Comments on the Future of Housing Finance

Fed-FDIC Conference on Mortgages and the Future of Housing Finance

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It is hard to find a silver lining in the events of the last three years but if there is any, it is the widespread recognition that we need fundamental reform of our housing finance system.

Now, there is a lot of disagreement about what those fundamental reforms should be. For the most part, the reform proposals start from a diagnosis of the problem that got us here, and try to solve that problem. For some, the problem was excessive government involvement in housing finance through its support of Fannie Mae and Freddie Mac and various affordability goals. In their view, the solution is privatization of housing finance. For others, the problem was inadequate consumer financial protection. For them, the solution is to crack down on abusive lending practices. Others see the problem as inadequate oversight of Fannie Mae and Freddie Mac but see tremendous value in a system of guaranteed pass-through mortgage backed securities. They would like to preserve Fannie and Freddie-like entities with some more protection for taxpayers. Yet others argue that flaws in private label securitization were to blame. Thus, the Dodd-Frank Act now requires "skin in the game."

There is merit in all of these diagnoses -- and in many of the proposed solutions. But, I would like to engage in a somewhat different exercise. I would like to articulate first what I think should be the main objective of government policy in housing finance, and then work from there to identify a role, if any, for the government in housing finance.

In my view, *the government's main policy goal in housing finance should be to reduce <u>excessive</u> volatility in the supply of housing credit*. There will, of course, be periods when housing credit – indeed all credit – will be easier to get than in other periods. But government policy needs to try to prevent the kind of excess supply of housing credit that characterized the period from 20001 -2006. But, in addition, the government needs to be able to provide some support for housing credit in times of crisis – crises like the Great Depression and the one we are now experiencing.

Essentially, what I am arguing is that government housing finance policy should try to play the same stabilizing role it tries to play in the financial system more generally. History has taught us that banking is inherently unstable. It was only after the creation of the Federal Reserve and the FDIC – our two hosts today – that we got a long period of relative financial stability.

But in the last 30 years we have witnessed the stunning growth of a market- based model of financial intermediation, with securitization playing a much more important role in our financial system. But regulation has not kept up. We need to devise new methods for ensuring financial stability in light of the development of this market-based model of financial intermediation. And nowhere is the market-based model of financial intermediation more important than in housing finance, although some of its growth was no doubt fueled by inadequate regulation of securitization.

Reducing excess volatility in housing finance is particularly important for at least three reasons.

First, real estate – perhaps because its purchase is so dependent on credit –has been particularly prone to booms and busts.

Second, because housing assets are the principal asset for most families in the U.S., the bursting of a housing bubble is particularly damaging to the U.S. economy, as we see now.

Third, because housing credit is the single-largest type of credit in the economy – there is $10.6 trillion of it outstanding – when there is a crisis in housing it has significant negative consequences on the ability of banks and other leveraged financial institutions to lend. $3 trillion of wealth was lost when the dot.com bubble burst. That led to a recession, but not a financial crisis, as leveraged financial institutions did not have a large exposure to this sector.

To repeat, *the government's main policy goal in housing finance should be to reduce excessive volatility in the supply of housing credit*. I do not believe that the goal of housing finance policy should be to lower the average costs of financing a home, just as the goal of broader financial policy is not to lower the cost of credit to corporations or consumers. Policies that ensure the safety and soundness of the financial system broadly and the housing finance system in particular may result in lower average financing costs, but that should be as a by-product of policy not its primary policy goal.

We already tried to lower the cost of housing finance through implicit subsidies to the GSEs. The empirical evidence that borrowers actually received substantial benefits is not compelling. Instead, it seems likely that originators and the GSEs themselves got most of the benefits of the subsidies. And even if we could provide broad mortgage subsidies – as we do with the mortgage interest deduction -- the social benefits of such a subsidy are unclear at best. It may just lead households to bid up the price of housing or overinvest in housing relative to other investments such as education.

The $10.6 trillion question then is: What are the policy implications of pursuing a goal of reducing excess volatility in housing finance? The answer to this question must reckon with two issues:

First, the precise mechanism that leads to an excess supply of credit isn't always the same. This time the housing bubble was fueled by low interest rates, deep flaws in the process of loan origination and securitization, and regulatory failures throughout the financial system. But there were different causes of the Japanese real estate bubble in the late 1980s and the Scandinavian real estate boom in the early 1990s. We need policies that are robust to a variety of causes of excessive credit.

Second, we need to design policies that work in a hybrid model of housing finance, based on traditional banks and securitization. We want stability of both forms, and we do not want policies favoring one over the other, as has been the case. For example, the amount of capital that the financial system had to hold to protect against mortgage defaults was much less if the mortgage was securitized by Fannie and Freddie than if the loan stayed on the balance sheet of a bank. This sort of regulatory arbitrage led to the enormous growth of Fannie and Freddie. It's dangerous and destabilizing.

So to begin the analysis, let's envision a world without Fannie and Freddie -- without entities that guarantees mortgages with a government backstop. In this system all housing finance would go through banks or through some form of private securitization. It would be a purely private system of housing finance in the same way that financing of corporations is purely private, with the caveat that the government is never completely off the hook when it comes to the financial system.

In this system of "private" housing finance we would still need regulations on mortgage lending to prevent excessive risk-taking by financial institutions and to protect the system from the excessive expansion and contraction of mortgage lending for the reasons I have already discussed. Thus, there are both micro- and macro-prudential rationales for the regulation of housing finance.

Let's start by considering the regulation of mortgage lending by banks. Risky mortgage products – for example, high LTV loans -- should get high capital charges under our system of risk-based capital regulation. That is, banks should have to hold more capital against a riskier high LTV loan than against a low LTV loan. In determining these risk weights we should not just be considering their risk to the specific financial institution making the loan, but also the risk to the system if that loan, and loans like it, go bad at the same time. Regulations must take account of the fact that there are spillover effects to the financial system and other homeowners when there are many mortgage defaults and foreclosures.

Regulation of securitization is more difficult, and will require a completely new approach. I think we've learned two lessons from our recent experience with securitization.

First, pooling risky loans and issuing securities against these loans is not as safe as issuers, credit rating agencies, and investors thought. Some of this was because they underestimated the

possibility that there could be a nationwide housing collapse. Some of it was because issuers and credit rating agencies had incentives to ignore just how bad the underlying mortgage loans were. This led to and excessive supply of "safe" securities and the extension of too much mortgage credit. These "safe" securities were often held by less sophisticated institutions, so when they turned out to actually be risky the consequence was complete paralysis of private securitization markets.

Second, we've all observed that structured credit is a terrible structure for dealing with distressed borrowers. If we are going to have securitization at all, the entity that is renegotiating with a borrower, or foreclosing on the borrower, should have a significant interest in the whole loan itself. It should not be a servicer with no skin in the game. It should not be the junior tranche holders whose incentive it is to "extend and pretend." It should not be the senior tranche holders whose incentive it is to foreclose. Indeed, an OCC study showed that when banks own the loan on their books they are more likely to successfully renegotiate with the borrower than if the loan has been securitized. This is not unique to residential mortgage credit. It's also plaguing troubled commercial real estate borrowers whose debt is held in commercial mortgage backed securities.

We need a regulatory regime for securitization that deals with both of these problems and also prevents regulatory arbitrage between traditional banking and securitization. This is no small task.

One possible reform is to regulate the capital structure of securitization trusts in much the same way that we regulate the capital structure of financial institutions. For example, there could be a minimum equity percentage, or a maximum senior tranche percentage in the capital structure. Those parameters could vary with the risk of the underlying loan pools. Such regulations would lower the probability that senior tranches ever become impaired which – as we have seen – might be expected to have serious spillover costs given the kinds investors that hold these tranches. Second, these regulations would encourage greater market discipline of the underlying loan underwriting process – just as they do in a more traditional banking context.

Another possible reform is to prohibit certain types of risky mortgages from being securitized altogether given the difficulty of assessing the risk of even senior securitization tranches and the difficulty of dealing with distressed borrowers. For instance, only certain types of "plain vanilla" low LTV mortgage products such as the 30 year FRM or traditional ARMs might be eligible for securitization.

To facilitate more efficient renegotiation with distressed borrowers, a third possible reform would be to require some investor to hold a "vertical strip" in all of the tranches equal to some percentage – say 20% of the economic interest in the loan. The investor would have to be a qualified financial institution with the capability to deal with distressed borrowers. The

institution would have all the decision rights with respect to their dealings with the borrower. This would provide some of the benefits of securitization while ensuring that there is some party with the proper economic incentives to deal with a distressed borrower. The vertical strip could be a larger for portfolios of riskier loans.

The possible reforms I have outlined above could help to limit the excessive supply of mortgage credit and facilitate workouts with distressed borrowers. But what happens if there are shocks to the financial system that significantly impair the extension of mortgage credit? What happens if we fail to properly regulate this expanded private securitization market? In this case, it could be useful to have the government be a sort of lender of last resort. It is now playing this role through Fannie, Freddie, and the FHA.

What I am envisioning is a government owned corporation – let's call it the Federal Mortgage Insurance Corporation (or the FMIC) -- that would guarantee mortgages in pass-through securities much as Fannie, Freddie and the FHA do today. During normal times guarantee fees could be set high enough so that FMIC's market share would be low. Or there could be limits on the dollar volume of guarantees during normal times. The guarantee fee could then be determined based on this supply of guarantees – e.g., each month FMIC could sell off a limited supply of guarantees for loans meeting certain specifications. During a period of significant stress to the financial system, the FMIC would guarantee more mortgages because their guarantee fee would allow pricing of mortgage loans below that of the private market. Or the FMIC could simply increase their supply of mortgage guarantees.

In a way, this approach would mimic the recent history of FHA's guarantee program. As the subprime market took off in 2001 and peaked in mid-2007, the FHA's market share dwindled from 10% to 3%. As a government agency, the FHA had little incentive to chase market share. So while they took losses on their high LTV loans, these losses were not so large that it prevented them from increasing their guarantee program.

By contrast, when Fannie and Freddie lost market share as the subprime/Alt-A market took off, they chose, as for-profit entities, to chase market share by expanding their Alt-A loan guarantee program. The result, of course, was a disaster, with huge losses coming from these loan guarantees. As a result, Fannie and Freddie were only able to support housing credit with a lifeline from Treasury.

There are two important lessons from this experience.

First, if we want an entity that could play a countercyclical stabilizing role in mortgage markets, it should have "dry powder" to guarantee loans during a period of crisis. That means having little credit exposure during normal or boom times so that the losses on the existing portfolio are small.

Second, if we want to make sure the entity indeed has dry-powder it's important that it not have incentives to expand during normal or boom times. That is why it could make sense for the entity to be a government agency or government-owned corporation.

To summarize, I am proposing that housing finance reform should be targeted at reducing excess volatility in the supply of housing credit. I have suggested tighter regulation of mortgage lending by banks and suggested some new approaches to the regulation of mortgage backed securities that would make them a more stable source of housing finance with less adverse effects on borrowers who default. I have also argued that we need to design a system that prevents regulatory arbitrage between the banking and securitization sectors. Finally, I have argued that there is a role for a government-owned corporation to backstop mortgage markets during periods of stress in the financial system.

Change is not going to be easy given the size of our housing finance system, and the extent to which it is enmeshed in the rest of the financial system. But the painful failures of the last decade have given us the opportunity – and I hope the resolve – to redesign our housing finance system.