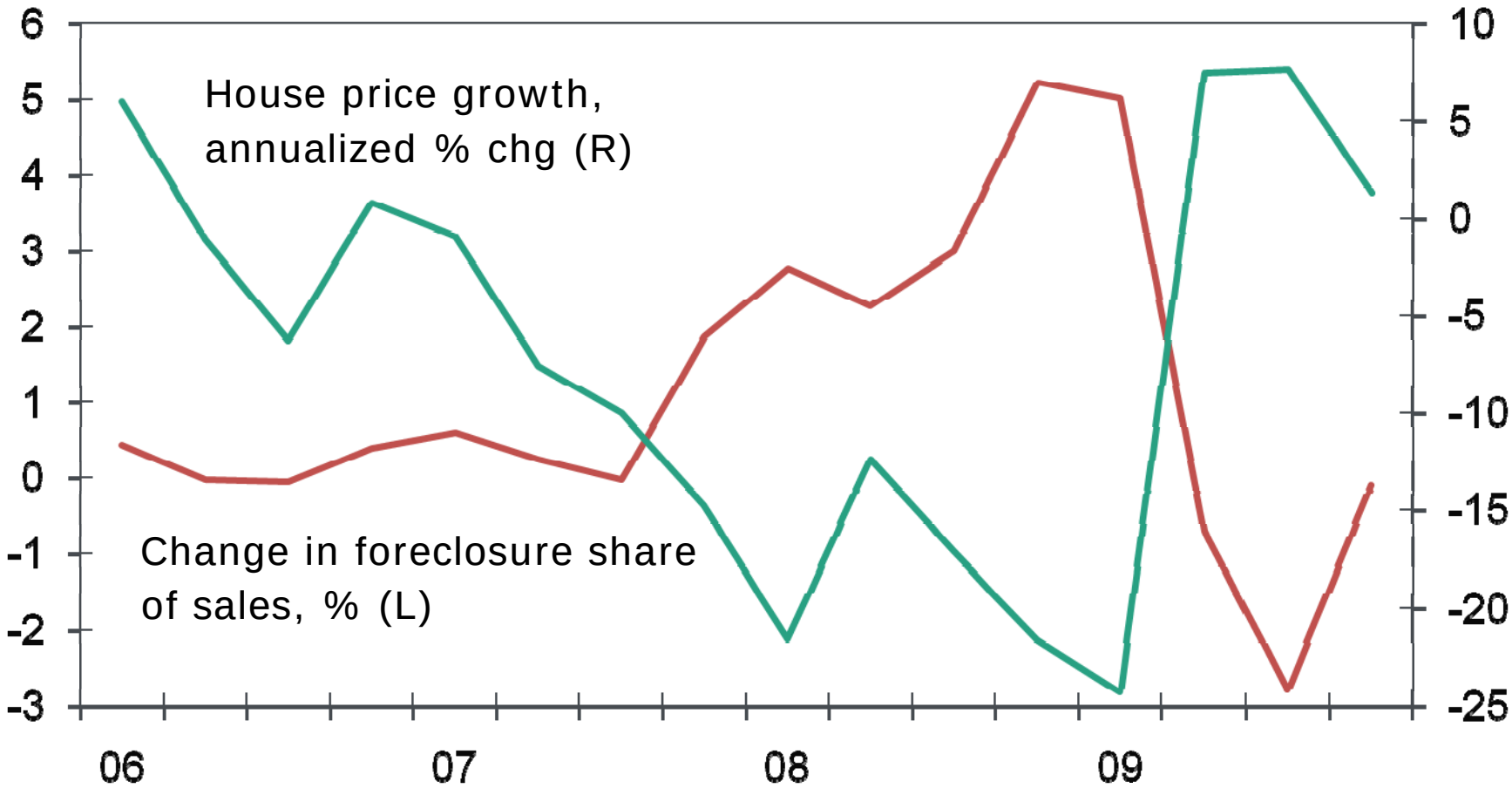
Future of Housing Finance Depends on How We Treat Pro-Cyclicality

- Housing prices impacted by:
  - Rates
  - Terms

- Any potential shift in the terms of housing finance could catalyze repricing, which must be accounted for

- Monitoring these changes just as important as tracking inflation, in regards to their macroeconomic impact

Foreclosure Sales are Key to Pricing…



Sources: Fiserv, Zillow, Moody's Economy.com

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  - Adam J. Levitin and Susan M. Wachter

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  - Andrey D. Pavlov and Susan M. Wachter

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